PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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INVESTOR ADVISORY GROUP

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MEETING

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MONDAY, OCTOBER 20, 2014

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The Advisory Group met in the Hamilton Ballroom of the Hamilton Crowne Plaza Hotel, 1001 Fourteenth Street, Northwest, Washington, D.C. at 9:00 a.m., Steve Harris, Chairman, presiding.

PRESENT

STEVE HARRIS, PCAOB staff, Chairman
BRANDON BECKER, TIAA-CREF
ROBERT T. BUETTNER, Newbrook Capital Advisors
MERCER E. BULLARD, University of Mississippi, Plancorp, LLC, and Fund Democracy, Inc.
CURTIS L. BUSER, The Carlyle Group
T. GRANT CALLERY, formerly of FINRA
JOSEPH V. CARCELLO, University of Tennessee
NORMAN J. HARRISON, FTI Consulting, Inc.
MICHAEL J. HEAD, Creighton University
PETER H. NACHTWEY, Legg Mason, Inc.
BARBARA L. ROPER, Consumer Federation of America
LAWRENCE M. SHOVER, Solutions Funds Group
DAMON A. SILVERS, AFL-CIO
TONY SONDHI, A.C. Sondhi & Associates, LLC
JUDGE STANLEY SPORKIN, U.S. District Court (Retired)
ROBERT M. TAROLA, Right Advisory, LLC
LYNN E. TURNER, LitiNomics
GARY G. WALSH, Luther King Capital Management
ANN L. YERGER, Council of Institutional Investors

ALSO PRESENT

JIM DOTY, PCAOB Director
BRIAN CROTEAU, Securities and Exchange Commission
MARTIN BAUMANN, PCAOB
LEWIS FERGUSON, PCAOB
JEANETTE FRANZEL, PCAOB
JAY HANSON, PCAOB
JAMES SCHNURR, Securities and Exchange Commission
MARY JO WHITE, Securities and Exchange Commission, Chair

C O N T E N T S

P R O C E E D I N G S

(8:59 a.m.)

MR. HARRIS: Welcome everyone. Let's get started.

And since this is Chair White's first appearance before the Board, and likewise Jim Schnurr's -- where is Jim? Oh, yeah, Jim Schnurr's since his appointment as the Commission's new Chief Accountant, I think it's only appropriate that Chairman Doty, that you open the meeting by welcoming them on behalf of the whole board and with any other remarks you may wish to make. And then we'll proceed with the day's schedule.

CHAIRMAN DOTY: Thank you, Steve.

Of course, everybody in this room knows that the support and the counsel of the SEC is actually critical to anything that we can do or hope to do at the PCAOB. And with that in mind, it seemed to me watching the Commission over time that the job of the Chair of the SEC has expanded so that now it is expected that the Chair of the SEC will be thinking about everything that has to do with the capital markets all the time. There are very few points of rest or points of repose in the

Commission's agenda now. And while Mary Jo White is, of course, up to that task it reminds me that we are very lucky to have a piece of her time.

This is a part, it's an important part of what Chair White and Jim Schnurr and the Commission are about, but it's only a part. And so for her to take time and for Jim Schnurr to take the time to come and sit with us and hear how to, to see how the Investment Advisory Group works and to hear what you have to say is an especial privilege.

And it is also, I would have to say -- I want to say that she's available. I have been able to get her on the phone, talk to her and get her counsel and her views when I've needed it and that is a very important thing for the Chair of the PCAOB. She and Jim have both made a special effort to reach out to board members and to involve themselves in what the mission and the plans of the PCAOB are. So Chair White, we are grateful to you, grateful to you, Jim Schnurr, with two weeks on the job, for being here.

And with that, I'll turn it back to Steve.

MR. HARRIS: Chair White, would you like to make any brief remarks?

CHAIR WHITE: Just very briefly. First, thank you for inviting me. I was trying to figure out with Chairman Doty in the hallway I wasn't here last year. I think I must have been in some foreign land doing some of those things that maybe do require that, you know, bandwidth of the SEC Chair. But delighted to be here.

I see what's on your agenda today. I'm sorry I can't be here for the whole meeting, I will catch up through Jim Schnurr and Brian on all the topics, really mightily interested in all of them. The PCAOB, this advisory committee to the PCAOB really could not be more important to investors and to the SEC. It's a -- I mean, auditors are clearly, and I talk about it all the time as they remind me, -- but just are critical, you know, gatekeepers in our system. You may have seen some reflection of that really almost from the time I arrived, obviously working on kind of the back end.

But we did form a new task force in Enforcement and Financial Reporting Audits, it's also known as, shorthand, the Fraud Task Force. But it really is, you know, aimed at making sure the SEC on the enforcement side is really doing its part to keep gatekeepers up to snuff. We have an operation called Operation Broken Gate which you may know about which is also, again, focused on auditors who, you know, fall down on the job. And so it could not be a more important set of issues.

And obviously Enforcement is only a piece of it. You know, what you're talking about today are very important pieces of it as well. I think audit performance standards -- and I think I've said this publicly a time or so, too, that the PCAOB is working on I think are very important priorities for the PCAOB. I look forward to seeing that work carried forward.

I notice that one of your topics on the agenda is also addressing the relationship between the auditor and the audit committee. I mean, this is of particular interest to me. I mean, I think that clearly I regard directors and audit committee chairs and members of the audit committee as very essential gatekeepers as well who have to do their job right in order to protect investors and the integrity of our financial reporting.

I do think that the PCAOB -- I've thought this for a long time and certainly that view has only been underscored since I've been at the SEC -- that the PCAOB and audit committees and audit committee chairs ought to be really linked arm in arm as strongly as possible, really have the same objective. So the more we can do in that space the better.

Let me just end by thanking you for all of your service on the Investors Advisory Group. I thank Steve for chairing this. I thank Chairman Doty and the other board members for their leadership. With that, I am here to listen -- you might not have thought so because I went on a little longer than I intended, but thank you for inviting me.

MR. HARRIS: Chairwoman, I thank you. And as I recall last year you were legitimately, totally, heavily involved in sequester so we appreciate your having attempted to make it but we totally understand that there was a far more important issue to be dealt with at the time.

And with that now I'd like to welcome everyone to today's Fifth Annual Meeting of the Investor Advisory Group of the Public Company Accounting Oversight Board. We know how busy all of you are and we appreciate very much the time you have taken to participate in today's meeting.

In particular I want to thank the working group members for their work on the topics we will be discussing throughout the day. Their presentations reflect a thoughtful consideration of the issues and I anticipate a productive session.

At the outset I want to provide the standard Board disclaimer that the views we express today are our own and do not necessarily reflect those of the Board or the staff of the PCAOB. The topics we will be discussing will fall under three broad headings: The Audit Firm Business Model; How to Improve Audit Quality and the Relevancy of the Audit; and the Relationship and Role of the Auditor with the Audit Committee.

I too want to extend a warm welcome to Chair White and Jim Schnurr. We look forward to working with you and we certainly welcome you.

In addition we're pleased that Brian Croteau, the Commission's Deputy Chief Accountant is here with us as well. Brian, thank you for your ongoing participation and interest in these investor advisory group sessions.

I know that Chair White has to leave at 10:45 so I'll be brief in my remarks before recognizing my fellow Board members. And I appreciate your having gotten here earlier than we anticipated. That's very much appreciated.

These investor advisory group meetings are important to the PCAOB because they allow us to hear from those who have a well-recognized commitment to investor protection. The Board's mission is clearly stated in the Sarbanes-Oxley Act, quote, "is to protect the interest of the investors and further the public interest in the preparation of informative, accurate and independent audit reports." Your views help the Board in considering and establishing its agenda.

While observers generally agree that audit quality and effectiveness has improved due to the Sarbanes-Oxley Act and the PCAOB, additional improvements need to be made. As noted in our 2013-2017 strategic plan, quote, "PCAOB inspections continue to find high rates of deficiencies at the global networks. This is true at the international level as well where survey results demonstrate that regulators around the world are encountering similar issues with respect to audit quality." I think most of you know Lew Ferguson chairs the IFIAR Group.

Many of the topics we'll be discussing today are issues of concern to investors worldwide. I have the opportunity to see this firsthand as Chair of the Investor and Other Stakeholders working group at the International Forum of Independent Audit Regulators. This particular investor group consists of the PCAOB and audit regulators from eight other countries; Canada, France, Japan, the Netherlands, Singapore, South Africa, South Korea and the United Kingdom.

Certain common themes include by way of example, a need for an expanded auditors report that includes more content and broader disclosures of key issues; improved audit firm transparency, governance and the need for more audit staff training in key areas; the need for auditors to exercise more independence, objectivity and professional skepticism while conducting an audit; and how auditors and audit committees can better serve the interests of investors.

Also I'd like to note that today's first topic, the firm business model, will likely be a priority subject at the next IFIAR plenary meeting in Taipei in April.

Now let me very briefly outline how we organized the day. Each topic will be presented by a working group after which the presenters will lead a discussion among all members. We will end with an hour of general discussion and the general discussion session will provide an opportunity for each member of the working group to bring up additional topics or issues that were not discussed during one of the day's panels.

Finally I would note that today's meeting is open to the public and is being web-cast. As a result, please identify yourself before speaking. Also slides and information connected with the presentation will be posted on the PCAOB website.

Now let me turn to my fellow Board members for any statements they may wish to make. And in alphabetical order we'll start with Lew Ferguson.

MR. FERGUSON: Thank you, Steve.

I just wanted to talk briefly about my experience last week. I spent a week in Toronto with the members of IFIAR and with the leadership of the largest six global audit networks. We were talking about the economic model of the firm, we were talking about inspection findings that they have and we were also talking about particularly this sort of evolving both role of audit around the world and the evolving nature of these audit firms, what's happening.

One of the topics we talked about that I thought was particularly interesting was the beginning of rotation in Europe. The European Union has put in place a directive that will require rotation starting in 2016 but it's already beginning to happen in countries. Particularly in the United Kingdom it's beginning to happen.

One of the things that they're finding, the Europeans are finding is that when there is tendering there appears to be a decline in audit fees from between 20 to 40 percent in most countries. It's not so true in the United Kingdom. And one of the reasons in asking the question why is it not happening in the United Kingdom, one of the speculations is that there is -- because the United Kingdom has a sort of unified reporting system now where both the audit committee and the auditor itself has to put out a fairly elaborate report, the audit committee's report is really quite elaborate report that they have to put out, that auditors are very concerned that they have very high quality audits to help them do that.

Secondly, the other factor that appears to be important in the United Kingdom is the fact that a lot of audit committees are chaired by former auditors which is not the case in most other countries. So there seems to be more of an understanding of what is required for the audit. But the firms are concerned about this. They're concerned about that.

So we talked about various kinds of ways of dealing with this. Some of the regulators are talking about requiring sort of a two-stage tender that, if you're going to have tender process, that the first thing you do is you pick the auditor on the basis of quality. Secondly you can negotiate the price, but first you pick -- you make a choice of auditor on quality factors and then you pick price. Or for example, if you have a point -- several audit committees have a system where they appoint or they have a point system, like 100 points that's assigned to the audit bid and only 30 of those can be related to price.

Another concern that was expressed to us about the rotation and tendering is that, for example, in a firm like Ernst & Young which audits three of the four large oil companies in Europe, it audits British Petroleum, Total in France and Eni in Italy. And it will lose all three of those clients under the rotation regime. They're very, very concerned that there will be tens of thousands of their employees who have worked for years on these accounts that frankly will have to be redeployed.

That's true in other things, for example, if you have big banks, Deloitte in Spain which controls the banking industry, as they lose those clients the deployment of these resources and their, you know, speculation about whether there will be mass movements from one firm to the other so, in fact, all you have is the same team rotating.

But in any case, these are the kinds of things that are being considered as part of the ongoing rotation. So it's going to be very interesting to see what the consequences of mandatory rotation is. Some of the firms believe that, in fact, contrary to what its initial intention was, which was to increase competition, that in fact it will increase concentration because the early experience appears to be that the winners of these tenders tend to be the two firms that have the largest share. So when the third or fourth-ranked firm loses a client, it tends to go to one of the larger firms which may, in the long run, actually increase concentration rather than decrease it.

So these are just some of the issues that I heard about last week but that I thought you all would find interesting.

MR. HARRIS: Jeanette Franzel?

MS. FRANZEL: Thanks, Steve, for your continued leadership and chair of this group and thanks to all of you for being here today. We really do value the views and the recommendations provided by this group and by other investor representatives through our SAG and through our other outreach.

My first IAG meeting was right after I was appointed to the Board in 2012, probably two weeks after I came on board. And then we waited about a year and a half before we had another one. So I actually went back and reviewed all of those meeting materials from those two meetings that I've attended as a Board member in an attempt to analyze what have we done and what have we accomplished along some of the lines of the topics discussed here. And it was an interesting analysis because I often get frustrated by the slow pace of the work at PCAOB. The difficulty that we have sometimes articulating the good work that we do and putting out information to the public about that. And the difficulties of just bringing it all together.

And some of this does involve my multi-year efforts, but I did -- I was pleased to see that we've got a lot going on in areas that I think are important to this group. And I think it is worthwhile for us to put together some kind of a framework to analyze what kind of progress are we making or have we made in the topics that are important to this group? And what else do we need to do?

And I went back to the survey from the March 2012 meeting on the role, relevancy and value of the audit. And I think, Joe, you and some others worked on that. And you know, that was really -- those were really interesting results. And I think that would be a survey worthwhile to redo again. We're probably not quite ready to do it yet because I don't think we've we really accomplished enough to be able to measure progress, but when I looked at the survey results and compared it to the comments that were received, it was very insightful. So I guess I would encourage you all to take another look at that and think about whether you think doing another survey along those lines would be valuable.

Again, I guess I would suggest we haven't accomplished enough yet for that to be meaningful but I'm really hoping that we can in the next year really accomplish a lot of -- and bring in some of these efforts that we've been working on. So the role, relevancy and value of the audit, topics that we think about all the time and that we try to work on here constantly.

Independence, objectivity and professional skepticism, again we've got a lot of activities that we've been focusing on. Heavy emphasis on professional skepticism in our meeting with firm leaders, and I think the firm leaders are really finally -- or have finally grasped that concept and tried to work it into training. It took a while. You know, at first there was this resistance but we've been really emphasizing professional skepticism and we've published some things on that.

And Board members have spoken at various conferences and I think we're making some progress in that area. And certainly in our outreach with audit committees and their oversight of the independence of auditors, we've certainly emphasized that. And you know, that's -- this is an area where we can never stop our work. And so we -- that again is something from the 2012 meeting that was very relevant and that we continue to work on.

Audit quality indicators, I think this is an extremely important project at the PCAOB. I'm a little bit disappointed about the delay. I think that we were hoping to have something out months ago on this but it turns out that this is really a complex topic and so the staff continue to delve into the complexity. And the firms at the same time are starting to delve into this.

And so that's the good news. And I think we in the firms need to have some transparent results on this real soon and get something out, and I appreciate this group's input about the need to have indicators that are audit-specific in addition to firm-specific. And so I hope that we've got some results on that in the near future.

PCAOB general and inspection reports, we're still working on that and I think you'll hear about some of the progress. We're actually having a meeting in D.C. tomorrow on that.

Audit firm governance and incentives, again we've got ongoing work but we need to do more.

Auditor interaction with audit committees, I think we've made a tremendous amount of progress there.

So again, I think that all of these topics that have been presented in the last two meetings that I've attended at extremely important and relevant and they continue to be so. And we need to develop some kind of a framework, I think, for analyzing our progress, analyzing our performance and then matching it up against some of these topics.

So I thank you for being here. I look forward to the discussion and to continuing to move forward on many of these issues.

MR. HARRIS: Jay Hanson?

MR. HANSON: Good morning. Thanks, Steve.

I don't have a prepared statement, I just wanted to be brief and welcome all of you and I appreciate the effort you've put into the preparation for today and I look forward to the discussion.

Thanks, Steve.

MR. HARRIS: Chair White, the way we've scheduled the morning, recognizing you have until 10:45, I've asked each working group team leader or co-leader to present a five to seven-minute summary of their presentation so that you get a full and general overview of each topic after which we'll have a fuller discussion of the first topic which deals with the audit firm business model and incentives. But before doing that, let me ask each member of the working group to go around the table and very briefly introduce themselves. And why don't we start, Norman, with you and work our way right around the table so Chair White who's got all your bios can meet you directly?

MEMBER HARRISON: Thank you, Steve.

Thank you, Chair White, for your time this morning.

I'm Norman Harrison, Senior Managing Director at FTI Consulting. And my career as a practicing attorney, banker and fund co-founder has involved a lot of work with the issues we discussed at this Board's meeting. Thank you.

MEMBER HEAD: My name is Michael Head. I recently retired from TDAmeritrade, one of the larger retail broker/dealers. And currently I am a resident instructor at Creighton University in Omaha, Nebraska, teaching accounting and auditing related classes.

MEMBER TURNER: Chairman White, I'm Lynn Turner. I currently serve as a trustee on one of the hundred largest pension funds in the world. I sit on our investment committee, audit committee and shareholder voting committee as well.

MEMBER SILVERS: Chairwoman White, I'm Damon Silvers, I'm the Policy Director of the AFL-CIO.

MEMBER SONDHI: Chairman White, I'm Tony Sondhi. I run a financial consulting firm and I'm currently member of the Emerging Issues Task Force of the FASB. And I also serve as Chairman of the Corporate Disclosure Policy Committee of the CFA Institute.

MEMBER YERGER: Good morning, Chair White. I'm Ann Yerger, Executive Director of the Council of Institutional Investors.

MEMBER BUSER: Good morning. I'm Curt Buser, I'm the Interim Chief Financial Officer at the Carlyle Group.

MEMBER NACHTWEY: Good morning. Peter Nachtwey, CFO of Legg Mason. We're a 700 billion traditional asset management firm and former partner, audit partner at Deloitte.

MEMBER TAROLA: Good morning, Chair White. I'm Robert Tarola, I'm a former audit partner from a big firm, a former CFO from three public companies, public reporting companies, and now serve on the board of a mutual fund group and operating company, and on the audit committee. And I do turnaround consulting for companies in financial distress.

MEMBER BULLARD: Chair White, I'm Mercer Bullard. I'm a professor at the University of Mississippi School of Law. I run Fund Democracy which is an investor advocacy group and before teaching I spent about ten years in private practice and with the SEC.

CHAIR WHITE: You’re skipping the SEC people, hoping I know them. And I do.

(Laughter.)

CHAIR WHITE: Last year, who knows?

MEMBER SHOVER: I'm actually regulated by the CFTC and the SEC so I have a double whammy. But I'm Larry Shover, CIO of an alternatives mutual fund. I'm also a contributor to Fox Business News.

MEMBER CARCELLO: Good morning. I'm Joe Carcello, I'm an accounting professor at the University of Tennessee. I run a governance center there on this group and, as you know, on the SEC's Investor Advisory Committee.

CHAIR WHITE: Thank you for both.

MEMBER ROPER: I am Barb Roper, Director of Investor Protection for the Consumer Federation of America.

MEMBER CALLERY: I'm Grant Callery, I retired two years ago as general counsel at FINRA and have been doing some work since that time with an outfit here in town called the Yellow Ribbon Fund. We're trying to develop a financial planning pro bono program for wounded warriors and their caregivers at Walter Reed and also been doing some work with the Association of Governing Boards of Universities and Colleges and their consulting group.

MEMBER BECKER: Brandon Becker, I'm Executive Vice President and General Counsel of TIAA-CREF, and in a former life I was director of something then called the Division of Market Regulation.

MR. HARRIS: And then joining us, Robert Buettner is the Managing Director of Newbrook Capital Advisors. He'll be joining us shortly. And then later on today, Judge Stanley Sporkin will be joining us this afternoon.

With that, why don't we move directly to our five to ten-minute overview presentations. And Grant, why don't we start with you --

MEMBER CALLERY: Okay.

MR. HARRIS: -- with respect to the Audit Firm Business Model.

MEMBER CALLERY: All right.

MR. HARRIS: And why don't you take between five and ten minutes, we'll go through the three different subject matters and then we'll turn back to you.

MEMBER CALLERY: Okay. We will -- I'm not going to do -- since the group will be making its presentations while Chair White is here, I will just sort of a give touch on the various topics and give a little introduction.

This seemed, when we were trying to put the groups together, to be a very popular topic. I think when Steve came out with his solicitation for topics and volunteers to work on the subgroups, I think we got about half of the entire investor advisory group. And as we talked through what we wanted to do, we were focusing on wanting to provide -- and this is something that Barbara Roper had said I think at last year's meeting -- to give the PCAOB, look at things the PCAOB could delve into and could become interested in and work with from a practical standpoint rather than just sort of talking off in the stratosphere. And looking at it all as this group is supposed to do through the lens of an investor, whether it be an institutional investor or individual investors.

And the purpose today I think is, these topics are wide-ranging and some have a lot of -- as we've heard, a lot of the topics that you're dealing, that the Board's dealing with have a lot of different facets to them. But I think if we could get a good robust discussion today to give some information to the Board members and to the PCAOB staff that they could take and work with, that would satisfy, I think, what we would like to accomplish. And I think also, if it could lead to generation of discussion within the Board, within -- between the Board and the auditing community and Board, the auditing community and the Commission, that would also be helpful.

We realize that a few of the topics that we got on the list are somewhat sacred cows and are difficult to, you know, work through. But as someone said, you know, sacred cows make the best hamburger so we'll see if we can get a little movement there.

I think one theme that you will see through the topics, and as I look through our slides again, is there will be a lot of discussion of topics that were contained in the 2008 report of the Advisory Committee on the Audit

Provision, the ACAP. And this was a bipartisan group that was appointed by Secretary of Treasury Paulson and included actually a number of the people around this table. And I think when they went in the -- if you look at their final report, they expressed optimism that the oversight of the PCAOB, the recommendations would receive recommendation. Now obviously that's one of those reports where everybody's trying to get their little piece in so there's some hedging going on.

But I think that one of the reasons that that report is still very important is, while the PCAOB and others have directed a significant amount of attention, there is still a lot of recommendations and that was really a true blue-ribbon panel of knowledgeable experts in the area that have still to be worked on. And I know as people have said, it's sort of a tough slog to get through it and there is significant work to be done. But I know that Chairman Doty, in a speech he gave earlier this year at the Baruch College Financial Reporting Conference talked about the importance of the firm business model and looking at those issues and said that these are emerging reality for all of us, is the need to understand the effect of these trends and pressures on audit quality. And so I think this all ties together at the end of the day in audit quality from a different group of perspectives.

The slides that we will be using as we talk through these topics have been prepared by four subgroups of our working group, and I think that they have been distributed and I think that there's a lot of thoughtful work that went into them and some things that, you know, hopefully the discussion today will augment that. But I think that on the documents themselves it's a pretty good start.

And what we have done is we've got four groups. The first one is sort of the international landscape, and that will be led by Joe Carcello. And it's basically looking at international initiatives, the ACAP report, where the U.S. is and where international organizations are on issues like the engagement of partners, engagement partner signatures, expansion of the audit report, independent non-executives on governing boards, transparency reports and audit firm rotation. And I think the slides sort of show that the U.S. is maybe a little bit behind the curve on some of those issues. In just coming to conclusions, you may not -- you know, without preordaining the conclusion, we ought to at least work through it with the interested constituencies.

The second is consulting creep, and there seems to be, you know, a re-emergence after the audit firms spun off their consulting groups in the post-Sarbanes-Oxley world. And there are issues around that. Again, the conclusions are things that we've got to figure out but I think it's important to look at those. And Brandon Becker will lead that discussion.

The third is auditor transparency and the various aspects of that which will be led by Mercer Bullard.

And then the 900-pound gorilla room, who should pay for the audit, and Lynn Turner will take the lead on that. So that is basically an overview of what we're going to talk about.

MR. HARRIS: Thanks, Grant.

And then Ann and Joe maybe can give the five to ten-minute overview on how to improve audit quality and the relevancy of the audit. And since Chair White will not be able to stay beyond the first session, you know, feel free to explain that in as much detail as you like initially.

MEMBER YERGER: Joe and I are going to split up the summary of our recommendations. Our subcommittee had six recommendations and as you look through, I think, the bulk of the slides you'll see there's some overlap.

We as well dug into the 2008 ACAP report from the U.S. Department of Treasury which I should disclose I did sit on. And we looked at the report and other issues with the prism of how can this enhance audit quality and the relevance of the audit? And interestingly, there's -- obviously, I think, not interestingly -- obviously there is overlap. I think things that people feel would enhance maybe the governance of the firms we believe also would enhanced audit quality, ultimately.

So one of our recommendations is that we urge the SEC and the PCAOB to work together in consultation with all the appropriate bodies to analyze and explore the feasibility of the firms enhancing their own governance, whether it's by the addition of independent directors with full voting powers and/or through perhaps the creation of advisory councils, which I believe some of the firms have done this.

We obviously recognize that the firms are structured as private partnerships and as such they are not subject to the governance or disclosure requirements of public entities. However we believe the really special place of the firms, and unique place, really, in our capital markets, warrants, we think, some higher standards for their governance and their transparency. And we believe in the end, I think that independent directors and advisory councils could enhance the top enhanced management oversight, and we think that, in turn, would improve audit quality. So that's one of our recommendations.

Another recommendation attaches on the going concern issue and as we're all aware, in August the Financial Accounting Standards Board issued a new standard regarding management's responsibility to evaluate an organization's going concern status. The standard places the responsibility for making the assessment on management who may be extremely reluctant for lots of very valid reasons to make that call. And it also sets a probability -- a probable standard and a one-year time rise from the date this statement is released for that determination. Some users are very concerned that this new standard will actually result in fewer going concern opinions and ultimately with information being disclosed too late to be of real value to investors.

Well before this August pronouncement, I think it's probably been two and a half years ago, this Committee addressed and discussed the going concern issue in the context of the financial crisis. And we, I think, concluded that there was fairly abysmal performance of that standard in that context. So I think that this is a long way of saying the new standard really heightens investor concerns about the quality of the going concern analysis. The PCAOB, and we commend it, recently issued a staff audit practice alert on its own standards for auditors considering a company's ability to continue as a going concern. I guess I'll state my own personal view is that certainly, at CII, we would oppose any weakening, further weakening -- or any weakening, really, of the PCAOB auditing standard and, indeed, I think CII would support an effort to heighten the auditor going concern analysis. And that's really to ensure more timely and meaningful disclosures to investors.

And our final recommendation touches really the SEC directly, so I'm happy that you're here. As you know, shareholders have filed proposals at companies for decades now and for, I'd say maybe a dozen-plus years, they have filed proposals addressing auditor issues making specific proposals asking for the ratification of auditors have been on ballots for many, many years now. In recent years there's been a ratcheting up of interest in shareholders filing proposals on auditor issues. In particular, we've had shareholders filing proposals covering different types of auditor issues in the recent years, including auditor rotation and auditor independence reports. To date all have hit the ordinary business roadblock at the SEC and companies have omitted these proposals from their proxy materials.

Our subcommittee sees real value in the direct shareholder feedback that is provided through shareholder resolutions, so we would encourage the Commission perhaps to ease off the brake a bit as it's analyzing auditor related proposals, particularly ones addressing public policy issues that are being debated really around the globe today.

Joe will cover the next three.

MEMBER CARCELLO: Thanks, Ann. That's a wonderful overview of those three.

If you would, Chair White, I want to add just a couple of bits of color to what Ann said. On the audit firm governance bodies, I would encourage you, if you have not already done so -- Ernst & Young has done this globally, it's required in the United Kingdom, Ernst & Young has chosen voluntarily to do it globally. The group is chaired by Mark Olson, who I believe you know. Deloitte has chosen to do something voluntarily in the United States, the group is chaired by Dan Goelzer who was a member of the PCAOB for a number of years. In speaking with both of them, I would say their experiences have been very positive and they believe these groups have been very positive for the firms.

In terms of the auditing standard, as Ann alluded to the FASB has now used the word probable. The auditing literature talks about substantial doubt. If you go into the academic literature, which is pretty voluminous on this, there would clearly be a higher threshold on probable than substantial doubt. So as Ann alluded to, in all likelihood the information content to users will go down if the PCAOB was to adopt that same language.

In terms of shareholder proposals, I think you see immediately that at least two or three or five colleagues might find appeal to let the market speak, which is really what we're getting at with shareholder proposals rather than putting in place rules. It would allow shareholders to speak on various things and right now their voices are being silenced on some of these issues.

The other three recommendations that we have -- I wouldn't be a good college professor if I didn't have handouts. So handouts are coming around. So the first is to implement an expanded audit report that provides meaningful, incremental information to investors. So as this comes around, you'll see on the first page is a letter to the Chairman of the PCAOB, Mr. Doty, from Chuck Bauger, talking about when the GAO adopted the requirement that GAO auditors sign their name. And I've highlighted relevant sections of this letter but the one part that I'll direct your attention to is the fourth paragraph, the second sentence. So that one change resulted in a significant improvement in the quality of the audit work in the report.

