PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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INVESTOR ADVISORY GROUP

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MEETING

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WEDNESDAY
MARCH 28, 2012

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

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

NORMAN J. HARRISON, Senior Managing Director, FTI Consulting

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

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

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

ANNE SIMPSON, Senior Portfolio Manager, Global

Equity, California Public Employees' Retirement System (CalPERS)

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

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ROBERT M. TAROLA, President, Right Advisory LLC

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

ANN YERGER, Executive Director, Council of Institutional Investors

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(9:00 a.m.)

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

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

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

Jim Kroeker, the SEC's Chief

Accountant, also is testifying and sends his regrets.

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

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

Achieving the best results for investors requires that the Board work closely with the Commission, particularly with Jim Kroeker and his office. And Commission Walter, we appreciate the cooperative relationship that has developed between our two organizations.

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

It seems appropriate on the tenth anniversary of Sarbanes-Oxley that investors, the group the law was designed to protect, take time to discuss what the PCAOB has accomplished since the Act was passed and to look ahead at what the Board still may need to do to fulfill its mission.

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

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

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

We will miss Dan but we welcome Jeanette. Jeanette comes to the Board with a legacy of public service, having had a distinguished 23-year career at the Government Accountability Office, where among other things she conducted numerous financial and program audits that significantly benefit taxpayers and the public interest.

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

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

MS. FRANZEL: Thank you.

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

COMMISSIONER WALTER: Thank you, Steve.

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

Financial disclosure and financial statements are at the heart of what the securities laws are all about and auditors stand as very, very important gatekeepers to assure that investors have the information they need to make informed decisions.

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

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

MR. FERGUSON: I just want to welcome all of you and join Steve in doing that and saying that how much we appreciate the fact that you dedicate your time and make efforts to come to Washington to do this for us. You know, we meet with a lot of people as part of the PCAOB but this is a group I always particularly look forward to meeting with because the worlds of auditing and accounting can be rather hermetic and frequently we meet with people who are dealing with the technical details of that. I always get the sense that from this group we get a perspective that is kind of real-world perspective. How are the things we are proposing or thinking about affecting investors, affecting people out in the business world and the various constituencies we are trying to serve.

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

MR. HARRIS: Jay?

MR. HANSON: Thanks, Steve. I would like to join my fellow Board Members in welcoming all of you and everybody that is here in the room with us, as well as listening. I think this is the first time we have had a meeting actually broadcast with faces and talking heads on the internet. So welcome to everybody and I think you all, the IAG members for taking time out of your busy schedule to come here and I really appreciate the work that you put into the working groups in preparing for the reports.

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

And as Board Members, we are going to be challenged with where do we go because the input is so sharply divided. So I am looking forward to hearing all of your comments about that project today.

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

So I would like to also thank

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

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

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

As you know, the Board held a two-day public meeting last week to explore ways to enhance auditor independence, objectivity and professional skepticism, including a consideration of audit firm term limits. As expected, there were divergent views on the issue of mandatory audit firm rotation. But what was most striking about the two days last week of input and dialogue from a very wide variety of stakeholders, we had 47 participants that came and presented over two days, was the common understanding and agreement among all of the stakeholders that improvements are needed to the current audit model in order to make financial statements more credible and relevant. And that was a theme that just kept coming through very strongly. So we have a responsibility to really explore some of these. And it was really, I would characterize this as a consensus view that came out of the meetings last week. And so I think it is really fair to say that the status quo is not an option.

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

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

So the list I just rattled off is not comprehensive. The PCAOB staff now faces the huge task of compiling and distilling everything that we heard last week. But I mention all of these things just to illustrate really the task before us in looking at the audit model and trying to come up with good ways to improve the credibility and reliability of audits.

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

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

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

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

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

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

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

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

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

MR. CROTEAU: Good morning. Brian

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

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

MS. SIMPSON: I know Damon Silvers

will be joining us in a little while.

My name is Anne Simpson. I am the Senior Portfolio Manager for Investments and Director of Corporate Governance. CalPERS is a very large pension fund. I think everybody knows that. It is $230-odd billion dollars, depending on which day of the week you look at the charts. But the most important thing to say is that for every dollar that we pay out to our members, 66 cents, roughly, come from investments. We produced this now with one and a half million members called the CalPERS Buck to remind people 66 cents out of every dollars comes from investments. That is why governance matters. That is why effective regulation matters. And I think as the invested community, we need to be more vocal and clear about the importance of effective regulation. It is really our job not only to say thank you for inviting us to be around this table but we need to be aware that if we do not have well-regulated markets, we as active owners can't play our role and that 66 cents in every dollars is going to be under threat.

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

MR. TURNER: I am Lynn Turner. I am an individual investor in the market as well as I serve on the trustees of CoPERA, which is a 40 to 45 billion dollar investment fund that invests on behalf of about a half million people, mostly in Colorado. And I echo several times over what Ann just said. If our members are going to have sufficient money to retire on and live in a respectable fashion, they too have to have that 60 to 70 cents on every dollar generated from returns and that does require a well-regulated market but it also requires a market that is very open, very transparent, and provides us the information upon which we can make some sound investment decisions and allocations.

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

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

MR. HEAD: My name is Michael Head. I am the Chief Audit Executive for TD AMERITRADE. And obviously TD AMERITRADE is very concerned about our individual investors and their having good information and good access and transparency. And thank you very much for allowing me to participate and contribute. I think this is a very, very important group and your goals and responsibilities are critical to the success of the markets and therefore our customers and individual investors and I look forward to the activities today.

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

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

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

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

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

So I look forward to the discussions today. We are getting into some pretty interesting topics. Thank you.

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

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

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

I have had the honor since PCAOB was created to serve on both the Standing Advisory Group and the Investor Advisory Group now. And I really think one of the things that this Board has done that should, we would hope, set a model for other regulatory agencies is create this active mechanism for both investor input in this committee but also in the Standing Advisory Group bringing all of the stakeholders in a way that allows us to test our ideas against each other and try to reach consensus. So I think that has been a very effective mechanism that the PCAOB has created and I suppose, like everyone else, I am pleased to be here.

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

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

Since the Investor Advisory Group meeting in March of last year, the Board has taken up a number of your recommendations, which I think proves the importance of this group. This also demonstrates that the recommendations of the Investor Advisory Group have made a difference in the Board's work and helped the Board to establish its priorities.

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

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

In response to this and other

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

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

When we last met, the group also discussed fraudulent financial reporting. This has been a long-term project for the Board and last month we issued a proposal that would increase auditor scrutiny of related party transactions, significant unusual transactions, and executive compensation practices that may create incentives or opportunities for misstatements in financial statements.

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

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

As in prior years, the specific topics that will be discussed today have been identified by Advisory Group members themselves and the members have organized into four working groups. To begin the discussions, working group leaders will give a very brief overview of their topics. And following those introductions, each working group will lead a full discussion of the topic they have been studying by presenting their findings to the group, leaving time for further consideration by the full membership.

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

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

Finally, the standard PCAOB disclaimers apply that anything that anyone from the Board may say today, including any remarks I have made in this introduction will be the views of the speaker and not necessarily reflect the views of the Board or its staff.

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

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

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

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

(Laughter.)

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

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

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

I will give you the punch line

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

MR. HARRIS: Either Anne or Lynn. Anne?

MS. SIMPSON: Yes, thank you very much.

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

So we were asked to look at the question of Going Concern. And we have got quite a detailed set of slides and a discussion memo where you can see the detail. But let me tell you what the conclusions are.

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

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

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

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

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

The second recommendation is around timing. We think it is all very well, fine and good, to be looking at the next 12 months. Is something dreadful going to happen over the next 12 months to come? But what about month 13 or 14, you know when maybe big debt has to be rolled over? We think it is important that the time period looks out beyond just that one year. The 12 months is really arbitrary to think about it. So we think that is also going to be helpful.

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

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

And obviously Damon is here now, a

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

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

MR. TURNER: No, that was great.

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

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

MS. SIMPSON: Oh, okay.

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

MR. BECKER: Right.

MR. HARRIS: Okay, Brandon go ahead.

MR. BECKER: Our group was looking at firm practices and transparency which increasingly focused on the question of measurement and compensation. And while my colleagues to my left will do a much better job later in the afternoon providing a more sophisticated and nuanced description, briefly, we thought that it would be a worthwhile idea for the Board to continue to pursue a concept release on audit quality and the measurement thereof that the dialogue could be meaningfully advanced by the Board taking that step.

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

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

MR. HARRIS: Well thank you very much. And as you know, I think what we want to do is get as many ideas out on the table as possible. And I don't think it is essential that there be any consensus. We just want to have a marketplace of ideas here and have a general discussion throughout the process.

So thank you for all that.

MR. BECKER: We had a robust marketplace.

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

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

MS. ROPER: Sure. So my working group and two of my working group members are here with me, our topic was on auditor independence objectivity and professional skepticism, which is obviously a hot topic right now with the PCAOB concept release out on how to improve performance in these areas.

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

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

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

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

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

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

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

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

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

I'm going to be the conveyer of data. And that is what we did. We accumulated a fair amount of data around a number of questions. And I want to walk you through that. It may appear like I am reading it to you. And I don't really want to do exactly that but I want to make sure that I convey the nature of the data and what we thought it should mean to us as we looked at this topic.

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

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

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

The survey was 21 questions

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

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

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

The bottom line here is 45 percent net favorable. So let me give you a sense of what that is. That is the two agree categories minus the two disagree categories. That is how that number comes about.

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

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

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

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

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

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

And generally, we found that the commentary often came from those who probably were the neutral or maybe the negative viewpoint of a question because we thought it was more natural for someone who agreed to just move on.

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

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

In terms of comments, the

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

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

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

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

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

Respondents, that is the goal.

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

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

So there was questions of effectiveness in this particular area.

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

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

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

Unclear whether quality has

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

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

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

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

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

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

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

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

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

It is critical but more critical is the impact which the auditor, having given an opinion, has on the reporting from companies.

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

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

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

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

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

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

And other view, that it has been a

gravy-train for the auditing profession.

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

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

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

Confidence of investors in financial statements is critical.

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

It should be critical to the integrity of markets but does not seem to add much value as would be expected.

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

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

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

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

Only good auditors mixed performance overall. The auditor can play this role. Whether it is currently genuinely effective, we would very much doubt.

So again, some more qualifying commentary.

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

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

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

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

Also in the presence, the auditor plays an effective role in the quality of corporate governance. This was a fairly high net favorable. A bit of a 30 percent neutral respondents.

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

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

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

So we listed about a dozen different information sources and asked the respondents to give us their sense of how often. So always, often, sometimes, rarely, or never were the options for answers to these questions. And I think it is interesting to point out that audited financial statements were used almost all the time. If you add up always, often, and sometimes, you get pretty much all the time. So the audited financial statements seem to be the underpinning of many investment decisions.

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

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

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

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

Information contained in financial

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

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

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

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

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

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

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

Brokers' advice was another source of information.

Let's turn to the future. The next six or seven questions are about what the investors thought were important looking forward. So the question was the auditor should provide an opinion on the earnings release. Only a six percent net favorable on this question. Basically, the disagrees more or less offset the agrees. There wasn't an overwhelming interest in the auditor getting involved at that stage in the reporting process, which I thought was interesting.

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

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

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

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

The next question about the future. The auditor should provide an opinion on management's discussion and analysis. Again, a net favorable but not an overwhelming net favorable of ten percent, more or less the disagrees offset the agrees.

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

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

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

Another one about the future. The auditor should provide an opinion on quarterly reports. This was much more favorably viewed in terms of a 32 percent net favorable. And the commentary was more on the negative side, probably similar to earnings release and the value would be questionable, but that is interesting commentary, given the pervasiveness of the interest in providing -- and I can't be sure if all the respondents knew the difference between an opinion and a review report and all that. So we will have to take that one as an indicator, not conclusive.

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

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

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

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

Another future question. Should

the auditor specifically report on the quality of disclosures?

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

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

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

With some remarks from the

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

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

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

And this question was about other information that issuers are either asked or desired to present in their public reports. Sustainability data, compensation data, operational data. Should the auditor be involved in that information? A 12 percent net favorable, not overwhelming. A high neutral rating. So it didn't seem like the respondents were necessarily driven to ask the audit profession to get involved in these kinds of data.

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

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

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

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

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

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

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

With that, I will stop and ask my

Task Group if they have any further commentary.

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

MR. HEAD: I would agree with that.

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

Bob, let me ask one question.

MR. TAROLA: May I kick off a question?

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

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

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

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

But I feel very strongly over the last ten years, based on my interaction with my company's audit committee, my involvement with professional organizations, especially from an internal audit point of view, and my executive management and CEO, CFO, and our corporate risk structure, that there is a strong feeling, there has been significant progress but that we are not across the finish line yet. That there is still meaningful things that can be done to encourage, incent, and improve audit quality.

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

And so I just wanted to share that.

MS. ROPER: I guess I would just add maybe a slightly different perspective with my usual sort of negative view of the world.

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

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

We have watched in the European crisis auditors signing off on valuations for Greek bonds. For example, for two different clients they are dramatically different and finding a way to get comfortable with both. We see marketing materials that suggest that auditors still see their roles as being supportive of management and I ask myself you know, yes, this is progress.

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

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

Did you get any data in the course of doing this that gave you a sense of the people you surveyed, the investors' view of the relevance of the audited financial statements over time? Meaning, what is the directionality of change here?

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

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

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

So assuming that the financial statements as initially prepared by management haven't deteriorated, that is an assumption, but you know, certainly 302 and 906 should theoretically help. And if audit qualities have gotten better, you could at least extrapolate to think that financial statements have gotten somewhat more useful but we didn't ask about that directly.

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

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

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

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

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

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

You folks, Brandon, would you agree with that?

MR. BECKER: Absolutely.

JUDGE SPORKIN: They don't give

much credence to the --

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

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

And, secondly, I have long term

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

MR. TAROLA: Let me take a stab at that. I don't think we got as deep as you might have liked us to get on that question. The commentary and the results indicate to me anyway and I hate to interpret data without talking to the people that provided it, but the Respondents seem to put the auditor in a box. And more or less they sort of like the box that they're in right now. And that they would just like them to be more forthcoming about what they see and hear and feel. But they're fine with them being in that box.

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

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

But go ahead, Tony.

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

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

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

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

Ultimately, Hans Hoogervorst, the Chairman of the ISB, had to step in and say that you can't possibly have seven French banks coming up with seven different amounts of losses on the same bonds. And you've got to do something about this.

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

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

I would view this survey as an introductory approach at trying to understand where we are. I think what it tells us is more about the questions that we ought to be asking. That's the real import of this survey. We need to take these comments and then develop something that allows us to better understand what's going on.

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

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

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

And this is a view that Mike Cook,

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

I guess my question to you is should the auditor be involved in things like that. Can he be involved? Is there a way that that sort of information, the contemporary information, that gets into the market can be analyzed in a way that would help investors?

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

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

I think, Dan, you might have

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

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

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

MR. HEAD: Again, our survey even though it didn't go deep enough and why the last point on the general statement is the survey initially results, they would like to see audit quality as a focus. But focus on financial condition, the estimates, and quality of disclosures and that that would be the most meaningful three areas for audit quality improvement to address in light of all the things they could. And I think they think that's much more important than getting too deep involved on some of the front end things or even MD&A. But again we didn't go real deep. This is only opening questions, not necessarily answering all those.

MR. HARRIS: Lynn Turner.

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

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

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

Right now, we've just got as you know the lawyers drafting legalese risk factors that is useful quite frankly if you read them. Unfortunately, most people don't read them. But they are useful. But they don't tell us what the company is doing to mitigate those risks which is a major shortcoming in how the thing has turned out. So it's probably time to revisit that.

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

And, quite frankly, Mike might be right that the auditors aren't involved. But in reality if they were following GAAS, they would be involved which gets back to the point other people are saying. If the auditor isn't involved and on top of the operations and doesn't really understand the business which is what the survey highlighted at times, at least the belief they aren't, then how can they really get the numbers right? And if they can't get the numbers right, why would we give them a bigger assignment when they don't seem to be able to get the current assignment done right?

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

We didn't find the auditors finding the problems at an Olympus or at any of the Chinese companies. We didn't even find the auditors finding the problem at Diamond here in the U.S. It was analysts and other people and information coming into the public domain that's available.

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

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

So I think the work of the PCAOB is important. I think the exams are very important. But unless we can get better audits and better transparency, the marketplace will deem them no longer relevant. And I think that will certainly happen within the next two decades if substantial changes aren't made and if people don't see value to what they're spending money on.

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

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

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

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

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

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

There's a difference in involvement, robust and being involved in it and opining on something. And I think one of the very good pieces of work that's came out of this group earlier that a lot of us worked on was the consideration of an auditor's disclosure and analysis.

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

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

Brian.

MR. CROUTEAU: Thanks, Steve.