The next letter is from Sir David Tweedie, who was a partner of a major firm for many years, Chairman of the IAASB, certainly a well-recognized person. And again, I've highlighted various aspects of this letter for your benefit. But language in, by having the partner identify would weed out weak auditors because his or her reputation is now on the line. These all seem to be useful benefits.

If you look at the -- I'm still on the first recommendation, the next three slides are on the second one.

But if you'll look at the criticisms of this recommendation, there's discussion of enhanced liability. I think as you know, as an attorney, if there's litigation, the partner's identity is going to be easily discovered. There's concerns about consents. With the help of Pete Nachtwey, we think we have a good proposal on that that we will get to later. There's also concern that some of the firms have shared in comment letters about the personal safety of partners. As someone who has personally identified herself in the past when prosecuting people like Sigmund the Sea Monster and The Butcher, I doubt you have very much sympathy for that. But anyway, there is that concern.

MEMBER ROPER: I do not recall those particular defendants, but, okay.

MEMBER CARCELLO: So that's our first recommendation, in addition to the three that Ann had.

Another would be to require the audit report to include the -- I'm sorry, to implement expanded audit report that provides meaningful incremental information to investors in addition to the signature.

And the last three slides I have are excerpts from audit opinions in the United Kingdom. As you know, this expanded audit reporting already exists in the United Kingdom and we have a year of experience now. And the first is from Rolls Royce, which is obviously getting a lot of attention. And if you look at that last paragraph talking about the estimate is acceptable but mildly optimistic, now if you are a user that's clearly incrementally valuable information to you. I don't think any reasonable person could look at this and not conclude that that's incrementally valuable information.

The next slide is from the BP audit opinion, talking about the scope and really getting -- I've underlined at the very bottom there -- some very specific work that the audit team has done here. In this case, the senior statutory auditor in getting comfortable around some of the high risk areas in this engagement.

And then the last is for Britvic and talking about materiality. And I'll just let you look at that on your own convenience.

And then our last recommendation, our sixth recommendation is to implement a rebuttable presumption. So the presumption could be rebuttable that the auditor of an issuer will be inspected -- and we have some specifics in here, but essentially if there's a large decline in fees or if there's abnormally low audit fees after you size an industry adjust, this gets at what Lew was talking about and we have some very specific data from audit analytics that we'll talk about later today. In talking with senior leadership of a number of organizations, this is clearly a problem. And it also, I think, dovetails with one of the other group who we'll hear from today.

If you think about the Sarbanes-Oxley Act, in my opinion the audit committee is the lynchpin of that Act and the reason it's the lynchpin of that Act is to basically remove the CEO and the CFO from negotiating the fee and dealing with the relationship. I think in too many cases that role has been, maybe not officially but in practice, that role has been abdicated and the CEO and the CFO is still driving the relationship or the audit committee views their role as getting the cheapest audit fee. I don't see how that can possibly be in the best interest of investors or consistent with good public policy.

MR. HARRIS: Thank you very much Ann and Joe.

And why don't we move on to Bob Tarola and Tony Sondhi on the relationship and role of the auditor with the audit committee.

MEMBER TAROLA: Good morning again, both Chair White and the members of the PCAOB.

I co-chaired a committee with Tony Sondhi and supported by Curt Buser, Norman Harrison, Michael Head and Peter Nachtwey. And our group explored how the intersection of the roles of auditors and audit committees could provide more confidence in the financial reporting system. We reviewed the current state of regulation and reporting, the efforts underway by a number of advocacy organizations to enhance transparency and our own experience working with and serving on audit committees. The result was a series of observations and questions that we will put before the IAG later today. But the main message from our review is that there is opportunity for auditors and audit committees to enhance each other's role in the reporting and disclosure framework.

For example, the work of the audit committee could be made more transparent. The evaluation of the audit committee's work by auditors could be made more specific. And the protection of the independence of each could be made more clear. As a result of that we're going to pose four questions to the group later today. They are: Should the audit committee report on its role alongside the CEO, CFO and audit firm? In other words, should the audit committee report in 10-Qs and 10-Ks instead of just the proxy statement?

Should auditors be required to assess and report on the duties and operational effectiveness of the audit committee or should some other body take that responsibility?

Should the auditors' evaluation of the audit committee's role reported to the full board or more publicly than just to the board?

And should the auditor be required to assess the objectivity of the audit committee and expect that the auditor's independence be protected by the audit committee?

So those are the questions we'll be asking.

Our group believes that a highly capable and functioning audit committee is essential to audit quality. We therefore encourage the regulatory bodies that have audit oversight, two of which are here today, to seek ways for auditors and audit committees to continue to support the effectiveness of their interdependent roles. And we look forward to a robust discussion.

Thank you.

CHAIR WHITE: I really am here to listen but let me just say one thing, and first I think it's -- you can't overstate the importance of the audit committee in functioning at the highest possible level. I mean, one of the -- and I've certainly alluded to this publicly, the staff is working, you know, on the audit committee report and probably early in the year a concept release will come out on that we'd look forward to everybody's comments on that as well. So we see many of those same issues and are quite actively engaged on that.

MR. HARRIS: Tony, did you want to add? You co-lead this one.

MEMBER SONDHI: Thank you, Steve. Just a couple of brief -- a few brief comments. And many of them have already been covered by Robert rather well.

I just want to add that, if you take some of the issues that Robert has mentioned about the audit committee and its role, its competence, the question we should also be thinking about or asking is, is it a component of the evaluation of the internal controls at the entity?

Another question that, as an investor, has bothered me a great deal is this growing divide between GAAP measures and what is discussed in earnings conference calls. And you know, so from a perspective of earnings and valuation, what we're talking about and what people are asking about in the earnings conference calls has been very, very different from what we see in the financial statements. So the question to me from that -- on that issue is, how do we ensure that the audit committee and the auditors are looking at those aspects as well?

And then the last piece that I want to be -- that I would like to emphasize is the issue of this growth of principles-based reporting. And I certainly agree that we need more of that but the question that comes to me is, what is it then that the audit committee should be more aware of with respect to the fact that we're moving toward principles-based reporting?

And then from the auditor's perspective, if the substance of an agreement and if the substance of the practices of a company matter, at least as much and maybe in some cases more than expressly written contracts, then how does that affect auditing and what should the auditing -- the audit committee be aware of with respect to that?

So I think these are concerns that come from this role of the auditor and the audit committee.

Thank you.

MR. HARRIS: Thank you, Tony.

And before turning to Grant, Chair White, we certainly appreciate your understanding and forbearance. In terms of how we run these investor advisory groups, as you can tell these issues are brought to our attention by this group. I do understand and am sensitive to the role of the audit committee in terms of the jurisdictions involved. The primary jurisdiction is clearly with the SEC and therefore we tend to focus on the role of the auditor regarding the audit committee.

Having said that, we do not control this group and there was an overwhelming desire on the part --

CHAIR WHITE: That's good.

MR. HARRIS: -- there was an overwhelming desire --

CHAIR WHITE: That goes without saying.

MR. HARRIS: I know you know it goes without saying.

MR. HARRIS: But having said that, we welcome the input of everybody and therefore you will see and get unfiltered opinions from all the members of the participants today.

And now having said that, let's move directly, Grant, to your group on the Audit Firm Business Model, and we'll take that through 10:45, at which time I know that Chair White has to leave.

**AUDIT FIRM BUSINESS MODEL**

MEMBER CALLERY: All right. I will take my watch off and look because my primary role here will be to make sure that each of the sub-group folks maintains their 15 minutes.

As you were clearly here, while I said that I thought the principal purpose of this was to, you know, sort of open the discussion and have, you know, all sides viewed, you will clearly hear among the members of the group, as Steve alluded to, there are those who have very strong views on some of these issues. And so I am -- this is our large subcommittee and these are the four topics that I had outlined that we were going to go through. And I will hand the magic clicker over to Joe Carcello who will lead the discussion on the regulatory initiative.

MEMBER CARCELLO: Thanks, Grant.

So my role here was to just try to do a review of what's going on around the world. And so let me try to go through that relatively expeditiously. So the items to be covered, some of these we've already alluded to, was audit engagement partner signature, expanded audit report, independent non-executives on firm governing boards, preparation of transparency reports and audit firm rotation.

So audit engagement partner signature has been in place in much of the developed world for many years. Australia, Taiwan, China, in some cases, for quite a number of years. The European Union varies by country but on a global basis in many cases for at least five or six years, even on the short end. Evidence of the effect of partner signature requirement, as you can imagine, academics love to do research, that's how we get tenured and keep our jobs.

Audit quality improves and audit fees increase after the adoption of the signature requirement. That's a paper I did with Chan Li that is in the Accounting Review. We looked at the United Kingdom, we basically looked at the effects before and after, and that's relatively recent. And then there's a forthcoming paper in Contemporary Accounting Research by Robert Knechel, two other authors that partners whose reporting is aggressive or conservative in the past, that behavior tends to persist over time.

So if you're an investor and that matters to you, you now have a sense of a partner's DNA. And it does extend to the partner’s other clients, and that paper is also evidence that the market prices this, that it does matter to the market.

There are challenges to implementation, obviously. One challenge is that consents are needed in registration statements, and the partner may have left the firm. That's one of the things we're hearing is a major roadblock, and I don't take credit for this. I think Pete, you're the one who suggested this and I appreciate it very much, is that the SEC could designate consents as Evergreen unless financial statements or the nature of the audit report has changed, and that's generally a rare occurrence. Again, this is one of the recommendation that was included in the ACAP report.

Second item is expanded audit reports. An expanded audit report has been in place in the United Kingdom since the fall of '13, so we have about a year of information. Have a couple of quotes up here, one from the Chairman of the Audit Committee asserting that the quality of the audit has improved. The reaction of the audit firms has been positive, their position's been enhanced. Initial reaction from investors has been very positive. And again, that's the Chairman of one of the regulatory bodies in the United Kingdom.

Again, there are challenges to implementation. One of the objections is that new information may be communicated in the audit report. Some people feel very passionately about that. I've never really fully understood that objection. It strikes me that new information is what creates value and providing value to users should be the goal of the audit report.

The IAASB's proposal related to an expanded audit report is progressing more rapidly than a similar PCAOB proposal, so we already have this in the U.K. My guess, we'll have this around much of the rest of the world because a lot of the rest of the world patterns after IAASB and we're moving more slowly. And again, this is an ACAP recommendation.

Independent non-executives on firm governing boards, again I've alluded to some of this, has been in place in the United Kingdom since 2010. Although subjective, I've had conversations with senior people at the FRC and the ICAEW, both have been very positive about the effects of this and I've talked about how E.Y.'s implemented it, other firms have chosen to implement it throughout Europe, even though they're not required to. Some have chosen to implement it only in the United Kingdom. Deloitte has established a similar advisory committee composed of INEs in the U.S., we talked about that.

There is challenges to implementation, that could be disclosure of proprietary firm information, but it would strike me that confidentiality agreements could potentially solve that. And this was an ACAP recommendation.

Preparation of transparency reports, these have been required in the European Union for a few years. Again, there could be disclosure of proprietary information here. If that's a concern then aspects of the transparency report could be limited to being filed on a confidential basis to the PCAOB, and again an ACAP recommendation.

And then the last, audit firm rotation. EU, as we heard earlier today from Lew, is implementing a form of mandatory firm rotation. There are some of the specifics there. Italy has required audit firm rotation every nine years since the mid-'70s. Mandatory rotation existed in Spain from '89 to '95, although then they moved away from it. And South Korea has required auditor rotation every six years since '06. Brazil has increased the rotation period from five to ten years. There clearly are pros and cons on this. I would say the ones I've put up here, at least on our group, there's probably more disagreement on this than on the others as to whether this is a good idea or not.

There would be loss of issuer specific knowledge if there was mandatory rotation, and -- but you would potentially have an increase in auditor objectivity and so you'd have to trade those off and weigh those out.

Okay. To Brandon for consulting fee.

MEMBER CALLERY: Yeah, we've got a little time. So are there other members of the working group who would like to weigh in on any of these issues? We do have a period for just open discussion later, but if there are thoughts that other people from the working group have on what Joe has said, we could take a few minutes of that before Brandon proceeds.

Lynn?

MEMBER TURNER: Just two quick points. It would be interesting to know, in the case of the foreign countries, where the audit partner is disclosed, France, Taiwan, et cetera, how often the SEC has required the consent be actually signed by the partners when those companies have filed a registration statement as opposed to the consent being signed, just by, in the name of the firm, which I think is almost always what is done. So the notion that all of a sudden here in the U.S. we've got to treat the audit partners different raises a serious question as to why.

The second thing is on the loss of knowledge. If you look at any particular audit, 85 percent plus of the work is done by senior or lower level accountants. Very little is done by the most senior and the partners only spend about five percent or, as in the case of one of the PCAOB inspection reports, they said it was like one percent. So -- and those people often turn over.

We've seen some stuff in recent court cases where those people are turning over quite rapidly. So the people who do the majority of the work, there isn't a loss of knowledge about the firm that isn't already going out the door. And so this notion of loss of knowledge, I think, is somewhat a figment of some people's imagination. Partners, yes, and when partners change they typically, you know, exchange data between one another. But even they get rotated every five years now. So there is not that amount of inherent knowledge. And even where we see that knowledge, that knowledge hasn't turned out to prevent problems.

MEMBER NACHTWEY: Grant, if I might, a couple things. One on the expanded audit report, and I think what we've seen over in the U.K. is that's actually working pretty well. The question here, and as most of the group who's been around a few years, I always point out that there's an F in my title, not an I so that's -- the F stands for financial. The I generally at our types of firms would stand for Chief Investment Officer. So I always make sure and go around and talk to those folks and, you know, what do they actually look at and what are they concerned about, and what do they think of this idea?

And in general, I was quite surprised to hear that a number of our largest portfolio managers thought this could be a good idea. The challenge will be substance over form and do we end up -- no disrespect to the lawyers in the room, but lawyers have roles at public companies and at the audit firms. And does it end up being a lot of legalese and boilerplate versus something meaningful? I think that's the challenge.

The other challenge was put out by someone who runs our small-cap business so he's managing $40 billion of assets under management investing in small companies. And his point of view was, you know, it better be substance over form because if it's costing these companies 250,000 to 500,000 a year, extra time for the accountants, extra time for the lawyers, that's meaningful to a lot of the registrants out there, you know, it might not be meaningful to the Fortune 250. But the Russell 4000, it will matter.

And then on audit firm rotation, and this is a real tough one in my mind. The -- my former firm, we went through a risk analysis, and I -- in deference to those who have left sooner, Jim, more recently, I've been out for seven or eight years. But back in I'd say the timeframe starting about the mid-'90s, there was a very rigorous process of risk identification amongst, you know, clients, which clients, which industries, clients within industries. And virtually every time there was an auditor change where we're the new -- my former firm was the new auditor, that almost a priori became a high-risk audit.

And you know, until there was two to three years under the belt, particularly for the largest most complex companies, my last role while I was at Deloitte was auditing one of the three largest clients of the firm globally, there were 200 partners globally that touched that audit. Forget about all the other staff, et cetera. So the issue of institutional knowledge is really important in, you know, making sure that doesn't get lost.

Thanks Grant.

MEMBER CALLERY: Okay. Brandon?

MEMBER BECKER: Thank you.

We're turning to Consulting Creek which is a topic of some interest that has grown. We know that, as a practical matter, the various codes and policy statements allow auditors to provide consulting services that do not conflict with the auditor's independence, and that's standard. But in the past we did see a consultancy buildup where the level of consultancy revenues constituted just 13 percent of total revenues in '81 and it had grown by 1999 to about 15 billion. And we saw a significant increase in the number of restatements during that period of time, broadly referred to here as the Enron effect.

After Enron and after those disclosures we saw a pull back from consultancy. Most of the large firms either divested, sold or otherwise disposed of their consulting activities. Nevertheless, since that time we have seen a variety of standards put into place, and I think it's important that we pause for just a minute and take a look at those because that's going to be an important issue in the next couple of slides. We do now have a regulator setting standards, we do have SOX. We have more robust audit committees, a better definition of independent standards. We've seen a firm fail. We are developing additional disclosure of fees.

So the context has changed in terms of the regulatory oversight of consultancy activity and of the firms themselves. Nevertheless, what we see as a practical matter on the ground is a return of the role of consultancy as the big four firms, including tax services, have increased to about 65 billion in fiscal year 2013, a 5.5 percent increase over 2012, and the acquisition of consulting firms such as PwC's Booz and Co. We can see that graphically here, and here is where I urge you to take a pause. And you look at the blue line which is audit revenues versus the green line which is pure consulting, not consulting plus tax, just pure consulting, and you can see that from 2010 to 2013 a gradual increase in the consulting fees into the mid thirty-percentiles and a gradual relative decline in the audit fees.

And part of the question that is before us and the debate in general is, in light of the additional controls that we just saw in the prior slide, is this a source of increased concern? You can see it more graphically here when you put all non-audit revenues into a bar chart and you can see that, for example, it ranges from about 55 percent at KPMG in 2013 to hitting 60 percent for Deloitte in 2013, so that the numbers are significant in terms of the non-audit fees.

Now that gets us to the question that is really forefront which is, should we care? And the reasons why we think we should care, or at least have some concern, is talent management. Does this really change the incentives, particularly as we've talked about governance and a partnership structure that's the draw of consultancy revenues basically suck out the talent into the consultancy side of the business as opposed to the audit side? Does it change the governance or do we have good governance controls that allow the firm to still focus on its audit leadership as opposed to getting the next consulting dollar?  And it's sort of a marginal revenue analysis.  If your marginal returns are greater than your consultancy, is the firm going to tip its focus into the consultancy world?  And that is played out in part because of the partnership model and the difficulty of cross-subsidization.

Market risk, a firm may decide to exit audit services further reducing competition in the field?  And a broader public interest concern, are we creating adequate incentives on audit quality, core audit services not met because we'd see an increased focus on the consultancy role?

Having said all of that, you still then need to think about, well, what if anything do you want to do about it?  Even if you do decide that you're concerned and you decide that the reforms post-2002 weren't adequate, what might you do about it?  Well, one approach is to cap non-audit services, permit it for audit clients.  The other we mention is white list of non-audit services, specific services an auditor would be permitted to provide. Basically in both of those areas you're trying to make sure that within the construct of an audit firm you have a sufficient economic driver that it's the audit that's driving the revenues and focus of that firm. And to use a rough metaphor, the consultancy is the frosting, and that the cake remains the audit work.

The strengthening of the audit committees basically is, again, a focus on how does the audit committee itself police the audit services? I think that has gotten stronger. And then ultimately, mandating audit-only firms, so eliminate the ability of audit firms to provide non-audit services to any client. That's a structural division. The Commission tried it in 1936 with broker/dealers, it was an interesting experiment, it lasted for a while. But it's tough to think about drawing those bright lines within financial services firms because of the cross-fertilization.

It has an intellectual appeal but then, if you go back to the talent management concern, have you just created a world where now you've limited the revenues of the audit-only firms so that, fine, now you start off in your first year going to the consultancy side because you don't want to join the audit-only firm because you've already been tapped out and you've got a ceiling there. It's not unlike the debate that's going on about banker compensation, whether it's here or in Europe.

We did not have an answer to any of those questions but we thought they were really interesting. And I think if we had to put it together, we would say that -- and I want to let the rest of my colleagues jump in here -- that the driver of concern is do you have the revenues and the talent that is still focused on audit or do you tip that scale where you become a consultancy firm? So the cap on the amount of consultancy has some appeal or some balance because, at the point that you're a 70 percent a consulting firm and a 30 percent audit firm, there is the tail wagging the dog becomes a real concern for us.

MR. HARRIS: Chairman Doty. And I think we want to make this as interactive as possible as long as we fit within the 10:45 timeframe for Chair White. But Chair Doty --

CHAIRMAN DOTY: Well, it was a very crisp presentation. And congratulations on the balance. It may have been the best summation and condensation of the concerns that we ought to have that I've seen anywhere.

I take it latent in this, though, is that none of your team believes there is hard evidence or disbursed evidence of a database type for any of this, that these are things people may have seen and may have been worried about, but we don't yet know the extent to which the concerns are with us? And if that's true, I would be interested in whether the group thinks that perhaps the initial efforts that we should be making in this area are special focus in their inspection?

MEMBER BECKET: Well, I don't want to speak for all my colleagues or try and prove a negative, but I think it's fair to say it's hard to go beyond anecdotes to hard, systematic data. Now as the old saying goes, you collect enough anecdotes and you've got data. But we did put in new controls in 2002. It is a creep, it is not a dominance. It would be good I think for the Board, through its inspection program, to try and look for where those tips are occurring.

And I think it is integrated -- I'll just finish and let the rest of my colleagues join me -- in I think the governance conversation because whether it's a non-executive member of the governance board or the audit committee oversight, a robust governance process I think can help address some of these issues but needs to speak directly to these issues. And I would think the inspection process could look at that also in terms of whether that's effective or are we kidding ourselves in terms of window dressing?

MR. HARRIS: I think what I'd like to do is, Grant, I'd like to let you monitor the clock for your group.

MEMBER CALLERY: Okay, I am doing that.

MR. HARRIS: I'd like to get through it but because we've got a number of cards and I'm going to let you recognize the team as you see fit.

MEMBER CALLERY: Okay. Barbara and Curt were the other members of this subgroup. So Barbara?

MEMBER ROPER: So first to your question, Chairman Doty, I would say we will have data when the system blows up again. So that's -- but I think there's a sort of regulatory philosophy behind this. Yes, we have new controls in place since 2002 and yes, we still have a persistent concern about lack of professional skepticism and concern about, you know, persistent low-quality audits. And I think the reason, one of the reasons, is that regulation works best when it's not swimming against the stream of financial incentives.

And so you have to care about all of these issues related, you know, across the topics of this committee, but all of these issues related to the compensation of the auditors and the audit firms and the financial incentives that govern their work precisely. Because if you're swimming against financial incentives that work against the quality of the audit, all of those regulatory provisions we've put in place are not going to be effective.

MEMBER CALLERY: Curt?

MEMBER BUSER: So some of the things I think it would be very helpful to see is really the outcome of the audit quality initiative work that the PCAOB is undertaking. Especially looking at issues like, you know, make versus take issues I think would be very helpful to the analysis.

In the end, I think a lot of this, though, is, you know, dependent upon very good judgment by the audit committee. You know, putting in specific rules prohibiting bad behavior is often difficult in such far-reaching type items. And so having the audit committee, you know, that initiative that you're undertaking, I think, is really critical because that's going to put the right tone and the right people in place to make the complex judgments that have to be made, you know, in each individual situation.

MEMBER CALLERY: I guess just one final point there. You know, I think Barbara's probably correct, unfortunately, that the next time this really comes to the fore is when there's another blowup. And we want to get out ahead of that. So Jim, I think to your question, if the PCAOB has the ability to, as part of their inspection program, to look at -- to look and talk to the firms about what is happening, the incentives, the independence, are these -- is the balance that is -- we're seemingly creeping toward -- I mean, you could think of almost a situation where, you know, over a period of years you have the consulting rise to a certain level again and then all of a sudden the firms all spin their consulting firms off like they did in the early 2000s.

And as you're approaching that point and people within the firms start seeing that that's in the cards then what does that do to the internal structures of incentives and independence and, you know, where are people's mindsets within the firm? So I think to the degree that you can gather information, as imperfect as it may be because it's -- as Brandon said, it's not easy information to gather, but to sort of, as best you can, get your arms around where the creep is going and are there warning signs, I think that would be helpful. Because the worst of all scenarios is you get to another place where there's an absolute blowup.

MEMBER CALLERY: Okay. Actually, I don't know that we have time to do that. So why don't we move on to the next two presentations, get those done and then we'll come back and remember everybody who had your card up to put it up again.

The next piece of it is the transparency. And that is Mercer Bullard. I pass you the baton.

MEMBER BULLARD: Yeah, we wanted to just initiate some discussion on the issue of auditor transparency as to their role in financials. And what you see here is, again going back to ACAP, the recommendation of ACAP, to follow the lead of EU's Eight Directive, Article 40 which is to provide some basic information about ownership, legal structure, corporate structure. And I note that corporate structure is extremely important in the accounting industry, as you probably know, in that the largest four firms have dozens of different entities in different countries. So that becomes important in terms of the way you approach financial disclosure.

And then finally, the financial information that we're all familiar with because it's similar to what is already provided under SOXA. I went back to ACAP to just sort of pick up what the general tenor of the report was. It's hard to really know because it's my understanding the vote was as to every recommendation in the report. So it's hard to really tell where people stand. But I looked back at the co-chair's introductory letter and I found a comment that I think sums up much of the report and replies specifically to this issue.

The co-chair said, the major auditing firms are key actors in the public securities markets. They must comply with the same principles of transparency that we ask of other major market actors, both for the sake of the credibility of the market system as a whole and for the credibility of the long-term health of the firms themselves. And I think that that captures one of the arguments that is made in favor of more financial transparency, and that is that here we have entities that are essentially not necessarily quasi-governmental but certainly serving a public function. They have an exclusive public license. But ironically with respect to the things for which they are responsible they do not comply themselves in that they are auditing others' financial statements and do not make their own public.

Another irony I found was that we often hear of the claim by these firms that legal liability threatens their financial existence which is interesting in that that claim would seem to have to be based seeing the financials that they think would be threatened yet those are not disclosed. And of course, the financials of Pricewaterhouse are not going to look like your average operating company. You're not looking at hard financial assets but it would be interesting to look from an accounting point of view as to exactly how a liability, a potential legal liability would threaten their continued existence. Perhaps it's in excess dividends being paid in the form of compensation. But it certainly would be interesting to play out that argument in the context of more disclosure.

Another aspect that I found somewhat eerie is that I also teach in the area of banking regulation and the four accounting firms dominating the audits of the S&P 500 are strangely similar to the four largest bank holding companies holding more than half of bank holding company assets. And I don't want to push the analogy too far but, of course, the financial statements of the four largest bank holding companies are the most legally scrutinized financials in the world whereas the four largest public company account firms' financials receive no scrutiny at all.

Along the lines of, if it acts a bit like a duck, doesn't really look like a duck, well interestingly, if you look at the requirements for registering as a reporting company, it's not clear to me at last, before the Jobs Act why these firms were not required to be registered. I haven't done that much research into it but they certainly had enough beneficial owners to have triggered the 500 person limit and certainly had $10 million in assets. Today with the limit being 2000 investors with a maximum of 500 non-accredited, they probably don't trigger registration anymore. But it's not just in that respect they look very much like public companies. Ernst & Young and Pricewaterhouse are two of the largest ten private companies in America and they each employ more people than every private company in America with the exception of Aramark, which you know is providing poor university food to a lot of areas of the country.

(Laughter.)

MEMBER BULLARD: So the large number of employees doesn't necessarily mean a good thing.

And this is -- you know, I don't really have a strong opinion on this, this is really just sort of to stimulate discussion. So give that bit of a background, let's look at where we are. And of course, you heard a number of times that where we are is the division of fees among different categories in Form 2, which now having been through it, I think if you wanted to bury the signature or the name of the person doing the audit, that would be a good place to bury it if you don't want people to pull it out. But I thought it would be useful in this context to actually look at one of these disclosures which is a last-minute addition in a separate handout in your charts.

The top shows the part of Form 2 where you actually see the data. And what you actually see there are numbers twenty-five, five and zero that represent the percentage of all fees billed to clients, which is obviously not intuitively obvious. If you dig into it a little bit and you think a little harder you would realize that, if you want to know the percentage of fees charged to audit clients, you would put the five and five together, it would be ten over thirty-five, which would be about twenty-nine percent.

The reason they're both rounded to fives is that they are actually rounded to the nearest multiple of five which actually means that, if they were on the low end on the numbers two and three and the high end of number one, that could actually be a total of fifteen percent as opposed to twenty-nine. If you rounded the numbers down for the audit services and up for the other services, it could actually represent sixty-seven percent. So given the rounding what you really have is what appears to be 29 percent percentage of non-audit services but in fact, because of rounding, it could be anywhere from 15 percent to 67 percent. I don't think this would really satisfy any data presentation test and certainly could be improved in that respect.

It's also important to see that the flip side of this, of course, is the issuer disclosure. Here we have the issuer disclosure looking very different, to the dollar. And I chose this in part because it shows the trend that Brandon was just illustrating for us, you can see from 2012 to 2013, you see an increase, an uptick in the tax fees, a decline in the audit fees. It makes me wonder whether, with respect to the data we looked at before, there's really been a change in audit as opposed to a decline in -- a change in non-audit as opposed to a decline in audit. So you've really got to figure out which number is actually moving there.