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

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

MR. CARCELLO: Obviously, it would be conjecture, Brian, on any of us as to what that means. But one possibility in terms of more transparency on a timely basis would provide more incentive for firms to improve audit quality, taking both that comment and some of the other free response comments that you saw throughout the presentation, there seems to be at least among who knows how many, one or two or three -- you've got to take that with a grain of salt -- statements about concern about the lags and the lack of disclosure associated with part two of the inspection reports. And more transparency would improve audit quality and again given some of the comments earlier in the slide deck, if you go back and look at it, I think that might be where people are coming from.

The problem as you know as well as anyone, as I understand it at least, that's part of the law. That's not something that the PCAOB could unilaterally change. I'm not even sure the SEC could change that. I think that's a Congress issue as to whether you're going to make part two public. And the way the law is written that's not, at least, my understanding that's not an option.

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

MR. CARCELLO: Yes.

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

MR. HARRIS: Tony, Lew and Ann, a couple people had their cards up here for awhile. Go ahead.

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

MR. HARRIS: Please do.

MR. SONDHI: Some people will use any excuse.

(Laughter.)

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

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

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

MR. CARCELLO: I would just point to this last slide for the benefit of the Board and the SEC people here today. I think there is a couple of things that at least I heard come out of this presentation. And I thought Bob made a very -- did a really nice job presenting. And that is although we might have thought there would be real strong demand for more, as we said earlier, there seems to be strong demand for making what we have better particularly in that third bullet, "want a more informative audit report." I think that definitely came through as well as more information about financial condition and estimates in the fourth bullet.

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

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

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

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

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

MR. HARRIS: Lew.

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

And do this over a period of time

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

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

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

It is important to include both the upside, not just the downside, but the upside because people do respond and particularly those people which is most people who really do want to do a good job will pick up on that because they're not going to be left behind the pack. So you get rid of some of your outliers. I would very much encourage you to think about that.

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

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

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

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

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

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

And if we've got four global networks responsible for auditing the bulk of our investments we need to be paying attention to the structure of the audit model. And unless we expand our thinking and consider what constraints are put on the quality of the audit by this bigger structure, we're not going to get a lot more out of it.

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

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

MR. TAROLA: Let me take a shot at

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

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

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

MR. HEAD: And the reason I was

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

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

At my audit committee, they didn't

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

MR. HARRIS: Ann Yerger and then Bonnie Hill.

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

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

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

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

So I guess in a way I would just like to urge the Board to continue to go boldly forth on some of its initiatives or its considerations of issues about whether there are ways to enhance the auditor's report to investors and whether there are ways and how there are ways to enhance its reporting to audit committees.

MR. HARRIS: Bonnie.

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

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

Sometimes the question is are there things that the Board and the audit committee know that they really do not necessarily want to be for public disclosure because of competitive reasons or other reasons. How much forward thinking can you in fact do and still maintain a certain edge?

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

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

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

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

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

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

MR. HARRIS: Kelvin.

MR. BLAKE: Thanks, Steve. You actually have raised my question and the question is how is the PCAOB reaching out to the accounting profession in terms of publicizing the most common deficiencies found during the audits, the inspections or the enforcement actions taken by the PCAOB that think it's a good learning tool if these accounting professionals, not the high level but even down to the staff assistants are aware of the common deficiencies and what they should not be doing and the serious sanctions taken by the PCAOB if they engage in such activities.

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

And we've got a problem with respect to the enforcement, the transparency of our enforcement proceedings. Once again, under the law, we are unable to communicate that publicly. But what are some of the things that you would like us to get out there that you may not be receiving?

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

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

MR. HANSON: Let me make a couple comments. Excellent points. We do have a series of forums we call Auditing in the Smaller Business Environment where we take this on the road to I think it's around seven cities around the country. And it's geared towards to the non big four and non national firms. And we get over 700 auditors come to those. And we do focus on what are the most common findings and actually do little case studies of here's what the standard requires. Here are some facts. Let's have a little discussion about them. So those have been very well received and a lot of repeat attendees at them. I'm not sure that the press ever shows up at those events. But we are trying to do that.

And with respect to the larger firms one of the gauges that we use in effectively the question do the firms get it is they all have their own internal inspection routes. So one of our gauges is how consistent are the results that they have internally with the results that we have. And for the firms that are pretty close, and they understand their issues and are communicating dealing with them. Feel pretty good about that. The firms that are a little further apart we kind of push them pretty hard about "Well, gee. Are you looking at the right things if your results are different than ours" and pushing them along in that.

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

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

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

Bob.

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

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

But right now the presumption is I

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

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

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

MR. HARRISON: Thanks. I'll be very brief. It went down because I think my comment was made in bits and pieces as the discussion progressed. But I wanted to just tie back very briefly because it relates to the point that Judge Sporkin originally raised about value of backward looking audit process and statements to investors who by nature are forward looking.

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

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

There are still a lot of funds out there who do pick stocks. And I think the way that they do their business can be simply distilled to a process of collecting relevant information including historical financial statements and the results of audits and commentary around it and projecting the expected future performance of a company, its capacity to generate earnings and cash flows and discounting those back to a present value at a discount rate that reflects the level of risk that the investor attaches to those projections.

And I think that what we're hearing from investors and I agree with Anne, I think we heard a lot today that is consistent with what our working group heard last year about the relevance or potential expansion and the scope of the auditor's report. I think we're hearing from investors that there are qualitative assessments or commentary, whether it's in an EDA or whether it's conveyed in some other manner relating particularly to issues such as estimates. Or I think one topic we discussed last year were situations in which more than one accounting treatment would be permissible for a particular category of expense or other financial statement item and where the company has chosen perhaps the more aggressive position should there be some commentary by the auditor about that fact, all of which helps investors to assign a level of variability or risk to their projections.

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

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

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

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

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

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

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

MR. HARRIS: Lynn and then Damon.

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

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

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

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

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

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

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

And not only should we have the information with respect to where there's been shortcomings, but to build upon the point that Robert made, I think we need to have some disclosures about audit quality. And I know when we went through this discussion with the firms during the Treasury Committee hearings and meetings that they often told us, in fact almost universally told us, you can't measure out of qualities. There is no definition, no central definitions, or common definitions, etc. which made me think if the firms don't know what audit quality than I sure as heck know they aren't measuring. And if they aren't measuring audit quality, I sure as heck know they aren't managing to it.

And I think we ought to have the firms report to you and to us on some key drivers of audit quality. And if they can't figure that out then we should all be concerned. It shouldn't be that hard to come up with them. They should already have them quite frankly. And if they don't have them, then they sure as heck should come up with them very quick and should be required to make that as part of an annual public report.

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

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

But you just don't see the

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

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

But I think all of those things, the part two being in a 4010, disclosure of the companies, disclosure of audit quality drivers and some accountability would all be useful to improving the system.

MR. HARRIS: Damon.

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

I think the survey data we have here is consistent with I think much of what the PCAOB has heard from a number of parties in various public events over the last few weeks which is that the work of the PCAOB and the effect of Sarbanes-Oxley has been to improve all of the things being equal to improve the effectiveness of public company audits and thus to in certain respects improve the reliability of the financial statements.

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

The second problem is the consequence of globalization and the fact that more and more of the operations of our public companies and in some cases the entirety of their operations is located in countries that are simply not prepared at this time to enforce minimum standards of audit independence and audit quality.

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

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

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

Now this is not something that can be wholly addressed by the PCAOB. It really has much more to do with FASB fundamentally. But it increases the challenge to the PCAOB in precisely the way that a number of my fellow panelists has spoken to today which is that in order for audited financial statements and the audit itself to be relevant to investors in this environment there's an increasing investor demand for auditors to make more and more qualitative judgments about the nature of the preparer's financial statements and the narratives associated with those financial statements because increasingly it's simply not enough against the background I just described. It is not enough to be able to say "Well, the basic numbers on the page haven't been -- aren't fraudulent. They're not. We don't have a WorldCom problem here." That simply doesn't -- Saying that is not enough to make the financial statements relevant in the increasingly complex world we operate in.

And our experience, the labor movement's experience, in talking to audit committees of major financial firms in the 2008 and 2009 period bore this out quite dramatically that in many instances it appeared that whether or not this was true I could never satisfy myself. But those audit committees essentially were prepared to represent to us that they simply didn't understand the companies that they were monitoring and that they were sort of unable to properly oversee the discretion that appeared to have been undertaken by management in those circumstances.

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

MR. FERGUSON: Following up on something that Damon mentioned about globalization because when we've talked about audit quality here. We've tended to think about it in the domestic context. And in some ways that's not really even relevant to big audits today because great global companies, in fact, their audits are conducted all over the world by groups of firms, not by a single firm which are not the same juridical entities. They're separate entities subject to separate regulatory regimes and separate legal incorporations and things like that.

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

But I think that will be the first time we will actually have been able to look at the kind of audit quality on at least an extra U.S. basis. I wouldn't say totally global because there will be certain jurisdictions we can't get in and there will be difficulties in coordinating. But at least we'll do it in a number of jurisdictions which I think will give us a much better view of what's really going on around the world.

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

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

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

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

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

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

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

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

(Pause.)

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

Anne, I know you're starting us

off.

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

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

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

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

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

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

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

So in the interest of time, here

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

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

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

The second thing is they are going to prohibit audit tenders which confine the option to bid to the Big Four. In other words, they're trying to find a way to open up choice and I think give more opportunity for non-Big Four audit firms to get experience, either through joint audits, but certainly getting an opportunity to pitch.

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

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

Now given the global nature of the audit networks, the Big Four which are responsible for auditing most of our portfolio will, of course, be influenced by what's happening in Europe and will be needing to respond. So I think I would only echo the point that was made earlier that we welcome the PCAOB's attention to cross border regulation. This is a very good example where I think there's a lot to be learned and certainly a lot to be coordinated and a lot that's of real interest.

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

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

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

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

But certainly for CalPERS, given how widely exposed we are in these markets, we are certainly affected by systemic losses. I think our fund was down $70 billion through the impact of the crisis, but we do all need to be thinking about systemic benefits as well as individual costs to particular companies.

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

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

And then the final section is recommendations. And Damon is going to present those. And as I mentioned earlier, we've got some quite specific things we think can be done to improve the definition of Going Concern that will be helpful. The timing, triggers for Going Concern and also some thoughts about the issue of enforcement.

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

We know it's not a substitute for being active owners. It's certainly not a substitute for the role that boards of directors play. Those points have been made. But let's try to understand that this is a three-way responsibility between boards and owners and regulators, and we have a mutual interest in the system working smoothly.

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

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

On to the Going Concern issue and we'll cover the history a little bit here because I think it's good to understand where we've been and learn from some of the lessons of the past. If you go back to the '72-'73 bear market, and those who lived through there at that point in time, we came out with large bankruptcies, companies collapsing just as we did a decade ago, and the corporate scandals, and again as we went through the subprime crisis. We had national student market, likes of Penn Central, which is still one of the largest bankruptcies in the history of the country. Equity Funding, large financial institution that went down at the time and out of that they established a Cohen Commission which was chaired by the former Kennedy appointee as chairman of the SEC, Manny Cohen.

And when that Cohen Commission came out with their report in '78, they urged the accounting profession then to reexamine the issue of Going Concern. And in fact, their recommendation was to get rid of the Going Concern report, just eliminate it. That it was better for management to take on the issue and discuss it and provide the disclosures than the auditors.

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

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

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

Interestingly, those were the same things people were asking for yet today. But under an extreme heavy lobby from the business interest, the AICPA took their original proposal which had all these disclosures in it and gutted it and came back with a much watered-down final standard and ultimately it had an impact in the financial crisis, because we didn't get any of the disclosures. We'll talk about that.

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

But let's put an onus where the onus belongs, on management. They should be the first ones coming forward. And the SEC, at the time, urged the FASB to act on it. Unfortunately, that didn't happen until a few years ago. Finally, the FASB in 2008 comes out with an exposure draft that probably moves them in the direction of the international standard where there is in the accounting literature a somewhat ambiguous definition. It's not really even a definition. It's some ambiguous language we'll look at with respect to Going Concern, but at least they moved in that direction. But they couldn't get agreement at the Board. Unfortunately, the Board punted.

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

That leads us up to where we are

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

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

MS. SIMPSON: Sorry to interrupt.

MR. TURNER: Go ahead.

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

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

Everyone is working on it. What

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

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

So with that, Anne will pick up the survey.

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

And Damon is going to go straight

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

COMMISSIONER WALTER: Thank you and I appreciate that.

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

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

Before I do that, I just want to -- we sort of neglected in this presentation to begin with just a basic point about the importance of the Going Concern issue. The entire nature of the financial statements, as prepared by the issuer, presumes that the firm is a Going Concern. And therefore, if it is not, and the question of what constitutes not is going to be the subject of what I'm about to say, but if it is not, then the financial statements as a whole are simply not a fair representation of the financial condition of the firm.

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

Now the key -- there were three basic recommendations that our subgroup came up with. The first relates to the question of what is the standard for determining when a financial statement and the auditor must disclose a Going Concern concern. To understand that, it's actually worth looking for a moment at one of the pie charts. We surveyed investors on the question and this is pie chart that's on page nine. It says "When should a company be identified as a Going Concern?" And we surveyed investors on this question. And we gave them three possible analytic frames for this.

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

The second option we gave people was more likely than not, 51 percent. And then the third is reasonably possible which is less than 51 percent, but more than trivial possibility. And as you see, there is a strong view on the part of those surveyed that the appropriate standard is a more likely than not standard which we see 50 percent support. And that is the recommendation of the panel of our subgroup that the standard be moved from the current 80 percent plus to more likely than not.

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

And this goes to the second issue, the second point of our recommendations which is a recommendation about timing. Currently, that guidance which exists views -- I'm just paging back to my summary sheet, that guidance which exists views the relevant time frame for Going Concern assessment as being the 12 months following the date of the financial statement. And the problem with this is that it creates a cliff and it presents a problematic situation where companies and auditors are aware that, for example, on the day after the 365th day, an event is going to occur which raises a serious issue of the firm continuing as a Going Concern, a specific event on a specific date.

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

And so it is the view of our

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

COMMISSIONER WALTER: Damon, question.

MR. SILVERS: Sure.

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

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

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

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

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

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

COMMISSIONER WALTER: I do.

MR. TURNER: In response to your question, there was also some additional information that was given to us yesterday by CFA Institute. They did their own independent survey and on your point only 19 percent favored limiting it to 12 months. Thirty-two percent said the foreseeable future which they defined as one to three years. And then 44 percent said limited to the next 12 months from the date of the financials, but also consider foreseeable events occurring shortly after the next 12 months such as the need for debt financing, loss of major contract, etcetera, which is I think where the international standard is. So they had 44 percent there; 32 percent foreseeable, in 1 to 3 years. Only 19 percent was a solid hard stop at 12 months.

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

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

MS. SIMPSON: That is absolutely right. Our thinking about this is that you want something on the definition and obviously, that's FASB. You want something about the time period which Damon has spoken about.

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

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

MR. TURNER: Elisse, I think they can be done separately. I don't think they have to be done as a group, but the package does need to be done. So the notion, much to what Anne was talking about, is create a system where you have early warning disclosures, so you have the FASB on financial stability and risk and mitigation of the risk coming from the SEC, including give us the KPIs, require companies to give us KPIs, because those are typically some of the best red flag warnings you can ever see. So give us that. Give us mitigation of risk, okay. And that comes from the SEC. Then the FASB can give us the disclosures on financial stability before you ever get to a Going Concern.

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

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

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

MR. TURNER: No, I think, certainly from my experience in running companies and all, and working with companies, you're still going to have that ramp up in disclosures, even if you bring the threshold down to 51 percent.

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

COMMISSIONER WALTER: Yes.

MR. HARRIS: Since the Commissioner has to go in two minutes, actually, she's going to give us two minutes more time, I think, if you could quickly go through the recommendations. We're begging five minutes of additional time -- and I know you've got to get out of here.

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

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

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

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

And the last piece is the

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

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

COMMISSIONER WALTER: Let's talk soon.

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

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

And I want to spell out a little bit about that around the question of enforcement, but also to give a little more insight into the recommendations I just went through in terms of the way in which both the accounting rules and the auditing standards ought to apply here.

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

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

Now, these firms issued financial

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

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

And there was no legal requirement

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

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

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

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

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

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

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

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

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

MS. SIMPSON: Comments and questions?

MR. HANSON: Before we jump into the questions, I just want to make one comment. Damon's referred several times to an 80 percent rule. And just to clarify, the original SAS 59 that our current interim standards are based on, there's no specific rule in there and in practice there's a lot of variability. We heard it at the SAG meeting in May that there's uncertainty about what the percentage actually means and so it's not a rule --

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

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

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

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

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

And then you can take into account the fact that despite all the work that we may have done, good or bad, nobody has ever attempted to solve or tackle the problem of coming up with a good cash-flow statement for financial institutions. Those are the kinds of things that Equity Funding, Lehman Brothers, these are the -- that flexibility, the financial flexibility, and the cash flow, that's what would tell you about this. But there's nothing on those issues at all.

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

So it seems like the things that were going -- or were proposed were the things that would have actually given everyone a much greater heads up, much earlier in the crisis. But, obviously, those are embarrassing things for anyone managing a company to have to say because it in essence says, hey, you haven't done a very good job of managing the company. Or it says something has dramatically changed in your industry that maybe is outside of your control.

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

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

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

And the reality was, as we all know now, they didn't know what they were going to do. And in fact there was no plan in place that would have done it, which brought around the demise of the company. That disclosure was not there. The financial stability disclosure was not there and I find it very troubling that to this day the FASB is still refusing to act on that and punts.

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

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

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

MR. HARRIS: And Damon, first of

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

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

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

Then we go to the question of management disclosure, which I think in some respects gets to what Tony and Lynn were just describing, which is that if there are events that are reasonably foreseeable that would lead to an entity not being able to meet its obligations, most obviously these sorts of liquidity problems, then there has to be a discussion in the financial statement, if reasonably estimable, of what those events are, the possible effects of those events or conditions, a clear statement that if they were to occur, there would be a real risk of discontinuance of operations; a management evaluation of those conditions and events; any mitigating factors, plans for actually being able to refinance debt, for example; whether those plans can be effectively implemented, the likelihood of doing so; and the recoverability or classification of recorded assets amounts and liabilities that would bear on these circumstances.

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

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

Now, I'm not going to go through

what our concerns are with auditing standards. I'm just going to go through what the recommendations are.

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

And, as the case with audits in general, the auditors should be required to understand the company's plan for dealing with contingencies of the type that I described a moment ago in the FASB section: checking key assumptions, consistency of assumptions and data, challenging key omissions, understanding industry-specified factors, and we've had a fair amount of conversation about that in the financial sector, and look at what, if anything, past trends would tell us about the likelihood and seriousness of the issues in play.

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

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

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

Part of this involves requiring the board and the audit committee to play its role of defining objectives from the auditors and the process that the audit committee must use when there is a Going Concern issue. So having been told that this conversation was going on in another room, the audit committee needs to have clearly stated procedures for how to address its own responsibility in that circumstance.

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

And in addition to that, a more detailed disclosure of key performance indicators. Some companies provide information in the public domain of this type in their 10-K statements and others do not. This is an overall -- we're making recommendations around an overall disclosure regime that takes a little bit of the edge off of some of the questions of Going Concern issues.

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

And so what this would involve is disclosure of factors critical to the success of the company, its operations, and in particular, its cash flows, to Tony's point. And, obviously, these types of disclosures vary greatly by industry and require a great deal of monitoring by corp fin if this type of approach were to be adopted.

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

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

And by on the brink, I mean literally on the brink. There were at least two major firms which I discussed before, Citigroup and Bank of America, where chief executives called the United States Government and said we are going to be insolvent within days if you don't act. This is a matter of public record and yet, as I said before, where is the financial accounting and auditing regime in relationship to the reality of imminent insolvency in these firms?

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

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

MR. HARRIS: Mike, you had a question.

MR. HEAD: And I'm not sure if it's a question or a comment or just a butterfly that's in my stomach. One, I want to applaud all the detailed recommendations. And as a CPA and as a former external auditor of financial statements and as a head of an internal audit function that has a fiduciary obligation to shareholders, audit committees, and ultimately management, but I said them in that order intentionally, the Going Concern opinion to me, for whatever reason, my gut tells me I go all the way back to your history that you presented, and it seems to have no place in today's current environment to me.

What makes so much sense to me is the disclosures, and it's not the same as risk factors, but it can't be separated from risk factors at all. It seems robust, ongoing, enhanced disclosures relative to the financial condition and economic situation that companies are encountering is what's really, really important and ever since I encountered the first time where I had, as an auditor in the public, for the public accounting firm, had to have a discussion about assessing is Going Concern relevant or not, distracted from the entire needed point which was how do we get the right information and disclosures so the investors and users of the financial statements understand the circumstances and can make educated, informed decisions versus getting hung up on again a boilerplate piece of paper that relates to a lot of fights and going to national and trying to determine what is the true criteria, and you spend all your energy on trying to conclude if that opinion should be in there or not, and justifications for yes or no versus all the things that are giving you concern are they adequately disclosed either in MD&A or in the risk factors or in the financial statements.

And so I don't have an opinion one way or another on Going Concern other than I agree wholeheartedly it's under understood. It needs a lot of guidance and the end result, I would hope, would be substantially better disclosures on a continual basis to provide the users the information and then I'm not sure if the piece of paper matters or not with an opinion or not. But that's just -- I'm reacting out of my gut, not studying it like you guys have as a working committee for a long period of time.

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

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

The problem is, is that these are small firms. We have a major double standard here. And it's not the only double standard that we've seen in the last few years, but these types of double standards fundamentally erode the public's confidence in the financial regulatory system.

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

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

MS. SIMPSON: I think Jeanette --

MR. TURNER: Oh.

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

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

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

And in the audit piece, auditors are required to design the audit to obtain evidence with respect to Going Concern. So that implies in all cases -- so can you explain the alignment between those two? Is it your intention that management would be evaluating Going Concern in all cases and then the auditors would be evaluating that consideration in all cases?

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

Right now, the auditing standard if you go back and look at SAS 59, it says the auditor only has to use the evidence that they pick up in the other parts of the audit. They don't have to specifically look to anything with respect to Going Concern or go out and try to obtain any evidence beyond what they're doing elsewhere. That seems somewhat ridiculous, especially as we look at some of these entities in the public data that was available. That's like saying I'll audit to management's numbers rather than audit the numbers. So therein that lies the problem.

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

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

I suppose that's what we're trying to recover in these recommendations, is the sort of stepped disclosure of basic notions of relevant and timely. These are two notions in reporting that we take for granted. But that system simply did not work. The warning bells did not go off. The dogs didn't bark in the night. I suppose that's what we're doing is going back and saying, good grief, how could that be? How could the system get to the brink? How could the taxpayer be on the hook to that level? How could there be calls in the night to government and reliance on bailout as a strategy for dealing with a situation? And it wasn't properly addressed through the financial statement.

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

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

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

MR. HARRIS: Thank you very much

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

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

So aside from fears of losing a large client, what's going on here? Are the auditors applying separate standards for little companies? What are they doing? What's happening?

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

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

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

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

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

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

I would like to -- let me come back to one point that Mike made about these Going Concern reports and whether they're relevant or not today because that was an issue back with the Cohen. At the end of the day, we're writing a product for investors. In the CFA Institute survey, which should be part of the record, is very good on this point. They note that 81 percent of them said that on a scale of one to five, having that Going Concern opinion was a four or five to them. Eighty-one percent. This is very important to them. So to remove it is degrading the product. And 92 percent of them said that they believed the auditors -- ninety-two percent, that's unbelievable, almost unanimous said the auditor's report should identify the basis and reasons for their conclusions.

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

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

Jeanette?

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

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

From an investor's perspective,

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

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

MR. HARRIS: Brian.

MR. CROTEAU: Thanks, Steve. Just two things. One, I just wanted to make an observation that I don't think I've seen any or certainly not very many, if any, inspection findings for annually-inspected firms related to Going Concern. I think none might be the answer. So as we think about whether there is a different standard, it may be that they're partly a scope point relative to inspections, but perhaps there's more to do there relative to evaluation of that. And so I just draw that observation.

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

MS. SIMPSON: Again, this is an investor comment and Lynn can make an accounting comment. My view is that substantial doubt is too late and too close to disaster. And when we were in the Working Group we said we want some steps along the way. We don't want a cliff. We want a slope. Maybe it's a downward slope, but do we invent terms like nagging doubt or a bit worried or I'm biting my nails? But we need something that gives us an indication of anxiety in advance of a panic attack.

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

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

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

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

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

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

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

MS. SIMPSON: It's fundamental.

MR. TURNER: And the role of an audit committee in an oversight function, not perform but an oversight function, none of these things are new. It's just like with the financial stability disclosures. We all had a chance to do it and never did it. Now people have lost trillions in value and watched their retirement disappear almost overnight. So it would seem to me we've got a great lesson. Now it's just are people here in Washington going to do something about it?

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

MS. HILL: Thank you. Mine is more of a question, Anne. I was wondering, given the extensive risk analysis that companies are required to make, when you look into -- I just read tons of them -- so when you look into the disclosures and all the things that they have as concerns, I'm wondering if you looked at whether or not the lawyers and the accountants, and you know the auditors talk to one another, because it seems like a no-brainer to take a look at the deep discussion on risk which have a lot to do with Going Concerns, that somehow or another being able to bring those together gives you a pretty good picture of where the concerns are. I was just curious if anyone had looked at that.

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

JUDGE SPORKIN: It seems to me everybody in this country has a credit score. Why doesn't every company and it need not -- I'm sorry, I don't have it on, I'm sorry. It need not be only the accountant. It could be an outside group. There are many, many metrics out there in which you can determine.

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

Can't you do it in every case?

MR. TURNER: There is what's known as a Z factor risk score out there with respect to Going Concern. There is what's known as a Z risk. Most of the firms, I suspect all the Big Four, certainly my firm, started to use that data, so that Z risk is out there. It's publicly available. Auditors should be considering that. That's one of those pieces of public information that is very good that should be considered that management probably isn't going to give them.

So that data is already out there.

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

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

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

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

JUDGE SPORKIN: To who?

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

JUDGE SPORKIN: No, but as long as it's available to accountant, that's the important person. Then he -- whether it's disclosed to the public or not, I haven't gotten to that issue yet. But the issue right now is whether the accountant get the information.

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

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

MR. TURNER: My firm --

JUDGE SPORKIN: Do the accountants score it?

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

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

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

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

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

MR. HARRIS: Barbara.

MS. ROPER: So first of all, I think you guys did a terrific job and I'm very supportive of your recommendations and I think they're very thoughtful. The one thing that did occur to me as I was just listening to some of this, it will obviously be important on how you move forward on those recommendations, because I think when you're talking about gradations of information and risk we want to avoid -- we should learn something from the terror risk alerts. We don't want to create a system in which every company is amber, you know, always. There needs -- if we're going to go that route, there needs to be meaningful differentiation and not just have management and then the auditors sort of migrate to some sort of comfortable median ground where they express a certain amount of concern. So that would be my only comment.

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

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

MR. HARRIS: We'll put all that on

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

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

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

Apparently, it means that between March of 2008 and September of 2008, while the greatest financial crisis of our generation was occurring, we would have had standards that generated a wide range of Going Concern opinions from accounting firms. It's hard to replay what happened between March and September of 2008 and what would have been the contribution of those Going Concern opinions to that process between March of 2008 when the financial markets almost seized up.

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

This strikes me as potentially raising really interesting issues of the interaction of the Board's requirements and the oversight of our financial system and what we expect accounting firms to do in the interplay of that oversight. So I think that your challenge in terms of just what you're going to ask accountants to do as opposed to financial analysts and portfolio managers is enormous if what you're asking them to do is to opine upon systematically important financial institutions based on publicly-available information including Federal Reserve Board stress tests.

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

MR. BECKER: I would go back to

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

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

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

MS. SIMPSON: It's a one-line wrap up because everybody is hungry. And the critical thing is that we understand that these parties to ensuring that we have true and fair reporting, these parties need to work together. So our recommendations are looking at the standards. We actually think the recommendations we're making will make it -- Bonnie, back to your point -- easier for directors of companies to understand what's going on. Because we know that in the failures, all right, we've pointed the finger at the regulators. We've pointed the finger at shareholders. We know that directors admit they didn't know what was going on. And we're here today to think about what auditors could and should have been doing.

So let's think about this in the need for independent audit, for skepticism, and for other measures that are going to support my independence. It's not just going to be through standards improvement that we're going to get this. So the other wider discussion about rotation, about non-audit work and potential conflicts of interest, professional skepticism, this is all highly relevant. So it's important we develop a view about improving audit quality. It's going to take account of all these component parts.

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

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

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

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

(2:01 p.m.)

MR. HARRIS: Let's get started. Our next presentation and discussion addresses topics related to how audit firm practices and transparency in the areas such as key audit quality indicators and partner compensation can affect audit quality.

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

MR. BECKER: Right.

MR. HARRIS: So appreciate very much your starting.

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

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

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

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

With respect to measurement, I

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

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

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

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

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

But we think that disclosure of the key indicators would help the quality of audits, the ability of smaller audit firms to compete with the larger audit firms -- we discussed earlier the leveling effect -- the audit committee's ability to have a robust selection process, irrespective of where you come out on mandatory rotation an informed assessment of your auditor could be enhanced, shareholder ratification, as well as Board oversight, by having those standards.

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

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

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

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

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

MR. BECKER: Anything else?

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

MR. BECKER: Yes. Let us get through our presentation, Joe, and then -- so we will get everything on the table and we can take it from there, because we did see an interconnection between quality and compensation incentives. We came out in one place, others may come out others, and I think they do merge in some sense.

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

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

I would, without trying to gild the lily, suggest that the conversation this morning about the importance of getting the basics right is consistent with this recommendation, that there is much work to be done as in the going-concern conversation, but getting this right struck us as sufficiently fundamental, that it would be worth the allocation of resources by the Board, while we recognize that we don't want to get too micro into the Board's organization.

Anything folks want to add to that?

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

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

MS. HILL: And I might add one of our concerns here was just duplication of effort. We just wanted to be sure that if something was already being done, or there was a place where you could handle it, that we weren't establishing something above and beyond what is already there. So just the efficiency of the use of resources.

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

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

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

The good news is that they

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

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

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

The audit profession is sort of exempt from Dodd-Frank-related issues in this space, possibly because Sarbanes-Oxley covered this area. As we all know, Sarbanes-Oxley included two provisions that sort of directly and indirectly at least addressed audit firm compensation.

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

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

However, you can see from the chart that the number of companies providing -- number of S&P companies that are getting non-audit-related services from the audit firms is increasing slightly, and the value of those services has gone up. But as Norman astutely observed, that if you look at that on an average basis that is not a very high number, if you divide it by the number of companies. But, still, it is a trend that these services are increasing.

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

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

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

We have been told that perhaps in response to those footnotes that audit partner pay and promotions at some firms may be being influenced by the provision of non-audit-related services. We don't have empirical data on this.

And while we did not have an opportunity to evaluate the standard relative to what is in place outside of the U.S., we have a general sense that ethical and regulatory standards in some countries are stricter than what our standard is here. So, and that might be an area worth further exploration by the Board.

So the overarching question for

the working group was, what, if anything, should the PCAOB do when it comes to audit partner compensation, particularly as it may impact audit quality?

We centered our analysis on three areas, which was, first, should the PCAOB recommend that the SEC kind of close that footnote loophole? Second, should the PCAOB be doing more in the inspection realm when it comes to audit partner compensation?

We appreciate that the Board currently does look at audit partner compensation, but at a high level. The question is whether there should be more specialized, more robust audits of audit partner compensation, particularly as it regards and relates to audit quality.

And the third question was, should there be some sort of public disclosure of audit partner compensation trends and practices? And, Lew, this sort of I think gets in a way at your point about whether there should be some overarching report from the regulator in those areas.

As Brandon highlighted earlier, our group was mixed on this. I'm having trouble advancing. Why is it me and Power Points -

(Laughter.)

-- do not get along? Thank you. There it is, there it is.

MR. BECKER: One of the skills I have.

MS. YERGER: I like being consistent with past performance.

So our group was actually really split in this space, and I think it's fair to say that two of us were really in favor of all three of those questions. We felt like there was room for the Board to look and do more.

We felt that changes were consistent with the intent of Sections 201 and 202 of the Sarbanes-Oxley Act, and we also believe that compensation can be one reason why audit partner and audit -- the auditor's skepticism may be impaired.

On the con side, we had two members who believe that the current analysis of Sections 201 and 202 are appropriate, and that it was -- it's inappropriate to further band audit partner compensation, because that was not the intent of Congress in the Sarbanes-Oxley Act, and also it was unnecessary because audit committees are doing so much more in this space.

So we are presenting you a sort of mixed bag of recommendations and look forward to input from the full group. If anyone from the working group has comments.

MR. HARRISON: I will -- just to follow up, I will weigh in briefly first. On the issue of compensation, I think another way possibly to look at the sequence -- or the possible courses of action we have considered is to think first perhaps in terms of the Board enhancing or implementing some formal inspection procedures around compensation formulas and results as a pre-cursor to considering whether a recommendation to revise the SEC rule -- the statute might be advisable.

I think it is -- you know, as Ann mentioned, we didn't dig too deeply into data, but it is noteworthy I think on the occasion of a 10-year respective on Sarbanes-Oxley to remember what happened in the immediate aftermath of the Big Four.

And most public accounting firms sort of got out of the consulting business, in some cases by divesting entire units of their business, but they are certainly back in it. And to a significant degree -- I just did a little quick research over the past couple of days -- but as of results reported for last year, in terms of total revenues for each of the Big Four, their consulting or advisory revenues were anywhere between about 25 and almost 38 percent of total revenues for the business. And what is even more interesting I think are the growth rates.

I think we all know from those of us who are in the profession, or those of you who are in the profession, or those of us who work with boards who deal with auditors, that audit firm fees, audit fees have been under some significant pressure in recent years, and in fact most of the Big Four reported declines in their audit revenues in 2009 and 2010, or flat growth.