And again, what that shows, again not intuitively, is that 21 percent relationship but again what's interesting about both of these, and this is true of SEC disclosure universally, and it is a bit of a pet peeve of mine, is that there is no context. There's virtually no disclosure in which what you get is data in the context of what other people are doing. So if you look at the dollars or you look at these percentages, not only are the top ones misleading because they're rounded, you have no idea where that firm stands in relation to anyone else. Is that a large number? Is that a small number? Is it off the charts? Is it meaningless? So again, I think that's not particularly useful information for accomplishing the very limited purpose for which it is provided.

With those thoughts, I also thought we'd look at the U.K. requirement. Again, it looks very much like the -- not surprisingly the EU Eighth Directive Article 40 requirement, which is the governance, the corporate structure, ownership and then the same financial information. But when I went in and actually looked at the U.K. requirements for a couple of the big firms and then compared them to the EU requirements and then compared them to our Form 2 and our issuer disclosure, the U.K. is actually much better. They have year-over-year numbers. They're not lined up in columns next to each other but they also are described in plain English terms that make it very clear as to what is a percentage of what -- if you actually wanted to target any of this disclosure at a retail investor, the U.K. I would probably give an eight or a nine. I'd probably give the EU about a five and then we'd probably get about a three.

So even on the front of the disclosure we're currently providing, which is extremely limited, it's somewhat wasted in that it's not really making the point that the supporters of this kind of a disclosure wanted to make.

Other issues we might want to consider is to think more thoroughly about the relationship between the total percentage of non-audit fees and what we might think about conflicts of interest. Is a firm dominated by non-audit fees? You don't get that at all from the U.S. disclosure because it's completely empty as to, you know, what else is going on in the firm. So this was, again, just to stimulate initial discussions or think about where we are and what our current disclosure is doing, and then maybe also think about the reasons that we may want to look at requiring, as was suggested by ACAP, a much more fulsome disclosure of financials which, by the way, the U.K. also requires. The U.K. has profitability numbers which you don't see anywhere else, for example.

So that was all I had, in case anybody has any other thoughts. I know we're running short of time but we've got some initial input.

MEMBER CALLERY: The other members of that subgroup were Ann Yerger and Ann Simpson, who is not here today. Ann, do you have any thoughts to add to what Mercer said?

(No audible response.)

MEMBER CALLERY: Okay. Then why don't we move on and make sure we get the fourth topic done which is the "who should pay for the audit." And that's Lynn Turner.

MEMBER TURNER: Let me go ahead and start while we're waiting for the thing to come around.

But first some -- maybe the best way to do it is to set some background and talk about some of the reforms or things we've gone through in the past in this country, in the last 100 years or so. We started out a little over 100 years ago with the 1909 panic that ended up with the creation of the Federal Reserve and resulted in the first accounting standard setting in 1917 that was actually drafted by the profession, and really the beginning of standard setting in the private sector in the United States.

And then of course, we all know that we had the '29 crash which gave us the '33 and '34 Act and the requirement for an audit again in the private sector, although that law, as initially drafted, was going to have the auditors in the government sector and only a late change to that law left it in the private sector after Senate Banking Committee hearing.

And then in the '60s and '70s, some of us old enough to remember will remember Penn Central and Equity Funding and National Student Marketing which brought us the Public Oversight Board and the initial inspection of firms by another firm. Brought us the creation of the start of what's now known as the Quality Control Standards that govern the quality controls that are the subject of Part II reports by the PCAOB. And also for a few years anyway, initial disclosure of the consulting fees, not in terms of dollars but at least in terms of percentages.

Then the '80s we had the S&L crisis. Steve lived through this again up on the Hill, knows it well. It led to our first audits of internal control and the COSO framework that we now use for assessing control.

And then in the '90s we also had corporate scandals, started off with the Waste Managements, the Cendents of the world, if you will, and kind of erupted into Enron, Worldcom and many, many others. And that led, of course, to SOX, some of those are early-on problems before Enron and as well as an investigation of PwC led to the new SEC auditor independence rules at that time as well.

So all along we've had these problems, had reforms, had problems, had reforms, problems, reforms. And yet today we're kind of in the same place we've been for the last 100 years, we still get very fine PCAOB inspection reports that cite some very serious problems with audits that are very troubling to an investor community. I've talked to our CIO at our fund, a $47 billion fund, our portfolio managers aren't even relying upon the audit report because they see very little value in them. And I think that's true. And we're moving to indexing which even reduces the need for the audits as well and raises a real question about what is the value of the audit in today's environment where many of the big problems are never identified by the auditors until it's already been identified by hedge fund or a reporter at the New York Times or Journal or someplace?

So with that kind of in background, I do think the big issue and the elephant in the room, ultimately the one we don't deal with, we've done all these reforms, we've tried to deal with it through independence rules, I know that one all too well. But at the end of the day we always come back to the same issue and problem and we've never fixed it. And it's because at the end of the day we refuse to take on what is the elephant in the room and the tough issue, and that is who pays the auditor.

And it's not just who pays the auditor but more importantly it's how do you line the auditor up to where their interests are being viewed as those of the investors' and get that alignment?

And what's troubling about that is that about a year or so ago this month, the National Association of State Boards of Accountancy, their Board was holding a meeting and they entered into -- they had a great debate at that meeting. And the debate was whose interest does the auditor serve? And the Chair of NASBA was arguing that they serve the investors' interest. But one of the senior partners in one of the big four firms was arguing that investor -- or that the auditor had no public interest, had no obligation to the investor, it was a matter of law. And that is very troubling when you see a senior partner at a big four firm arguing that in that type of venue.

But that's not the only place. You can go to the court filings in Florida a few years back where one of the big, top six firms, BDO was found guilty three times. That case was tried three times and all three times the jury found them guilty. And in that case, though, BDO filed a brief with the court that again argued they didn't have an obligation under law to the public whatsoever.

And so you've got this great disalignment which is why we end up with the problems that we do today, and that should be no surprise to anyone when you really get down and think about it. So the question becomes then, how would you go about realigning that interest and taking on the elephant in the room rather than kicking the can down the road and always just nibbling at the edges and keep coming back for over 100 years now and having the same darn problem again?

And I've given it some thought and here's some ideas. One, just to as some would argue with the credit rating agencies, I would eliminate the requirement in the '33 Act for an annual audit of the financial statements. Just get rid of it. And initially that sounds, whoa, do I really want to leave all those CFOs out there doing their thing without any oversight? But research has shown that about 70, 75 percent of the time, the CFOs actually are doing the right thing. And I think they would, I have that level of trust.

Now 20, 25 percent of the time, though, research has shown on a number of occasions, not just once but on a number of occasions for the last 15 years or so that they do cook the books by a material amount. We've seen surveys, surveys survey on that, that's true. But the problem is those surveys also show the auditors aren't finding them. So on that percentage, why pay the cost of the audit if they aren't finding them?

So I wouldn't do away with the audit because I think there is value if it's done right. If it's not done right it's misleading and it's worse than no value. It misleads investors into making wrong decisions and wrong capital allocations. And very costly, not only to investors but to the country. So I'd replace it with a government mandate in the law that says every three to five years investors get a right to vote on whether or not an audit. And I think almost all the time investors would require that and vote to have the audit. But it changes it from being a federal mandate to being a decision made by investors so you're only protected as an auditor as long as the investors are willing to vote for it.

And then I'd also give the investors the annual right to approve the auditor who has been selected by the audit committee. So you have now all of a sudden really changed the alignment as to who's saying you've got to have an audit. It's no longer a government mandate, it is investors. And if the auditor isn't getting the investors what they want, gone.

So then that keys up the issue is, okay, how do you pay them? Well, we've got a vehicle for doing that. The PCAOB collects the fee today from the companies. We can do the same thing and put it into a pot of money. I would still -- people ask me who would you have negotiate the fee? I would still have the audit committee negotiate the fee which most often is not done today. There is a false sense that it's done because of SOX but that's not true.

I participated in a conference put on by FEI and CFO Rising in Vegas a couple years ago. Maybe casinos was the right place to do this one. But at any rate, the question that got asked to the audience, there was about 300 CFOs and controllers in the room and the question was asked, how many of you negotiate the fee and the terms of the audit engagement letter of the audit contract versus how many of you, that's done by the audit committee, either chair or as a group? And of the 300 or so people that we had there, there was, I think, five or six that said the audit committee did it. And the rest of them all said they're actually doing it.

So I would turn around and make sure as to who's going to negotiate that fee so you're again breaking the tie to direct -- to management. You're breaking the tie as to who signs the check. The audit committee would negotiate it, present the bill to the PCAOB. The PCAOB would turn around and pay the bill and that would then start to make your alignment directly between the auditor.

I would also give the PCAOB the right in that scenario that, if they found a really bad quality audit, as we've seen in some of these inspection reports, they would have the right to demand that the auditor be changed out. And there's two different sides to rotation, but at the end of the day what it's all about, are we getting good audits? This ensures that if the PCAOB in fact, factually finds a problem with the audit, they're given the right to demand the audit committee replace the auditor.

And there's other things that I would probably do as well. Certainly the point Jeanette made about audit quality indicators. I can say more, that that's been six years since we issued the ACAP report, six years way too long to have to wait for that. That's not a six-year project.

The staffing realignment, there has to be something done differently. We're still having, you know, 85 percent of the work done by fairly junior level people, good people, very talented people that these firms hire, but they are so far in over their heads from the audits I've seen. I've been retained by a number of U.S. trustees to take a look at them and what I'm seeing today is very, very discouraging. And they just aren't getting on top of it. They're in way over their heads. So I think the -- and I think we've seen some of this also in the PCAOB inspection reports as well. And the QC standards have got to be updated to take care of that and make that change.

I do think Paul Volcker's concept of an audit-only firm, which he really developed out of Enron and Arthur Andersen where he sat on their oversight board, I think is a valid point, probably a much more valid point than rotation. I think that's something that has to be considered. I commend Chairman White, if you're working on that, a committee report, Harvey Goldschmid and I wrote that while we were there and it's long overdue to redo that report. It was a step forward at the time, quite frankly, as far as we could go and get something passed at that point in time. But it needs major revision, major reworking at this point in time on that.

And I do think we've got to redo the auditing standards in terms of auditors, got to start looking at more of the external data than what they currently are, which is usually negligible or next to none. And that's why the hedge funds and the New York Times reporters find it and the auditors don't. So with that, I'll leave it --

MEMBER CALLERY: Okay. Well, we said we were going to get to a couple of sacred cows and we did.

The two other members of that subgroup, we're coming in on time here, were Brandon and Bob. Do either of you have any comments on follow-up to Lynn?

MEMBER BUETTNER: I would just ask Lynn one question.

Lynn, you brought up the concept of indexing. So just to what extent do you think that this move towards passive investing, were all of these to be adopted and obviously investors at that point would be voting on whether to have an independent auditor or not, to what extent do you think the indexers would be more inclined to vote against that? Obviously not bearing direct responsibility for a ten percent position that might collapse.

MEMBER TURNER: Well, I can use our fund as an example because we indexed the, in essence, Wilshire 5000 and we have both a significant passive as well as a significant index fund. And I actually chair our committee that oversees our shareholder voting.

I don't think it would change our voting because our voting guidelines and what we use to vote and how we make our decisions on voting is based upon, in essence, what we're seeing going on with the audit and how we feel about that. Unfortunately today we don't get the information we need to make a real informed decision which gets back to Jeanette's comment about audit quality indicators. You're asking us to do a blind vote today.

And if we had the audit quality indicators I don't think -- I still think we would be taking a look at those. In fact, I know we'd be taking a look at those and still voting yea or nay on this. I think most of the time we would vote to pay to have an audit because it does give you that assurance. But we'd also have the trigger if we didn't like what we saw to then say, no, we want someone else.

And we get on the phone a fair amount with other large institutional investors. I can't -- and we've been on the phone with a number of them about audit issues. I can't help but think that, if there was something that showed a problem on an audit, that we wouldn't get on the phone with other people and kick it around and decide whether or not to vote against the auditor. We've been on the phone with others, Damon and his people and others on audit issues. So I don't think it would change.

The whole thing with indexing is, once you go to indexing, the value is in where the market's going and what's driving the market up and down. Not so much --

MEMBER CALLERY: Okay. In the interest of time I'm going to cut you off, give Brandon a couple minutes. And we will --

MR. HARRIS: Actually we have four minutes. And can I just pre-empt Brandon and ask a question, if that's all right?

MEMBER CALLERY: Certainly.

MR. HARRIS: And then we have a lot of tent cards after the Chairman leaves so we've got an hour for discussion.

MEMBER CALLERY: Yeah, we've got an hour for discussion.

MR. HARRIS: But I would like to touch upon the economic guidance of the SEC and the costs and benefits of what we're dealing with, and realizing that we can't answer this in four minutes, you know, whether it be Joe with you on transparency or Brandon with you on the consulting creep or Lynn. If each of you could talk just for two minutes in terms of how you would recommend we measure the benefits versus the costs and how we deal with the Jobs Act as we go through these various recommendations, I'd appreciate that. And then, as I say, we'll wrap this up in three minutes because I know you've got to get out of here at 10:45.

Anybody who'd care to respond to that?

MEMBER BECKER: I wouldn't pretend to know how you deal with the D.C. Court of Appeals but I think you look at the inspection reports and you look at the history of damage to compute your costs and benefits. Because if you just look at the out-of-pocket expense of dealing with consultancy, the numbers are going to be wildly skewed in terms of the expense side of the ledger. You've got to look at what happens when this stuff blows up.

And then I think -- I'd love to get the courts to accept this -- you've got to do a distributional analysis because small shareholders and retail people get hurt disproportionately in those situations. My guys aren't heroes but my portfolio managers can see stuff. It's those who are caught disproportionately are the retail who get hurt when this stuff blows up.

MEMBER CALLERY: Barbara had one comment.

MEMBER ROPER: So I actually have spent a fair amount of time looking at that decision and it doesn't, in fact, require you to have data that you don't have. It requires you to have a good story about why this is a necessary regulation, about why you think it is reasonably likely to work. It requires you to have made a good faith effort to collect data. But where the data is not available it doesn't stop you in place. And there have been a couple of decisions now, one at the CFTC on commodity pool operators, registration, the SEC's on -- was it on conflict minerals -- where the analysis has passed muster with the Court.

So I don't think -- I mean, I think it's really useful to go back and read those decisions and see what it is that they're saying. And I don't think you have to be afraid to act where there is not data available, as long as you've done -- gone through the reasonable steps of collecting data and can explain in reasonable terms why your approach makes sense.

MEMBER CALLERY: Mercer?

MEMBER BULLARD: Steve, was your question generally how to look at the Jobs Act or --

(Laughter.)

MEMBER BULLARD: -- I mean, in terms of determining how effective it is. One area in which it directly affects the accounting is that, you know, I've been trying to look at whether confidential filings are allowing firms to hide and then see if the SEC catches accounting issues. And of course, a firm that had that problem earlier in the last decade was one of the reasons that we had that confidential filing provision. So I think that would be something very useful to look at.

A recent study came out showing that there's a massive amount of insider trading going on, based on SEC comment letters that are coming out to the public later than they're coming out to executives. So I would expect perhaps the same thing is now happening with respect to their confidential filings.

And also, for personal reasons I'd like to see that because it is -- I've been trying to research this issue. It's almost impossible to do a redline version of one registration statement against another, which is yet another reason why I think the SEC should require that every amendment to a registration statement be redlined like everyone else at this table has done with a Word document, have words that have been eliminated crossed out and words that have been added shaded so we can actually see what the changes were.

MR. HARRIS: Grant, you've got the final word and then it's time to take the 15-minute break.

MEMBER CALLERY: Okay. We hope that has been a useful discussion and we do have an hour when we come back to -- when we'll go through in the same order so everybody can get their tent cards ready and we'll go through the four issues. And thank you all for the presentations.

CHAIR WHITE: If I may just say, it has been enormously useful and I do intend to watch the exchange in the next hour. Sorry I can't be here live but I think I can see it, right? So you know, I definitely will. So I appreciate it very, very much. Thank you.

It wasn't easy to stay quiet as I did, either, so --

(Laughter.)

(Whereupon, the meeting recessed at 10:45 a.m. and reconvened at 11:02 a.m.)

MR. HARRIS: All right, Grant, if you could take it away. I know that when we broke there were a number of tent cards up.

MEMBER CALLERY: There were.

MR. HARRIS: If people could put them back up and then you can recognize them in whatever order.

MEMBER CALLERY: Right.

MR. HARRIS: I do think we have another good hour worth of conversation on this topic and then we'll break for lunch.

MEMBER CALLERY: Okay. Why don't we go through in the same order we did last time. And so for your tent cards we will start with what Joe covered, the international landscape which is kind of the -- what's going on around the world and some of the ACAP recommendations. And we'll do the questions or the discussion from the group in that same order of the four topics. So starting with the international landscape, tent cards up?

Where'd they all go?

(Laughter.)

MEMBER BUETTNER: Grant, if I might just opine very briefly on that?

MEMBER CALLERY: Sure.

MEMBER BUETTNER: I think the recommendation that some objectivity or subjectivity, if you will, be put into the audits similar to the three examples that you pulled out, the Rolls Royce example, the Britvic example are extremely helpful certainly to someone like myself who does invest funds and who does pay close attention to audit quality. I would say that if those -- if something similar were to be adopted here in the U.S. in our accounting profession there are very few people who historically read audit reports and that there should be some requirement that if we go down that route there should be a means to publicize those subjective and/or objective or additive work that was done by the accounting profession so that investors are aware of the auditors' interpretation of how management is presenting their financial statements.

Thank you.

MEMBER CALLERY: Barbara?

MEMBER ROPER: So I agree and I thought it was particularly interesting when Lew Ferguson was speaking earlier, that the presence of that requirement in the U.K. appears to have had a measurable impact in terms of the different effect of auditor rotation in that context. And the statement that auditors who have to provide this more robust reporting then want to make sure they have the audit to support that is exactly what we're talking about in this context of, if you're -- how do we change the incentives to improve audit quality.

MEMBER CALLERY: Okay. Any others on topic one?

Oh, yes, Lew.

MR. FERGUSON: Yeah. Just sort of adding a little bit to what Barbara just said, you know, the experience in the U.K. was quite interesting because the original requirement did not require auditor rotation. It required that the audit committee tender every ten years or so and then if it kept the auditor, it was permitted to keep the auditor forever if it wanted to, but if it kept the auditor, it had to explain why it was keeping the auditor.

And the experience, particularly with large issuers in the U.S. -- in the U.K., that the FRC found was that audit committees were very reluctant to have to explain why they were keeping an audit firm. And so rotation began to happen even in the absence of a rotation requirement, which I thought was quite interesting. Now of course, it's a different landscape because rotation will be mandatorily required with the new EC directive.

MEMBER CALLERY: You had mentioned when -- in your opening comments about the possibility or are they actually seeing audit teams following when there is a rotation?

MR. FERGUSON: Not yet, but it -- you know, one of the interesting questions will be, for example, for big banks, and both Barclays and HSBC are changing auditors there and there really are only two firms that audit banks in the U.K., KPMG and Pricewaterhouse. And so the question is, will they simply swap or not? And if another firm comes on, either Deloitte or Ernst & Young, they don't have strong banking practices in the U.K. so the question is, what do they do? How do they get those people if they happen to be picked to be the auditor?

MEMBER CALLERY: And if they do that, are they going to rotate?

MR. FERGUSON: If they do that, are they going to try to hire the team and things like that? So there are a lot of issues.

The other issue that's kind of interesting in the U.K. will be, there was a great deal of buzz about these -- the audit reports, the auditors' reports this year because they -- particularly in things like Rolls Royce and a company called New World Minerals, the auditor actually opined on his view of, for example, the riskiness of some of the financial statements. But one of the questions being asked right now is, okay, what do we do for an encore? What happens next year? And are we simply just going to repeat the same thing? Because probably the company hasn't really changed very much from one year to the next. So I think there was -- will this -- historically or in retrospect, will this turn out simply to have been a kind of a flash in the pan or will it actually lead to more thoughtful audit reports each year? And I think that is unclear.

MEMBER CALLERY: Damon?

MEMBER SILVERS: Yes. I just wanted to note that there's a great deal of -- that there's a significant amount of overlap between this part of this working group's report and the next working group's report. And to the extent that the folks from the Commission are paying attention and so forth, I think this is really noteworthy because it really suggests strongly that there's a sort of common body of policy recommendations here that different groups of people working independently will come to in terms of the partner signature, the expanded audit -- the audit report, and the issue of independent directors on audit firm boards.

I wanted to observe two things about sort of taking off from that. One is that in relation to the expanded audit report, it's been mentioned a couple times earlier today by members of the working group that there's a concern about boilerplate, which is a concern I share in these areas, if it's not real clear what it is we're asking for. And in my view, what we ought to -- in my view, what gets you away from that is a requirement to tell -- to discuss the most significant matter of concern that arose in the audit process.

I think the examples that are attached here seem to actually -- seem to get you there. And in our society which is different than the British public company landscape, we may really need to mandate that more directly in order to get that outcome.

The other thing I wanted to observe, which I'm not sure when to observe it in the course of all these things, but I've got the floor now, which is that really the PCAOB should be, I think, listening to a lot of what is said in this presentation and throughout this morning as really kind of disturbing evidence of important voices in the investor community and in the auditor community that are represented in this committee feeling increasingly agitated, that public company audits are simply of diminishing relevance. And that there are reasons structurally for that, and some of those reasons seem to be bringing back conflicts of the past.

But also, I think a growing sense fed by anecdotal experience on the part of a number of different people in a number of different situations at major companies that auditors are simply providing a false sense of security and are not getting at the real problems that exist in public companies. And then those problems surface later and people are harmed, and in particular small investors, and less -- as Brandon said, less well-informed investors are harmed.

The depth and the urgency of that concern, I think, coming out of -- that leads to recommendations of the kind that Lynn went through earlier seems really kind of obvious from these recommendations, and particularly when contrasted with I think kind of what you heard had the similar people been gathered say ten years ago. And because in fact, a similar group of people was gathered ten years ago, made many of these recommendations ten years ago. And the way in which these concerns have grown over time, I think PCAOB ought to be attentive to.

MEMBER CALLERY: Tony?

MEMBER SONDHI: Yeah, I'd been thinking earlier about a couple of other comments. And one of the things I wanted to talk about was the issue of the cost, and the cost that the small firms are facing. And one of my concerns would be FASB has been their decision to form that private company group which is now creating some separate accounting standards for smaller firms. And I know that as investors and at the CFA Institute we've always been against that because we're concerned about what effect that has on financial reporting.

And I realize, I understand the cost concern that was mentioned. Unfortunately it's not only had the effect of creating and issuing some standards that don't work very well, but in at least one case the impairment of intangibles, some concerns mentioned by small firms have led to the diminishing of the accounting for even larger companies. So that creates, I think, a very significant problem.

The other issue that Damon was just mentioning about the concern that whether people are using audits and so on, not quite the indexing issue but another problem is an issue that people have raised is the use of non-GAAP measures. And I would just like to remind people that all those non -- or many of those non-GAAP measures actually are adjustments to GAAP measures. So I don't think that we're not paying attention to auditing, we're just using it differently.

MEMBER CALLERY: Joe?

MEMBER CARCELLO: Just a very quick response to Lew. Lew, your point about what happens next year as an encore is a fair point. Obviously as we say in academia, that's an empirical question.

But just to give you the sense, and I'm sure that you've had some of these same conversations privately, my conversations with at least some of the regulators in the United Kingdom is, although they're pleased with first year, they don't think they're at the end state they want, what they envisioned. And the sense that I get from listening to them is that some of the companies there realize, and the audit committees realize they're not where they need to be yet, and the reaction has often been, well, it's the first year, this is a start.

So if that's accurate and if we see that going forward, that augers well for the future. But you know, we'll have to wait and see.

MEMBER CALLERY: Okay. I don't seem to see any more tent cards on this topic and we're 15 minutes in so that's good.

Consulting creep. Here come the cards.

(Laughter.)

MEMBER CALLERY: All right. Why don't we just go down -- Norm?

MEMBER HARRISON: Thank you, Grant.

First just briefly a word of thanks and praise to you and everybody in your group. It's really a great presentation with a lot of, as you mentioned, top-drawer issues none of which are of recent vintage, but they don't diminish in importance over time. So I'm glad we're having these discussions this morning.

I wanted to briefly follow up on an observation that Chairman Doty made in his comment following Brandon's presentation about whether perhaps the issue of consulting creep should be explored further through the inspection process, and I would suggest that it should. And that that in particular a related, potential related phenomenon of what I'll call fee creep should be included in that.

And what I mean by that is, I think we know we're certainly still in an environment where reporting companies are working their auditors pretty hard for reductions in audit fees and I think we have to acknowledge what very often happens in those circumstances is that there is some form of an implicit or an explicit agreement to provide a break or some reduction in the audit fee in exchange for some willingness on the part of the company to send business to another aspect of the firm, tax return preparation or the tax provision work or some form of consulting services which may, may or may not raise an independence issue with the capital "I" but certain at least raises one with a lower-case "I" or some form of conflict.

And it raises a number of issues including what significance do we attach or what is really the meaning of the categorical disclosures of fees, if there has, in fact, been some tradeoff or subsidy or transfer occurring through this process. It reminds us that the -- to the broader issue of firm culture and incentives that are driving the economic model. It reminds us that the three segments of -- three or four segments of an audit firm are not independent actors, they're part of an integrated business, and I think that's something else we need to be mindful of as we look through these.

And the issue we've discussed in this forum many times of whether, you know, we're still in an environment where we have audit firms that also offer tax and advisory services or whether we have advisory or consulting firms that also offer tax services and audit services which I think is an important question. And it also touches on the issue Lynn and others alluded to and that is, you know, getting some further visibility into who's really in the driver's seat in terms of negotiating the fee.

So I think that it would be a topic, you know, well worth some effort in the inspection process. It would involve peeling back the onion a few layers but I think when you begin to do so you'll see there are a lot of important questions here. And you may, depending on how you decide to approach it, come up with some interesting data about how fees are negotiated and allocated and whether there is, in fact, some form of transfer or subsidy occurring that might raise some significant issues.

MEMBER CALLERY: Mike?

MEMBER HEAD: Obviously the three topics of rotation, consulting creep and the level of fees and who should be paying the fees, it's almost impossible to separate the three because when you turn one lever, I think they impact the other two levers. But I -- some observations as I listen to the comments and as I read the presentation, and my own experience of dealing with audit committee and the selection process and who's negotiating fees, I have to kind of start where Lynn ended up.

I personally, because I was part of a team in the negotiation process with the audit committee and supporting them, where early on the audit committee made the stance of we are not going to pay our audit firm for any services other than auditing. I think that's the key and I think that should not only be what the audit committee, through their discipline adopts, but that it should be -- mandated is a little strong term, but strongly encouraged by PCAOB and the SEC. Because I think if you get that right and the coexistence of consulting in these large firms that the consulting, at least the way our firm -- and we used EY -- the way our firm would draw upon those consultants that had the subject matter expertise to complement in the risk assessment and execution of the audit. And we didn't have the worry that they had a pass to the halls to sell their consulting fees because that was usually why the conflict was there. They wanted to bring them in to "educate management," quote/unquote, educate management, when what they really were wanting to do was have a way of convincing and showing their subject matter expertise that could lead to non-audit fees. It had much higher realization and profitability than what the audit fees did.

And by still allowing that, but they knew they were prohibited, we were not going to hire them for consulting, then the true wanting to educate management and improve the quality of the audit and supplement the team became much more effective for us and we felt that was -- led us down the path of then the rotation would be driven by quality of audit and the fees would be driven by quality of audit.

But I do think if you took and -- in my case, I was supposed to be the data gatherer, I was supposed to coordinate with the audit committee and the CFO and others involved in making sure the fees and the quality of the audit and independence and objectivity all were accomplished.

I can tell you from practice under the current scenario, that is a very difficult task because the CFO does believe that the services being provided is directly related to the product they're supposed to be providing to the shareholders and to the board. And you can't separate that accountability for the product from the fees totally.

But I think if Lynn's model was more of the pooling and the fees came out of a pool not controlled by management or even the board of the audit committee and it was -- then you could get the CFO fully engaged knowing that the fee wasn't being controlled by the negotiation between the firm and the auditee. Then the negotiations would be the right team, the quality, and if they aren't delivering that, would they ultimately then want to put the bid out for services?

I'm afraid if you mandate rotations and try to address the consulting without addressing the fee you're going to get unintended consequences by turning the dials separate from it.  I think you have to address the fee at the same time.  And I know I ramble a little bit there but because I think it's so complicated and intertwined you can't leave the payment of the fees out or you're going to get unintended consequences on the other two topics.