Whereas, on the other hand, you know, advisory or consulting revenues grew in 2011 between 15 and 18 percent for each of the Big Four. If you go back five years, those growth rates are still in the eight to 12 percent range. So, you know, accounting firms are like other businesses. They are in business to generate profits and to share those profits with their owners.

And I think that there is, you know, every indication that at least at present revenue growth is being largely driven by the consulting and advisory practice. And I would think perhaps for that reason alone it is worth some level of examination as to whether or to what extent perhaps there are -- I wouldn't expect that you would go in and conduct a review and find that there is a point system awarded to audit partners for referring business to other parts of the firm, or anything quite as transparent.

But I think there is a fair question here around an examination of culture or of qualitative factors brought to bear on compensation in the firms.

And as I mentioned, in particular, in an environment in which audit fees have been under such pressure -- and I don't believe in regulating by anecdote, but I think probably any number of us could recount experiences we have had either with clients or in talking with people in the profession, you know, one of the ways in which I think firms have tried to mitigate the impact of the pushback they received on audit fees is by exploring or encouraging clients to consider using the firm for other aspects of their work -- for tax return preparation or tax provision work or perhaps in some cases for some type of consulting service.

So I think that, you know, all of those trends -- and, again, given the fact that the scale of revenue from those -- the consulting practice has become such a significant component again of audit firm revenues and is clearly the growth area, that it would be prudent to undertake some level of appropriate examination to ensure that compensation processes and formulas are still being conducted, with a view toward the regulatory requirements.

MS. HILL: I might weigh in at this point and say that, first of all, I think if one is going to take a look at the growth of revenue from non-audit work versus audit work, one has to go back to pre-Sarbanes-Oxley, because during the Sarbanes-Oxley period audit fees went up tremendously.

I mean, you have only to look back and recognize that the burden was so heavy on many companies, and particularly smaller companies, that there had to be some rethinking about all that had to be done.

So audit fees of course went up quite significantly. And the fact that they are ratcheting back I would think is a testament to the fact that the work that was done during Sarbanes-Oxley has probably paid off in some ways.

I think the other thing is that we recognize that the world has changed significantly, and that in terms of our -- of the globalization of our economy, and all of the other things that we have to look at on a regular basis, there are a lot of other things that have to be audited.

My experience, 20 years of

experience, on over 11 different boards, I have not found that audit companies came in and sold us services for non-audit fees. What I found was that on those audit committees that I served on, when we had a need for something beyond our regular audit services, we looked at it.

We then looked at the number of firms that could do that service for us, and we looked at the cost and the time, and we made the decision as to who we wanted to have do that.

I would tell you that my experience today is not that we are sold services, but that we in fact review the needed services, and then we look at the best resources of the shareholder's funds, because that is what we are using, the timeframe, and who can best do the job in the most expeditious time period and the most efficient way.

So it is for that reason that I am

certainly -- as Ann talked about, you know, the split, I am on the side of saying, you know, there is some obligation on the part of board members and audit committees, and the SEC has already put forward a ruling as to how it is to be dealt with.

And unless we are just looking for something additional to do, I think, you know, it doesn't mean that you can't review it, but we review it in the board room, audit committees review it. We have to approve any additional non-audit fees, and they are reviewed not only by the committee but also advanced to the board as well.

So it is not done in a cavalier way. It is done with a great deal of thought and consideration for more than one factor.

MR. HANSON: I'm glad you brought that up, Bonnie, because that is one of the questions I was going to ask of you. And I can't remember if others of you are currently serving on audit committees, but from either side of the table, either as a preparer or the audit committee member, any more color that you want to provide around the substance of the audit committee preapproval of the services that came in after Sarbanes-Oxley, and how that factors into the views, I would be -- so I am very glad that you said that. If anybody else wants to comment on that, I would appreciate it.

But then, a second question I wanted to ask, on that table on the -- the four-year table on page 5 of the S&P 500 and the value of the non-audit services, if you have also looked at the trend of the percentages of the non-audit services compared to the total audit fees, if there is any information there that would be useful to talk about, so --

MS. YERGER: Regarding the trend, let me just quickly -- no, we can certainly try to get that data and follow up.

MR. BECKER: And our experience is

very much the same as Bonnie's, that it's a highly formal process by which we consider using our auditor for any consulting or independent services. It is reviewed by our audit committee, by our chairs, and done I think fairly infrequently because of our concerns not only about formal independence, but what I would call optical independence, how well it will stand public scrutiny.

MR. TAROLA: And I will just confirm what Bonnie and Brandon said. From my experience, it's presumed that you would not use the auditor unless it is a unique situation.

MR. FERGUSON: On the compensation question, we are very aware of the issue of the relationship of compensation to audit quality. And it is, to some extent, difficult to measure because -- and I will tell you how we do do it, though, which we think is a reasonable surrogate for it.

But you can clearly look at a

firm's compensation policies, but we don't sit in the rooms where the compensation committees are making those decisions and allocating the resources.

What we do do, though, and what you can look at is you can see what happens to particular partners, for example, who have had less than perfect results, as a result of the internal inspections or as a result of our inspections. What does that do to their compensation? Does it affect it negatively? Does it affect their promotions? Does it affect the kinds of jobs they get?

And those kinds of things we look at very carefully, and in fact I think are paying increasing attention to that issue, because, you know, clearly to the extent you want to promote audit quality I think you want to relate that to compensation somehow. You want people to be rewarded for doing a good job.

MS. YERGER: Well, and I think to

speak for the working group, maybe incorrectly, I think there was real consensus that we wanted the auditors to be paid for high quality audits. I mean, that was -- but the question is, are there tweaks here that we could ensure that is what is happening? And that is really where I think ultimately this really was.

MR. HANSON: And we have -- it is mixed results in what we see in the firms. And I think I would characterize it as they are all in an evolution of how they are factoring in the different quality elements and the transparency to -- in terms of what gets documented and what we see as lucid.

We can't sit in the room when there is a substantive deliberation about how is a particular finding going to affect a particular partner's compensation. And we are challenging the firms to better document what went through their head in terms of what went into the compensation.

So we can see that, and we have their attention. And we are expecting them to make meaningful progress on dealing with the criticisms that we have had. And we have had very blunt discussions with the firms about the need to do that, and at least from my chair I think they are kind of getting the message that we are very serious about this and we are putting it in the findings.

MR. HEAD: My initial thoughts -- and I come from this, again, with our audit committee is responsible for hiring and making these decisions, as everybody has explained, and the process is much more robust post-Sarbanes-Oxley and all of the rules.

And, again, it is another demonstration of all the progress that has been made through -- over the last 10 years. I do think that this element, the compensation of firms, and, therefore, partners can't be looked at without considering the topic we are going to talk about after this, which is audit rotations, because this is another dial that you continue to move dials to ensure independence and objectivity.

And it is a whole different discussion in the audit committee meeting and room knowing that the audit committee has said, "We don't hire you for non-audit services," no matter if it's prohibited or not prohibited.

Then, you don't have that as a table. The discussion is: are you getting compensated at an adequate level to perform the audit quality that we are asking for? And this is it, you are not getting anything else, and that creates a whole different atmosphere and discussion than if it is justifying quals and if it is cost beneficial and is it really a conflict or not a conflict. It takes all of those discussions off the table.

And I actually feel this dial is just as strong on ensuring objectivity and independence, maybe even stronger than it is

-- than considering audit rotation, because they -- if they know that what they have to be focused on is providing the highest quality service to the audit committee, and that they need to be compensated for that, and there is not a lost leader, there is not another average return on investment, that it is -- you are here to do one job and one job only. I think that is a much stronger message than worrying about audit rotations, which you will see as I get comments on the next one, but I won't broach into that.

And so that is my thought. But, again, this is one of those over the last 10 years it is significantly a different environment today in the audit committee board room than it was before Sarbanes-Oxley. This was an issue prior to Sarbanes-Oxley, and I don't think it is nearly the issue because of the rigor that the audit committee oversight goes through today.

MR. HARRIS: Let me recognize

Chairman Doty. Thank you very much, Jim, for coming. I know you had a day testifying before the House, and I imagine it was a ton of fun, but we welcome you.

(Laughter.)

We are on the subject of audit firm practice and transparency. But if you want to make any brief comments, or otherwise we will just move directly to Joe and Barbara.

MR. DOTY: No, I'm here to listen. I'm here to listen and happy to be here.

MR. HARRIS: Then, Mike, why don't you go ahead and --

MR. STARR: Norman, you laid out the statistics on the growth in the non-audit practices over the last two or three years. And my question goes to, what consideration did you give to the impact of that growth on the culture, and, as a result, on audit quality?

MR. HANSON: I think that that, at least from my standpoint, may be the question to be explored. I mean, the data were simply public data taken from the firms' websites and disclosures.

But my -- I think that it is -- I must say also that I take with great respect, and I appreciate the point particularly of my colleague here, who I know any audit committee Bonnie Hill is on is going to be the gold -- the platinum standard.

And it wasn't really even my intention to suggest that there isn't great reason for confidence in audit committees today, and their awareness of their obligations with respect to independence issues.

It was more an observation that -- and I think as we all know, compensation, particularly given that there isn't -- I think each of the firms may take a slightly different approach, and even with each firm there may be variations by practice group, and there are qualitative assessments that inform evaluations, particularly at the more senior partner levels, that in that environment it would be -- and, again, given the trends in terms of where revenues are coming from and growth rates among the three principal practice groups, that it would -- that there could be no harm in some assessment of the environment around compensation and the rigor of the process to try to measure exactly what you raise in your question, which I don't have a real sense for or any objective basis for assessing, you know, as I sit here today.

MS. YERGER: If I could just in for one second, too, because I am uncomfortable in a way that we have sort of moved into this place where it is like the audit committee versus -- and everything else is exclusive. And I don't think that is probably where Norman and I were on this issue.

I think it has been so important that the audit committees are doing so much more in this space. I think the question I was asking was whether we should be -- there should be changes to ensure that the audit firms, in terms of how they are making decisions about audit partner compensation, whether that should be tweaked, and whether one of those tweaks is through that footnote to the SEC rule.

So I guess I am -- I think I maybe am splitting the baby a bit by saying we could have both of these, and I think they would be good things.

MR. STARR: And if I could ask just one more question. Lynn earlier talked about the need for quality indicators. And I think you touched on it in your slide, right? And my question is, what consideration did you give to looking at those quality indicators and pushing them down to the ground level, to the audit partner and staff level, and having that become the basis for compensation both at the staff level and the audit partner level?

MS. YERGER: Well, I think our initial slide -- and this is why we thought measurement and money go hand in glove is that first of all there need to be -- we need to at least consider, how do we measure audit quality? And obviously, then, that should be sifting down to the compensation issues. But right now I don't think there is a good sense there is a nexus, nor can there be, because there isn't -- we don't have any definitions of what those key audit quality indicators are.

MR. BECKER: Our thinking was -- and the group can correct me -- was if you develop those key indicators, you set up a framework, just as Lew and Jay described, that you can then go in and examine and ask yourself in the greater context of governance and compensation within the firm, whether that compensation -- whether those standards are being reflected in the compensation of particular audit partners.

MS. HILL: And I think if you start doing that, there is another factor that has to come in. As you know, audit partners are rotated every five years. And so if you are going to look at audit quality, I mean, I think you have to say, "Okay. What was happening during the first four years? Did something change during the fifth year?" There are so many factors that come into it when you start looking at all of these things that it gets to be I think more of a challenge if you don't really have a clear set of objectives.

I think the other thing is that when you take a look at the growth of the non-audit fees, it would be very important not to use a broad brush and say they are all growing, but to be able to do more of a deep dive, just say, "Well, where are those growth areas?"

I mean, I think you would look at every company and you would find they would be very different. It might be that they had to use the same firm on an international, you know, audit or something that -- you know, or an issue there of fraud or something.

So there is no clear-cut one way to do it, and I think we reached that conclusion, but there are a number of factors that we would hope people would bring into play.

MR. HARRIS: Joe?

MR. CARCELLO: So wasn't that fun, Jim?

(Laughter.)

I have a question for Norman and, really, a comment as well, and then I guess either Brandon or Ann.

Looking at this information, Norman, on non-audit services, I think there are two issues. And I think we have hit them but maybe haven't tightly delineated them. One is the growth of non-audit services for audit clients, which is really all you can get out of the proxy statement.

And, clearly, that is going up in magnitude. And whether it is a problem or not, you know, different people can be the judge based on these numbers. But then there is also another issue, which in my opinion is more insidious, and I think this is the issue that Mike got at, and that is the growth in non-audit services for anybody, whether it's an audit client or a non-audit client.

And I always like to take things to an endpoint, although endpoints don't usually happen. If non-audit services are growing at six to eight to 10 to 12 percent a year, and audit services are essentially flat, and if that continues for an extended period of time, at some point you have a situation where non-audit fees or what I would call essentially consulting fees are 60 or 70 or 80 percent of total firm revenue, and audit revenue is the balance.

And at that point -- and maybe --

I think this is what I heard Mike saying; I couldn't agree more -- at that point you have a consulting firm that does a little audit, not an audit firm that does a little consulting. And those are fundamentally different animals.

And I think the Board -- I don't know if there is an action they need to take now, but I think they need to be monitoring that.

And let me get my other question, and then if you want to comment, Norman. And then my other question would be I guess either for Brandon or Ann, and you are talking about audit quality indicators.

And I couldn't agree more -- we have had -- as the Board knows, we have had previous conversations around this -- at least one that I remember, maybe more than one -- at the SAG. And it was an interesting conversation, but we didn't get real far.

But one of the things that I think

it is important to think about with audit quality indicators is to clearly define or differentiate between inputs, process, and outputs, because the firms will be very, very happy to give you all kinds of inputs. And they will tell you how wonderful all of the people are that they hire, and how much they spend on training, and on and on and on and on.

And I'm not saying those things aren't important, but those are already in their transparency reports. You allude to that on your last slide. A lot of this already exists in the transparency reports in Europe, and the major firms have started producing that report voluntarily in the United States, or at least they did it a year or two ago. I don't know if they are still doing it.

Process -- they will give you some information on that, but not quite as much as inputs. When you start talking about outputs, which is what I think investors care about, at least that is what I would care about if I was managing money, they don't want to go there. And it is a lot harder -- I'm not saying it's easy -- it is a lot harder, but I think that is what matters.

And so I think to say we are going to do audit quality indicators, it is going to be a bunch of input stuff. I don't know if you have really accomplished a whole lot. So I would be curious of Ann or Brandon's perspective.

MS. YERGER: We wrestled with this issue of, could we define what we were looking for, and the answer was no. I mean, I think our message to the Board is we think a concept release -- nice job, Bob --

(Laughter.)

I think the issue for us was it is time to issue a concept release and get these ideas percolating, get input from the marketplace. And I do agree with you that I think the investors are mostly interested in the output piece. But I suspect that the feedback on any concept release is going to be extremely mixed.

MR. BECKER: Let me just add that, yes, I think outputs is the place that you ultimately want to get to. But as an old bureaucrat, I think that if you could start with inputs and processes, even though you might be codifying that which exists, Joe, I think it would create a momentum that would get you further down the road. And that unless you start down that road, we will endlessly debate whether we should take the first step.

MR. CARCELLO: Let's start with inputs and process, because you can probably get agreement on that, and then eventually you probably get output.

MR. BECKER: That's my guess.

MR. HARRISON: I just wanted to first of all thank you, Joe, for in your typical fashion, you know, tabling an issue in an articulate way. I was probably -- in an articulate way. I was probably trying to get there earlier with some of the points I was making and didn't quite get it.

But I think you raise an interesting point about another reason for at least some inquiry and monitoring, if not concern, about the growth of the advisory practices, and that is the potential impact on the marketplace for audit services, because it is sort of the reverse conflict, if you will.

If a company has an established relationship with an auditor but is using two of the other Big Four for millions of -- or tens of millions of dollars of consulting and advisory fees year-in, year-out, when it comes time to revisit the process and perhaps select a new auditor, you have the issue then about, you know, the firms with which there is some established relationship on other fronts.

So in an environment where issues

of mandatory rotation or other initiatives are being discussed, that are designed to, you know, preserve the marketplace for audits, objective audit services, I think that is a very relevant concern. I appreciate your raising it.

And then, on your second point about the outputs, I think you saw in one of our slides that one of the areas that we think would be -- it may, again, already be part of what you do currently, and there may just not be that much public visibility on it, but I think it would be in the area of compensation a question worth examining is whether failures to deliver a good product and a good service to a client, and whether they are documented by a PCAOB inspection or by some form of internal quality review, whether significant failures in an audit have consequences in terms of compensation or advancement or other performance metrics.

So I think that is part of what,

you know, we intended to raise as an issue in our presentation.

MR. HARRIS: Damon, you might address the definitional issues involved with audit quality.

MR. SILVERS: Well, I was going to make an observation. I'll come to your request in a second. I was going to make an observation about the "been around a long time" part of this.

(Laughter.)

I have been party to both -- more than 10 years of conversation in this standing -- no, it's not more than 10 years. It feels like that. I guess it's eight years of conversation in the Standing Advisory Group here around these issues.