Thank you.

MEMBER CALLERY:  All right.  We've got four more tent cards and about twelve minutes for this topic, assuming we're going to divide them equally.  So if everybody could shoot for three minutes.

Lynn?

MEMBER TURNER:  First of all, on the slides there was a slide that said "Enron Effect" and it had the KPMG, EY, PwC spinoff.  My point on those is it wasn't an Enron effect because all of those were negotiated or basically sold before Enron ever popped up.  What drove the people inside the firms to sell those was the value that they thought they were getting at that point in time.  They all thought they were getting five to seven, and in the case of PwC I think something like fifteen to twenty times revenues.  And it was the dollar sign that, in each one of those cases, caused the firm to turn around and decide to sell. In fact, in PwC case we had met with them in December of '98 and they vehemently opposed any condition or attempt to force -- or sell the business.

Then we issued an enforcement action against them over independence in January of '99, they started to lose substantial clients including some big ones. And within like forty-eight hours of when they'd been called by, I think, three of those big ones they called us up and asked for a meeting and came in and announced that they were going to put a article in the Wall Street Journal saying they were going to sell their consulting practice because it was the right thing to do. And in that article they talked about how not having consulting was the right thing because it was the audit that really counted.

And so it is amazing it was all about the dollars that pushed those things off. And if you look at where we are today it's all about the dollars in terms of acquisition of underwriters, investment bankers, et cetera. And that's what drives them and that's why Paul Volcker is so strong about the audit-only firm. I think

Paul's probably right about that one.

I did have a discussion two years ago with a senior partner, the top government relation partner for one of the big four, and he indicated to me, because they had a big consulting practice, that the consultants were actually -- absolutely driving the leadership of the firm crazy over what the consulting firm side of the practice wanted to do or not do. And certainly we saw this in the Andersen case. And as you well know, Jim, what that led to in terms of arbitration and the outcome and the ability of one group to control the other group.

And so I think those factors all have to be considered in what you do. But at the end of the day it's like the mole game at the circus. Certainly I was involved with the audit independence rules we did in 2000 and we knocked down a bunch of them. We picked of all the big ones at that point in time in between what we did and what Steve did with SOX. It took those all out and with the spin-offs that went down they popped right back up again.

And now it's in risk management or other areas. It will keep doing that until you take on the elephant.

Because it's the elephant in the room, it's who pays that drives the conflicts and the problems. And most importantly human behavior. And this is all about human behavior and how people act given the incentives. That's a hundred percent of what this is about. And if you don't fix that problem you can do all the independence rules you want, you'll have another mole popping up.

MEMBER CALLERY: Tony?

MEMBER SONDHI: I'm thinking back to what Mercer did so well with how carefully you need to look at tables and disclosures of information. And I was wondering whether we have, one, the right metric in terms of comparing what's going on with consulting versus the audits. And second, whether the information we actually -- the data, I should say, that we have on the fees and the revenues is actually reliable.

I remember, as Joe pointed out earlier that, when you're an academic you need to think about research. And my interest would be in terms of the empirical information I can get and the empirical analysis that I can do. And there is one thing I've always known about accounting allocations, and the only thing you can really say about them is that they're arbitrary. So I don't know whether the numbers we're getting are reliable. So the fact that they may not be growing that much or may be growing that much is something we can't say unless -- as somebody else, I believe, or maybe it was Mercer who pointed out, we really do need information from these accounting firms about their financial results that is reliable and transparent. Then I think we can understand.

But there really is a substantive issue about the quality of the work being done in audits versus the quality of the work done by their consultants. And as Lynn points out, they -- the consulting folks certainly do drive what's going on in some ways. But whether they're -- whether we have the right metric to evaluate them is, I think, an open question.

MEMBER CALLERY: Pete.

MEMBER NACHTWEY: Yes, thanks. So I absolutely agree that there's got to be the right tone at the top in these firms in trying to find the right balance between the sacred duty that they have as auditors and, again, whether there was really a choice of ultimately having the concentration that we have or not is water under the bridge. But at this stage we've got the concentration in the big four firms and they audit substantially all of the major companies in the U.S. And they've got to acknowledge the fact that that is a sacred responsibility to the investors around the country.

But having been there, I don't know how in the world you do a complex audit today without deep experts in a variety of areas. And CPAs are simply not trained to deal with the complex valuation issues, the complex tax issues, the cyber security and systems, et cetera, et cetera. So we can either have a world where we force them out of these businesses and then they're going to hire third parties, and now you're going to have how many different experts coming from a number of different firms to come in and audit these things or we figure out a way that they can live together. And part of living together is going to be you can't have top talent -- and I'll go back to one experience that I had formerly at Deloitte, right, when I led the valuation practice when SFAS 141 and 142 came out which were on fair value.

And the whole reason that the firm asked me to go do that, because I didn't know, you know, spit, I'll say, of valuation binomial models, et cetera. But what I did know was, you know, where we needed that kind of expertise to be deployed on complex audits. And how did you connect the dots between the valuation folks who frankly the practice wasn't built around audit support. Occasionally they'd do audit support.

The majority of what they did was deal with Wall Street and helping to design complex financial instruments that met the rules or they were valuing power plants and dams for, you know, companies that were requiring those types of things. Doing audit support was kind of a hobby and had to go from being a hobby to being, no, this is really important. If you're doing this then the audit side of the firm is relying on you.

And so again, just a multiplicity of areas where that comes into play. So how do we ensure that there's access to those world class kind of resources inside the firm when you need them? And it's not going to be just purely audit support because, you know, you're not going to keep the top talent if that's all they're doing.

MEMBER CALLERY: I mean, that's, I think --

really is part of what Brandon went through, you know, the -- what are the solution lists that we've got and how do you blend them? Because I think what you're saying is you -- either you go to this model where every time you get something that's outside of the regular wheelhouse of the auditor you're bringing in an outside third party and that has to impact costs, it has to impact efficiencies, all this kind of thing. And how do you balance that against, say, the firm's needing to have this talent in-house, be able to use it, and when they're using it for non-audit purposes then that drives the growth of the consultancy again? So you get into this whole cyclical thing.

And if anybody around the table's got the answer, that would be a great one. But -- Mercer?

MEMBER BULLARD: Yes, I --- In looking at some of the disclosure that I had up on the slides before there was one thing that really struck me, was that there was nothing about any of the non-audit fees that were paid to the non-auditing firms. And to really understand what the relationship, you would need that data point. And one reason it's not provided may be that everyone assumes

-- and this may be the case -- that when you hired an auditor that auditor does all of your non-auditing services.

Now if that's case, think about that for a minute, that means that every time a company chooses an auditor they just happen to find, if they're using one of the top four, that the one they chose to do their audit also happens to be better at all of the non-audit services than all of the other three every single time? Now if you ask an anti-trust lawyer about that they would say that can't be true, that's an economic impossibility if they have real competition. And then the explanations would not be very nice.

One would be outright collusion, it's probably unlikely. Another might be a more benign form which it's a tying arrangement, if you do the audit you've got to do the non-audit services or vice versa. Another theory might be it's just flat-out influence. We will buy your non-audit services if you give us a soft audit which, of course, is the theory behind the disclosure in the first place. And then the last theory would be that, well, they're so intimately connected that when you get somebody to do your audit then you should have them do your non-audit services.

That's exactly how we chose the things that you were prohibited from doing under SOXA, so if that's true then those things that are that closely related should not be allowed to be done at all.

So just the fact that it seems that all of the non-auditor services are always being provided by the auditor shows there is something just deeply wrong with the economics of that relationship. And I think it would be essential to know whether that really is the case, and if it is the case what possible economic explanation could there be?

MEMBER CALLERY: Jim?

MR. DOTY: Just a couple of fact points. One to Norman's point.

We do look in our inspection process in the risk selection of audits at swings in the compensation. Where there has been we think a suspicious adjustment of compensation one way or the other, that goes into a factor-laden determination along with identity of the engagement partner and the issuer or the registrant, the industry, a lot of other factors. So it is something I think we have looked at, I think we're going to look at more.

Of course, we are out with a consultation paper on estimates which serves up this -- the question that you're on that Pete Nachtwey mentioned. And we are -- among the long list of things that standards has to address is the supervision issue. How does an auditor supervise someone whose skill is simply not his own?

Recent discussion on all of this, on the estimates, in the roundtable led to an interesting exchange in which it was proposed, well, you should simply separate the opinion of the non-auditor and that should be part of an understood non-audited part of the financial presentation. We are hoping that groups like this are going to give us a better sense of how to slice the onion and how to deal with this problem of what the auditor supervises in these areas where the auditor is not an expert.

MEMBER CALLERY: Okay. Try to do these quickly. Damon?

MR. HARRIS: So Grant, you know, we can -- I mean, this is such a highly topical subject matter that, if you want to go 15 minutes over, we can take 15 minutes out of the open discussion at the end. Because I think if there are questions that people want to ask, your issue has traction with respect to everybody here.

MEMBER CALLERY: Okay.

MEMBER SILVERS: And quite frankly, internationally as well.

MEMBER CALLERY: I just don't want to blamed for getting --

MEMBER SILVERS: No, take --

MEMBER CALLERY: -- in the way of -- I mean, it's not as bad as getting in the way of the cocktail hour but getting in the way of lunch might be bad.

MR. HARRIS: I'll put the gavel down with respect to lunch. But if you want to go 15 minutes over, I know that I've got a question that I want to ask. And if it's toward the -- at the very end, that's fine.

MEMBER CALLERY: Okay. Damon. Still try to move quickly, but --

MEMBER SILVERS: I get the point.

(Laughter.)

MEMBER SILVERS: You know, for those of us who have been around this subject and were present during the debates over Sarbanes-Oxley, this conversation has a peculiar feel to it. You know, I don't know whether it's true that, in order for -- in order to do a complex audit of a global firm you need to have all the subject matter expertise inside your firm. I would suggest that that is, in general, not the direction in which large organizations of all kinds of movement in the last 20 or 25 years. It's not the way we run our federal government. You know, we don't have all the expertise that our government needs to do highly sensitive things inside the government. Some people think that's a bad idea but it's a fact, we don't.

So I don't know if that's true, but it seems to me if you're making that argument you've got a heavy burden in the context of the way things actually function in this world today.

I also think that we around this table are at a disadvantage in this conversation that arises out of what was discussed earlier this morning which is that we don't really know anything about the internal finances of the firms we're discussing and how the audit function and the consulting function interact. The PCAOB may know and inspections may -- Steve is shaking his head. I guess maybe you don't know, either? But we certainly don't know, those of us around this table, at least certainly those of us who have not been partners of Big Four audit firms.

But I think there is something we do know and that is that there is a fundamental contradiction between what we ask audit firms to do when they audit public companies and what audit firms are asked -- and what those same firms are being asked by those companies to do when they hire them as consultants. The purpose of a public -- of an audit is to answer the question of whether -- is to answer without regard to what is in the company's interest the question of whether or not the financials are accurately stated. You don't answer that question with the qualification of maybe I shouldn't answer it accurately if maybe that would not be in the firm's interest to answer.

On the other hand, when you're hired as a consultant you are hired to act in the interest of your client. Now I don't see how those two things really coexist in a manner that benefits the public within one firm. I don't see how you do it. And I think that the subtext of this meeting is a very troubling one which is that, if it's true that the economic model of the large -- of the Big Four audit firms requires that coexistence, then that economic model cannot get the job done that we are here to help the PCAOB get done. And that is a big, deep problem if that's true. And I think Lynn was kind of alluding to it earlier in his part of the presentation, putting some rather sacred cow killing responses to that problem.

I'm less convinced of what the solution is than I am, sort of, impressed by the depth of the problem that is being identified here in a somewhat indirect way.

MEMBER CALLERY: Lynn?

MEMBER TURNER: Someone made the comment -- I think it was Norman -- about you need the expertise do to these audits and I couldn't agree more with that. You do need to know what you're doing in some of these areas. Unfortunately with the junior-level staff doing some of this stuff, seeing them work on derivatives and all just kind of makes you cringe at times. So I have no problem bringing the expertise in.

But there are good consulting firms, there are people, some of the top expertise in many of these areas don't reside in the Big Four. And when I sat on the board of Sun Microsystems and we decided to go to another party, we found mistakes in our financial statements that our auditor, with all their expertise, especially in the tax area, didn't find. And so going to someone else, sometimes you can -- quite often you can find expertise in valuation, the best people are not necessarily inside the Big Four.

So this notion that you've got to go to a Big Four firm for this expertise is ridiculous. And in our case we actually found that the expertise was better with another firm, and cheaper even. So it is amazing, you don't have to have it.

The firm could go hire people if they need to go get that expertise and bring that expertise in. And we look at audits like J.P. Morgan a year or so ago where they totally missed on their derivative trading over in

London, if they had all this expertise, where was it and why weren't the risk management and lack of controls over there identified ?They had all the expertise but it didn't happen.

And so I have no problem if someone wants to turn and -- to deal with Damon's issue, go have -- give the auditor the right to hire someone from the outside, bring them in. And then there's the issue that Jim appropriately teed up, the supervision of those type of people. One of the problems we're finding is when the expert comes in on a case from the firm, they aren't necessarily supervised that much. It's kind of like come on in and tell us what the answer is and we'll go on down the road, you know, auditing. And because you're within our firm we don't need to supervise you. And there's problems with that.

So this notion you've got to go to one of the Big Four for this expertise is such a misnomer and so misleading.

MEMBER CALLERY: Tony?

MEMBER SONDHI: Thank you.

I also wanted to comment on what Chairman Doty had said about the evaluation of subject matter experts. I served in 2008 on the expert advisory panel on the measurement of the fair value of illiquid securities. And you know, it was very clear there, the people who knew what the value of an illiquid security was, you know, were the traders and the people who were, you know, working on the floor there. And their ability to have a conversation with the auditor, you know, it's like an alien talking to somebody on earth. And I don't mean offense to anybody, it's just that they don't talk the same language.

The same thing happened with the measurement of whether we have enough capital in -- during that crisis in 2008. Deferred compensation of some of the management being part of the equity, the auditors have an expertise in equity, they have an expertise in deferred compensation. But they hadn't been asked about the risk aspects of it the same way.

At the EITF in the last year, and these are -- I will be very, very clear, the caveat is that I don't have enough observation yet. But one of the things I'm finding, for example, we spent two meetings discussing an issue, we put up a draft abstract, we got 74 comment letters asking whether we knew what we were talking about. And as a result, the next, the third meeting we completely changed the way we were looking at the topic. It was no longer a tax issue, it was an investment or a fair value issue.

So I think that there are people in audit firms whose expertise is extraordinarily at odds with some of the information we need to have a good audit. And so I come back to what Chairman Doty said, whether they monitor them, whether they evaluate the subject matter experts, the point is it's not clear that they have that ability to do it.

MEMBER CALLERY: Curt -- Curt. Excuse me.

MEMBER BUSER: Maybe to potentially repeat a little bit of my prior remarks, but I think whether or not there's a causal issue here is important to understand. Does consulting creep cause audit quality deficiency? If it doesn't and we can't prove that, a lot of this isn't really what we're focused on. I think over the last ten years a lot of good work has been done by this organization as well as by the audit firms in terms of being focused on improving audit quality. We need to know whether or not that's working and we need to know whether or not consulting creep actually causes a problem on audit quality.

MEMBER CALLERY: Joe?

MEMBER CARCELLO: A lot of good comments from everybody.

I think Chairman Doty and Board members, I think this is a pretty complicated issue, as you've heard from the comments.

One thing that's not clear to me as I've listened to people is, if we're differentiating between the type of non-audit service. And I think you need to think about that carefully.

So there's non-audit services provided to audit clients. I think there's a mistaken belief that audit clients no longer have non-audit services as a result of Sarbanes-Oxley Act. Based on some of the work I've done, that's very inaccurate. So as you know, Section 201 of SOX bans many types of non-audit services. But there's a lot of types of non-audit services that aren't banned.

And so the issue is whether the preamble in the

SEC rule that implements Section 201 is really being followed in terms of the spirit of the law not just the letter of the law, and we could have an interesting conversation around that. But that potentially has a direct effect on independence. Because that work is being provided to the audit client, okay? So that's one piece.

There's a second piece. And the second piece is consulting work that's provided to non-audit clients. Not to the audit client. So the concern there is that, over time, I think we used this morning at some point, maybe 70 percent of the firm's billings is consulting work. You have a consulting firm that does a little bit of audit. So the concern there is around the culture of the firm. And has the culture of the firm changed in such a way that audit work is damaged, not for any one particular client but across the board? And this is really what Curt just said. Is there evidence that that's happening? I don't have any evidence one way or the other.

One thing I do think you have, based on what Greg Jonas is working on, one of the -- as I understand it, one of the AQIs that they're talking about are firm surveys. Now Greg and I have a little debate back and forth as to whether the right group to survey is people who currently work for the firm or people who have recently left, but we'll leave that aside. But certainly, I think you can get a sense of the culture inside organizations via these surveys. And that's very important to you.

A couple of other things. One thing that does trouble me, I've talked to the firms about this but the behavior doesn't seem to stop, is firm advertisements. Okay, now you might say, why should we worry about firm advertisements? If I'm willing to put something out for public consumption that says I'm sleeping in the same bed as you publicly, meaning my best -- you know, what's good for you, client, is good for me, firm, what am I willing to do privately? And just within the last week I've seen an ad from a major firm in the Globe and Mail. I've seen an ad for a registered firm but not a major firm in an airline magazine with this type of language which is, to me, a bit disconcerting.

Around the issue of outside vendors, whether the approach is to use outside vendors rather than to have the expertise in-house, and I don't think there's any question as Pete and others have said, you can't do an effective audit today without skill sets in valuation systems, data analytics is increasingly important. And I would caution those who just argue we'll just use outside vendors. We see this with comp consultants. The outside vendor likely either is working for the company or wants to work for the company. So to think that these people are going to be lily white, I think, is a bit naïve.

MEMBER CALLERY: Brian?

MR. CROTEAU: Thanks very much.

And I should just start by saying the standard disclaimer applies to me as well.

Joe actually just made, I think, most of the point I wanted to make relative to the growth of non-audit services and consulting, and I think it is important to understand how much of that is being sold to audit clients versus non-audit clients. While our issuer fee disclosures may be imperfect, I think they do provide a good amount of data. And I know that we look at that closely over time, Audit Analytics aggregates that. And as we look at it, it has stayed at relatively flat rates over the last few years. Since 2005, I think the average rate is about 25 to 30 percent relative to audit fees for non-audit services.

Now that doesn't mean we shouldn't focus on what's in that 25 to 30 percent, and also keep an eye on whether it's growing. But I think bifurcating the concerns into how much of this relates to the strategy of firms, where they're headed more globally versus how much of this relates to selling non-audit services to audit clients I think is an important distinction. Because if we're going to start talking about white lists or caps or those types of things, I think understanding that data in enough detail and the types of issues that we have relative to the types of services is very important.

Thank you.

MEMBER CALLERY: Okay. Two more. Marty, you've had your -- Lynn never took his down, I don't think.

(Laughter.)

MEMBER CALLERY: Which I'm not sure what that says. But --

MR. BAUMANN: Thanks.

I just wanted to address a couple of the comments made about specialized skill, which were really important comments.

But first of all the risk assessment standards that the PCAOB issued in 2010 require firms to assess, as part of the risk assessment in an audit, when that audit requires specialized skill and knowledge. So as part of the risk assessment, looking at that audit client's business, to know when you need special valuation skills, appraisal skills in an oil firm, Exxon, Entergy, engineering skills, et cetera, as well as IT skills in complex data security environments. So the auditor has to do that. We've seen execution problems in that through inspections but they don't always recognize where they need those skills but the requirement is there.

And then separately there is a standard certainly for the use of specialists and the auditor, if he has a specialist on the firm -- in the firm, that auditor is supposed to supervise that specialist sufficiently so that he understands that the work supports the conclusions reached. Or if they have an engaged specialist, they can go out and get a third party, but they still have to review that work, although that standard is weaker and we think it needs to be improved.

This is another area, though, of auditor performance issues. We think there are standards there and inspection shows a lot of cases where I think the point that was made, essentially accepting the work that the specialist does and just putting it in the files has been too much of a problem. And so these are areas we're addressing.

But in the case of valuation, as Jim mentioned, we have a staff consultation paper out on auditing accounting estimates, and that's basically what financial statements are, and fair value measurements. And we're looking for comment as to how auditor performance could be improved in that area. And the subject of specialized skills certainly came up at our special SAG meeting that we had just a couple of weeks ago.

And we're also planning a staff consultation paper to go out sometime near the end of this year, early next year, on the use of specialists and how firms can do a better job in terms of what the audit performance procedures should be regarding overseeing specialists and making sure their work is both qualified and properly reviewed.

Lastly, the engagement partner on a job is supposed to have the sufficient knowledge of that industry that he or she is in so that they can understand what a specialist has done. So all of these things are being addressed but clearly there are auditor performance issues in these most complex of areas which tend to be where there are serious problems and risks to misstatements. So I wanted to share a little bit of that.

And Steve, can I just take one second more on -- just a lot of things came up in this report about auditor -- in this meeting about auditor reporting and transparency, just to say where we are?

MR. HARRIS: Well, why don't you wait until the last hour because, in terms of the -- we'll have the open discussion. Because I do want to get Ann Yerger and Lew in on this as well.

MR. BAUMANN: Okay.

MR. HARRIS: So we'll give you the last hour and you can recap on that. We've got a whole hour of discussion.

MEMBER CALLERY: Lew?

MR. FERGUSON: Thank you.

You know, when I look at the question of non-audit services, and if you assume that audits, auditors are rational economic creatures, it seems to be one of the things we have to look at is what are the contribution margins of these businesses? How profitable are they, relative to the audit business? And it seems to me we have to look at that two ways. One, the contribution margins of the firm as a whole, look at the group together. What are they -- are they contributing at the same rate? And secondly, what's the contribution margin per partner?

And what we were told at least last week in Toronto by the global leadership of these firms that in the last couple of years actually the consulting practice has been less profitable than the audit practice. And nobody knows quite why that is, whether there's more competition than there is in audit, but it is actually less profitable.

The other thing is that three of the four big firms, in doing consulting, do not do either implementation work or systems integration work which is the kind of work that is enormously highly leveraged and leads to very high profits per partner. That was essentially the business of Andersen Consulting and that drove Andersen Consulting apart. But three of the four big firms, Deloitte is the exception, it does do -- and it never got rid of its practice -- it does do this kind of work.

But if that's the case, most of the businesses that these firms are in appear to me to be less leveraged and less leverage-able than the audit business. So things like valuation businesses, actuarial business, the IT stuff is, particularly if it's writing software and things like that, it's less leverage-able which may be part of the reason that it's less profitable.

But when I think -- you can't really understand this stuff economically unless we really understand where the dollars go and where the dollars are being driven.

MEMBER CALLERY: Ann?

MEMBER YERGER: Just very briefly.

You know, Damon, like you, I sort of have gone through the wars since Enron, and just the large numbers, the trends that you pointed out Brandon, are obviously -- I think they're troubling. The question is, are they serious? And it strikes me that there's two things that need to happen and it all involves data.

First of all, it strikes me that the Commission needs to be, I think as you said you are, evaluating the numbers that are disclosed. But then I think also doing a really deep dive about whether there's items that are currently excluded from being provided to audit clients are still appropriate today. And I don't know the answer to that but it strikes me; it's worth looking at given these larger numbers.

And then for the Board, just going back again to the 2008 ACAP report, there was a strong belief that in terms of just the transparency issue, Marty, which I suspect you'll talk about later, that at the very least the PCAOB should be getting detailed financial information from the firms so that you can understand what's happening and what's driving business decisions and might be setting the tone at the top. And I don't believe the Board is at this point getting that kind of information. But it strikes me as extraordinarily important. And rather having sort of anecdotal evidence about what's going on would give you information that would help with regulation.

CHAIRMAN DOTY: Without commenting specifically on what we're getting and not getting, this forum and the other public meetings that we've held I think confirm that we are keenly interested in getting within the economic structure of the firm and understanding what's below the skin and how it's working. It's a subject that occupies us.

MEMBER CALLERY: Steve, do you want to have the last word? We didn't get to auditor transparency and who pays for the audit, although a lot of who pays for the audit has been woven into a lot of the other comments. We could open those up as part of the open discussion if you'd like later? Would that be -- what do you think is the best way to proceed?

MR. HARRIS: I'll raise my issue later. Why don't we see if there are any questions on the last item? And if not then I'll raise my question.

MEMBER CALLERY: Okay.

MR. HARRIS: Jim?

MR. SCHNURR: First of all, I have my disclaimer as Brian said as well.

But clearly, you know, based on my own experience, there -- I think the fundamental question here is what issue do you think you're trying to solve in terms of where is the problem? Is the problem the mere size of the consulting practice in relation to the audit practice and the fact that the DNA of a consulting practice is markedly differently than the DNA of an audit practice? They don't really have professional standards, they're not subject to inspection, they're not subject to enforcement, they don't typically have the liability issues that an auditor faces.

As opposed to is there a conflict or an independence issue at a particular client because they're providing non-audit services? Those to me are two different things and the solutions or the recommended solutions to those are very, very different.

MR. HARRIS: Well, since nobody else has their tent card, let me just ask a final question. And that is, Brandon, you and a number of others have talked about where they used the term cross-subsidization between different business lines. You brought that up in the context of why should policy changes be considered.

I'm interested in terms of what cross-subsidizations between business lines you're most concerned about.

And then Damon, you referenced conflicts of interest. Norman, you talked about it being part of an integrated business. Mercer, you raised the issue as well. So very briefly, if we could finalize this section by talking about whether it be the cross-subsidizations, the tie-ins, the marketing advantages or others, that would be helpful.

MEMBER BECKER: Sure. I think cross-subsidization is just a large category to capture a lot of what's already been discussed here, which is subject matter expertise, whether or not you're providing a net deliverable to the client on an all-in basis is more useful for that client. Of course it's sold as being beneficial and more efficient.

Damon made the point about outsourcing and the fact that you don't have to have it within the same enterprise.

The question is, can you build walls to maintain the integrity of the audit process sufficiently while still getting the benefit of the integration of the services? And I do think that the discussion nicely highlighted that those walls can be just as important even if you're outsourcing. Outsourcing -- the corporate forum isn't going to determine for you the possibility of the overreach. Because whether or not you go to XYZ Consulting Firm outside of the audit firm itself, they're still going to be wanting to sell their product, to sell their services. So I think that set of cross-selling efforts are always going to be with us and you've got to look for walls to maintain them.

MR. HARRIS: Does anybody else have any comments?

(No response.)

MR. HARRIS: Okay. Well, I guess that is a wrap for this morning. I mean, I hope the Board and the staff got some valuable inputs here. You know, one takeaway that I have is there is a -- there's definitely a need for data. And whether it's something that the Board can collect by itself, whether it's the Board and the Commission working in tandem, I think Ann's comments were spot-on, you know, that you see this thing and you say, are we going back where we were? And are we going back to problematic areas? And without those specific data points, I think it's difficult to make those conclusions. And they're intelligent -- I mean, what Curt said, you know, you can't just jump to conclusions without the proper reasons.

So I think to the degree that you can gather this information and make it available so you can make, you know, good judgment decisions as to is there a problem, and then if there is how do you address it? Because they're all tough ones. So hopefully this will lead to some of those conversations.

Do you want to have the final word?

MEMBER BUETTNER: Yes, if I could just jump in for one second.

Just in terms of study, whether this is something, Joe, you and your group might want to look at, or Steve and your group, the idea of a company losing its chief financial or chief accounting officer and then hiring the audit partner on that has been something that I've looked at for years in the investment business. Something that's always sort of raised concern. Any time I see a CFO change, but more significantly whenever that company that is experiencing the CFO change then turns and hires their audit partner. And it might be useful to see what the post-hiring performance of that company is, both in the public markets and obviously from the standpoint of their reported earnings. And I would be more than happy to give a few examples to whomever might like to look at that study from situations I've been involved in to sort of kick that off. Just a thought.

MR. HARRIS: Well, we'd welcome that. And Grant, I want to thank you on behalf of the Board for a really excellent discussion on this topic. I think you brought a lot of fundamental issues to the Board's attention, to the Commission's attention. And I think you've done an outstanding job.

So with that, why don't we take an hour for lunch and be back here at five after 1:00.

(Whereupon, the above-entitled matter went off the record at 12:04 p.m. and resumed at 1:00 p.m.)

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

1:00 p.m.

MR. HARRIS: Ann, we'll turn to you now, you and Joe, and -- on the topic of how to improve the audit quality and the relevancy of the audit. I appreciate the work you've done, the slides that everybody has. So why don't you go ahead and start?