The presentation refers to the Treasury Department Committee on the future of auditing that a number of us were involved in. You know, while there are obviously voices from audit committees and from audit firms that had concerns about the issues around quality indicators and around the fraud center, these have really been the consensus position of investors and of I think a variety of voices within the profession for some time now.

And the question I think that bring -- that having this discussion again about them really raises is, I mean, at what point is "yes" going to be taken for an answer? I mean, I think that is really the issue here.

On the other hand, I am sort of profoundly disturbed by the findings in this presentation about non-audit services and the role of non-audit services in compensation.

When Sarbanes-Oxley was enacted, as a number of people around this table well know, there was I think an openness on the part of the drafters of the statute, and of the Commission at the time, which were made up of people who were very serious about ending conflicts of interest, significant conflicts of interest in the auditing profession, there was a kind of willingness to be reasonable about, you know, allowing certain exceptions and things around the margins.

This report really suggests that as a result that has turned out to be an excuse for really not making the cultural change that Sarbanes-Oxley was designed to make. And there is an alternative approach to this, and I think that in addition to doing what this proposal -- what this presentation suggests, which is to look into the impact of compensation arrangements around non-audit services for audit partners, that's something the Board absolutely needs to do.

There is another way of dealing with this, and that way of dealing with this is to insist on the audit-only firm. And it seems to me that, you know, enough is enough. If being reasonable is not -- if the major firms don't understand the idea that reasonableness on the details entails seriousness and commitment to cultural change on the other hand, if that is beyond people's understanding, then I think it is time to talk about less reasonable solutions.

Now, Steve, your question about the metrics of audit quality. There is of course a kind of view that thoughtful people know a quality audit when they see one, and that, thus, it is -- and that it goes to the whole nature of the interaction of the audit team with the preparers of the financial statement, with the audit committee, and that it is "hard to measure that."

And at one level that is -- at one level that is true, as is true of almost anything in life that's complicated. The best type of assessment is a kind of qualitative assessment by very experienced people of the kind of the intangibles of a process.

But that being said, when we looked at this matter at the Treasury

Committee, I well remember the many conversations about a whole bunch of -- whole list of quantitative metrics that could be brought to bear on the quality of an audit, ranging from measures of the seniority of the individuals involved, the time involved in comparison with the size of the firm, looking at the -- when you have a longstanding audit relationship, looking at issues of restatement and the like over time, if one is looking -- rather than looking at particular issuers, if you'd look at the question on an audit firm basis, comparing a variety of sort of after-the-fact problems against, you know, on a firm-wide basis, obviously starting with things like restatements.

There are a whole wide range of quantitative measures that can be deployed here. These are the sorts of basic kinds of metrics that I think are generally used in business to evaluate business processes. It is a little unclear to me why we wouldn't --

so it's unclear to me why we wouldn't want to have such basic metrics in auditing.

I think that does not mean -- that should not relieve either investors or boards of the requirement to engage in a much more sophisticated qualitative type of assessment, as is true in evaluating any other process. But to not have any quantitative data organized in a manner that tends to address audit quality strikes me as sort of not having the foundations in place.

MR. HARRIS: Bob?

MR. TAROLA: This is a tough question, and I commend the task group for putting it on the table the way they have. And it is -- I think it is totally appropriate that they were unable to come to some clear conclusion.

In terms of audit quality, so much of the audit is now done by some -- by specialists in particular areas, whether it is security valuation or actuarial measures or operational assessments or technology control assessments, and if we are going to have quality audits, you really need people who are experts in those fields doing those assessments.

Does one stay an expert if they are an adjunct to a process or a service? Or do they stay an expert because they are personally sought out by other customers to do similar things in that field? And that is the dilemma I see, because if the auditing firms were forced, if you will, to be audit-only, and, therefore, narrow the field of experts they might have available to them, I'm not so sure that would improve audit quality.

JUDGE SPORKIN: You preempted me. I was going to say the same thing, that, for example, I want the forensics to be used in the audit. I mean, if the audit-only is going to be looking strictly at financial, they are going to miss a whole lot. I have now been experimenting with a client of combining the forensic with the financial audit.

And there might be other areas like that, like where Bob just mentioned, but -- and so I don't want them to be that sterile. I really don't. I think they have got to have these other -- you can't say we are not going to be looking at whether there is fraud or something else, if something like that occurs.

MR. HARRIS: What is the reaction of your client with respect to combining both the financial and the forensic?

JUDGE SPORKIN: It has worked like a -- we have done it now for four years, and it has, as far as I'm concerned, worked like a charm. The clients like it. They thought the big problem was going to be that clients wouldn't pay for it. But now with FCPA, and all of these other problems, they love it. They think it's terrific.

And as soon as I get released, I'd like to write about it, because I do think it is the thing to -- you can't separate the two anymore. I mean, this concept that a financial audit is going to look at materiality, look at only the finances, and the heck with corruption or fraud or anything else like that. I mean, if you want to look at what the public wants, what the investor wants, he wants to know whether the company is -- you know, if they are getting a good count, is there dishonesty involved, or anything like that?

They are not going to be -- it's too long now since we have heard about, "we are financial auditors; we don't care about these other things." And it is coming back to haunt both the clients and the accounting profession, because when they say, "We are only going to look at the financial, we are going to look at materiality," well, what happens in a big firm when the government comes in and sues them for dishonesty, as recently happened with the Federal Government coming in and suing a company?

The financial auditor can't say, "Well, that's too small. It is only going to cost so much." That's not true anymore. And that, you know, goes into 10A and everything else. But it is -- you know, you've got to have a robust, broad-based auditing firm that can deal with the appraisal values, values of inventories, and what not, that takes expertise, and an accounting firm needs it.

MS. ROPER: Can I jump in just a minute?

MR. HARRIS: Sure.

MS. ROPER: I want to actually take the liberty of speaking up for Damon, since he had to leave the room, and I have been in enough of discussions with him on this particular topic. Damon absolutely believes that looking for fraud is part of the audit.

When he is talking about audit-only, he is not talking about an audit that doesn't look for fraud. So I think that is a fundamentally different issue from one that involves non-audit services, in the way that at least Damon is framing the issue.

And then, just also -- and I will just keep this brief, because I deal with this -- for those of you who aren't sick of it yet, I deal with it in the next session as well. But when you look at non-audit services, one of the things you have to recognize is after -- when the rules were written after SOX, the SEC went in at the behest at the accounting firms and redefined a lot of non-audit services as either audit services or audit-related.

So the pool of services that is in the audit services -- one reason those audit fees went up is because a lot of other stuff that they were doing that were previously not counted as audit fees were now in the audit fee category. So to the degree that there is growth, the problem is more significant than it would otherwise appear if you don't recognize that change in definition that occurred.

MR. FERGUSON: Well, you know, when we talk about non-audit services, oftentimes the discussion is in terms of what is the growth rate and what is the proportion of revenues. And I, frankly, don't think that is terribly meaningful, because I'm not sure that that is really how businesses govern themselves.

One of the things that I have both thought about and have urged the PCAOB to think more about is to look at things like, what are the relative profitabilities of these various lines of business? What are the changes in profitability? What is driving the growth? Where is investment in the firm going? What are we investing in? Is investing in a new line of growth taking -- moving investment dollars that the firm has away from other things?

But, you know, having the kind of

deepest understanding of what the economic drivers of the profession are, and which in the final analysis are profitability. They are not absolute growth; they are profitability. That's what these people are in business for.

And part of the reason they are driven by profitability is that they are very concerned about the fact that if probability starts to fall in the firm, they won't be able to attract good people, because the people who are the best people have options. They can go to other professions where people make more money.

So I think it requires -- if you really want to talk about this stuff, it seems to me you really need to have a very deep and a pretty subtle understanding of what is going on here. It is not just about growth and percentages, it seems to me.

MR. HARRIS: Mike? Sorry, Norman, did you want to respond?

MR. HARRISON: I actually did want to respond, and thank you. I take your point completely. And, obviously, under the current regime, those of us who don't have inspection rights don't have a lot of insight or visibility into those topics.

There is another slide at the end of our presentation which at least indirectly raises this issue, and I just wanted to point that out to everyone -- that another topic that has been out there for some time is the question of whether the Board should require some more formal and detailed financial disclosures by the auditing firms, which perhaps would give us at least a little bit more insight into some of the issues Lew touched upon.

MR. HARRIS: Mike?

MR. HEAD: Thank you very much. And, Barb, this is one where you and I are passionately on the same page with, on what should be in scope of audit because it's not just forensic or fraud, it is not just actuarial, it is not just -- it is technology, it is whatever that industry -- if you go from insurance to financial services to manufacturing to defense, you know, you pick an industry, you pick a group of potential audit clients, that firm needs to have the deep expertise to provide all of the related business analysis and understanding, so they understand the risk factors and understand all of the risks that they are facing, so that they know that they are looking at all of the right things to come up with a judgment on the financial statements.

And technology is probably just as big as forensic, and we like to characterize those as general computing controls and applications. But, you know, it is all of that has to be part of the scope.

So in my definition, when you talk about an audit-only, it is not changing the expertise that the firm needs to bring to the table at all, it is a matter of them understanding that they are providing all of that expertise for audit and audit-related services only, not on a consulting basis, and, therefore, they are eliminating a potential for conflict or revenue.

And the part that makes me a little nervous here, and someone alluded to it earlier, where if non-audit services grows from, you know, 80 percent to -- or audit services decline and non-audit grows to 80 percent, eventually the end state is they will choose to get out of auditing, because that is not the way you run businesses. How do you make money?

And if eventually auditing isn't making money, and one potential solution is you eliminate that conflict, potentially, while allowing them to have the expertise, that is why firms will say, "Okay. We just went through a merger. We are talking about needing to eliminate independence and remediate, because we have to decide what firm is going to do the audit work on the new merged firm."

And believe it or not -- you probably do believe it -- post-Sarbanes-Oxley, firms would say, "We choose not to bid on the audit work because we don't want to remediate the conflicts," because it is much more profitable for us and we don't have the litigation risk with those services.

Therefore, it is not, is the audit committee going to consider the RFP? They just walked away and said, "We're not even going to give you an RFP. You asked us to give you one. We are not going to because we don't want to remediate or eliminate this conflict." And the only choice the company would have in that case is to say, "If you don't RFP on the audit work, we are not going to give you the non-audit work."

Well, you know, that makes no logical sense at all. So I really -- you know, Barb, we talk off and on a lot. This is one where I'm not saying I'm definitely a proponent of audit-only. But as soon as -- non-audit services really has nothing to do with expertise and knowledge and understanding of the business.

It is: what are they focusing on for you on delivering services? And what do they feel like the revenue sources for you are? And it should not be distracted from the audit services, because then it creates a potential conflict on, are they focused on audit quality? Are they focused on revenue and profit maximization for their firm?

MR. HARRIS: I think we are going to get into a lot of those issues in the next session as well. Joe?

MR. CARCELLO: Steve, and others, there may be intermediate ground between what we have now, where as best I can tell the firms will perform a wide range of services as long as it is profitable and growing, versus audit-only, right? Those are potentially two endpoints.

The argument around allowing firms to do services beyond the audit, and not going to audit-only firms, is they do need a broader skill set. So one argument might be to -- where those skill sets are part of the consulting practice, not to be as troubled or not to discourage them -- things like valuation, actuarial fraud, systems tax, those certainly seem to be core skills that you need to do effective audit.

As we were sitting here, I pulled up my handy-dandy iPad, Ann, and I pulled up one of the Big Four firms. And I won't mention the name because we could use any of them, they would all be the same. And performance improvement, finance, supply chain, customer, it's not obvious to me how doing that makes me necessarily a better auditor.

Transaction services, corporate

development, lead advisory, restructuring, operational transaction services, transaction support -- I'm not sure how that makes me a better auditor.

Human capital consulting, global mobility, performance and/or award -- how does that make me a better auditor?

I could give more. I could give more. You get the general idea.

So some of these services are there to make money. There is nothing wrong with making money. But that, at some point, potentially compromises the culture of an organization, where with an audit the focus should be on the benefit of third parties, benefit of investors. With consulting, you should be a client advocate. That is why you're there. Those are fundamentally different mindsets.

MS. HILL: Steve, a quick question here, or at least a comment. If I were one of the Big Four, Five, Six, whatever you want to call it, and it came down to, well, you can't do absolutely any other functions outside of audit, whatever "audit" is defined as, why not just spin off, have another company set it up independently, you know, completely separate.

You've got a whole other revenue stream, and what you've done is just simply set up another business to do the business that you can't do as an auditing firm. I mean, come on, that's what a lot of the HR firms did when they were told they could do no other work for, you know, the company, if they were working for the compensation committee.

So what happened? You spin off and you set up another business. I think we probably really need to get real about what we are doing and what is going to happen and what the end result is, because people just find ways to get done what they want to do.

You know, and then you will have another body sitting around talking about the consulting firm that has been spun off and whether or not they are doing the right things and did they leak into audit. I just have concerns about how far we continue to go and what the real purpose is. What is the intent? What are we afraid of?

I mean, I know the concern in terms of fraud, and maybe nobody is keeping their eye on the ball, because we are doing so many different things. But there must be ways -- Joe, you said somewhere in there there is a middle ground. There probably is a middle ground, but right now I don't think we are touching on it, and it's just a personal feeling.

JUDGE SPORKIN: I really think we are onto something here. Why would I want to combine forensic with the financial audit? It's because, to take care of looking for the fraud, and the concept came about because the firm has a forensic group, and they have a financial group. But they weren't -- the forensic group was doing other clients.

And the concept was: why can't we use them for this client? And I do like the fact that you can have a broad array of services being performed, so long as they are not being performed for this client. There is no reason why they can't be engaged in valuation and these other things, as long as it is not being done for the client.

They have to erect a wall, so that they cannot be doing that for that particular client. For that particular client, it will be audit-only and with -- I would throw the forensic in there, but not do the -- I wouldn't do tax. I think that ought to be done somewhere else, because tax involves strategies, and what not, that I do believe can be detrimental to a financial-only audit.

But, yes, we are going to have to -- one size doesn't fit all. But we are going to have to be a little bit strategic and say what is it that -- where do you draw the line? And I think you can draw the line.

MR. HARRIS: Judge, what are the cost implications to the issuer?

JUDGE SPORKIN: Well, the cost implications to the issuer are, it seems to me, if they are not going to be paying for these other services, it so happens that the forensic -- they like it, at least -- because of the money laundering, because of the FCPA and other things, they want to have some assurance that their people are not engaged in that kind of stuff. And this the auditor can do. They can perform those services. And they can give you what the public wants.

If you look at any man on the street, he thinks an accountant is going to ferret out fraud, right? He is not going to think that they are in there to give you just what the Generally Accepted -- they don't know what a Generally Accepted Accounting Principle is.

And so they are looking for those kinds of things, but I don't see any reason why you cannot have -- you do want a healthy firm. You do want a firm that is robust and can do some of these other -- making it in another areas. There is nothing wrong with that. But I do think that you -- I think the concept of audit-only, it might sound right, but I don't know if it's the right way to go.

MR. HARRIS: I think you might have a tough sell with the business community. But once you got your client able to talk to us about the model that you are talking about, I think the Board would --

JUDGE SPORKIN: Well, they're not going to pay for it.

MR. HARRIS: -- be very open and look forward to seeing it.

And then, finally, I would like to raise one issue, get back to what you brought up, Ann, and Brandon as well. We are budget-constrained, as you know. You brought up the Center for Excellence and the Fraud Center.

We do have it in the strategic

plan, but could you go over once again -- Jeanette is new and other Board members have not heard -- you lay the foundation aggressively for it. What is your rationale for it in a budget-constrained environment?

MR. BECKER: We think it goes back to the conversation begun this morning about getting the basics right, and to what Judge Sporkin just highlighted in terms of protection from fraud, getting the numbers right.

And while we recognize that the overall work of the Board and its inspections helps contribute to that, we think that more targeted focus -- fraud aspects, forensic, or otherwise -- will help propagate an educational process.

It will strengthen the focus of fraud and preventing fraud, and it will respond both to an investor concern, because while investors have a wide range of concern or interest in future earnings, I wouldn't speak for all the investors here, but most fundamentally we want to know that the numbers, even the historical numbers, are correct.

So that verification process is sufficiently critical that we think it is worth the Board considering a more targeted focus on fraud and the historical assessment of how that happens and what steps we would expect the accounting profession to take to try and prevent it in the future.

Let me just pause and see what my colleagues want to add.

MR. HARRISON: Yes. I would agree with everything that Brandon just said, Steve, and I understand -- I think targeting is an important idea, especially given the budget issues that you alluded to. But I think there is also value in a -- sort of a retrospective and a compilation of lessons learned.

I think also, though, that, you know, there can sometimes be, in exercises like that, too much of a focus on solving the last crime. And so I think that, you know, some balance in the approach -- it occurred to me as I was thinking about this the other day that there are areas now that are very clearly targets of enforcement by the SEC and by the DOJ.

The FCPA comes to mind. I mean, we are in the midst of a third or fourth annual year of enforcement actions being commenced at record rates in the area of FCPA enforcement, and it is a good example, perhaps, because FCPA violations take the form of activities that hit the financial statements and impact the audit process in a couple of ways.

One is that there are improper payments, illegal payments, allegedly being made that are not correctly being accounted for. Attempts are made to conceal them in the accounts and the records of the enterprise.

And, secondly, in most cases,

there has been some breakdown in or some absence of an internal control environment where the process around requesting and obtaining approval for, and obtaining authorization to remit payments to consultants or advisors or other intermediaries who then pay the bribes are absent. So there is an internal control implication.

Something perhaps that the Center for Excellence or Fraud Center could do would be to -- as a trend, as an enforcement trend begins to emerge, to serve as a clearinghouse or a source of guidance or information on best practices relating to the audit process. That might help raise the bar or enhance the ability of the profession to advise their clients or conduct better audits of companies that are in exposed industries. So just --

MS. HILL: Steve, you mentioned resources, and the whole concept of an audit fraud center makes it sound like really an expensive endeavor. It might be that, at a bare minimum, you could begin by making an assignment somewhere within PCAOB where there might be capacity to take on this kind of an assignment, and then to begin to grow it as long as, you know, there is a way for the function to be done.

I wouldn't want you to think we are thinking of, you know, a really -- I don't know what the recommendation was, but --

MR. HARRISON: A new building.

MS. HILL: -- in terms of the building --

(Laughter.)

-- yes, building a center, or what have you, but perhaps in some way assignment could be made to begin work on it where you might have some young people, because that is -- all of us would like to be young people starting out -- who might have a real interest in this and could do it perhaps on an internship basis or something to begin. But we think it is important to be able to help start this process.

MS. YERGER: At least from my life experiences, there has been no greater teacher than my past mistakes. And that is why I think it is so important that there be some, whatever we want to call it, center, division, something, that focuses on this particular issue. And I appreciate that it is something that the Board does routinely as part of its work, but it is just, I think, raising it, moving it to a higher place where there is some focus.

And I guess I might respectfully disagree about whether I think it is the appropriate place for a whole lot of, you know, right-out-of-school interns to tackle, because I think experience is a value sometimes as you are exploring some of these issues, especially complex ones that might be resulting from fraud.

MR. HARRIS: Well, I have said it before, but I want to say it again. I very much appreciate the effort that has gone into each of the panel presentations. I know how much work it has been throughout, and we are three for four, and I know that we are going to be four for four in 15 minutes.

So I would like to take a 15-minute break and convene back here promptly at 3:30.

Thank you.

(Whereupon, the above-entitled matter went off the record at 3:14 p.m., and resumed at 3:31 p.m.)

MR. HARRIS: Saving the least controversial until last, our final presentation is by the Working Group that has been examining auditor independence, objectivity, and professional skepticism. Barbara Roper led this Working Group and members included Kelvin Blake, Judge Sporkin, Eric Vincent, and Meredith Williams. Barbara, thank you very much and take it away.

MS. ROPER: Sure. So, obviously,

this is a natural segue from our last panel, which dealt with a number of issues that relate to independence. And just in preparing this presentation we took sort of -- we did not come here with specific recommendations on the policy proposals that are before the Board. Instead, we thought we'd take a historic look at the issues as they've developed over the years and how that informs a discussion about the proposals that the Board is considering, so open that up to get a broader set of viewpoints in the second half.

So, I thought it was useful to start with a reminder. We throw around this word about auditor independence. What's the basis for that? And the Supreme Court decision in United States v. Arthur Young says, "This public watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."

And one of the things that struck me as we talk about these issues about independence is how far we are from that ideal. I mean, even in the strongest, sort of most extreme proposals in this area, no one is really talking in any meaningful way about getting to total independence from the audit client at all times. So, I think that's worth keeping in mind as we consider these issues.

Second, when the SEC was updating its auditor independence standards in 2000, one of the things -- it talked about why independence matters. Why do we care? And they talk about two goals; one is to foster high-quality audits by minimizing the possibility that any external factors will influence an auditor's judgment. And it seems to me that when we talk about this issue we spend a lot of time, I think appropriately, focused on this issue of: will the reforms we're discussing lead to higher quality audits?

But the other related goal that the Commission talked about is to promote investor confidence in the financial statements of public companies. Investors are more likely to invest and pricing is more likely to be efficient the greater the assurance that the financial information disclosed by issuers is reliable. And I think, again, it's worthwhile as we're thinking about that to ponder how confident do we think investors are today in the reliability of the financial statements in the independence of the audit, because that matters, independent of the issue of audit quality.

And then just more generally, taking this issue one step forward, why independence matters. In sort of a fundamental way, the audit has no value if it's not independent. You know, if it's just another set of eyes confirming management's view, they have -- we have sort of an internal financial reporting function at companies to provide that. We look to the auditor to provide an outside objective, skeptical view of that information. And that has become more important, not less, as we move to more principles-based standards, greater reliance on judgment.

And, yet, we have this basic conflict in the business model, the client pays business model, that says, in essence, we've decided we're not going to have a truly independent audit, so the auditor independence rules are really designed simply to minimize the conflict, mitigate its effects and promote objectivity and professional skepticism in the conduct of the audit. And so really, independence, in my view, at least, is sort of a means towards an end. It is the role of independence in promoting that professional skepticism that's what we're really talking about here.

In looking back over this issue,

one of the things that struck me is just how long we have been having various different versions of this debate. So, 1977, in the wake of the scandals at Penn Central, you have Senator Lee Metcalf and his Subcommittee publishing a report in which they express grave concern over the alarming lack of independence shown by the large accounting firms. And in that, they discuss both the issue of non-audit services and the long tenure of audit engagements.

There was at about that same time, I don't have a slide on this, but at about that same time, so Congressman Dingell was having hearings in the House Financial -- I mean, the House Energy and Commerce Committee about auditor conflicts.

There was an up-and-coming young man who gave a speech at the American Accounting Association at that time in which he talked about the need for realism in financial statements. Stanley Sporkin talked about how the accounting literature is now replete with cases where the independent auditor simply ignored facts which they knew or were readily available to them, and one of his ultimate recommendations was that in all instances, an accountant should maintain a healthy skepticism. So, that was 1982.

So, when this came up at the SEC in response, in part, to the hearings that Congressman Dingell had been holding, the SEC actually issued a report in 1994 indicating that they didn't think any fundamental changes were needed at that time. But what you see soon after that is, you know, a real change in attitude at the SEC, and evidence of growing concern at the Agency, so that in 1998, I think Lynn referred to this earlier, you have the numbers game speech that Arthur Levitt gave. And what he was talking about there -- it's actually not primarily on accounting. He's talking about the pressure that companies were feeling to make the numbers in terms of earnings estimates, in a market where missing the numbers by a penny or two could have dramatic consequences for companies.

He talked about a game of nods and winks between corporate managers, auditors, and analysts in which the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation.

And then there's another change directly related to what we were talking about earlier that started to occur over the 1990s, and that was the growing importance of consulting services within the audit firms. The consulting services were both becoming more important to the bottom lines of the audit firms during that period, and to individual auditors' compensation and advancement within the firm.

So, you saw a progression from where 1991 you had consulting revenues just 13 percent of total revenues. By 1999, for the

Big Five firms, consulting services accounted for roughly half the revenues. And you would see this play out in some fairly dramatic ways with specific audit clients.

There was a 2001 report which said that, as a general rule, companies were paying $2.69 in consulting service fees for every $1.00 they were paying in audit fees, but at certain companies you see this much more dramatic skewing. And you can see some of the examples here; KPMG's audit of Motorola, $3.9 million for the audit, $62.3 million for other services.

And, obviously, these were the extreme examples but they weren't isolated examples. There were actually a fairly surprising number that had sort of this dramatic skewing between the role of the audit and the role of the consulting services.

And at that time, Arthur Wyatt, who had been with Arthur Andersen for years gave a speech at the AAA Conference in 2003.

He's actually looking back now, a retrospective of what he'd seen happen over those years leading up to Enron, and he talks about how the firm leaders in this environment where consulting services were becoming more important had failed to recognize how the widening range of services was impairing the appearance of their independence, but also how certain services were changing the internal culture of the firms, which is something I think Mike was getting at with his comments earlier; that he said in that environment you started to see within the firms a growing focus on revenue growth and profit margins, and that, as a result of that, that the auditors were more willing to take on additional risk in order to maintain revenue levels, that clients found it easier to persuade auditors to see issues their way, and as he said, healthy skepticism was replaced by concurrence. So, this was sort of the insider's view at that time of what effect this growing role for the non-audit services had played within the audit firms.

And one of the things that we saw -- we tend to think -- you know, we talk about Enron or WorldCom, in fact, at the period right before Sarbanes-Oxley, we had seen just a dramatic increase in the number of restatements, so we'd gone from 33 restatements in 1990 to 157 in 2000 to 233 in 2001, so this was not -- you know, when Congress started drafting Sarbanes-Oxley, yes, they were intimately focused on Enron, but they were also looking at a broader phenomenon that had occurred where there seemed to be indicators that the audit simply was not providing the effective assurance that it had in previous years.

So, in that environment and before Sarbanes-Oxley Act, the SEC took some actions. They had started throughout the '90s to start raising questions about these consulting services, both particular consulting services that they thought were in direct conflict with the auditing role, and with the amount of money that firms were getting from the non-audit services.

In July 2000, they famously proposed their rules to limit non-audit services. They actually had a list of non-audit services that they wanted auditors not to be able to provide to audit clients. They also addressed some of the issues with regard to financial relationships between the auditors and their audit clients, such as receipt of contingent fees. And in that regard, they added an express prohibition on contingent fees.

Now, we've seen in the current environment where we're talking about audit rotation, mandatory rotation, a dramatic response from the accounting firms in opposition to that proposal. It is nothing, in my view, compared to -- maybe we haven't seen it all yet, but compared to the response that they launched to the SEC rule proposal on these non-audit services. Massive lobbying campaign, really sort of scorched earth rhetoric, they were going to members of Congress, getting them not only to write letters to the SEC in opposition, but to include riders on Appropriations Bill to defund the effort if the SEC insisted on moving forward with the independence rules.

And in the end, the response was that the SEC significantly watered down those rules, so they took certain of the services off the prohibited list, including internal audits, financial system design. They opened up loopholes in some of the other services that were on the list in terms of the definitions. And one of the things they did -- the way the rule had initially been written, it spelled out certain principles for determining auditor independence, so that, beyond a list of prohibited services, you'd also have sort of a general principles-based standard for what was and what was not a permitted service. And that was moved out of the language of the rule itself and into sort of a more guidance role, sort of making it less prominent, less enforceable.

And then shortly thereafter, Enron implodes, and in imploding brought renewed attention to this issue, in part because Enron was sort of Exhibit A for all of the things that people had been talking about for years, for decades even, when they talked about issues of concern about lack of independence in the independent audit.

So, there came out in various different reports evidence that Arthur Andersen had been aware at various different times of questions, had had serious questions about some of Enron's accounting, had dismissed it as not material, had perhaps helped design some of the transactions that were keeping debt off the balance sheet, viewed the audit engagement that Enron is too big a client to lose, certainly for that particular office, had been both the internal and external auditor and had lobbied heavily against having internal audit on the list of prohibited services, had been Enron's auditor since 1985, so long tenure, had the revolving door so that the Chief Financial Officers, Chief Accounting Officers at Enron were alumni.

And the press accounts at the time, they talk about this chummy atmosphere, so Andersen had office space at Enron, and the Andersen employees were wearing the Enron T-shirts and they're drinking from the Enron coffee mugs, and they're going on the Enron ski trips. And they describe a culture in which there doesn't appear to be any sort of meaningful cultural division between the company being audited and the auditors who are responsible for that review.

So, just quickly, I mean, Enron was sort of the Exhibit A, but there were a number of contemporary examples -- there were a host of accounting scandals at the time. There were a number of contemporary examples where you saw the same kind of things; auditors who were applying for jobs at the company they were auditing while conducting the audit; compensation based on the auditor's ability to cross-sell non-audit services.

And then, again, I won't run through them all again, but again Waste Management was another example where really every single one of these features that people were focusing on as a concern about auditor independence was evident in that particular case.

So, it was in that environment that Congress set about writing the Sarbanes-Oxley Act. And at the time, certainly, if you go and look at the legislative record there is a huge amount of testimony that's focused on this issue of: how do we promote auditor independence?

And the Senate -- the report for the Senate Banking Committee, Steve probably wrote it, says: "The issue of auditor independence is at the heart of this legislation. Public confidence in the integrity of financial statements of publicly traded companies is based on the belief in the independence of the auditor from the audit clients."

So, when you look at the Sarbanes-Oxley Act, there's a section of the Act, Title II, that is called "Auditor Independence." And it's there that you find -- so, they took the SEC rules that they had previously approved on prohibited non-audit services and they both codified it and basically restored the original list, added back in the things that had been deleted, closed the loopholes that had been added into the definitions of the various different services. They added in the concept of audit committee preapproval of audit and non-audit services, mandatory partner rotation. I mean, you all know the list, all of the things that we've been talking about since SOX that have been put in place to improve the independence and oversight of the audits.

There are also, scattered throughout the legislation in other places, provisions that definitely distinctly relate to this issue. For example, the provisions making audit committees responsible for appointing and paying the auditor, overseeing the conduct of the audit, strengthened independence and financial expertise requirements for audit committees, and not least, the PCAOB responsibility both to set standards in this area and to inspect for compliance with those standards and bring enforcement actions for violations of those standards.

I throw this slide up here just to make the point, if you look at the legislative history, there was a lot of testimony in which people recommended independence reforms that are not included in SOX. There was strong advocacy at that time for things like a total or much broader ban on provision of non-audit services to audit clients, mandatory rotation of audit firms. There were discussions of ideas about how you could put a third-party, like an exchange or someone else into the role of hiring the auditor so that the -- get rid of the client pays model, more robust provisions related to cooling off period. So, even at the time when SOX was adopted, there was a pretty extensive record in favor of going beyond the reforms that were on auditor independence that were actually included in the legislation.

And then we came to implementation. And I'd sort of forgotten before I went back and got out my files on this just how really annoyed I was at the time. It's nice to know that I'm not just cranky now, I was back then equally distraught that when it came to the SEC to implement some of the rules on the legislation, a number of things that the audit firms didn't win from Congress, they got almost immediately from the SEC. So, there had been an issue of: could you pre-approve non-audit services through policies and procedures? Congress had said no, SEC said yes, and they not only said yes, but they said pre-approving through policies and procedures was just as good as explicitly individually approving them.

The SEC, in their initial rule proposal had talked about the role that the principles for auditor independence would play in an evaluation of the approval of non-audit services, the final rule, any suggestion that audit committees were expected to look at those principles for independence in evaluating audit services was gone.

There was also the change I -- there were some others, but the change I mentioned earlier, there was no requirement in

SOX that the SEC go back and look at these categorizations, these disclosures firms were required to provide about what they were paying for audit and non-audit services. But the accounting firms lobbied heavily to get those definitions changed, and what they did then is go in and take a number of services and either classify some audit-related services, the audit services and more of the non-audit services into an audit-related category, so that what was left in the pool of non-audit services was much smaller. And, also, any ability to compare pre and post-SOX this percentage of fees for audits and non-audit services sort of went out the window.

And Jonathan, I'm pretty sure it was Jonathan Weil, wrote a column at the time when this had come up, the SEC was describing its rules, and they said that they had adopted these changes in response to public comment. And the SEC, he said, asked who outside the audit firms had suggested the change? The SEC official said it would be a good time to move on to a new topic. This was something that was actually strongly opposed by the investor groups in the proposal but was adopted in the final rules.

So, right after the -- shortly after this all went through the implementation process, we actually got our hands on this document, and it happens to be an Ernst & Young document. There's no reason to believe Ernst and Young was alone with this. This just happens to be where we got the documentation; how they were presenting this new responsibility to audit committees for their clients. How you're -- let us provide you with our guidance on how you should fill your role in approving non-audit services, in which they suggested that it was perfectly fine for the audit committee to just rubber-stamp through policies and procedures whole classes of services, suggesting that the SEC did not intend, having taken it out of the final proposal, that the non-audit services be reviewed in light of these principles for auditor independence, and encouraging the clients to group virtually everything into this audit-related service category.

So, at that point, you know, that soon after the adoption of SOX, a lot of these provisions that had been placed in the legislation were weakened. Now, that doesn't mean that audit committees followed this guidance. You know, I'm not here to suggest that this then became common practice, but my point is that at a point when the SEC could have sent the message that they were really serious about this, they sent a very different message. And we don't know what the effect was on how those decisions were being made at companies at that time.

And then beyond that -- I'm just going to go quickly through these, because everybody knows that. Beyond that, you have this authority for the PCAOB in terms of setting standards, conducting inspections, enforcement, and they have used that authority in all three categories since the Act was adopted and they were created.

They did new standards on tax services that had been hotly fought during the legislative battle, and they came back looking at at least limiting advice about tax shelters and some other related issues. They've also taken a number of enforcement actions since they were established. Kelvin actually went through all of the enforcement actions related to auditor independence and professional skepticism and looked at what some of the allegations were in those cases, and what the sanctions. Did you want to add anything?