**How to Improve Audit Quality**

**and the Relevancy of the Audit**

MEMBER YERGER: Joe is going to set the stage for us and then we have divided our responsibilities between six of the subcommittee members. And I don't -- who has the clicker?

MR. HARRIS: I do. I don't know how I got it.

MEMBER CARCELLO: Okay. So our subgroup focused on possible recommendations that we think have the potential to meaningfully improve audit quality. And so we had a number of iterations from the members of our group in terms of ideas that might move the needle in a substantive way and we ended up with the six recommendations that we presented briefly this morning which we'll expand on here over the next 45 minutes or so. And as Ann said, we are breaking these up by person.

And so the first one was supposed to have been thrown to someone not in the room. Ann, do you want to handle it or do you want me to handle it?

MEMBER YERGER: Come back to it.

MEMBER CARCELLO: Come back to it? Okay. So we'll let Ann take on the second one.

MEMBER YERGER: All right. Audit partner's signature or name. I know the topic of the signature was already sort of briefly touched on this morning. And in a way I don't want to unnecessarily belabor the point but I do want to emphasize that our subcommittee strongly supports the PCAOB rule mandating the engagement partner's signature or name on the auditor's report. This is not a new issue for the PCAOB which has already proposed a change, and recently announced it would be reproposing the change, I believe. This is not a new issue for this committee which has long and consistently supported this change, nor is this a new issue around the globe as we saw earlier this morning. The EU, Australia, Taiwan and China require this transparency and at this point, frankly, the U.S. is looking like a global laggard.

This is also really not a new issue in the professional context. As we know, under SOX, the CEO and CFO must certify the published financial statements are a fair representation of the company's financial condition and that the financial process doesn't contain -- include any deficiencies or material weaknesses. And signatures are also standard in other professional contexts. Lawyers sign court documents, doctors sign prescriptions. My own personal view is that nothing sharpens the mind like a signature or a name on a document. I believe requiring this transparency would result in greater accountability. I believe it will result in greater due diligence and improved audit quality. And in turn, I believe this would strengthen confidence in financial statements.

I do not believe that such a requirement would impose on signing partners any greater duties or obligations or liability than what is currently imposed on them as members of an auditing firm. I also do not believe that the consent issue should be an impediment to this reform. Indeed, I see it a bit as a red herring and I believe the Board and others could readily find solutions for these very limited situations. And I think Pete and Joe earlier presented a really creative approach for handling this.

In closing I think I view this reform as low-hanging fruit and I would urge the Board to move forward.

MEMBER CARCELLO: Our next recommendation relates to fees. And we are recommending that the Board implement a rebuttable presumption that would be communicated publicly, that abnormally low audit fees will result in an inspection. There is a large body of literature that finds that audit quality is inversely correlated with audit hours and prior research finds strong evidence that fees and hours are related. Higher fees lead to more audit work, there's no evidence of rent seeking on the part of the auditor. If issuers know that abnormally low fees will result in their auditor and engagement being inspected, there's every reason to expect that such low-balling behavior will be mitigated and a reduction in low-balling behavior will increase audit quality in the short run, and arguably a more profitable profession will attract better entrants improving audit quality in the long run.

Just anecdotal before we go to the next slide, we talked a lot this morning about ACAP. And Lynn and Damon and Ann -- am I leaving anybody out -- were on that group. And I had the privilege of testifying before that group, probably Lynn and Damon and Ann forgot my testimony. But one of the things I did is I took what the starting salaries were in the public accounting profession when I started in the mid-'80s and what the starting salaries were in law and investment banking. And then I basically incremented them to what the salaries were at the time I testified, which I guess was back in 2006 or thereabouts.

And although you would expect, and it was the case obviously, accounting salaries was the lowest of the three in both time periods, the gap between accounting and the other two fields had grown at an increasing rate. And when I worked you got paid overtime. So you now have a profession where, both in terms of the absolute salary as well as the per hour salary is less attractive today than it was 30 years ago. And as you think about the expanding demands that we talked about this morning on valuation, business analytics, so forth, I just think in the long run you're not going to have a healthy profession if fees are constantly being driven down.

So let's see if there's any issue to be concerned about. We'll go to the next slide.

And this morning I told you that we would provide some data for you. So what we've done is we've looked at auditor switches and auditor fee changes from 2010 to 2013 using Audit Analytics data. Now one thing I need to make very clear, the firms 1-3, firms 4-6, firms 5-6 you can probably guess. But firms 1-3 and firm 4 are not necessarily listed in order of size. So it's not necessarily that 1 is the biggest and 2 is the second and 4 is the smallest. That's not -- it's just firms one through four are Big Four firms, I'm not saying which Big Four firms they are, okay? Is that clear to everybody?

All right. So with that said, when there's a movement from three of the Big Four to a fourth of the Big Four or firms 5 or 6, a movement in that direction, fees go down fourteen percent. When there's a movement in the other direction fees go up six and a half percent. It's a 21 percent swing. That's a big enough swing to affect behavior.

You can look at some of the other swings. If you just say well you can't really compare the Big Four to firms 5 and 6 so let's just look at firms 1-3 to firm 4. If there's a movement in that direction fees go down seven percent. If there's a movement in the other direction fees go up 6.4 percent. Again that's a 14 percent swing.

Guys, these are big enough swings that this is going to affect behavior. And so I hope that you guys are monitoring this kind of thing. And I think in general there's clearly an issue with audit fees. It's been an issue for as long as I can remember. I remember when I was on the SAG, I used to poke at the -- I guess now going back two or three chief accountants, to some extent this is an issue the SEC has to deal with. But to the extent that the PCAOB was the signal that they would publicly inspect if fees were abnormally low, I do think it would likely change behavior in a positive manner.

Okay. The next recommendation is over to Tony.

MEMBER SONDHI: Thank you, Joe.

Here we're talking about how to improve audit quality and the relevance of the audit itself. And you'll recall that there was a comment earlier about, you know, discussion where the partner of one of the accounting firms, the audit firm was arguing that they have no public interest and then there was a comment from someone about another accounting firm in Florida saying three times that they didn't have any public interest.

So one suggestion -- the recommendation we have here is that the appointment of independent directors would serve that public interest because you can -- we expect that the independent directors would be advocates for that public interest. And we also expect them to be disciplining mechanisms but obviously in order to do that they have to be independent. Obviously, you know, we know that in the corporate community, the better the corporate governance the more of the improvement that you can see.

Greater diversity of thought in these types of bodies always helps, so that's another sort of, you know, reason why we expect it to improve. There is evidence from elsewhere that independent non-executive members of governing bodies do help and they've been required in the U.K. for many years. And many in the U.K. are quite positive as to the impact of those independent non-executives on those boards. And both the FRC and the ICAEW have said that.

And then finally, in the ACAP, as usual I -- maybe what we could have done is just simply said every single thing in here has already been done by the ACAP and, you know, we would have been -- but in any case, I do want to mention that. So that's our -- that was the recommendation that I was asked to talk about.

MEMBER CARCELLO: And the last two recommendations we're going to let Larry Shover bat cleanup.

MEMBER SHOVER: I am happy. I got the two best slides in the whole thing here.

When we were preparing for this, they both received a lot of support from just about everybody. And they are near and dear to my heart. You need to know that I'm a portfolio manager and I manage money for somebody that's got $1000 in the IRA to a pension fund and everywhere in between. At the end of the day it's somebody else's money, it's not mine. So if we can do something to help with, especially with the relevancy of the audit, you know, I'm all for it.

The first one is heightening the auditor going concern reporting. Audit quality is better if investors are provided with an early warning of impending firm failure. I mean, I know it's overstating the obvious but it's important to keep that in mind.

Investors are particularly concerned with fraud and bankruptcy given the large losses typically triggered. The need for improvement, very few financial institutions received going concern reports before the financial crisis. And I don't think we have stats on that, but there was very, very few. And any reduction in auditor going concern reporting would clearly reduce the information set received by investors. Some have expressed concerns of impact of new FASB standard on related auditing standards.

And the next slide, really important, of the relevancy of the audit, allowing shareholder proposals on auditor issues. And we all do recognize that this is an SEC issue not a PCAOB issue, but nevertheless, substantial enthusiastic support for this recommendation among all the subcommittees when we were preparing for this PowerPoint.

Audit quality would improve by more closely aligning the auditors' incentives with those of users of the audit services. And we expect more informative audit reports produced by higher quality auditors fairly compensated. And in many ways this one recommendation, particularly if mutual funds were required to attend too, addresses a number of the other issues in our presentation. This enables private ordering rather than one-size-fits-all regulations which has the benefit of greater tailoring to individual issuer auditor circumstances. And obviously it's important that it provides investor feedback to the regulators.

MEMBER CARCELLO: Damon's not back, Ann, so maybe --

MEMBER YERGER: Okay. Our first but final recommendation is urging an expanded audit report. I could almost repeat all the comments I made about the signature, this is not a new issue for the Board which is -- it's been considering the issue. It’s actually not a new issue for this committee, we have discussed it and I think supported it quite robustly. And it's not a new issue globally, as we've discussed, expanded reports are in place in other countries and as we've learned, I think the Rolls Royce example is a terrific one, actually it seems to be working in a really significant way.

So you know, the issue of the quality of the audit report really has been debated for decades and I think there is value from an investor standpoint in the current very blunt pass/fail model that's in the report. It's concise, it's clear, it's comparable. But I think it is clear today that the current auditor's report is just not satisfying the needs and interests of investors who really are the final and the ultimate customer of these products. As we surveyed the members of -- what was it -- of the investors two and a half, maybe, two years ago, three years ago, on this issue there was strong support for an enhanced audit report from the investor community. CFA Institute has similarly surveyed its members and found the same thing. So this is a space where I think investors' viewpoint is pretty consistent and clear, that they would like to know more from the auditors.

You know, we do believe there's going to be an enhancement of audit quality if the auditor's report would be expanded, but I think there are also some other real benefits for investors from an expanded report. First of all, I view auditors as independent experts who have knowledge about the company that, you know, most of us investors can't get at. I think there would be real value in gaining from some of their knowledge and expertise and it would help investors analyze and price risks and make investment decisions.

I think an expanded report would really heighten the perceived value of the audit firm work, something that Lynn discussed earlier, and I think it might give firms some leverage to effect change and enhance management's disclosures and practices. And I finally think that this expanded reporting would enhance the transparency and promote real confidence in audited financials.

In terms of cost, Steve, you brought this up earlier, I think a lot of the things that we would like to see in that expanded report, sort of what was in the

Rolls Royce report, is probably already being communicated to the audit committees, so I don't know that I see this as a really expensive undertaking in terms of disclosing to the public.

And I also note, I know that there's a lot of debate about who should this expanded information be coming from? Should it come from the audit committee? Should it come from the outside auditor? And my view is there's real value in getting the insights from the outside auditor, the independent expert that's been retained by the firm. I believe there could be better disclosures from the audit committee but I don't think that the audit committee should solely be responsible for this.

And Damon, I'm sorry, I covered for you. Do you have anything you'd like to add?

MEMBER SILVERS: No, I don't think so.

MEMBER CARCELLO: So those are our recommendations. It was broadly supported by our group and we wanted to leave plenty of time to have a robust discussion around those issues.

MR. HARRIS: The tent cards as they go up or shall I? Or Ann, why don't you --

MEMBER YERGER: Jeanette, would you like to start?

MS. FRANZEL: Sure, thank you.

I have a question, and this is related to transparency and the new idea or recommendation that you brought to us today about evergreen consents, and I know this is not a PCAOB issue but I would be curious to hear how you envision that would work in practice?

MEMBER CARCELLO: Pete, since I believe you were the --

MEMBER NACHTWEY: Yes, the bell's around my neck.

MEMBER CARCELLO: -- the brains behind that, could you help?

MEMBER NACHTWEY: This will be me practicing law as not a lawyer, but particularly SEC law.

You know, but the thought is that, you know, whenever a report of the firm first goes into an SEC filing, so the consent has to be provided by the firm. If we move to the audit partners now signing and therefore the audit partner also has to consent, that so long as the firm is willing to continue to provide its consent in future years, even when that partner may no longer be with that firm, that unless there's been a change to the financial statements that were filed, some sort of restatement or other issue, that that consent on the part of the individual partner would be evergreen. So not the firm's consent, the firm would still have to provide its own consent. But unless there was a change, and if there was a change in the financials, they had to be restated, presumably another audit partner is going to have to sign off on those financial statements. So then, you know, we have -- if there's been a change, that new partner would then be required to provide their name and provide a consent.

MEMBER YERGER: Norman?

MEMBER HARRISON: Thank you, Ann. I'll be very brief.

I was a member of the working group for last year's meeting that addressed this topic. But the line in your presentation that requiring an expanded audit report would help investors better evaluate and price risk. It jumped off the page at me because I think, I think I said last year as well, that what intrigues me about this topic is I think it is ---- and especially in this body, the Investor Advisory Group whose mandate it is to advise the Boards on issues of interest or concern to investors.

And this is one of the issues, I think, that we deal with in this body that provides a perfect illustration of where the rubber meets the road, and where a change in policy, a change in disclosure requirements have a material, day-to-day impact on the quality of work that investors do in assessing investment opportunities. Because the entire process of evaluating investment opportunities and deciding among them and then making risk-adjusted bets on the future movements of securities is all about projections.

And projecting future performance of a company and its security or its capacity to generate free cash flows and discounting those back at an appropriate discount rate and all of the processes that we're all familiar with. And that entire process requires information to assess risk and price it or build it into valuation models appropriately.

And some of the issues that an expanded auditor's report could and ideally would touch upon, including I think as the group points out here, circumstances in which a -- there was more than one option with respect to an accounting convention to apply, and an issuer chooses the more aggressive or more -- perhaps less appropriate of the two, is something that bears directly on the -- an investor's confidence in the quality of the reported earnings and that in turn feeds into an assessment of risk with respect to projections of how that company will perform in the future.

So it's such an important topic. As we've talked about in prior meetings of this group, I think one of the risks you'll confront or one of the challenges you'll confront is ensuring that the requirements are written in such a way that they require actual discussion and qualitative assessment of the issuer’s accounting conventions and processes. I think, Joe, the examples you provided in your handout this morning are perfect illustrations of the materiality threshold. How is it selected? Those are all inputs, they're not check the box type of inquiries, it's not a list of things that are a yes or a no. They are -- it’s actual qualitative judgment-based reporting or expressions of views about the manner in which an issuer accounts for and reports its performance that I think is just -- again, is directly essential to the work, the nuts and bolts that institutional and private investors do every day.

MEMBER YERGER: Thank you, Norm.

I think, Michael, you might have been next.

MEMBER HEAD: And my comment is more of an observation or maybe some clarification and/or why you didn't go a little bit further. And I might be misinterpreting it, but when you talk about, enhance audit firm governance by requiring independent directors of firm governing and advising bodies. Is this of the public accounting firm's advisory and oversight or is this the boards of the companies that are being audited? I wasn't quite sure I was interpreting which body this is referring to and wanted that clarification first because I may embarrass myself if I go down a path I interpreted incorrectly.

MEMBER CARCELLO: Of the accounting firms, Mike.

MEMBER HEAD: Okay. Then never mind.

MEMBER YERGER: Barbara?

MEMBER ROPER: So, first of all, I want to thank this working group for actually coming to the Committee with recommendations as opposed to questions, which we've had -- you know, the fact that your report includes specific concrete recommendations and, I think, very thoughtful recommendations is impressive. And I strongly support those recommendations. And so, for what it's worth, you know -- I know we don't, in this body, tend to take formal action on the issues that we discuss but if we were to take formal action on these recommendations, I, for one, would vote for them.

As I look at these recommendations, you know, I think it was at least two years ago, maybe longer, that during a discussion I think at the SAG, we were talking about the auditor's signature. And I think I said, sign it, don't sign it, just don't ever make me talk about it again, because we had devoted so many hours to the issue of whether the auditor should sign the audit report. And you know, I think actually this morning you presented some interesting data that suggests that it has more of an impact than I maybe acknowledged in making that statement, that investors are able to glean information from that.

And I would say this has been on the agenda for such a long time and if the Board can't do this, then it's really hard to look at the rest of these recommendations and see how we're going to make progress on the issues that actually move the ball. You know, if you can't make a decision that there is going to be a signature, you know, I mean, I don't know -- I just don't understand how this one is that hard. So do it or don't do it, but never make me talk about it again.

MEMBER YERGER: Well, who would like to follow that? Bob?

MEMBER TAROLA: Yeah, do it.

I was a member of this group and I highly support all the recommendations except one. I want to qualify my support for the rebuttal presumption on low audit fees.

My fear is -- well, it sounds like price-fixing ---- but my fear, my larger fear is that it's going to suppress innovation. I feel like I'm a knowledgeable purchaser of audit services and if a firm came before an audit committee I serve, something with more like a cylinder business model than a pyramid business model, or something more like a daily auditing technology that can be implemented effectively, and that lowers the cost of the audit, I could very well go for it. So I have a little fear about the pricing recommendation suppressing innovation.

MEMBER YERGER: Do you want to reply, Joe?

MEMBER CARCELLO: Yes, you know, Bob's point is a good one. And just so the Board knows, on at least some of these recommendations, I actually vetted these with very, very senior people in some of the major firms. And one of the people I talked to about this, Bob, raised exactly the concern you did in that they believe that, through technology, they'll be able to perform better audits at cheaper prices. And so although they appreciated the thought behind this recommendation and the concern of abnormally low fees on audit quality, they were concerned that a world where technology allowed you to do better audits at a cheaper price could actually be viewed as a negative.

So when we started this, we had implement a presumption. The reason the word rebuttable is in there is exactly the reason -- is in response to what you just said. So again, it still may be something you're uncomfortable with but we did think about -- that we wanted it, we wanted the flexibility to reflect the fact that technology may cause the market to evolve.

MEMBER YERGER: Bob, any further questions? Okay. Lew?

MR. FERGUSON: Yes, I have a question about the -- your very interesting suggestion about the rebuttable presumption here. It seems to me it's relatively easy to do that and see that -- when there's a change of auditors and you can see the percentage, a percentage change.

But absent rotation, that's an exceptional circumstance, at least in the United States. So what would the criteria be for looking at a company that's not changing auditors? For example, would you suggest that we look at all the companies in a particular industry and compare them, and what criteria would we use? I mean, how would we do this absent a change of auditors?

MEMBER CARCELLO: Again, Lew, great question.

When we started we just had a decline in fees and as I met with leadership of the firms, one of the things they said is one of the things they see in practice is that there are certain clients that every year say, the fee is going to go down five percent. So it wouldn't trigger what we had initially, but after three or four or five or six years it's a problem. So that's what led to the more, some would say wordy, which is probably fair, actual recommendation.

And what you would have to do, Lew ---- and we just threw this out as a placeholder, I mean, you'd have to think about it in a lot of depth, but what you would have to do is, certainly industry adjust, there's no question you'd have to industry adjust, and you'd have to size adjust. Because by far the biggest predictor of audit fees, I mean the r-squared is around 60 percent, is size. So you'd have to industry and size adjust, and then I don't know what the right threshold is. I don't know if it's the bottom decile or, you know, bottom five percent, and at some point it's in the eye of the beholder, but that's the general tenor of what we're suggesting.

MEMBER YERGER: Lew, any follow-ups?

Okay. Curtis?

MEMBER BUSER: So I was interested in the governance recommendation and curious what the team thought about first power. So if I'm the director on a advisory group that has no power, will it mean anything? And then what power is important? I mean, what do they have the ability to do, do they confirm kind of who's the leadership of the respective firms?

And then second, how did you think about independence? So to find people that are truly capable and they're probably fully independent of any relationship with the four firms might be tough. And so would you take exception to independence in that case and, if so, how?

MEMBER CARCELLO: Let me try to respond to that.

Again, because I've had a number of conversations around this recommendation both with leadership people in the firms and people at EY's group and people at Deloitte's group. So you know, one of the things I've asked people at these two advisory groups is, you know, how do you know that this is real and this is not just a sham? And you know, they gave a reasonable answer, the advisory groups are still relatively young and so it's hard to know, you know, how they will play out long-term.

What I do know is that the leadership of these organizations show up, you know, to the point of the CEO and his -- in this case it's a man -- his deputies show up. There tends to be very robust discussions around the types of issues that we talk about. The sense that I get is the firm legitimately -- the firms legitimately do want the feedback. Now at the end of the day if the advisory group said, we think you should put a hard cap on non-audit services at 50 percent, would the firm follow that? You know, I can't answer that question, that hasn't happened yet.

So you know, I don't think this is a panacea but it does seem to be playing a useful role, and the fact that at least two of the firms have done it voluntarily I think is encouraging. So maybe there doesn't need to be PCAOB action, maybe it's just the bully pulpit. You know, Jim could give speeches if he thought it was appropriate, because two of the four are already doing it.

In terms of independence, that's a really good question. And probably Brian's the best person to answer that question, would be my guess. I don't know -- I'm trying to think, the Deloitte group is Goelzer, Arnie Hanish, Phil Wedemeyer, Zoe-Vonna Palmrose, and then there's a fifth person who I don't know. And the Ernst group is -- Olson is chairing it and then there's a number of very high level people, but a lot of them are global and I don't know the others. So I don't know if they are precluded from being on the board or audit committee of any client that Deloitte or Ernst would have and how they're navigating that because it's obviously a major issue.

I'm putting you on the spot here, Brian. Do you have any insights on this?

MR. CROTEAU: I won't give a specific answer relative to any particular firm, but certainly it's an issue that would need to be thought about and their role would be important in thinking about it in the role that they have relative to specific audits, whether they're in the chain of command. There would be a variety of questions to think, but I don't want to opine on any particular fact pattern.

MR. CARCELLO: My sense is that it's at least doable the way these two firms are doing it. They've figured out a way to make it work. But the specific -- I mean, my guess is you'd have just as easy an access as I would in terms of figuring out how they're navigating that.

MEMBER YERGER: If I can just add to that, I think you raised a really good point. And if I recall, I'm kind of looking at Damon because I -- and Lynn because this is -- yet another one of the ACAP recommendations.

There was a lot of discussion about this particular point. And I think the preference, at least within the subcommittee that had considered this, was that it would be non-voting -- you know, they would be voting members on the board. But the legal, there were issues with the legal structure that might have precluded that. And I think we saw the advisory board as a ---- sort of an interim step.

But there was also a belief that, you know, you don't have to have a majority of independent people on the board to really make a difference. So that in itself, even if it was one or two independent directors, that that could make a big difference in terms of tone at the top and how the organization is governed. But I think I still will look at the advisory councils or committees, whatever they're being called, as a positive step in this evolution.

Judge Sporkin?

JUDGE SPORKIN: I think you should be using the inspection power in order to do something. I think that's -- it shouldn't be a punishment. A firm shouldn't be inspected because its fees are too low, I think that's a mistake to use the inspection power.

The other real issue I think you have here is on the going concern. I've been thinking about this and what bothers me, as you know the audit -- the financial -- the audit of the financial statements is historical. You're looking at what happened last year. But we're now seeing such dynamic changes in industries upon industry that we need a better model.

For example, I was just reading in the paper the other day that there might be a change in the cable industry because HBO has now found a way to get to your home without going through the -- without going through cable.  That might change the entire makeup of the cable industry.  We've seen companies that go out of business or go -- are affected immediately, BLACKBERRY and other companies.

And so of course you can't ask the auditor to be a predictor of what the new business changes are, but certainly there has got to be some way of looking at some of these industries, some of these companies and raising concern.  I realize it's risk management, I realize there are other people that ought to be doing this, but it is a very, very big issue where people are trying to buy on the future, not buying on the historical.  And it may well be that Blackberry, or one of them, had a great year but its future is very dismal.

MEMBER YERGER:  Thank you, Judge.

Lynn, I think you're next up.

MEMBER TURNER:  First, on the director point. The directors I think have to have the authority that someone mentioned and there has to be transparency about them, if they're going to be a worthwhile endeavor.  Just putting a bunch of people on an independent board doesn't mean it works or doesn't work. We saw this, Andersen established a board and, probably useful at the beginning but lost its value and eventually went out of existence. To create it you'd almost have to have a requirement of the PCAOB, if you really wanted to keep it in there and keep it functioning because we learned from experience that otherwise it doesn't work.

On authority, you're almost going to have to give them some type of authority to review compensation because the way the managing partners in these firms get elected and that partner selects all the key partners around them and sets the compensation for all the key partners around them and has final say on that, unless you give that board some authority over compensation that board will not have much impact whatsoever. And then of course, you've got to put some transparency around it and have them report out so you can see what they are or are not doing or otherwise it will be a waste of time.

I'm in favor if it and was in favor of the ACAP recommendation but there -- unless you do some things around here, just saying, and some of the people that are already sitting on them used to be principals at that firm, or have done a lot of consulting for the firms with some of their leading experts during the bid over PSLRA and got paid by the firms a ton of money for that, not exactly what I'd call an independent person.

So I think the notion that you've got to define independent and look for other people other than that or they are not really independent boards. And so some of these people that are on them today probably aren't very independent as it starts with.

On the second issue about the low fees. I'm not so worried about innovation as Robert is, you know, Volcker said the only innovation amongst banks in the last three or four decades are ATMs. I'd say the banks are probably ahead of the auditors.

The Texas State Board -- to Lew's point, the Texas State Board did adopt a regulation quite some time ago that says that you can't do an audit at a loss. Your fee can't be so low that you're not making margin on the work. I've talked to them in the past about that. I think they looked at one case but that's all, they really haven't enforced it at all, but you may want to talk to them about experience. I actually think it's a good --

what's been proposed here is an excellent recommendation.

When I was at Glass Lewis we had screens on this issue and we would screen across an entire industry segment. And we'd get the audit fee as a percentage of revenues, as a percentage of assets and I can tell you when you run those screens there will be outliers. You will see them stick out like a sore thumb. In particular industries we would run additional screens, select for retailers. We would also screen against the number of store locations and get a percentage there. So we would tailor it to a specific industry. But when you look at that you can find outliers and they'll fall out pretty quickly. And it doesn't take a rocket scientist to figure out which ones are way down and which ones are not. So I think you can turn around and do that.

As far as inspections being a punishment, I really don't view inspections as a punishment. I think the work you do on inspections is one of the highlights for you and one of the favorable areas where you guys have accomplished something. So -- but I'd hate to ever see it teed up as an inspection being used as a punishment, but I don't think it is in this case, if you had real low fees and you fell on the outside, the lower quartile on that screen, I think it would be -- it would beg the question, why aren't you turning around and looking at that because that gives you data that probably says they aren't spending enough time there. So --

MEMBER YERGER: Thank you, Lynn.

Damon?

MEMBER SILVERS: First, my thanks to my colleagues for picking up after me. I was at lunch with my wife and didn't realize that I was up next. So now I've gathered my thoughts, I have a couple of things to say about this.

The first is to repeat what I guess has been -- actually what someone said earlier which is, in relation to the question of the expanded audit report, it only -- just to put a further gloss on the recommendations that are here, it only makes -- it's only going to work, I think, if there's a requirement to disclose something. Meaning that if basically the expanded audit report is a mandate to tell us, tell the public, tell investors if something is wrong. The audit firm will, of course, say nothing is wrong.

Now that requirement, that further requirement may give the audit firm some leverage in private negotiations with the issuer but it's not going to result in any new information. What will result in new information is the requirement to disclose, you know, for example, the most -- you know, every audit has matters that come up that are of concern to the auditor that are generally resolved in some fashion that's mutually acceptable. The requirement to disclose the most salient such matter, there's always one, right? And the notion that you can't say nothing seems to me to be something that would actually add value of the kind that the examples in our report outline.

Secondly, I want to express my own reservations about the -- and also -- not reservations about the right word, it may be sort of express the complexity of the matter relating to the audit fee level that's in the report. It's -- I'm quite persuaded that low audit fees in relation to a relevant peer group are evidence of short-changing the audit, as Lynn just said. I don't think there's any doubt that that is -- that one could set that up as a presumption when looking at some level of reduced audit fees.

But what troubles me is the chair of the competition subcommittee, of the Treasury committee, what troubles me is I'm not sure how we would get from the current levels of concentration in large company audits to some more -- to some less concentrated environment without price competition. And so I'm concerned that -- and I want to make clear to the Board that I think that this recommendation is essentially -- should be best understood as a recommendation to try to figure out a wise response to the problem of low-balling. I don't know if this -- Joe's nodding his head. I mean, and I think it was apt on the part of our group that we didn't set a number, right? That we recognize there's a problem here and it needs to be dealt with, you know, with some consideration of the other -- of countervailing issues that are in play here.

Now the final thing I want to say really is about the issue of going concern. I take Judge Sporkin's point that there's a lot of change in this world, and I think there's always -- I mean, and this is -- in our economy we go through eras of rapid change and eras of consolidation. This is unquestionably an era of rapid change. I don't think that is really what the issue of the going concern opinion is about.