MR. BLAKE: Sure, just to give you a break. As a state regulator who does both compliance audits where I issue deficiency comments to help the investment advisor or broker dealer better run their practice and provide better services to the investor. Also, as an attorney where I bring enforcement actions, I was very encouraged by the PCAOB's track record, I guess, not only in issuing perhaps hundreds of thousands of deficiency letters where you try to encourage the audit companies to better serve the client and the public, but also in the number of enforcement actions brought by the PCAOB. And in those enforcement actions, which there are 47 total, 27 of the 47 involved violations of professional skepticism. And that shows how seriously you take that type of violation.

But I was also encouraged by the level of sanctions imposed by not only -- against not only the accounting firm where you have in many instances revoked the registrations of the accounting firms, but also against the accounting professionals, where you have barred many of the accounting professionals for engaging in violations of independence or professional skepticism. So, I was truly encouraged by the actions taken by the PCAOB. Thanks.

MS. ROPER: So, you know, that's sort of the history of how we got to where we are today, which reflects both some -- as I said, some long-simmering concerns, some persistent pushback from the audit firms against any suggestion that dramatic reforms were needed, steps by Congress, by the regulators to address certain of the issues, and yet here we find ourselves today hearing from the PCAOB, from international regulators that they're still very concerned about what they're seeing in terms of lack of professional skepticism, objectivity, independence in the audits of public companies. And in the interest of time, I'm not going to dwell on these except to say that we're talking not just about problems in small audit firms, audits of small companies, they involve some of the largest issuers. And they see a direct connection in many of these cases between the serious deficiencies that are found and the lack of professional skepticism in the conduct of the audit.

One of the other things that has come out in some of the inspections are materials -- marketing materials in which the auditor is described as a partner with a role of supporting the issuer, where they would stand by the conclusions reached and not second-guess our joint decisions.

Now, I don't want to put too much emphasis on marketing materials, but this is actually something we've heard over the years a number of times, which is this idea -- it's come up in some of these -- like the Complexity Commission, this notion, or SAG discussions. We shouldn't be second-guessing professional judgments. But I think to me, at least, and maybe I'm alone in this but the point of the audit is to second-guess. It doesn't mean it always second-guesses and differs but it is, in fact, sort of a -- it should be an independent second look at the issues, not just finding a way to support management's position.

And then there have been a number of specific examples out of recent inspection reports, folks at the PCAOB and at some of the European and Australian auditor oversight boards. I thought it was interesting in the Netherlands where the Authority for the Financial Markets did -- took a look at the audits of Big Four firms and found issues related to professional skepticism. Their conclusion was that a fundamental change of conduct is necessary to improve the quality of audits. The point being that both here at the PCAOB and at the European Commission, the suggestion has been made that we're not talking about something where we need to be sort of tweaking the system, useful as that might be, but we're talking about something where regulators are suggesting that fundamental changes are needed to address what they see as a very serious problem.

In the European Commission, I look at their response to the financial crisis as if they're having their Enron moment. A lot of the issues that they're seeing in the wake of the financial crisis mirror the responses we heard after Enron, and some of the policies that they're looking at in terms of limits on provision of non-audit services are similar to the issues that we addressed earlier in the U.S. and are looking at now.

So, meanwhile, we have at the PCAOB the Concept Release that came out where we've had a little interest, 630 comment letters as of mid-March, which if not a record has got to be up there in terms of the level of interest it's prompted. And the comment period is still open, so it's not too late. And then we had last week a two-day roundtable here devoted to this topic.

Now, in the interest of full disclosure I should say that I have not, in fact, read every one of the 630 comment letters, though I have at least browsed all of the public statements from the two-day hearing which is no small accomplishment. There were how many speakers, 40 whatever. And some of them I read in depth. And what I've tried to do on the next series of slides is give a sense of what messages come out of those comments, because I think the hearing did a good job of at least getting all the various different viewpoints out into the public.

So, I mean, I think you see there's a vast majority of commenters agree that the combination of enhanced audit committee responsibility, improved communication between auditors and audit committees, and not least PCAOB's inspection and remediation authority have improved the quality of audits and of financial reportings.

There's hardly anyone who fails to acknowledge up front that they think they've seen improvement since Sarbanes-Oxley was adopted. Beyond that, though, you get this sort of the spectrum of views from a sense that really everything is pretty much okay, that maybe we -- it might be appropriate to do some tinkering with the system, but really the system is working just fine as it is, to at the other end of the spectrum people who still see just a fundamental breakdown, a fundamental lack of independence and a need to radically reform, get rid of the client pays model. And in the middle a group of people who agree system is improved but there needs to be some fairly significant reforms adopted. And it's actually in that middle category that I put the advocates of mandatory rotation because while that's being viewed as sort of a radical proposal that's out there right now compared to some of the other suggestions that are on the table it's really sort of in the middle range of working within the existing system rather than trying to go after the client pays business model in a more fundamental way.

So, I threw in the slides, and since you can read I won't feel the need to read them to you. A series of some -- pulled out just some of the quotes from different statements that are representative of those different viewpoints.

I thought this one was interesting just because it comes from a different sort of perspective, but it says, "From the perspective of auditor psychology the question before the Board is easy and obvious. Of course, the current system undermines auditor independence. Indeed, the very notion that the current system allows for truly independent audits is laughably implausible."

So, as I say, at one end everything is working fine. It makes me look like a Moderate. I love it. And Chuck Bowsher, you know, it's timely and somewhat overdue that the SEC and PCAOB consider additional issues that would further strengthen auditor independence in addition to the ones enacted in Sarbanes-Oxley legislation. I think it's sort of indicative of the middle ground in this discussion.

And then there were some -- there's much more than this, but there were some comments within the letters on specific issues. For example, Arnold Wright had research -- we've talked a lot about the role of the audit committee, research that indicates that management rather than audit committees still plays the dominant role in decisions about hiring and firing the auditor. Well, given that that was something that SOX specifically set out to change, if that's true, then that sort of invites the question of what we need to do to revisit what could be done to make that more effective.

And then again the issue that was raised earlier of expanding advisory practices, including into areas that are less aligned with traditional audit and tax practices.

And then you see the same divisions play out when you look at the comments specifically on mandatory rotation. You have the range from strong opposition particularly among certainly the audit firms, and to those who think it does -- that mandatory rotation doesn't go nearly far enough. So, too far, not far enough, maybe you have, in fact, found Goldilocks' Golden Mean.

When you look at those who support mandatory rotation, you have -- so, you know, some of the comments about getting a fresh viewpoint, I thought Peter Clapman's comments were particularly interesting because he's been through it. And he says, "Having participated in three auditor rotations the results were better audits, similar costs, and none of the dire consequences being argued by many of the commentators against the PCAOB Concept Release."

So, the positives that people tend to focus on are a new viewpoint, fresh viewpoint, and that limiting auditor tenure might -- if they have less to lose auditors might be more willing to challenge management.

There were -- among those who were generally supportive, there were those who were supportive with some reservations that mandatory rotation was really the complete answer. They saw it as a first step, or might make things better, but it wasn't really going to fully address the issue of auditor independence.

And here again you get a quote, Max Bazerman at Harvard Business School who says, "The choice should not be between the status quo and the reforms being proposed; rather, the choice should be between whether our society wants independent audits, or whether it does not."

And I think this, again, is back to that sort of initial point. We have an assumption about what we say we want in independent audit, and yet we don't actually pursue policies that are designed to create a truly independent audit, was his point, I think.

Among the commenters, a number of commenters, probably a majority of commenters who are opposed to mandatory rotation, the basic arguments are it impinges on the authority of audit committees, it increases costs and disruption, and it could undermine audit quality particularly during the transition to a new auditor.

There are also some more specific concerns raised that there might -- it might create an incentive for audit firms to invest -- sorry, reduced incentive. I was going to say that made no sense at all. Reduced incentive for audit firms to invest in the audit relationship when their time horizon is short. There were concerns, specific concerns raised that there aren't always enough audit firms available for certain companies, that not all audit firms have the same level of expertise in all issue areas, so there were some sort of practical concerns raised about the workability of the approach.

And then, as I said, there were some who opposed mandatory rotation not because they thought it went too far, but because they thought it didn't go far enough. And among these is Jack, whose last name I won't try to pronounce. Thanks, I always get it wrong. Who has a proposal that he's put forward for, as he would say, to try to align the interest of auditors with shareholders in a more fundamental way.

And then just beyond that, if you go through the audit, the comment letters and the comments at the roundtable, you know, when we were at the last SAG meeting I said something about don't just tell me if you're against mandatory rotation, don't just tell me why you're against it, tell me what you're for. And the reality of these comments is there are a lot of suggestions in here about what people are for, so even opponents of mandatory rotation have put out a number of very concrete specific suggestions that they think would help to improve the independence and professional skepticism.

Some of them have suggestions that are specifically related to making the rotation model more workable, such as requiring a dual audit by two firms in the year preceding the transition starting with just large financial institutions, requiring more reporting by the outgoing auditor.

There's another whole set of proposals that I've called tweaks to the existing system. And I don't actually -- I realized when I was looking back at it, that sounds derogatory, and I don't mean it as a derogatory term. I actually think there are a lot of really useful suggestions on this list that regardless of what the Board decides on the broader issue of mandatory rotation are things that ought to be under consideration.

And I did a terrible job of organizing them. There's no logic to the way this list is thrown together. I just started pulling them out of letters and threw them onto the list. But I encourage you to look through them with some detail, because on there I think there are some that are interesting. And one of them that came up in a number of contexts, for example, is -- reflects this desire to get more information to audit committees about the results of PCAOB inspections. So, we have -- there's a lot of discussion about creating some sort of system that would permit the PCAOB inspectors to discuss directly with audit committees the results on a confidential basis.

And, you know, some of the things you would expect about improving training, and communication, some that I found troubling because it seemed to me that they were things that were already required by law. But, at any rate, as I say, I would encourage you to go through them.

One of them -- this last one I thought was also interesting. The suggestion -- I don't know if this is realistic in terms of resources, but that audit committees could request the PCAOB perform an enhanced inspection of the audit of their company and report the results, which I actually think, if it were workable, would be something that might be an interesting idea to try.

There are a number of other suggestions that are variations on the notion that rather than go to sort of a complete formal mandatory rotation, you have more frequent process for putting the audit out for bid. So, SEC Chairman Breeden has a suggestion where he said rather than having mandatory rotation at 10 years, you'd have a presumption, rebuttable presumption that after 10 years independence had been impaired. And prior to that time, the audit committee would either have to at that point either rotate the firm or explain why it had chosen not to do so, what its reasons were. And for the largest such audits he suggests that you could have a PCAOB inspection in the seventh year. And where they found serious problems they could require rotation. But where there were no problems identified, the period would start to run again, so the audit firm could be reappointed and that process would start to run again.

Former SEC Chairman Pitt had a similar example, and he talked about having audit committees do more -- to consider more frequently whether to retain the audit firm and to document in a pretty concrete way under appropriate guidance what was the basis for their decision. And, again, he had a provision where audit committees could be required to dismiss their auditors where there's a PCAOB finding of troubles. And then a further example.

And then there were a couple of

people who suggested, as I said, taking the more radical approach of changing the business model. Jack Bogle from the Vanguard Group talked about trying to find a way to make the institutional investors -- organize them to take more responsibility for overseeing the audit. He didn't spell out what he thought that might look like, but suggested that. And then, as I say, Jack offered a pretty detailed proposal for having financial statement insurance.

Now, that's something that the EU looked at and dismissed as not really sort of ready for prime time. But his -- he makes a pretty compelling case that you'd have -- you'd be using market incentives to -- would be aligned to create more reliable reporting, because you have the insurer who wants to minimize losses so they're interested in promoting good reporting, and they will set their premiums based on what they see as the risk, and issuers who want to lower their premiums who will then --

MS. SIMPSON: Oh, I'm so sorry. I apologize. But I'm just saying perhaps the gentleman addressed this, but the problem here is that that's still coming out of shareholder funds. I mean, just like D&O insurance, you just pay for -- it's like litigation. You know, you pay the first time when you lose the money, and you pay again when it's the -- so unless there's some other source of funding that's supplied you're just picking your own pocket.

MR. SONDHI: I'm sitting here as an investor. I now have to pay for the insurance company, I've got to pay for the auditor.

MS. SIMPSON: And you alleviate the duty on the directors to get it right.

MS. ROPER: So, clearly not a popular idea with this crowd.

MS. SIMPSON: The sidelines.

MS. ROPER: So that is designed to give you an idea of sort of the scope of ideas that have been put on the table around what the PCAOB could or should be doing to enhance independence, objectivity, and professional skepticism.

And just to sum up, there were two quotes that I thought were worth pondering before I throw it open to you all for your broader discussion. One is from a Washington Post editorial. I think it was probably written by Sebastian Mallaby back -- it was back during the Enron era when Congress was considering SOX. And he wrote, "There's a price to regulation. When you tell companies not to hire their auditors you may distort the job market. When you force them to rotate audit firms, you impose real costs, but the efficient allocation of capital depends on accurate bookkeeping, and the books won't be accurate so long as auditors remain conflicted or corrupt. In this contest between audit firms, business models, and the public's interest in disclosure surely somebody will take the public's side."

And then more recently, Jonathan Weil writing in a large article about MF Global and Olympus, he writes, "So many large companies have blown up after getting the all-clear from a Big Four accounting firm that many people regard auditor opinion letters as a joke. The biggest fear for the Big Four cartels should be that some day investors will become so fed up that they demand the status quo be chucked entirely figuring they've got nothing left to lose. We're not there yet, but give it time. If the auditing profession can't figure out a way to re-instill value in its most basic product even terrible solutions may start to look like drastic improvements."

So here are just some discussion questions that I've thrown together for you to consider, but I throw the floor open to all of you.

MR. HEAD: This is, obviously, out of all the things today and not that I have been bashful today because I have not, but of all the things today this is probably one where I'm the most passionate about, because I've been on both sides. I've been an external auditor for a Big Four firm. I started internal audit functions, I've helped create and start enterprise risk management functions, and I currently serve as a Chief Audit Executive for a registrant, TD Ameritrade.

And there's -- my first bottom line is I wholeheartedly agree, which this is a very, very well done, thought out presentation, and thank you very much for that, and very balanced and fair, so thank you. That I do think we want to be careful not to address the symptom, and try to address true root causes. So, my headline would be I think audit rotations is addressing a symptom, not a root cause.

But then, as you say, well, what would you do? That's nice, Mike, that's great, but what would you do? I really feel some of the root causes that if addressed would make audit rotation a non-issue which is addressing non-audit services and making -- not that they don't provide non-audit services to other clients, but to that client, it's nothing but audit services.

I really, really think there's a model that's somewhat of a hybrid of several of these where there could be a pay dues and someone like a PCAOB actually makes the hiring decision of the firm for a registrant, but it's not that an insurance policy -- the company would be paying into a pool, and the audit committee and the PCAOB maybe would have some mechanism of jointly considering hiring the firm, a recommendation coming from PCAOB based on a bid process, and the audit committee selecting it. And that based on performance indicators, and the performance over a period of time, be it five or ten years, and then at the end a reassessment of the firm, how did they perform? Was there consequences if they hadn't?

I think part of the bidding process should be a PCAOB examination of that firm and the results of that reported directly back to that audit committee. And as part of what the registrant is paying to -- if it's not PCAOB, another entity of some kind. And that if the performance has been good, and the results of that audit at the end of whatever period of time are good, then based on a competitive bid process they would be the leading candidate because they have the requisite knowledge, they have the accumulated audit knowledge, and they could and should be rehired. And address from that aspect, I think forcing an audit rotation and leaving it -- leaving the other things unaddressed, again, I think is taking aspirin for a fever versus addressing that the firm that's hired may be and could very well be the best, most qualified firm to do that audit. And by forcing the audit committee to fire them every six, or seven, or ten years makes no logical sense to me. It should be based on performance, results of the audit, the audit quality, and how you put the things in place to insure that does have objectivity and independence, not force a symptom to address the ultimate solution.

And the one thing that I have not heard enough about here is in a well organized governance structure for a company that has the audit committee overseeing all audit services including a qualified internal audit function that is complying with the professional standards that have been established by the Institute of Internal Auditors and they reporting from a functional and fiduciary point of view directly to the audit committee can serve a very important role in assessing management's opinion on internal controls, assessing the effectiveness of the external auditor's role, and be another

I'll call it objective because unless they were paid for not by the company, some people get hung up on the term independent. I don't. I think it can be independent and objective if the Chief Audit Executive is evaluated by the audit committee and the audit committee chairman, that they're reporting directly, that they're qualified, they have the right training, they have the right background, they have the right resources, and they can complement and add a lot of assurance and comfort for the audit committee and shareholders if they're structured right. And that partnership between that and addressing some of the root cause I think is a much stronger path to go than forcing a mandatory rotation just because that could be legislated and it ignored all the other things that are really, in my opinion, root causes.

So, thank you for listening to me. I'm obviously very passionate on this topic.