I think that that -- and I've been through -- I've been on the receiving end of this so I have some insight into it. It really is about the question of is it really clear that it would -- is it really clear that it would be improper to let the audit, which is based upon the notion of the firm continuing, let that out there without telling investors that there is as significant -- that there is a meaningful risk that simply will not be true in the relatively near future, generally as a result of issues surrounding the ability of the firm to meet its existing debts as they come due during the next year.

And I thought this was, based on my own experiences in working with companies and their auditors, I thought this was relatively well-established area in the auditing regime until the financial crisis when we -- again, I have firsthand personal experience of big four banks that literally were not going to make it through the week without government support. And then when --

and then were continuing to rely upon government support, implicit and explicit, at the time in which their financial statements came out. And yet nowhere was there a qualification and yet it was clear that if the United States withdrew its support of those firms, they probably would not have made it through the week then.

And so that strikes me as a situation in which there needs to be some change and strengthening of those rules. I'm very concerned that, as was reported earlier today, that FASB is actually retreating and seeking to essentially codify the unjustifiable and frankly, in my opinion, corrupt practices of the crisis.

MEMBER YERGER: Thank you, Damon.

Tony?

MEMBER SONDHI: Thank you.

I'm not sure there's a lot left. I agree -- I mean, Lynn has made some very good points about these artifice switches and fee changes and some of the analyses.

My concern was something that I've had with this type of research since 2010 to 2013. There are two things that I'll point out because they're a little bit different from what Lynn said. One is what was happening to fees from 2009 to 2010? And I think that would be relevant in knowing whether 14.2 or 6.5 is -- and therefore that 21 percent change. I'm not sure of that. But I don't know, I think the point is whether that makes sense depends on what the trend was. So picking the 2010 to '13 is something that at least I would like to know a little bit more about. And maybe the paper makes it clear. I'm just asking the question.

Another point is that -- and this is again anecdotal, you know, if you open up a software firm or a cloud computing firm say in Indiana or in Kansas, it's possible that firms four through six might have more knowledgeable person than firms one to three. And that pricing differential is something totally different. So in that sense, I think some of these issues, you know, the way you break these, the way you analyze this is much more -- may be more relevant, may provide more useful information. So I just wanted to point that out with respect to that particular issue.

MEMBER YERGER: Mercer, thanks for being so patient.

MEMBER BULLARD: I have a detailed comment and then a broader comment.

On the governance issue, of course there's a lot of corporate series literature on boards and I think that Lynn sort of captured it, that you really cannot force independent boards. What you can do is set up the usual standards, relationships, family members, employment and you'll create a lot more independence than you would have otherwise, so that's a necessary feature. But I think what you've got to do is you've got to have structures that have been shown, if anything is going to work, it will work.

And one is going to be you've got to have some requirements as to how they're going to behave independently. Typically that would be the authority to hire their own counsel or a requirement that they have independent counsel, the authority to hire outside consultants and have the money to do so. And then requirements that they meet independently.

Now that last one, of course, begs the question, as do the hiring counsel and consultants, well, what are they using all these for? And you've got to identify what the issues are that you're going to make them responsible for. Without specific issues that they are to provide independence on, then there's really no point in having them. So you've got to identify those.

And then we've seen that what has an impact is requiring that they make findings, those findings be public, they be in some kind of hopefully public financial statements in the future. And I think that you could also think of a couple of novel approaches. One would be that independent directors' compensation should be fixed. It always amazes me that somebody can be considered independent and have their income depend on the fortunes of the business. Not only should it be fixed, they should be guaranteed income for probably one -- six months to a year after they leave so you remove the threat of them being removed. And you could eliminate any kind of deferred compensation, which is somewhat indirectly a subsequent influence. But you know, these things seem obvious to me as ways to just create that kind of independence, that you've got to do structurally.

And then finally, you have to think about some kinds of liability. I mean, as you said, nothing sharpens the mind -- and I think the expression's actually -- like an execution in the morning. But some kind of, you know, exposure to maybe their continued right to be on a board as opposed to monitor exposure, I think it's necessary. You're not going to get the kinds of independence and people standing up to the owners of the company unless they've got that.

On the broader scale, you know, all these suggestions are really answers to the question that's left hanging at the end of the last session. And that is, you know, what is the problem, tell me what the problem is that Jim was bringing up. And I think that, you know, that's fair. I'm a skeptic, I go into situations like this and I say, if you have an advisory board they will come up with recommendations. And that really tells you nothing by itself as to whether something is needed

On the other hand, my -- you know, in my career I've seen a lot of development, coming from Enron and Worldcom, in the early part of the century, to the financial crisis in 2008, and all the promises in between those two that clearly were not solved, especially with respect to accounting. So it's hard for me to imagine a promise for it to be solved because accounting problems are at the heart of the financial crisis. I think that the question is being asked is whether the problem that's being solved is still a good one because I'm not so sure that we've really pinpointed exactly what it is, for example, about the financial crisis that exhibits a failure of accounting.

But I think that question really forces us maybe to focus harder on that. We've got to have a very clear, strong answer to that question and it's got to be short, it's got to be concise and it has to identify a specific problem. Because the financial crisis had a real impact on a lot of Americans' lives. Some lost 40 percent of their retirement and then they decided to get out of the market. So you know, these are the kinds of things that trace directly back to accounting. Money market funds, which is an issue I was looking at was another example. You know, we -- with the AFL-CIO and the CFA, we wrote a letter to the SEC in January of 2008 and we said, you know, there's probably going to be a problem with money market funds, you ought to do something such as requiring, let's say, streaming of valuations across all of the money market funds. And unfortunately that went unnoticed and now coincidently we have a requirement like that but it was a little bit too late for the industry.

So I really think we've got to focus our efforts more to get a clear idea of exactly what the types of problems are that we think our solutions will solve because Jim's right, we need -- more than anything, we need an answer to that question.

MEMBER YERGER: Thanks, Mercer.

Jay, thank you for being so patient.

MR. HANSON: Thanks. I appreciate the discussion and especially the perspectives around this audit fee and whether audit fees are too low and if that should trigger an inspection.

I just wanted to provide a little clarity and perspective around our selection process today. So there is no secret recipe for the sauce as to when an audit gets inspected. And it's a very complex process, we spend a large part of the year working on that selection process. And Greg Jonas is here in the room with me and his group works a lot on providing the inspections division some context around issuers that they should look at for possible inspection.

And that process is going on right now today for the 2015 inspections in the major firms. And I can assure you that audit fee levels and changes therein are absolutely a factor today in what gets looked at. It's one of the mix of -- I'll just call it flags that get thrown on the field. If no flags are on the field, a real, live human being looks very carefully at that filing to decide, do we want to look at that audit? And what would we look at?

And it's not a determinative factor, and maybe there needs to be more rigor around it, maybe there needs to be more weight around it. But I appreciate the context because it's another lens to look through. But I assure you, today it is a factor that we consider in whether we go look at a particular audit to inspect.

MEMBER CARCELLO: Ann, let me respond to that.

Jay, I had a sense of that as I was working on this, and I think our group had a sense of that. I think our concern is I wonder how many issuers are aware of that, and maybe you know the answer to that, but it just strikes us that better communication by the Board of that fact, which your statement alone hopefully will be disseminated by the friends in the press accomplishes part of that objective.

MEMBER FERGER: Steve.

MR. HARRIS: Yes, I don't want to leave Mercer's question unanswered. And I think it's very important that everybody that's made a recommendation address the issue of exactly what the problem is that we're trying to solve. To me it's pretty clear, and that is that audit quality is not what it should be. So how these recommendations will help improve audit quality I think is, one, determinative in terms of why you make the recommendation. But we do need to answer the question rather than throw it out and leave it unanswered.

For those of you who have answers and responses, I think it would be very helpful to create a record on that. So for all those who submitted recommendations, what's the problem that we're focused on and why the solution?

MEMER CARCELLO: Yes, Mercer, I'm going to follow up on what Steve said because that's why I put my tent up.

So this is quickly off the top of my head but I would throw out at least a few data points. Recognizing that PCAOB inspections are not random, and I do think that's an important caveat. I think it's an extremely important caveat, but recognizing that they're not random, ballpark in the last year or two, approximately 40 percent of inspections of the major firms have deficiencies. That strikes me as problematic.

A couple of years ago we had a panel on going concern reporting, and I thought Anne Simpson was extremely effective in talking about this, but virtually no going concern reports were issued on the financial institutions during the financial crisis. Now I guess the argument could be many of them didn't fail because of government subsidies. But I don't know if that was a reasonable assumption to make because that could have been removed at any time.

And then in terms of the audit report based on some of the work that Ann and Norman and Gus Sauder, who used to be a member of this group, did a few years ago, basically what we heard from users is, although they found the audit useful, they didn't even look at the report because it had no information content. And there are other things we could come up with but at a minimum I think those three are indicative of the fact that there are issues with both audits and the communication of the audit results, that these recommendations are designed to try to be responsive to.

MEMBER YERGER: Does anyone on the subcommittee have anything they'd like to add?

Lynn?

MEMBER TURNER: I would agree that there is an issue and that that issue is audit quality. When we look at the inspections and the findings in the inspections, which have increased, maybe part of that is attributed to the fact that you're doing better inspections today than what you were before, and I think that is, in part, true. So part of it's kudos to you for better inspections.

But I also think it's the type of things that are cited when you go through line-by-line in those inspection reports and you see the problems, despite what the firms say those are serious problems. I think they are recognition in many of the cases, not of just an audit deficiency but an audit failure, a failure to comply with GAAS. They give us an audit report saying they've done an audit in accordance with GAAS and yet we find in the inspection reports they haven't. In my mind, I think any reasonable person views that as an audit failure not just an audit problem or deficiency.

And so I look at your inspections, I look at the survey that the academics have done with CFOs where the CFOs themselves have said they've manipulated the numbers by a material amount, ten percent or more, and they haven't been caught by the auditors. That tells me there is a problem that's consistent with your findings. When I look at the audits I've seen, my experiences are very consistent with what's going on with your inspection reports. So I think they all point to the fact that you do have a serious audit quality problem.

Just as we did leading up to the corporate scandals, it didn't become a huge issue until Enron imploded but it was an issue before that point in time. And I think the difference between now and Enron is a downturn in the economy with people taking -- you know, companies having a tough time. And at that point in time people come back and say, why didn't you guys do something about it, that's what your job was?

So I think you've got a legitimate problem. I think you've highlighted it and documented it well and I think you need to go turn around and address it. We've got -- six years ago an ACAP report that came out with 18 recommendations. I don't think a single one has been implemented. If we were to have a serious downturn and have corporate scandal today, there wouldn't be a rock big enough for you guys to go hide under because the question would be, why haven't you done anything about it six years after the fact when a high level U.S. government Treasury commission said go do it.

And some of those are extremely important, I give Jeanette kudos on the audit quality indicators, I think that has to be dealt with. I think there's some other things here in terms of standard and other recommendations in that report that need to be dealt with as well and I find it unforgivable that six years down the road neither the PCAOB nor the recommendations to the

SEC in that report have been acted on. That's not why we as Americans pay our regulators, I think.

MR. HARRIS: Marty, since going concern was raised, do you want to just update the group in terms of what we're doing on going concern?

MR. BAUMANN: I'd be glad to.

So just for level setting for those -- for everybody here, reporting of going concern was always the auditor's responsibility, going concern uncertainties has been an auditor responsibility and has not been a requirement of management under U.S. GAAP. So our auditing standard requires the auditor to report a going concern uncertainty when he or she concludes that there is substantial doubt about a company's ability to continue as a going concern.

The term "substantial doubt" is not defined in our auditing literature and this group and our SAG have indicated in the past that different interpretations of that phrase can lead to very different auditor reporting. And apparently -- and also have indicated, both the SAG and IAG, that they perceive there's different interpretations of the term "substantial doubt." And we've heard that investors feel that the existing auditing standard is not working in terms of reporting going concern uncertainties to the extent that they should be reported. So we've heard that loud and clear and we have a project on our agenda to address that.

In the meanwhile, FASB, has been mentioned here a couple of times, issued a new standard which requires management now to report going concern uncertainties in the financial statements when management determines it is probable that the company will not be able to pay its debts as they fall due in the next 12 months. So the point that's been made here a couple of times is that the term "probable threshold," in the mind of some of the folks at this table and others has raised concern, is that going to be a higher threshold than the undefined "substantial doubt" in the auditing standard resulting in fewer situations of reporting?

So to avoid that we put out a practice alert that said, our existing auditing standard still applies and that is substantial doubt has to be reported by the auditor when he or she believes, based on whatever qualitative factors they assess under our auditing standard, notwithstanding the requirement to audit what management may report as well.

So at the same time we've said, and we're working diligently on this, we're working on a staff consultation paper to be issued around year end to lay out some views around this issue to, one, improve auditor performance and have a audit conditions that could give rise to going concern uncertainties and lay out some possible improvements for comment. And then two, to lay out on the consultation paper issues about at what point should an auditor warn investors about a going concern uncertainty? What is the early warning signal and when should they get it, and is it at the FASB level of probable? Is it substantial doubt? I mean, is there some other level where early warning should be given?

And so we'll issue a staff consultation paper I think around the end of this year laying out some thoughts on these matters about auditor performance and auditor reporting obligations and variations and possible thresholds there and seek comments. So we hope investors here and elsewhere will comment on that paper as to what their expectations of auditor performance obligations are and auditor reporting about early warning signals on going concern should be.

MEMBER YERGER: Bob?

MEMBER TAROLA: Thanks, Ann.

I'm going to go back to Steve's question. I think it's a question basically what does all this have to do with quality and relevancy. And from my point of view, quality is about technical competency and it's about state of mind. And this -- these recommendations are really going to that state of mind part.

You could put in audit quality indicators on the technical side, I think, but what are you going to do to make sure or enhance the chance that these audits are being conducted with the proper state of mind? So whether it's -- you know, whether it's the fee issue, you know, the fee threshold or the governance matter or even the signing, to me that all gets to the state of mind aspect of quality and relevancy.

MEMBER YERGER: Thanks very much, Bob.

Lynn, are you -- do you have anything you want to say, Lynn?

CHAIRMAN DOTY: Well, first of all I found this

-- this discussion is riveting and I think I would consider the afternoon lost if I didn't have the chance to say something about the transparency proposal of naming and signature.

Reasonable minds may differ on whether an auditor's sense of accountability is increased by either signing or naming. Those are matters in which the view of auditors, I mean the people who sign the audit or sign the firm annual have views that are as credible as any of us in the room. I may have my own view about what it meant to sign in my name a legal opinion. I may have my own views about accountability, but it doesn't really weigh in this discussion.

One thing though that does weigh is the confidence and credibility that people have in the audit and the way they look at the audit, something Bob was just going to. And as to that, the people in this room do have an opinion which I think has to be listened to. You've been asking for years to have more information about who does the audit. You've been asking on several grounds, but I would just suggest to you that the one ground for which I think there is no reasonable negative response is that it will enhance the credibility of the audit. It will do good things for the audit opinion and the audit profession and it will be something that investors will appreciate.

With that in mind, I was intrigued by Pete Nachtwey's remark for an evergreen consent. I was impressed that Pete, as a former auditor, was not bothered by the idea of a consent. Many people are. Many people are. If I'm right and it is my belief that we must join the community of developed nations who have capital markets like our own and who identify this information, we must get the information in the hands of the public and we must do it in a way that minimizes the friction that avoids -- that addresses the consents, the comments and the concerns over litigation risk. And it is litigation risk, it's not ultimate liability it's litigation risk. Those are real concerns.

And therefore, if we can do this by offering auditors an option to either put this information, the engagement name and the other firms named in the report, or -- or should they be sufficiently concerned about litigation risk, give them the option to put it in a form filed with the PCAOB, a form which would not be subject to any constraints about the information. It would have to be public and it would have to be approximate in time. In other words, I do not believe that the public interest is served and the goal that you're discussing is served by having a form which is filed six months, nine months after the release of the audit report.

So in my mind, my job is to try to get a package that very few people can really take difficult positions with and disagree with. I think such a package is to provide the auditor an option. If you don't want to put your engagement partner's name and the information about who did the audit in the report, but it in a new form, put it in a new Form 5, here it is.

Now I am in hopes we will have a supplemental request for comments in the hands of the SEC soon. I'm in hopes that that can go out soon. I'm in hopes that we can get comments on it soon and move forward with the kind of approach I've suggested. It is not the same thing as partner signing, it is not the same thing as naming the engagement partner because the issue of the consent remains there and some people, Pete, are bothered by the consent. It does seem to me that the responsible thing for this Board to do is to get out a package, a standard that will enable the information which we know is important information to get in the hands of the public as soon as we can.

It was intriguing to me to hear the discussion on governance. We have spent the last week with Stephen Haddrill from the Financial Reporting Council. They have accomplished a great deal in the U.K. with what he calls a soft-landing approach. And when it comes to the structure of the firm governance, the independent non-executive -- involvement of independent non-executive board members, it may be that this is the way that we should go. We first of all have the ability to begin to determine whether, in fact, with the firms that have this innovation, whether it's done something good for the audit and for the governance of the firm.

We are not prohibited in urging firms to do things that we think are useful and to urge them to do it in very strong terms, comparing, for example, what we see to be the results of it in firms that have it, if we see those results. But I am saying that I think, in fact, firm governance is not something that fits comfortably within the powers that we have at this time. I think that that would be quite an ambitious thing for us to declare their firm was required to make changes in its governance structure. And I think that that's something that will involve us in more complexity than the moral suasion that we can bring.

Finally, I thought the whole issue of the lowball, the low-fee, the lowball audit eventually came around to where it belongs and that's the fiduciary obligations of directors and audit committees to keep management out. You had it, you were all recommending that this morning, keep management out of the negotiation on the fee. This is an area where management is -- has its head under the tent and the camel is negotiating the fee. That begins in my mind to take a fiduciary obligation in addition to statutory violations of the spirit of Sarbanes-Oxley.

I am willing to sit and watch while I think corporate fiduciary law is going to move in this direction. I think one of the things that we do as a Board, when we increase auditing standards and increase the authority of the auditor to talk to management, I think we have an upward draft effect on conduct in the boardroom. This is an area -- and there are several areas where this happens. But this is an area where I think what we should do is begin to create the upward draft in the boardroom about how important it is for directors acting responsibly under SOX to keep management out of the fee discussion, negotiate the quality of the audit before you negotiate the fee and then finally to avoid what appears to be perhaps a trend toward a lowball fee.

If you start thinking of what we do in terms of the disclosures that we can now implement to enhance confidence that the public is getting the facts about the audit, and certainly they are, the audit reporting model is the biggest project going in that regard, the practices in the firm that we can lobby for successfully in talking to the firms. And then the final ultima ratio of where we can say we think this responsibility comes to rest outside, those are three fairly important sticks that we have to wield. They are three fairly important devices we have for improving audit quality.

And I do see the -- audit quality is the handmaiden of public confidence in the audit. But it seems to me that the 2008 crisis, we were told by you what you always come back to in these meetings is that the 2008 crisis did shake public confidence in the utility and the informational use of the audit. Something Tony Sondhi was saying earlier. And that it seems to me is where we as regulators must be worried. You may -- I'm inviting rebuttal.

MR. HARRIS: Before we take a break, the Chairman talked about litigation risk. I just wanted to focus for a second on liability on the transparency issue. To what extent do you view that as a real risk?

MEMBER BULLARD: I mean, I spent a lot of time dealing with Section 11 cases, classic example in which auditors were specifically named in the statute as viable defendants. But I just don't know where the liability issue is coming from. There is simply no way that any plaintiff worth his salt is not going to be able to find out who the audit partner is.

And second, there is no plaintiff's lawyer worth his salt who is going to think that's where the money is if you bring a lawsuit.  I mean, frankly, I think it's ridiculous to think there's real litigation risk exposure arising from disclosing anybody's name.  And I don't know where that's coming from, it certainly sounds like a superficially sound argument from a legal point of view. I think it has no merit at all.

MEMBER TURNER:  I couldn't echo what Bullard just said stronger, and in fact, if you actually look at the cases, the audit partner is seldom, very seldom named in the cases, even where they do know.  And the first thing you ask for as the litigator in these cases, you ask for the names.  So this is a façade, this is ridiculous even to have that issue teed up as an issue.  Any lawyer that knows the area knows it's not an issue and it's a façade.

And on top of that, you know, when you see that they are, in fact, not getting named because the deep pockets, if you will, are with the firm.  Individual partners aren't where the deep pockets are and where they're going to go after the money.  They're going to go after the money from the firm itself.  So seldom are the partners named even when you don't turn around and have a name out there.

So I just couldn't agree stronger with Bullard. This is a façade and if that's where people go then it's -- you know, there's just not sound reasoning going on here.

MR. HARRIS: Well, with that there are clearly strong feelings on the subject.

And why don't we take a 15-minute break. Ann and Joe, thank you very much for the recommendations. And why don't we come back at 20 of 3:00.

(Whereupon, the above-entitled matter went off the record at 2:19 p.m. and resumed at 2:42 p.m.)

MR. HARRIS: Okay. Bob Tarola and Tony Sondhi, if everybody could just take their seats we'll move on to our final topic for the day which is the Relationship and Role of the Auditor with the Audit Committee. And as I mentioned, you know, very briefly to you, Bob, notwithstanding the various jurisdictions that are involved, this issue has attraction domestically and internationally. Clearly the role of the audit committee is something that's front and center in the area of corporate governance and it's an issue that was taken up at IFIAR last year. Chairman Ferguson, correct me, but

I think it's likely to be taken up again. It was brought up at the interim meeting in Toronto, so this is well timed. So we appreciate your discussion and leading this group.

**The Relationship and Role of the**
**Auditor with the Audit Committee**

MEMBER TAROLA: Okay, thanks, Steve.

I'm going to set up the topic and then get to the discussion questions where the rest of the group will weigh in from their perspective on the discussion questions. And then we'll open it up for the floor.

We're approaching this, most of us in this committee if not all of us have either been servicing audit committees or served on audit committees and we want to give you that perspective in this discussion.

So first is our -- the current state. And these are our observations. That the role of the audit committee is fiduciary and statutorily determined yet the work is often not appreciated or even transparent to investors. The audit committees play a key role in financial reporting yet the report on their work does not appear in audited financial statements. And the audit committees may be made up of members who have far less training or experience than the individuals they oversee yet they are expected to challenge these individuals.

And audit committees actually spend most of their time on matters other than the annual audit, matters of risk management, internal audit oversight and just financial reporting, yet the oversight of the audit seems to be the one that is focused on for reporting to investors.

There's multiple regulators of audit committees and the auditors. So you have the Sarbanes-Oxley Act in terms of duties and responsibilities. The SEC oversees independence and monitoring. Exchanges cover governance roles and reporting and the PCAOB, of course, covers auditor interactions.

So here's what we believe are the current state issues. Investors and regulators are seeking more discussion and analysis of financial reporting and auditing matters but seem to be bypassing the audit committee for that information. Maybe not putting as much relevance on their role as we think they should. Governance advocates are calling for more discussion and transparency from audit committees. The NACD, CAQ and others have endorsed a call for action. That call for action is quite involved. As a chair of an audit committee in the proxy season just past, trying to respond to that call for action was actually quite difficult. The call for action requests the audit committee address why they hired the auditing firm, why they like the audit partner on the audit and why the fees were what they were. Those are quite in-depth questions to deal with from a governance perspective.

As mentioned here before, regulators outside the U.S. are requiring more information about the audit committee, even asking shareholders to get involved. And regulators within the U.S. seem to be accepting the bypass instead of subjecting the work of the audit committee to greater transparency and oversight.

So if you accept those current state issues, we decided to set up a potential future state. Barbara, these are sort of recommendations although we'll -- we use different words.

(Laughter.)

MEMBER TAROLA: So here's how we thought a potential future state might be set up. First of all the audit committees could become a more transparent part of the disclosure framework. Reporting on the processes they oversee within the same documents that contain the outcomes of those processes. So right now the audit committee report is in the proxy statement, often five or more months after the fiscal year end and at least three months after the audit is completed. So the question is whether their report should be part of the normal quarterly or annual reporting process with the financial statements.

We believe the audit committee report could be required to address specific interests of investors and regulators. Many of those interests were voiced today and conceivably they could be put in a form of expected disclosure from audit committees.

And then here's the dicey one. External auditors could be required to assess and report on the design and effectiveness of the audit committee. And this goes hand in hand with the requirement of auditors to assess the financial -- controls over financial reporting and tone at the top. It's hard for -- it was hard for our group to see how an auditor could make that assessment without assessing the effectiveness of the audit committee itself. And we saw that as a major dilemma. Can auditors independently and objectively assess the effectiveness of the body that hires them?

So with that as a setup, these are the questions that we're going to pose for IAG and for others to comment upon. I'll just read them more or less and then I'm going to call on Tony Sondhi to comment first.

So should the audit committee report on its role alongside that of the CEO, CFO and audit firm? As you well know, the other three report every quarter and of course annually as well whereas the audit committee is -- does not and its annual report is often delayed.

The second one, should the auditors be required to assess and report on the duties and operational effectiveness of the audit committee or, for that matter, should some other party report on the duties and effectiveness?

Should the auditor's evaluation of the audit committee's role be reported within the board or even made public?

And finally, should the auditor be required to assess the objectivity of audit committees and expect that the auditor's independence be protected by the audit committees? And this is one issue that I've had some experience with, where both the audit committee and the auditor could be at odds when it comes to independence. It seems to us anyway that a better situation would be where their -- each of their independent situations are protected.

So with that, Tony, I'll ask you to comment first and then we'll go through the rest of the group.

MEMBER SONDHI: Thank you, Bob.

The -- if I take the first one, clearly both the transparency and the availability of that audit committee report would be relevant, or is relevant to investors. And I think we would like to see that. These, by the way, you know, I'll make some comments on each one of them but it's very hard to make the argument or to leave out the sense that they are definitely interrelated and there are all kinds of interrelationships in here.

The second issue is, should the auditors be required to assess and report on the duties and operational effectiveness of the audit committee? Now clearly this is one of the issues that I raised this morning that, you know, the competence, for example, or the effectiveness of the audit committee itself is a component, I think, of the internal controls. And if you don't have a good audit committee then I think it's fair to say that you have material weakness in those internal controls. So I think that's something that we ought to be concerned about.

And whether the auditor should evaluate the audit committee or whether the two of them should work together to ensure that they're independent, and that they're independent of management and concerns from the perspective of reporting the financial risks of the company. So when you look at it from that perspective, I think that the two of them can actually work together to help ensure that financial reporting risks are dealt with.

So for example, when you have disagreements between management and the auditor, that's a place where I think the really independent audit committee could be very helpful.

The -- should the auditor be required to assess the objectivity? Well, that's exactly what we were saying earlier with respect to the internal controls.

Now I wanted to add just a couple of other things and go back into what I had said earlier this morning. One of the issues that I raised this morning was there is certainly an increasing reliance on non-GAAP measures, albeit very often those are based on GAAP numbers. They're adjustments to GAAP numbers. But I think it's really alarming at times to listen in, for example -- you should try it if you haven't had a chance to do this. Pick a cloud computing company, for example, such as SalesForce.com or somebody like that and then listen in on their conference call. You'll wonder what they're talking about because they don't talk about the financial statements as much. They don't talk about some of the measures that we would -- that we often think about.

You look at gaming companies, you look at some of the, you know, other IT companies that are very, very new in the marketplace and you have to ask yourself, what do those numbers mean? In fact, with some gaming companies, it's very interesting to try to figure out whether the current financial reporting model that we have actually does a decent job of telling us whether they're doing well. So there the question is, what is the role of the audit committee? How much can they help the auditor because management there has at least the intent to report in certain ways, and you might -- from an investor's perspective you want more, and very much more useful or helpful information.

The other thing as I pointed out this morning was, as we move towards more principles-based reporting guidance, and I think that's important to have because of the complexity of contracting out there in the marketplace, you have to ask yourself, are audit committees up to the task? Are the auditors up to the task? What are they going to do when, as we see more and more principles-based report? And I realize that in the IFRS and elsewhere in the world we've had, to some extent, of the other -- we've had principles-based reporting for a very long time.

But I caution you to be aware of the fact that enforcement in foreign countries is a different exercise. They don't have the equivalent of an SEC. The marketplace behaves very differently there. In fact, even investors have a slightly different role in places like Germany and Japan and France, for example. And I can give you more examples, the specific issues that come, but I'll stay -- you know, I'll stop at the issue of this principles-based reporting and the interrelationship between the audit committee and the auditors.

And in fact, to go back to our Chairman's point earlier, and something that Steve has also said, what is that we're trying to resolve here? We're trying to explain and actually delineate the role of the auditor and the audit committee in terms of providing investors with useful information.

Thank you.

MEMBER TAROLA: I'm going to go around from there. So Norman, any comments?

MEMBER HARRISON: Thanks, Bob and Tony. I'll just weigh in a bit further on. You know, as least what I've seen again is everyone knows or you can see from my background, I'm not an accountant, I've never been an auditor. My life has been primarily in a legal and consulting and investor role.  So I look at this more from a corporate governance standpoint outside-in.

And I think this issue of how you define operational effectiveness and follow on with the comments that Tony just made, I think it is -- I think what we're looking for here, the question we're posing is does the current state of reporting disclosure provide enough information for investors to develop a measured assessment and have confidence in the competence and the commitment and the level of rigor and diligence that the audit committee members bring to their work?  And if not, what are some of the options we might consider for greater -- some form of assessment and reporting on that process?

And if you think about the primary responsibilities of an audit committee, at least as it pertains to the annual audit, you know, in the first instance they're participants in the discussion and decision about whether to engage a particular audit firm or whether to recommend to shareholders that the auditor's appointment be renewed for another year through the annual meeting process responsible for negotiating the scope and the fees, as we discussed earlier, associated with the audit. Responsible for evaluating and making decisions on independence issues that the auditors may bring to their attention over the course of the year.

And most fundamentally overseeing the audit process and devoting time and effort to review the results of the audit, receiving the reports from the auditors, addressing and pushing back on significant issues or hearing the auditor's concerns on issues that rise to the level of management committee concern. All of those tasks and responsibilities and engagements are what audit committee members do in discharging their duties with respect to the audit.

And if the notion is that the audit firm should then in turn be tasked with assessing the competence and completeness and sufficiency with which the audit committee does those things, I just don't -- yeah, I don't know how you square that circle. I'm just not smart enough to square that circle.

So I think it then leads to some questions which we may get into in the discussion about, you know, if there is -- if it would be viewed as valuable to investors to have more insight into the manner in which and the competence with which an audit committee approaches those tasks then to whom do you look for some objective or independent assessment of their conduct? Is there another source within the company, perhaps? Or are there insolvable conflicts involved there as well? Should there be a requirement to obtain a third-party assessment, an independent third-party assessment of some type or an option to do so, or an opt-out option with disclosure if you decide not to? There are a lot of ways that you can go.

But to the fundamental question of whether the auditors should be deemed sufficiently objective or competent to assess and report on those aspects of the audit committee's responsibility and performance I think is very difficult.

MEMBER TAROLA: Mike?

MEMBER HEAD: I won't repeat what Norman said because he did that very elegantly. But I will say that I think the reporting on and assessing would add significant value to the users and the investors. I think the report and this assessment at least should be made available to PCAOB and maybe in the public documents also.

And I don't have a problem with the concept of hiring an independent outside party by the full board to do it. There's already supposed to be a self-assessment of the audit committee provided to the full board on their activities and by having niche legal firms that have expertise in corporate governance or the other public accounting firms that aren't doing the audit or, you know, a non-auditing firm, you know, there are several out there like Protiviti and things like that.

I think there's plenty of expertise in corporate governance that would allow the board to hire a firm to assess it and not put -- and resolve the dilemma of auditing your boss, in essence. But I think it would add significant value and go a long ways toward either restoring or maintaining investor confidence. So I think it's a good idea as a matter of how you would, you know, make it work.

MEMBER TAROLA: Curt?

MEMBER BUSER: So I tend to think that when we complete the work on audit quality we will find that the number one item is competence, capability and tone set by management. Number two is same by the audit committee. And so I think it's important upon all of parties with regulatory oversight to look at this issue more holistically than maybe what we've done here. I think timely reporting by the audit committee needs to be part of that solution. I'm a little cautious about some of the others in terms -- our other recommendations in terms of them turning into check the box reports as opposed to substantive reports.

And I do worry about bringing -- the ability to bring the third parties in to make the assessment especially because those assessments will be really over-confidential, difficult matters. And how that judgment is exercised is really what we're really asking people to assess. And so then, you know, can that realistically be done by bringing a third party into that exercise? The auditor is already there but then you've got the dilemma that we've already spelled out.

That said, I do think this is a critical area, as I said before, that really needs to be looked at holistically and not just a little bit by the limitations that we have for this exercise.

MEMBER TAROLA:  Pete?

MEMBER NACHTWEY:  Thanks, Bob.  Thanks for taking the lead and doing a great job at herding the cats the last couple of months to get us to some closure on things.

But yeah, I guess as I think about audit committee reports and maybe put this in the context of this comes from somebody who has to sign two certifications every 90 days on a complex global company, Curt who just spoke also has to do the same thing, internal controls and quality of the financials.  So to a certain extent there's a little bit of, yeah, why shouldn't the audit committee be there with the CEO, with the CFO?  Although it has to be a recognition that theirs is more of an oversight, you know, whereas the CEO, CFO role are clearly as management.  We can get in and impact and do things more directly.

But I look at this on maybe three levels.  The why, the what and the how.  And I'll speak more to the first two than the latter which is -- sorry Barbara if that gets to the hard part of exactly how would we do it? But the why in my mind, first and foremost is, there's got to be an intersection between what the PCAOB does from a macro level in overseeing the profession and what the audit committees do at public companies at the micro level on a company-by-company basis. I don't know exactly, again, how we get that intersection addressed. But if we don't, in my mind there's a gap and do -- you know, "gap" with a single "a."

Second is again around the why, is there's a tremendous difference in the level of quality of audit committees amongst public companies. I happen to work for one that I'm blessed to -- or cursed to have inherited an audit committee that is the ultimate in perfectionists. When I got there it was led by Denny Beresford who many of you know from the SAG as well as Chairman of the FASB. And one of the other board members noted that he's also a Professor at University of Georgia and that he wanted to make sure he got straight A's as being the audit committee chair of Legg Mason.

When he hit mandatory retirement the former National Accounting and Audit Director of Deloitte took over who Jeanette had a chance to work with prior to a visit with our audit committee. He was no less a perfectionist. So there isn't a best practice that we haven't tried and looked for more. And you know, quite frankly it's been a good journey I think for the committee and for the company.

But not all companies are created equal and they don't all have the resources. We certainly don't have the resource of a J.P. Morgan but we have way more resources than, you know, a company at the bottom end of the -- the Russell or the Wilshire. But by putting out there some best practices, having the public see -- get an opportunity to see what the best companies are doing, I think we're just -- I don't know if it will force a race to the top but it ought to elevate all boats in my mind.

So that's kind of the why at two levels.

The what, when I look at the things that our committee does around the level of focus that we have on the charter and the schedule of activities and the kind of things that the committee's responsible for, it's very, very detailed. And they hold themselves accountable to make sure that they're following up on all those items on an annual basis.

One thing that the reach-out from the board and from Jeanette in particular caused us to add to that charter, we realized we didn't have on there, on the schedule of activities, that we would actually go look at the PCAOB inspection report on PwC, our auditor. You know, kind of a blinding flash. We're going to give this to Jeanette and to Abe. And so these are the activities, we don't look at that report. It was just something that, again was a blinding flash to the obvious.

But those kind of things I think are really important. I think going back to what Tony's alluded to several times, non-GAAP financial measures, I broaden that to almost any kind of disclosure, particularly a disclosure that has a dollar sign on it or a number. Our audit committee insists that if we're making any changes to those that that's something we're going to vet with the committee and they're going to decide, you know, along with management whether that's appropriate information. Is that necessary information? Is it balanced? Are we just telling the good stuff? Was there another side of the seesaw that's the bad stuff we should be thinking about? And if we're going to disclose it do we have a system of internal controls around it that's equally as good to what -- around our GAAP numbers?

And then the earnings release, which is another place that the companies talk to the public on. That's something our committee spends a lot of time on. We actually spent about 20 minutes the last quarter debating whether we were going to allow the CEO to say he was thrilled about the quarter. They were -- they wanted to make sure that the word "thrilled" was something that we could -- that's the level of detail that we got into.

So I think, you know, different audit committees are going to have different levels of specificity, different levels of interest, different levels of scrutiny that they put on to their company management that I think are worthy of being reported out to the public. So in terms of the what, you know, I think that getting something out there in -- right now there's a report in the proxy, whether there's something that actually accompanies each of the financial statements, you know, would be an open question. But I think doing something that beefs up what's in the proxy and reassessing, is that the right place for it or should there be some other place for the audit committee report?

MEMBER TAROLA: Thanks, Pete.

I'm going to sum it up and then open it up for general questions.

This issue I think is on the table because folks believe there is a wide variation of how audit committees conduct their activities and the degree to which there is transparency about what they do. The call to action from the NACD and others I think has started to bring into the disclosure documents some idea of what the audit committees are actually doing and how they conduct their business.

Interestingly enough, though, for a large measure it's focused on the annual audit and the relationship with external auditors. Where I would suggest that audit committees do a lot more than that and perhaps their total activities ought to be in some way addressed in their report. And then also -- it also is clear, I think, that the auditors in accepting a client or continuing a relationship with a client must be evaluating their confidence in governance. And Marty, I suspect that that's one of your inspection points, is to see if auditors are looking at governance and making an assessment of their confidence in governance.

So that part of the auditor's role relative to the audit committee could also be an enhancement, in my view, to the information that's available to investors to give them confidence that the audit committee and auditor are effectively discharging their duties.

So I'll stop there and open up the floor.

Damon? Sorry.

MEMBER SILVERS: I think this conversation has brought up -- serves to focus in a way the discussions of the entire day. Because the point that was made a couple slides ago that it's problematic perhaps to ask the audit committee to oversee the -- it's problematic to ask the auditors to express an opinion about the audit committee which then turns around and hires the auditor. I think is a way, and neatly summarizes, in fact, the entire model of audit governance that we are -- that we've been discussing since this morning.

Meaning that the model we have is a model which, despite Sarbanes-Oxley, which sought to structure it in certain respects, is a model in which the audit committee, the management and the auditor engage in a process that -- you know, a process whose fundamental content is obscured from the investing public.

And where the ability to hold parties accountable is held by people who are inextricably kind of intertwined relationships with each other that again are not visible. Now I think that the -- this structure then leads to a set of problems that can't -- that seemingly cannot be resolved.

Now I think that the PCAOB, you want to ask yourselves as you listen to the discussion today and the range of opinions that are expressed among us, there is a clear set of recommendations designed to open up this process and create some external transparency and some external levers of accountability. And that agenda has been sort of stated and restated over and over again.

Now what's interesting about this agenda which is different from when this agenda was first in front of this Board in 2003, it's exactly the same agenda. In fact, I think I probably have the -- if my files were better kept I could find the agenda for a SAG meeting from 2003 that literally had these items on it. Just as -- we could have switched them for today's agenda.

Now what's different, though, is that -- and this is shocking when you think about the way the debates stood in 2004, is that basically the transparency agenda that we are arguing about yet again has not been embraced by the international auditing regulatory community. And it is shortly going to be an embarrassment to the United States that we are falling so far behind. This is exactly the opposite of the situation as it stood when this agenda first came up. At that point the United States was in the lead.

Now this will -- if it's an embarrassment, well, I guess we're often embarrassed internationally. But it could be far worse than that, if this system again fails. And the reality is that this system did again fail. It failed in the financial crisis of 2008, but nobody paid a great deal of attention because so many other things failed.

Now I think that the PCAOB, when looking at this list of items, items such -- and we've discussed them multiple times today, they include the question of how do you evaluate the strength of the audit committee given this intertwining of relationships? And there are now international examples of how to do that.

There's the issue of whether or not the -- whether or not we should continue the farce of maintaining the nominal secrecy of the audit partner. It includes the question of whether or not investors ought to have an ability through the corporate governance system to express an opinion on these issues. It includes the question of financial transparency of audit firms. All of these are issues are on the table, have been on the table for ten years.

And what the PCAOB ought to ask itself when facing them yet again, and hearing the same tired and, frankly, baseless arguments against them, the most recent of which I gather was yet another attempt to urge, that somewhere in our statute book it makes a difference whether or not the name of our audit partner is disclosed before the litigation begins. There is absolutely no evidence of any kind in law or jurisprudence that that's true.

The PCAOB ought to ask the question of this point. For those who urge you to maintain this current system that manifestly does not work and is leading to the increasing irrelevancy of both the auditing profession, the audit process and this Board, those who urge you to do nothing, what is their plan? What is their solution for the diminishing importance of what we are doing here? Because there is a solution: it's been sitting on the table for ten years. I'm not sure it's adequately, frankly. I think Lynn raises serious issues as to whether it's adequate or not.

But if you're urged to do nothing, right, you really need to pose the question to those who urge you to do so to ask more questions, to have more dialog, to spend another ten years pretending the system works. With how many more financial crises involved, what is your plan? What is the alternative?

Because if the alternative is the current system, if the alternative is the current system I would suggest to you that you know, as a result of your inspection reports and what you know as a Board about the relationship between the failure of the auditing -- of public audits and the recent financial crisis, you know that doing nothing is not really an option.

MEMBER TAROLA: Thanks, David. I think Bob, you were up next?

MEMBER BUETTNER: Yes. My question is for both Peter and Curtis, in your roles as chief financial officers. It was mentioned earlier in the presentation that there are some questions around the effectiveness of the audit committee results that are reported in the proxy largely because they're three to six months past the close of the particular fiscal year. Is it even possible to do something in a more rapid timeframe?

And is that something that you think would help investors, i.e., as soon as that annual period closes, within a fairly short period of time, maybe coincident with the press release on the annual figures, that audit committee results would be disclosed or audit committee standards?

And then the second question is, in terms of a process statement for how the audit committee looks at their responsibilities, would that be something that you think would either be proprietary to the company or a burden to provide? And if it's not, then I would think as an investor the process by which you go through to close your books on an annual basis would be of utility, certainly to the professional investor and maybe to somewhat a more limited extent, the retail investor who has an interest in these things.

MEMBER BUSER: So on the first, on timing, I don't see any reason why it can't be done quicker. I mean, the rest of the audit process, the Sarbanes-Oxley report and et cetera kind of get online quicker. Signoff of management, audit committee, et cetera, has -- you know, is done. So I don't know why an acceleration of that reporting can't occur simultaneous.

Now you get into probably the extended issues around is it a boilerplate report, or is it more customized? And the more customized probably the more valuable it is, would take some time. But you know, even there I would still argue that that should be done kind of timely and timely's a lot better than late, no matter what it is.

I also think, you know, to the extent we're so passionate about having partners sign, then that's the same motivation, if you think about it, that an audit committee should be kind of doing the same thing. With respect to the second one in terms of -- I think it was process around closing the books and disclosures around that, I'm not exactly sure I fully grasped the question.

MEMBER BUETTNER: Just that there was a thought in advance, or at least that's how I'm seeing some of this presentation, as not so much a boilerplate or checklist, but just the -- some of the steps that the audit committee goes through on an annual basis. Obviously some of the improvements that are made in that process on a year-over-year basis, obviously, Peter you mentioned something that you considered to be sort of a glaring example that you hadn't caught before but then you subsequently caught.

So almost -- just a process statement as to how the audit committee operates and perhaps improves upon its processes on a year-over-year basis so that investors can perhaps compare across the industry and say, boy, this looks like a very tight process. This company either is not disclosing, or is not acting in as complete a manner. And is that a burden to provide? If it's not, I would think that that would be helpful for comparative purposes.

MEMBER BUSER: I mean, my initial reaction is I think that would be relatively easy to put together in terms of the routine process that they go through, in terms of the things that they think about. I think it is, you know, essentially going to turn into boilerplate, is the only kind of downside with it.

But at least, you know, at a minimum the goal would be here is all the boxes that you have to check and they've affirmed that, is essentially kind of how it will go through. So I'm not exactly certain of the total value, but it's one that can be done. Pete?

MEMBER NACHTWEY: Yeah, I would generally agree with that, everything that Curt said. I guess I think of it, again, in terms of two factors. One, timing, and then content. And so timing, our audit committees meet quarterly then they meet coincidental with the timing around our earnings releases, they get a massive amount of information, et cetera. So the idea of them not being able to do something at the same time the company could be, I think I'd have a hard time understanding why that would be for any registrant.

The content, I guess it gets a bit, you know, what's done quarterly and what's, you know, kind of an annual report, if you will? I don't think putting something out there every quarter talking about what their charter is or schedule of activities. But on the other hand, maybe on an annual basis explaining what that is and-or updates. And the benefit of that isn't just being able to read it because again, I think there would be a rush -- not maybe a rush but there would be a movement towards the top.

You know, once more of this information was out there and transparent, I think committees -- you know, frankly there's going to be organizations like, you know, Lynn's former firm that -- Glass Lewis and ISS, et cetera, they're going to possibly add this to their criteria as how they think about voting for board members, what they recommend, et cetera.

But I think there's some -- you know, again, we're getting a bit into the how and I want to be mindful, because Steve did make sure to tell us, you know, there are some boundaries here in terms of what the jurisdiction of this Board is versus the SEC. On the other hand, if we're all, you know, altruistically saying we're trying to bridge the gap, we're not trying to usurp their authority but bridge the gap. But I think a little bit of this gets into the how, that we'd have to engage with the Commission on.

MEMBER TAROLA: Joe, I think you're up next.

MEMBER CARCELLO: Thanks, Bob. And thanks for your presentation. A few points I want to make. I mean, this issue keeps coming up over and over, both at the SAG when I was on that, and now on this group. I think as Pete made the point earlier, my sense, and I think the data supports this, there's huge variation in audit committee quality.

And I think one of the problems that the PCAOB and the SEC deal with is the people they hear from -- because I think back on the people who have been on these group over the years are people like Denny Beresford and Mike Cooke and Bob Guido and Bob Tarola. And these people are in the tail of the distribution on the good side. So hearing from them is not necessarily representative of the median audit committee member of 8000 public companies.

So then you kind of look on, in a more systematic basis on things like what do we see in terms of the behavior of audit committees? And I think a lot of this, candidly, is SEC issues, so this is really for the benefit of Jim and Brian as much as anything, and the Chairman if she's still watching. Is that we saw during the financial crisis when risk went through the roof, and a first semester auditing student would know when risk goes up, audit work goes up, which means fees go up. And what we saw is that fees went down.

If you look at comment letters that have come in on the partner identification project, virtually every institutional investor that has commented on that is in favor of it. And a significant amount of the comment letters that have come in from audit committees opposed it.

If you look at comment letters on the expansion of the audit report, most, if not all of the institutional investors that have commented support that.

Audit committees seem to be almost unanimous in their opposition. So these are groups that are supposed to represent the interests of investors and on major policy issues are taking policy positions opposite that espoused by investors.

If you look at research on audit committees, which is voluminous, the CEOs, CFOs still drive the process in a large majority of cases. When the governance committee is lax in dependence or have CEO involvement, any benefits of audit committee independence and audit committee expertise seem to vanish. There's a growing literature on social ties between management and the audit committee with the same deleterious consequences. So I would encourage the Board or the SEC to look at that.

So how do you deal with all of this? And I think that Damon is right. I mean, I don't think it's perfect by any stretch of the imagination, but greater transparency by audit committees which will call for expanded reporting. In fact, one of the things that might be worth considering is, should the shareholders have a vote on whether to accept or reject the audit committee report to insert additional accountability?

Although, at the end of the day, I think these things will only work if the very large asset managers where most of our 401K money is invested, Blackrock, Fidelity, Vanguard -- Pete, with all due respect, Legg Mason -- if they step up to the table and engage very actively in the process. Because at the end of the day, without them even greater shareholder involvement is just going to be driven by the public pension funds and the union pension funds. Although they're important, they don't control enough of the votes to really sway things.

MEMBER TAROLA: Thanks, Joe. Lynn, I think you're up next and, then Barbara.

MEMBER TURNER: I would echo what Pete said about audit committees having a wide variety in terms of how good they are, competency. I think it's extremely wide, and people need to be mindful of that.

Also when you talk about audit committee reporting on a quarterly basis, think back to the audit committee charter, and for many audit committees that's a half dozen pages, five, ten pages long or whatever all the duties they do. And audit committees often take those lists of items and lay them and schedule them out over the course of a year, so that you're making sure you're hitting each of the items over the course of the year.

That means that in any one particular quarter you're not doing everything, you're probably catching some of the items, some of the items are probably repeated, some of them aren't. So when you talk about an audit committee reporting on what they're doing on a quarterly basis, it is different than the reporting that you're asking the CEO and CFO to do which runs the same each quarter.

And actually with the CEO and CFO, it's just here's the point in time at the end of the year, and then kind of an update each quarter as you go along, have there been any changes? So you have to be mindful of that. It is an SEC reporting role. This body doesn't have any jurisdiction over it whatsoever, so it would have to be incorporated into rulemaking by the SEC and not this group.

Someone mentioned well, maybe you -- well, there was the issue of should the auditor evaluate the audit committee? And someone mentioned that perhaps you could have an outside party do it rather than the auditor. I've actually sat on a public board where we retained the NACD, because the NACD will come in and on an independent basis come in and do an evaluation of your board. It's a marvelous experience to go through in more than one way, if you have ever gone through it. Most boards have never done that. Most boards won't do that.

And so I don't know, realistically, if that's really a practical option or not. The NACD does a marvelous job, but most board members just -- when you tell them you're going to bring in someone new, independent and have them come in and tell you how you're doing, it's usually not viewed as a good thing amongst board members. Too much uncertainty, so most of them won't do it. So I don't know if that's realistic.

The other thing is an auditor evaluating an audit committee, that's still like, you know, you're going to go in and evaluate your teacher. And it's actually interesting in colleges where the students evaluate teachers, and so the teachers teach down to the students to get the good evaluation. And it's not a very good process, it's a flawed process that is pretty poor at best.

I'm probably not a very big fan of that idea because you're talking about someone reporting on someone who hires and fires them. And I think just given the way people work and operate these days, that's not a real successful process or outcome.

In fact, on a number of cases I've seen, prior to a company blowing up and going through an Enron type environment, the auditors and the audit committee, if you look at all the correspondence, they loved one another and they were all doing a good job. And immediately after the lawsuits start piling up, audit committees almost universally accuse the auditors of not telling them anything. And the auditors turn around and say, no, look at all the stuff we told the audit committee. And usually the truth, when you get into it, is somewhere in between the two.

But whether or not you get an honest self assessment out of that process, I think you're asking way too much of a human being to turn around and do that. I just don't think that would really turn out and be meaningful in any way, fashion, shape or form, given what our experience has been with those.

MEMBER TAROLA: Just a comment on that before I turn it over to Barbara. Right now, if I understand the way auditing works, the only recourse an auditor has if they come up with that situation, Lynn, is to resign. The notion here would be to put in a communication process. Now I'll turn it over to Barbara.

MEMBER ROPER: Right. So this last point, I mean, it does get to the point that Damon was making. We've got the system that's so intricately intertwined that you have an auditor who needs to evaluate the audit committee in order to evaluate the internal controls over financial reporting. And yet where there is just this fundamental conflict to having that evaluation occur by the person whose employment to conduct the audit is in these individuals' hands. So I don't think there's any reason to believe that would -- when you needed it to work that it would work.

But just more generally, you know, we have been concerned, ever since Sarbanes-Oxley was passed, frankly, that when we put this much responsibility on audit committees, this is a slender reed to carry the weight of responsibility that Sarbanes-Oxley placed on audit committees. And it's to this point, it's been mentioned by several people earlier, that there is a huge range, inevitably will be a huge range of quality in audit committees.

And that when you look at the list of things we ask these part-time people meeting quarterly, and obviously doing work between those quarterly meetings, but to be responsible for, it's hard enough at the really big companies who want to do a good job and can draw on the pool of top financial experts for their audit committees and, you know, have that function as intended. But to think it's going to function that way on the thousands of smaller public companies I just think is completely unrealistic.

So you know, I think it's a good idea to have this report. I think it's useful. But I also think we need to recognize the system that puts this much faith in audit committees to make the sort of independent audit work is really fighting an uphill battle.

MEMBER TAROLA: Ann, I think you're next.

MEMBER YERGER: Thanks, Bob. First, I did want -- I wanted to commend the Board because I think this area of trying to educate audit committees and audit committee members, you've done great work in terms of outreach. And I think trying to teach them and train them about the right questions to be asking. And I would just encourage you to continue doing that.

I just wanted to share my two cents on the transparency piece of this because I think the other questions are really interesting, and I don't know where I end up on them, to be perfectly honest with you. But as I reflect on today, so much of what we've talked about is transparency.

And Mercer, your questions sort of lie, you know, empirically there's a lot of data to suggest that investors and the public has lost confidence in our markets and some are still sitting on the sidelines in the wake of the financial crisis. And I think that this is sort of one small element of restoring some confidence in that space.

I guess I wanted to stress that I think there's a role for an enhanced audit committee disclosure but I don't think that that's the only answer. And I guess I would encourage the Board to work with the Commission as you're thinking about the transparency elements of this. Because I do worry that sometimes, you know, convenient answer is we'll just have the audit committee do it.

I worry that we're probably more likely to get boilerplate language from the audit committee, as opposed to, frankly, the auditors, and we've certainly had evidence that some auditors are really stepping up and providing, I think, you know, tailored commentary as they've -- as we would hope.

So I guess that would be my only observation is I would encourage -- I don't want to give up one to get the other. I think both are extremely important.

MEMBER TAROLA: Mike?

MEMBER HEAD: For the sake of kind of being a little bit redundant, but we continue to go back to this model that some have passionately said we've ignored for many years. And others less passionately have alluded to the same thing that, with this type of interrelationship it's hard to imagine how this could work. And I guess that's the elephant in the room for me. We've alluded multiple times here that one solution that could resolve a lot of the conflicts that we're dealing with is that the audit firm isn't hired by the company, isn't hired by the audit committee but is hired by the regulatory body.

And I know -- and in the United States, that's not been a popular concept but it eliminates about 90 percent of the conflicts that we've talked about all day long. And I'm not saying that's PCAOB versus SEC versus your next flavor of who you want it to be, but if the hiring and therefore ensuring the independence and the scope and that they could assess the entire process without having a conflict, and that the right amount is paid and they're incented to be aligned with the investors, all that gets resolved if you don't have the company being audited and their audit committee hire the audit firm and it's hired by pools that are supplemented and then -- and we have models in the United States that do that. That's what the examination bodies do for the banking industry and how they get their money to pay their examiners. It's a hybrid of that.

So with that, I'll stop being redundant and go back in my hole.

MEMBER TAROLA: Joe, go ahead, you're -- or are you finished? Oh, I'm sorry. Jim, I'm sorry.

CHAIRMAN DOTY: To take Jim Schnurr's approach, what's the real problem? What are we trying to solve?

I could suggest, there being a danger that you could define the problem so narrowly that you haven't done anything. But nevertheless I think the problem that keeps coming up is audit committees who are subservient to management. Audit committees who don't really do the hiring and the evaluation of the work they're doing. This -- there is a model that works here and it's the model that the SEC has.

The auditor -- you triggered it, Bob, in my mind because the auditor who sees something wrong does not have to resign immediately. The auditor has the option of taking his problem up the line. And if he does not get a satisfactory response up the line then his obligation under 10A is to go to the SEC. And by the way, he does not have a private civil litigation liability for failure to do that. He has a safe harbor.

You can imagine a rule in which we said, if the audit committee -- if the auditor noticed or observed undue management pressure, the reporting up the line would go first to the board if the audit committee was subservient to management. And if were not a viable option and they cannot get satisfaction going that way, bring it to the PCAOB. Now that's a different kind of rule but it is a reporting rule.

We have talked at different times at the Board among ourselves about how you stiffen the spine of auditors. But it is one of the areas in which, if we did it, if we considered it, the problem would be a narrow one. We're not asking the audit committee -- I mean the auditor to pass entirely on the effectiveness of the audit committee under all the aspects of their charter, do they have sufficient financial expertise, were they right or wrong when they accepted management's risk estimate? No.

We would simply be saying, does the auditor -- this becomes a material adverse failure issue. Does the auditor observe something which, in the mind and the terms of Tony Sondhi really amounts to a material -- a material weakness. Does the auditor observe conduct in the audit committee which renders the auditor unable to perform their duties because of management influence? And is that a material weakness in internal controls? And if the auditor observes that and if he takes it up the line and nothing happens, he has to bring it to us.

Now why I say this worked. Most of us I think around the room have seen in the private sector, you never get to the point of going to the SEC. You never get to that point. Once the auditor raises the finger, the warning finger and starts saying there's a wind blowing here, something happens. Something happens. Management backs off, the audit committee is reconstituted, the CEO's golfing buddy is replaced as the chairman of the audit committee, there are all sorts of things that can happen.