MR. HARRIS: Thank you. Bob.

MR. TAROLA: Barbara and group, thank you for distilling down three days or more of interviews and sessions. It was -- now, I don't have to go back and read it all so I appreciate that. But I agree with Mike in terms of getting the root cause, but I don't -- to me, the root cause is the business model. And you have an industry that has a public franchise that has barriers to entry, that no audit committee in their right mind would say I want the cheap audit, not the good audit. So, you have a high demand for services in a very structured industry.

The product is independence, objectivity, and professional skepticism, so it seems strange to me that some firm wouldn't take advantage of that situation and step up and basically put forward themselves as that kind of product, not the product of a whole website full of services. And in doing so, and maybe that's where the regulators come in, there's no -- I'm having trouble seeing the disadvantage of moving toward I don't want to say audit only, audit focused, audit insurance, whatever you want to call it, but a way to improve the public's view of the capital markets, and fulfill their public franchise. I don't think they're inconsistent. I don't think making money is inconsistent with that, so I'm a little at odds with the þ-- sort of the position being taken.

MR. HARRIS: Tony Sondhi.

MR. SONDHI: Thank you, Steve. I'm just wondering about the discussion we've had and the evidence you've shown about the split between the audit fees and the non-audit fees. There's a very simple principle in financial reporting that says when you sell two things in a bundled arrangement you can't take what you said the value of each of those was, you've got to figure out what the real value is. So, I think that the audit firms who are supposed to be applying the standard seem to be playing a game with that, too.

So, I wonder is it they're deliberately keeping the amount of the audit fees down when you look at the extent to which there's a difference. And I understand that it wouldn't necessarily apply if you were talking about non-audit fees that are sold to a company -- to a firm that you're not auditing. I understand that, but there's an interesting question, I think, in there. I think that they have deliberately played this game with respect to the audit fees.

MS. ROPER: So, it's an interesting question. So, pre -- in the initial disclosures, when they first did the disclosures were they deliberately making the audit fee look lower than it was by classifying a bunch of things as not part of the audit fee?

They certainly lobbied hard during the rulemaking process to get as much as possible thrown into the audit fee category, presumably because now non-audit fees were --

non-audit services were now blackballed, and because the audit committees were expected to look at this issue of proportion between audit fees and non-audit fees.

Suppose you look at that proportion in terms of thinking about conflict of interest, so I don't know what -- you know, the incentives have clearly changed in that period between how you want to present the numbers.

MR. SONDHI: I think the point really is that you can -- by saying that we are doing X number of things, we'll call all of these audit, but the fee we're charging is much lower. And I think that's the deliberate part of it. So, it's not really a question of what gets called what. That's something that I think is very, very difficult to accept from that perspective.

I think the other point that you made which is very important to keep in mind is the weakening of the financial expert requirement. I think that's a critical area. And, again, no surprise that they did that, but it's clearly there, because you can see þ- on the other hand, I must say that it also reminded me of the comment by the head of the audit committee for Enron who said that management was -- and he was a chaired professor at Stanford, who said that he didn't know why he would have to check anything.

MS. ROPER: Well, there was -- I remember right -- there was right around that time, and I couldn't -- I didn't take the time to dig it out, there was language that went out sort of post-Enron, pre-enactment of Sarbanes-Oxley that clearly some law firm had put out that basically audit committees were using to disclaim any responsibility for any kind of oversight of the numbers. We just sort of look at what's given us, and we don't -- so, it seemed to us at the time that there was -- that audit committees were a pretty slender read on which to pin our hopes for reform. And then when they did the rules, as you say, on financial experts there was a concern that if they set the standard too high, or least that's how it was presented, that if they set the standard too high they wouldn't have enough candidates to serve on those positions, which may be a legitimate -- I don't know.

MR. SONDHI: But they could phase it in.

MS. ROPER: Right.

MR. SONDHI: It's not as if you have to do it right away. And it's not as if that couldn't be built. It's not as if there aren't people out there.

MS. ROPER: And if you look at what the suggestions are now, particularly from the audit firms in this area of how we can improve the existing system, improving the expertise of audit committees, improving the resources they have available to them, improving training are all sort of up in there. We're still back to this notion of how do we make this audit committee oversight function work better.

MS. SIMPSON: Thank you very much to the group. I apologize. Thank you very much to the group, and to the previous group. I didn't get a chance to compliment you, either. This is such a useful day.

I have a question which is -- goes back to what's happening in the European Commission. And I know I rattled off a few points before we talked about going concern, but I'm going to make a statement of the bleeding obvious, as they say in London, which is the Big Four at the center of attention here are the same Big Four at the center of attention in Europe. So, the -- what the European Commission thinks it's tackling include an issue of independence, but they're looking at it in a rather more integrated way. And I think there's an advantage for that.

So, first of all, they're saying what's the purpose of their reforms? And remember what they're doing, they're proposing to ban non-audit consulting, to make rotation mandatory, and a string of other things. So, whether this all happens and they get it through, I don't know. But the same Big Four are having to deal with that agenda in Europe. It's the same networks. And this is why they think they have to put this package of reforms forward.

So, one, a lack of choice for audit clients resulting from high concentration levels, in essence, an oligopoly. Two, systemic risk if one of the Big Four collapses. Three, possible conflicts of interest and issues around the independence of auditors. Four, doubts around the credibility and reliability of the audited financial statements of banks and other institutions and listed companies. These came in for heavy criticism during the crisis.

So, I think that something I put really as a question to the PCAOB Board is, are we in danger of trying to think about the Big Four and the structure of this industry, the business model, the numbers, the oligopolistic, the dominance, I mean these same Big Four, just to give you the numbers from the European side. I mean, the dominance is extraordinary.

The market share of the Big Four for audits of listed companies is 99 percent of the first C100, 95 percent of the C350, in Germany two of the Big Four have the mandates for 90 percent of the companies on the DAX 30, and Spain all of the IBEX 35 are audited by the Big Four.

So, ought we not to be thinking about this from a regulatory point of view, from a global side? So, if we're having -- if Europe is battling all this out, and then the PCAOB is battling it all out, and it's actually the same networks, and the same people we're dealing with, and the same global economy, and the same capital flows, you know, certainly for CalPERS, we're in all these European markets as well as in the U.S. So, I just feel we haven't had the opportunity to do some joined up thinking.

So, I apologize for returning to the same point later in the day, but the Big Four are going to have to deal with mandatory rotation after six years in Europe. It's happened for good or ill. Surely, that sets a different conversation over here about what happens next.

MR. HARRIS: Well, to punt your question in the interest of time, what I'd like to do is, we've got 20 minutes left, and we've got a number of cards up, so I want to keep the cards up.

No, no, it's fine, but what I'd like to do in wrapping up is for the people -- everybody to make recommendations in the remaining time. So, rather than us asking questions, I'm punting the question because clearly we can't act in isolation. I mean, we can but we've got to be cognizant of what's going on throughout the rest of the world. But why don't we go around the room, and to the extent that -- Judge -- I don't want all the tent cards to go down otherwise we can finish five minutes early, or ten minutes early, which is fine, as well.

Judge, you had a point, and to the extent that anybody wants to make recommendations to the Board in terms of what you think we ought to be doing, in terms of wrap-up, or bringing up any other issues as we close out the day, that would be very helpful.

Now, you made the 1982 speech in San Diego, and not a lot has changed since there, so maybe you can take off on that.

JUDGE SPORKIN: I want to compliment the PCAOB. I've been around a long time, but this is one agency -- what I like about it, it seems to be free of politics. You seem to all want to be doing the right thing. I have known you what, 50 years. I've known

Doty, I know Lew. I don't know the other two, but I know that you all want to do the right thing. We start out with that, so we've got something good to build on.

The other thing that occurs to me, we've got -- with auditors you've got two issues, two problems. One, negligence, has someone screwed up and they didn't find something. And the other one is aligning their interests with management. Okay?

The negligence one I think you people, if you're not in control now, can be in control of. That's the kind of thing that the person didn't see some -- and, by the way, you and the firm itself is interested in rooting out negligence in a firm, so I don't think that should be the big issue.

The real issue is the alignment. The real issue -- and that -- we seem to be going around the subject. We're saying it's independence, it's this, it's that, it's the other thing. And really it is, is alignment.

And what these auditors have to do is they're like umpires in a game. They've got to call the balls and strikes as they see them. They cannot take -- just try to accommodate the people -- the company they're working for. That's got to be taken out of the game. You've got to do that.

Now, you and your inspections, obviously, ought to be looking for that tendency. Are they then trying to put their -- give their support to the issuer, and trying to do the kind of thing that I found in the Keating case and whatnot, in which they weren't doing their job. They weren't looking and say hey, look, this is wrong. Okay? You've got to root that out.

Now, what do you have to do here? How are you going to get the good audit? Well, that's really again up to you and the SEC. It seems to me that you could do things two ways. One, you can do a structural basis and do it like in a bureaucratic way. And I'm not trying to be too -- complaining about it, but the other way you can do an exception basis.

If you now find that the firms that you regulate are not doing what they're supposed to be doing, you've got to take action against them. And you can't be too big to regulate. Even though there are only four, you cannot be too big to regulate because our system will fill that void. We will get somebody else if we have to get rid of one to do it.

So you say okay, yes, if you perform you're going to continuing basis. And one of the things I don't like about trying to do on this rotation basis, it seems to me it's like saying that if somebody is too good and too smart he can't continue. That's not right. In other words, if you have a firm that's doing a good job and they've done it over the years, and they've done all the things we want them to do, there's no reason why they ought not to be able to continue doing that. Our system looks for excellence, and if people are excellent they ought to be continued.

But really, that's really on -- I say look at the exception basis. If somebody isn't performing, then they ought to be sanctioned. And you can put severe sanctions on companies. You can say that you cannot continue with that audit. They have to go out and get another auditor, but it means that you can't shirk your job, or the SEC can't shirk its job. They've got to go -- and that will take care of this problem.

I saw it done in my day. I hate to go back to that, but I think we did a pretty good job. Look, I brought in my day -- we sued the auditors 28 times in the time I was there because we didn't care. And we told them certain times you can't go and take new business, certain times you can't do certain things, but you've got to have that -- if you don't have that -- if that's not your goal, if that's not your objective, then really, you know -- and nobody can really find fault with that. They could do all they want. They can't go to Congress and say override the PCAOB if you make a decision based on the facts, and if you show that a firm has done something wrong and they're not complying. And try that as something you can do, you don't need any kind of -- you don't need surveys, you don't need anything else. You don't need legislation. All you've got to do is do your job. When they come in with a report, your people, look at the report. If they don't measure up, take your action.

MR. HARRIS: Spoken like a former head of enforcement.

JUDGE SPORKIN: Saying it like it is.

MR. HARRIS: Well, if people would like to make concluding comments, I think now is probably the time to go around. And if you want to offer any suggestions, ask any questions, please feel free.

MR. BLAKE: I just wanted to thank Barbara for her leadership, and doing the vast majority of this work. Thanks.

MR. HARRIS: I second that.

MR. STARR: We probably don't have time to address this, but the panel on -- or the Working Group on Audit Firm Practice and Transparency had under other considerations a question which was, should the PCAOB initiate or issue a Concept Release on whether global networks impact audit quality? And I would have liked to have heard some of your thinking on that.

MS. YERGER: We had no thinking on it. We thought it was important, but we really only decided to focus on those two items. I think we kept it as a placeholder and something, I think, of great value for consideration by the Board, this group, and others.

MR. STARR: So, when you say --

MS. YERGER: Decided we didn't have

time to address it. We thought it was important, but kind of tabled it.

MR. STARR: Okay, thank you, Ann.

MS. ROPER: What they thought was that you'd make a great Committee Chair for a Committee for the next meeting to lead that topic.

(Laughter.)

MR. STARR: Unfortunately, my views express my views solely, and I can't do that.

MR. HARRIS: Well, be careful what you wish for, as well. Does anybody else have any concluding remarks?

MS. HILL: Just one thing, well, two things. Tony, I think you had raised the question were audit committees putting pressure on auditors to keep their fees down. And I will tell you that the answer is yes, in all of the committee meetings I'm aware of after the tremendous fees to comply with Sarbanes-Oxley, then people started saying the books are clear. And what you're doing is status quo, and no, you can't raise your fees. So that's been very much a reality.

I think the other thing, to Barbara's point, you said that audit committees were told by the auditing firms what they could and could not do. And I would just say that it really is -- it has been governance lawyers, and internal counsel that has interpreted the laws to the audit committees and to the Boards in my experience.

MS. ROPER: Right. Can I clarify, because what I said was something specific. That an audit firm, and we had no reason to believe it was isolated, put out an advisory to its audit clients about its advice on how they take on this new role of reviewing non-audit services. And I think I was specific in saying that we did not then assume because they had done that that audit committees then fell into line and followed their pattern. So, I made a distinction between what the literature was advising, how they were seeking to use this process to achieve their ends, not how audit committees --

MS. HILL: Okay. And they may advise -- the reality is that that information really does have to come from legal counsel. One of the things that strikes me is that shareholders have been very vocal about a number of other things, so that if for some reason shareholders feel they're not being well served by the auditors, I can't imagine they wouldn't speak out, or perhaps they should. I mean, that -- again, shareholders have an active role in that. But as the Judge has said, as long as the company is being run well, things are going well, they tend to be very satisfied. That's not to say the Board is always, so I think the Board has to continue to take more responsibility, as well as the audit firms. It is not difficult to find financial experts to serve on the Board, so I think we have to continue that. I think that's a good practice, and that we should encourage it.

MR. HARRIS: Thank you. Anne.

MS. SIMPSON: Thank you, and I wholeheartedly agree with Bonnie. I think that it is time for shareholders to step up. And if we were to look at the votes cast on the reappointment of auditors in recent years, even where there had been grim, grim results that had not been detected in advance, I think we would all look rather ashamed that we weren't paying more attention. So, I think that's a place marker, the role of shareholders and what shareholders could and should be doing to back up the improvement in quality.

And just for the record, to say I would welcome the PCAOB looking at the European Commission proposals, there's an underlying, I think, shared interest in making this work. We as global investors would certainly find that extremely helpful. And because you're dealing with the same people through the audit networks it could actually be efficient. It doesn't mean that Europe's got it right, but it would -- I think we would all benefit enormously from that coordination. And if you think there's some work that we can help with -- accomplish through this advisory group, we'd be glad to contribute.

MR. FERGUSON: Let me just say that we are very aware of what the European Union is doing. We're in -- our people who do this stuff are in contact with them. We have discussions with them. We are in contact with the Financial Reporting Council of the United Kingdom, so we're -- and aware of the various reports that are being done, so we're very, very aware of that. I think we have not felt it appropriate to put out public statements on what other regulators are doing, but we are very, very aware of that, and very aware -- it's part of -- one of the things that motivates the many initiatives we're undertaking, because we're aware that these issues are being considered around the world.

MR. HARRIS: Brandon, then Ann, then Brian.

MR. BECKER: At the risk of being presumptuous, I think on behalf of the Committee I would just thank the Board members for the gracious extension of their time and their willingness to engage with us. I thought that the one consensus of the entire Committee was how critical the Board's role is in improving audit quality, and our view that by improving audit quality the Board is making a material contribution both to capital raising and protecting investors, and we very much appreciate your efforts and your willingness to listen.

MR. HARRIS: Thank you very much. Brian.

MR. CROTEAU: Thanks, Steve. I just wanted to comment on a couple of things, a lot of really good and helpful discussion today, and I really appreciate that. I was encouraged by some of the discussion, in particular, relative to insuring we're focusing on root causes not just symptoms. And some of the discussion this morning relative to inspection, process and reporting, and thinking creatively about ways we can even further leverage the results from inspection work, and think about the types of reporting that could be done under Rule 4010. I don't think anyone mentioned it this morning, but I know the PCAOB's Strategic Plan also has an item in it relative to outreach on their inspection reporting, as well, to think about ways to continue and improve their inspection reports, which is, I think, another important area for consideration. So, again, thanks very much for all the helpful input today and look forward to continuing dialogues like this.

MR. HARRIS: And I want to conclude where some members began. I want to compliment Joanne Hindman on her really outstanding work in pulling this together.

(Applause.)

MR. HARRIS: Congratulations, and Jennifer Jumonvile did a terrific job in terms of all the logistics, did an outstanding job, as well. And then I can't say enough about Bob Burns, our general counsel, Counsel's office, and Nina Majura Vassad, and finally compliments, plaudits to you. This has taken a terrific amount of effort and time out of your workload. It is a public service. We appreciate it, and we look forward to picking your brain. And as you can tell from the meeting last year, a number of your recommendations were taken very seriously and acted upon by the PCAOB, and I think we will take what you said today under advisement, and presumably get back to you a year from now. Thank you.

(Whereupon, the above-entitled matter went off the record at 4:52 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: Investor Advisory Group

Before: Public Company Accounting Oversight Board

Date: 03-28-12

Place: Washington, DC

was duly recorded and accurately transcribed under my direction; further, that said transcript is a true and accurate record of the proceedings.

Neal R Gross

Court Reporter