But maybe we ought to start considering it -- and these are much broader, these are much broader reforms, but at least we ought to start working on the problem we know we have and the problem that you all identify which is we need to start worrying about whether audit committees are under the thumb of management and what can we do about that targeted problem? Comments, rebuttal invited.

MEMBER TAROLA: Okay. Lynn?

MEMBER TURNER: Jim, what you just talked about in part reminds me of the Section 10A reporting requirement, okay? But the number of Section 10A reports that we've ever got on auditors is not only small, it's probably smaller than negligible. And we have seen where the auditor never reported a 10A violation and then when they get into court we find in the court documents, then all of a sudden there's a 10A.

So I think it is a good analogy but that experience has not worked and certainly has not worked well, and has led to a false impression that auditors are, in fact, reporting or required to report all these 10A violations. You might even recall Dingle on a few occasions asked for an update and they're just -- the bottom line is we just don't get Section 10A reports to speak of. And so I think you'd have to go back and say, okay, why is it that we don't get the Section 10As? And what would you do about it so you don't have the same experience here?

The second thing is, you don't have the authority to get into governance of a public company, not even the SEC does that. I think you would have statutory authority to do what you're doing if you're going to do it from an auditor perspective but you would have to deal with the governance issue as well. But I still just don't know that you're going to -- I think you're asking for more out of that audit firm than what you're going to get given the 10A experience.

CHAIRMAN DOTY: The idea that I'm playing with and that intrigues me is that part of the benefit that 10-Cap-A has wrought, it seems to me, is that there have been changes in corporate conduct which never reach the SEC or reach the reporting markets. And it's certainly true that there have been cases where auditors have failed in their duties under 10A. There are cases where they have, in fact, brought things to management's or the board's attention that haven't been remedied and a satisfactory response not delivered and the auditor did not report.

But we all know cases in which there were changes. And all I'm saying -- alls I'm saying, as we say in Texas, is that perhaps we should start addressing this problem at least with a specific kind of targeted invitation and direction to the auditor to call a material weakness out when he perceives a weakness in the audit committee and to follow the kind of 10A approach that would eventually result in him coming to us rather -- because we don't inspect everything. In other words, we don't -- we're not in a position to go around and find these examples of audit committee weakness.

MEMBER TURNER: But don't you have that ability under your current rules? Because if it's a material weakness you've got the issue with the auditor already reporting under internal control.

CHAIRMAN DOTY: What I'm saying, we don't inspect all these audits. We don't see all of those cases. And what the advisory group here is pointing out is that really the problem is that bottom of the iceberg, that all of these small companies and little size companies. And what I'm suggesting is you start putting out on the auditor -- you hand the auditor a club and you say to the auditor, you've got to use this club when you see a case for it. And if he does not use it the auditor then is flipping a coin. The auditor is doing what they do when they issue an audit report without a substantial basis. They're essentially taking on themselves a responsibility that they ought to be transferring to management, the board of directors, and bringing to our attention.

MEMBER TURNER: But if you find that, are you going to do the morning execution so you actually -- the auditor is actually going to do it and we aren't going to get -- let those investors --

CHAIRMAN DOTY: That could be the basis for a referral. It could be the basis for a quality control problem. There are a lot of things that could follow short a morning execution. It just seems to me that we have a gap, that we don't make this connection.

MEMBER TAROLA: I think, Jim, you got the point directly. So unless anyone else has a comment, I think as a group -- well, okay.

MEMBER SILVERS: Mr. Chairman, I think you're sort of asking the question how could we -- because right now we're talking about executing people at dawn. One of the issues that is -- one of the issues that is in real life present is that the auditor has a relatively narrow range of steps and they're mostly cataclysmic.

If the auditor feels that the financial statements don't accurately reflect the health of the company or the auditor feels there's an internal controls problem it's sort of an on/off switch and if you turn off that switch, you've really destabilized your client.

A number of the things that have been proposed today are attempts to try to give some other options, right? The enhanced audit -- one could understand an enhanced audit letter as having that effect. I think to some degree what you're talking about envisions that sort of dynamic. And as you correctly point out the outcome of doing that is to give the audit firm greater leverage behind closed doors in its relationship with the client.

And I think if your model of what is -- of what you're trying to get at is this circumstance where you have an audit firm made up of -- you have an audit engagement team made up of people who are, you know, deeply uncomfortable with what they are witnessing and want to do something but don't want to do something irresponsible. If that's the model you've got then these types of proposals that envision, largely keeping the audit process between the company -- between the management, the board and the audit firm may, in fact, be responsive. And I don't doubt that there are a number of circumstances like that and that anything that could be done to enhance the power of well-intentioned professionals in those circumstances is probably useful.

But I'll tell you, I don't think that's actually what the big problem is. I think what the big problem here, when you talk about large cap companies and things with significant impact on our members' retirement savings, it's not that at all. It is a set of relationships which everyone is quite comfortable in and where no one, not the audit committee, not the engagement partner, not the management is seeking to -- no one is lying awake at night, right? But they ought to be. Somebody ought to be lying awake at night.

And getting into that problem seems to me to be what is really in front of the board and really what I was talking about a few minutes ago.

MR. HARRIS: Well Bob, thank you very much. You certainly struck a chord, and notwithstanding my attempt to browbeat you not to bring it up because it's not within our jurisdiction, you clearly have struck a chord with the vast majority of the people here. So we thank you very much.

I also appreciate your comments with respect to the Board's participation here because Jay and Jeanette have been very active in terms of outreaching to audit committees, and Lew also in terms of IFIAR has raised this issue in the international level. And so we appreciate that very much, and the Chairman has also spoken about it.

Also where credit is due, notwithstanding Lynn's remarks, I think our inspections division has done an admirable job in terms of being the crown jewel of the PCAOB, and we've clearly made a difference there.

In terms of moving on, Marty, if you would, maybe -- we didn't touch upon the audit report. I'm not sure whether there are any standards that you want to bring us up to date on. Very briefly we touched upon going concern and transparency. But if you want to just spend maybe five or ten minutes on that. And then what I'd like to do is begin to wrap up. But before wrapping up, I'd like everybody to think through -- we'll go around the room and, as we've done in the past, if each of you could give us your closing thoughts and recommendations in terms of issues that you think we ought to be focusing on. You not only have the Board's attention, and so I would encourage you to stay within the jurisdiction of the PCAOB, but you also have the SEC here, too.

So we'll take the last 25 minutes or so just going right around the room. And Pete, why don't you start thinking in advance and right now we'll turn it over to Marty.

MR. BAUMANN: Okay. Thanks, Steve.

I'll touch on a couple of things just to pull them together that were talked about today, but also I mentioned a few other items as you suggested. But because it's been mentioned so many times, I will mention again in transparency, of course, our reproposal where the comment period ended in March of 2014 was that the auditor engagement partner would be named in the audit report along with other firms that participated in the audit over a certain threshold.

Responses to that, firms' responses largely were that would increase liability to partners and other firms because of the consent requirement which would trigger

Section 11 liability. So it was mentioned before by Jim, we will be issuing in the hopefully relatively near term a supplemental request for comment to address those concerns about liability and consider other options with respect to disclosure of engagement partner and other firms such as either in the audit report or maybe in a new form, Form 5 which could be searchable, or you could choose both; put it in the audit report and put it in a new form.

So we'll lay out some alternatives in that supplemental request for comment. And please, this is such an important issue to all of you, please weigh in on that supplemental request for comment. We'd like to hear your views.

On auditor -- expanded auditor reporting, we are very committed to this project. And as was mentioned earlier this one and some others, we were at the forefront of these issues and some other standards around the world have moved ahead of us. Some of the complications of economic analysis, which is important to our rulemaking, and other factors of the U.S. liability regimes create some greater challenges here.

So we've issued a proposal for the auditor to disclose critical audit matters in the audit report and also to describe what the auditor's responsibility was with respect to other information accompanying the financial statements.  Some of the non-audited -- some of the non-GAAP measures and others which could be reported in the other information where the auditor has to read and consider that.  But we were heightening some of the requirements there.

We also held public hearings on the expanded auditor report in April of 2014.  So our plan now is to issue a reproposal on expanded auditor reporting requirements, taking into account the comments we received during the comment period as well as at the public meeting and to issue that reproposal probably in the first quarter of 2015.  We are staying obviously very close to all of those global developments and have had many conversations with the IAASB and European Commission and others.

Just in terms of timing, somebody mentioned falling behind, hopefully we won't fall too far behind here.  the IAASB expects to approve a standard on expanded auditor reporting at their December meeting. And that they expect to be effective for year's ending on or after December 15th, 2016 such that expanded auditor reporting would take place in 2017. So if we can get our reproposal out in the first quarter as I suggested, and hopefully move that along, maybe we can get on track.

By the way, that IAASB report that they expect to approve in December, the IAASB report, does include a requirement to disclose the name of the engagement partner in the audit report so that will be a requirement basically around the world for all those countries over 100 jurisdictions that follow international auditing standards. So again, please weigh in on that reproposal on expanded auditor reporting that we'll issue in the first quarter of 2015.

Comments and ongoing concern at some length, and the bottom line of that was that we will be -- that the practice alert said that existing auditing standards continue to be applied to auditors and they have reporting responsibilities under existing PCAOB auditing standards. With that also we will be issuing a staff consultation paper around year end, December or early January, to lay out, as I mentioned, possibilities for how the auditor can improve their performance in this area and what the investors might expect in terms of early warning signals, and at what level should that early warning signal -- kind of at what stage should that take place.  Again, please comment on that, it's very important so we hope you comment on it.

Some other things, PCAOB inspections have identified some areas as very problematic in audits and certainly a major one has been audits of internal controls of financial reporting, represent a significant amount of findings from Helena and her team.  They've issued some reports on the extent of those deficiencies.

In response to that what we do is issue practice alerts and so on October of 2013 we issued a practice alert on considerations for the audits of internal control over financial reporting and laid out what some of the key issues were and how the auditors should think about the risk assessment standards and link that into their responses to testing internal control over financial reporting, and addressed many of the deficiencies that inspections noted.

And we'll be working with -- monitoring closely with ORA and Inspections, any improvements -- or the responses to that practice alert to see if we see better results, as well as for various other inspection activities.

A standard we did adopt, the Board adopted a standard in June of 2014 which I think is important in this area. One of the critical areas of financial reporting problems over the years has been dealing with related party transactions, significant and unusual transactions, and a company's financial relationships with executive officers.

So the Board approved and adopted a standard, Auditing Standard 18, and related amendments to other standards in connection with those matters. And that should -- subject to SEC approval in the very near term, we hope -- and if so, those new standards and rules will be effective for audits beginning on or after December 15th, 2014. So that's important for upcoming audits in the next season and interim reviews next year.

Another place where we've issued a paper for comment where again we'd like to have this group's response, and we had a SAG meeting just recently on October 2nd that dealt with a staff consultation paper on auditing and accounting estimates and fair value measurements. I referred to that earlier, as well.

This was another area, not just in PCAOB inspections where auditing fair values has been a very high rate of audit deficiencies in PCAOB inspections, but based on the IFIAR annual global survey of inspection results around the world, auditors are having challenges and difficulties and regulators are noting deficiencies in audits of fair value measurements and complex estimates, like the allowance for loan losses, around the world. So it's not just under our standards, it's under the international standards in auditing, as well.

So we need to look for ways to improve auditor performance in this area that works both with our standards, as well as with the ISAs, and the IAASB has commented at that meeting that they'd like to work with us on this project to improve their own standard. So this consultation paper is out for comment and the comment period closes on November 3rd. And we look to hear from as many people as possible on that.

Another area where Inspections cites a lot of deficiencies, and a really important area, it's the top line of most financial statements, is revenue. And, again, significant challenges in estimates and auditing revenue, a high rate of inspection findings there. There's also a new accounting standard on revenue recognition that's expected to -- that's been issued, expected to go into place a couple of years hence.

So we issued, again, a practice alert addressing these issues and ways in which auditors should improve their performance with respect to auditing revenue, and we issued that in 2014.

Some other things coming up, Steve, not out yet, but we expect to issue a staff consultation paper on specialists and the oversight by the auditor, both of their own employed specialists and engaged specialists and how they should look at the work of management specialists and evaluate that work, as well. So that will be important, also, for us to seek comment on what people -- what are the expectations of auditor performance with respect to the oversight of both management's and auditors' engaged specialists and their own internal specialists.

Related to that, also, is how auditors should supervise the work of other auditors on a multi-location engagement. Another place where we've seen some problems through the inspections so -- and a place where we think standards needs to be improved in terms of the lead auditor's oversight over the work of other auditors around the world participating in the audit.

And then finally, importantly, as well, the staff has been performing extensive outreach with academics, investors, forensic accountants, prosecutors and many others regarding the auditor's responsibility with respect to financial reporting fraud, with a goal to -- as Lynn and some others have pointed out, this is an area where these matters are often found by hedge funds and short sellers -- with a goal to improve audit performance in detecting financial reporting fraud. And we are planning robust discussions on this topic at the upcoming SAG meeting.

And then last but not least, I'll speak outside of my area here, but Greg Jonas and team in the Office of Research and Analysis, working with the other divisions, as well, have before us the paper on audit quality indicators.  And hopefully this will get out, Greg, around year-end timeframe or so, which I know this is important to all of you.

So a lot of things where, again, we'll be seeking comment on that document, as well.  So I think a lot going on, we'll be seeking comment on very important matters, all relating to the improvement of audit quality.

MR. HARRIS:  Marty, thank you very much for that summary.

And then as I indicated, why don't we go around the room and conclude.  We welcome your input, welcome your recommendations for priorities in terms of what we ought to be focusing on.  And, Pete, we'll start with you.

MEMBER NACHTWEY:  Well, great.  Well, first of all, thanks to the Board and particularly, Steve, you, for putting this group together because I think it's important to get a lot of different viewpoints and constituencies.  And clearly there are lots of things we agree on and there's lots of things that we differ on in this forum, so a good place to get those out on the table. Sometimes it's not as good a place to get them fully wrestled to the ground, but hopefully give you guys a broad perspective.

I guess just from a 50,000 foot level, I stepped back and it was particularly crystalizing for me as we were going through the couple of the different topics that I was working, to go back and look at what really caused the last two crises or what -- you know, what did we learn coming out of that? And those being the '01 with the Enrons and the Worldcoms and the Tycos, versus '08. And both of those crises were typified by some massive corporate failures from bad business models. But, in the case of '01, it was bad business models with bad people, many of whom are still in jail.

It's clear that auditors have to share some responsibility around not catching that, not reporting that, not, you know, being more on their front foot about it. But I think Sarb-Ox has helped to address a lot of that. I also think that the way the firms have changed, there's a double-edged sword behind the scale of the numbers. When I look at just how large the big four have gotten, on the one hand it's a bit scary. On the other hand, it was always a bit of a challenge, how do you have these -- when there were eight firms, how do you have these eight relatively small firms facing off against these gigantic corporations? There's now, I think, a better scale, if you will, between the firms themselves and the clients that they audit.

But I also think there's been some changes, and I don't know whether it's been this way in all of the firms. I at least know of several where one of the key aspects, in my mind, of what caused the failures, particularly Enron and David Duncan, who wasn't necessarily a bad guy but in a bad structure. And the Houston office of Arthur Andersen getting such a massive amount of their revenues from one client and getting to make the technical decisions on both auditing and accounting. And my sense is that most of the firms have moved up to a national level where you're now looking at firms with, you know, 15-plus billion dollars of revenue. And yeah, 15 million is still a lot but it's not the same relative amount to the whole firm as it was just to the

Houston office.

So I think the lessons that we learned from that crisis, we've got to be careful now in terms of applying them to the most recent crisis which, in my mind, was more bad business models, not necessarily bad people. Some would argue, well, you know, we haven't been aggressive enough at going after the Richard Fulds from Lehman Brothers or whatever in terms of putting people in jail.

But I think the reality is we found from this last crisis, is that it was bad business models but not necessarily bad people. Bad business models of allowing financial institutions to get levered thirty-five, forty-to-one. Bad business models of, you know, having highly rated products in money market funds, which I think someone alluded to earlier, around the breaking of the buck of money market funds was caused in part by the wrong kind of instruments being in those funds.

However, everybody was following the rules. If it's AAA-rated by one of the rating agencies, even though it might all be tranches of subprime mortgages that supposedly could be AAA-rated. And when we found out that, well, Fannie, Freddie aren't going to be solvent and aren't going to be able to stand behind all that paper, then money market funds could break the buck.

So I think that there was a lot more complexity there than just auditors. On the other hand, I do think the audit firms, inside those organizations, they know, you know, what feels right, what feels like a bad business practice or what feels like a highly risky business practice. And a lot of the things that we're trying to tease out about auditor reports, you know, I think go at that issue.

But I think we've got to come at all this stuff with the recognition that Sarbanes-Oxley did change a lot, that the way the firms have changed is important and, you know, Marty and I were having a conversation at lunch as to, you know, have all the firms really kind of gotten it, that the real tough decisions that get made should get made at the national office? At the end of the day, it still has to be the individual audit partner who's going to sign that audit report, but it should be the firm that's making those tough decisions at a very high level.

So I think, you know, again ,it comes back to tone at the top, you know, structural issues within the firms. And then on this expanded audit report, that we get it right and that it's useful information and not just a lot of boilerplate at the end of the day, if we're going to have companies and the investors in those companies paying for that extra work.

MR. HARRIS: Thanks. Thank you very much. Bob?

MEMBER TAROLA: Yeah, thanks, Steve. Thanks to you and to your fellow Board members on engaging us in this way. It's quite interesting and robust.

I think kudos go out to the Board for truly improving the effectiveness of auditing. I think over the last ten years, that has proven out and your diligence in that regard I think is appreciated by investors and users.

I think perhaps the next focus for the Board is in building the confidence of the reporting system and taking to heart some of the recommendations you heard here today about transparency and accountability and collaboration. And using those as a way to help promote more confidence in the system.

I'll stop there.

MR. HARRIS: Mercer?

MEMBER BULLARD: Yeah, I've sort of noticed in this meeting and the last meeting a common theme of whether the Board has jurisdiction over issues, notwithstanding they're very closely related to the issues that are well within your jurisdiction. And, you know, in the securities laws and in ERISA and to some extent in banking regulation, there's a pervasive model that's essentially like the rule that you can't have any cookies before dinner unless you get your homework done. And that is the model that if you up your behavior, then we'll cut you a break on some requirements that, over time, we realize might be more burdensome than they're worth. And it satisfies the economic principle of revealed preferences while also allowing the parents to get what they want.

And I think in the long term you need to think about things like being able to adjust the boards of auditors as a possible, you know, benefit that would be worth giving something up. And that in the long term, I think, a mature agency has to have some exemptive authority along those lines.

So you probably want to be thinking, because this is going to come up repeatedly, whether, you know, that's an avenue you want to pursue to give you more flexibility to do some of the things that you might prefer and that your regulated entities might prefer, as well.

MR. HARRIS: Thank you.

Brian, I think we'll save you and Jim, the best for the last, with exception of the Board, who we'll consider to be the best.

Larry, your thoughts?

MEMBER SHOVER: I am grateful. First of all, I'm just thankful for Joe who just left, and Ann. They really prepared us really well, with passion. I learned a ton, I learned how much I didn't know, and it was just really good.

Not to be too weird about it all, but I'm thankful for the members who have been on this Board for a long time, I know Damon, Barb, some other people who speak with a lot of passion. You probably roll your eyes when see a guy like me because I'm like, oh, my word, I want things to be finished in like -- don't tell me this stuff's been on the docket for ten years. Oh, it's so sad. But anyway, that said, I'm thankful for them.

But, for me, the relevancy of the audit hits home for me, it really does. I mean, it seems so common sense to require a signature of the lead engagement partner or something like that but I understand there's a lot of tentacles and a lot that goes behind the scenes.

And also for the shareholders, that's where my heart lies, in just allowing shareholder proposals and auditor issues. It's something near and dear to my heart. And that's what I'd like to leave you with.

MR. HARRIS: Barbara?

MEMBER ROPER: Thanks. So I have two thoughts. One I've said before, when we deal with these issues, with an audit that only has value if it's independent, and a business model that ensures that the audit will never be really, truly independent. So if you're going to stop short -- and this is sort of to the point that Mike apologized for being redundant, but that is sort of to some of the points that he was raising -- if you're going to stop short of the kind of revolutionary reforms that would really, significantly change the independence of the audit, then you can't be timid about the rest of these things.

And so there have been a list of proposals that have been put forward, none of them is -- I mean, some of them have technical questions about whether they'd work or not, but none of them is radical in the sense -- you know, short of Lynn's presentation on changing the business model -- none of them is radical in the sense that it fundamentally changes the world. They're really about incremental change. And I think it's important to understand what you're trying to change with those. But the notion that we really need to do something significant to increase professional skepticism and the quality of the audits at a time when we have persistent problems with that despite years of attention to those issues.

And then the second point I'll make, it's a little -- it's not quite as snarky as it sounds, but we've talked a lot today about increasing investor confidence in financial reporting. And I think we have to question whether lack of confidence isn't a rational response to the world that investors live in. And what we want to do is give investors a basis for increased confidence in the financial reporting system. And that, again, brings us back to being willing to tackle on a fairly fundamental basis some of these issues that call into question the independence of the audit.

MR. HARRIS: Thank you, Barbara. Grant?

MEMBER CALLERY: Okay. Again, thanks for all of your assistance in getting this to here. And Nina, who I see has left the room, should also be given kudos for all of the assistance she's provided us over the last couple of months.

I guess I have three comments, and I'll work from sort of the macro to the micro. The first is we keep hearing about ACAP and there are lots of recommendations in there. It's been, as many people have pointed out, a good number of years now since that report. And I think it's important for the Board, the Commission and the Board, whatever the right combination is, to address those issues, either adopt them or give a reasoned decision as to why -- that can stand up to the scrutiny of public, you know, view -- as to why they're not going to be adopted. Because I think as more time goes past, credibility ceases to exist. And it's a good report and there's a lot of good stuff in it. So that's my macro issue.

The middle ground issue comes down to the issue that we talked about in Brandon's piece of the report, which is the consulting creep. And I think that a number of people had mentioned this: there is a lack of empirical evidence. But I think you can do some digging, again, maybe in combination with the Commission, to come up with some things so that the next time we talk about this we can be looking at some specific and targeted approaches that we can take if there are areas where we can determine that there are issues that need to be fixed.

And because if you just try to do a broad-base, you know, you shouldn't have any consulting, people that are going to say, why? And you've got to be able to come back and say, this, this and this. So I think a targeted approach there would be more helpful.

And the micro level is the disclosure of the engagement partner's name. I give no credibility to the litigation risk, personally. But I think you've got to come up with a methodology at the end of the day, and quickly, if you can, to get a good disclosure that's not hard to find. Whether it's exactly what everybody wants, I don't know. I don't know why you don't just sign it on the report, but, you know, come up with something that's not hidden. Because, again, it goes to credibility.

And if you come up with something that looks like it's, you know, succumbing to the pressures from the industry and that it's going to be all hidden, you're not going to gain much out of it. Because I, for one, don't want to hear Barbara have to say again that she never wants to hear this issue again. So those are my points.

MR. HARRIS: Thank you, Grant.

Brandon?

MEMBER BECKER: I think the likelihood of structural reform is small to nil. I don't think you're going to turn accounting boards into de facto mutual fund boards. I don't think you're going to turn accountants into quasi-government employees by giving the Board the power to hire, fire and set their compensation. I think none of that is likely to happen, whether or not it's a good idea.

Although, with respect to turning them into government employees, I would not hold up the experience of the financial regulators and their examination and inspection programs with respect to financial institutions as an empirical example of how much better those conflict-free, self-funded examiners were than the accounting professional was.

So I tend to be much more of an incrementalist. And the task I would suggest for the Board is to figure out what it wants to do between now and January 20th of 2017. We're going to be in a frozen, polarized environment, it's going to be very hard to get anything done for the next three years. If you could get going concern, signatures on Form 5, audit escalation procedures and the rest of Marty's agenda, you would have done a hell of a job. And I think it would be something the Board could be very proud of and would make a material difference. And I worry that chasing the perfect will be the enemy of the good.

MR. HARRIS: Brandon, thank you.

Norman?

MEMBER HARRISON: Thank you, Steve. I'll echo Grant's thanks to the staff for the terrific work they did in preparing for us today and making this such an enjoyable day. And thanks, of course, to all the board members for your time and your interest in the work of this group.

I'll be brief because first of all some of the observations I would have offered have been covered already. I don't want to be repetitive. I'll end on the note or theme I mentioned in one of my comments earlier, and that is that I would strongly urge the Board, in everything you do, but in particular in the rulemaking in which you engage that pertains to the audit report and some of the other disclosure-oriented issues that we've mentioned today, to bear in mind that one of the things that the audit profession and audit firms can do where I think there is tremendous room for improvement is to be an additional source of valuable information that informs the investment process, as we discussed earlier.

That's why we're all here, because we all have an interest in ensuring that there is an audit process, an audit profession that provides in some way, and perhaps a variety of ways, meaningful inputs into what it is that investors do every day. And that is, fundamentally, simply measuring and pricing risk, however else you want to define it. That is the essence of what's involved in the investment process. And the more information, the more intelligent or objective professional inputs that can inform a decision about what level of risk to assign to projections about a company's future performance is fundamental and essential to what investors do and to the well-being of those whose money they invest and who depend on them.

So in particular, with respect to the audit report, I plead with you to resist frameworks or pushback which lead us into a formulaic or check-the-box or preprogrammed language framework and push the members of the profession to speak with a voice. To voice and articulate points of view, not boilerplate language, not pre-prescribed formats, but offer us information based on their professional judgment that actually means something.

With that, I'll say thanks, again, it's been a pleasure to be here today.

MR. HARRIS: Norman, thank you.

And Mike?

MEMBER HEAD: I would also echo and thank the Board and the staff for everything they've done. It makes this a very enjoyable event and activity. And I'd like to thank Bob and Tony for all the hard work you guys did leading up to this.

And I won't be redundant, and I do agree with you, Brandon. I'm an incrementalist also, because, at the end of the day, if we can make progress and add value to the audit process and the quality of the information for shareholders, that's what it's all about.

MR. HARRIS: Lynn? Or should we skip you?

(Laughter.)

MR. HARRIS: Damon? No, Lynn.

(Laughter.)

MEMBER SILVERS: I can't let that happen to Lynn. Do you have anything to say?

MEMBER TURNER: What's the question?

MR. HARRIS: The question is final

recommendations or priorities for the Board in the short-term. I think you may have already said your piece, but we're giving everybody a last word.

MEMBER TURNER: You know, I've been coming back here now for a decade, for ten years, to these meetings. And each year, about this time in fact, we've been, either on the SAG or on this group, been told about things that you're doing.

When I look at those lists of things that you said you were working on or doing and compare it to what actually got done, I see some positive things, again, from what you're doing on inspections, room for improvement there and transparency, especially. But, you know, I think the staff have picked it up and some good moves there.

But on the rest of it, I just don't see anything. And so often I've had an expectation, given what I've heard, that great things are coming out of this Board. And certainly I think great things can come out of this Board. But it's gotten to where I just don't expect anything anymore. It just never gets done. The Board has never really done anything big. The interim standards

I think have become de facto final standards because they never get done.

And, you know, this is 12 years after the commencement of this Board. And given what's going into it, I think it's fair for the American public to expect much more in leadership from this Board than what it's getting. And rather than trying to do things right, it seems to have gotten caught up in the politics of D.C. and it's just become another bureaucratic, governmental Washington, D.C., board.

So really no more expectations than what I expect any other regulator like this back here. And I think that's unfortunate, because I think this Board has the ability to do great things. But at this point in time a bird in the hand is worth many, many in the bush.

MR. HARRIS: Well, I was about to say "thank you," but we're we supposed to thank you?

(Laughter.)

MR. HARRIS: Damon, why don't we turn to you.

MEMBER SILVERS: Yeah, now I'll say something positive.

(Laughter.)

MEMBER SILVERS: Look, you know, I'm here because I actually have a great deal of admiration in and confidence in the Chairman and the Board and the staff. And I think that Marty's labored mightily around the agenda that he described earlier. And I, for one, and the people that I represent, are grateful. So I want to sort of make that the starting point of what I have to say, because I think the -- you know, that's not going to be enough. You actually have to -- you actually have to get it done, right? I'm here because I have confidence that you're trying and I couldn't say that about every room in Washington.

Now, what are you trying to do and what should we ask of you? And what should our stance be? It's unquestionably true that the way policy is made in every setting is usually incremental. But positive incremental change does not come from the people who would benefit at asking for little things. If you ask for little things you get nothing. And then I think -- and so in order to -- so one's ambition -- the job of a body like this is to make serious demands upon the Board, knowing that the Board must live in a world of complexity and politics and so forth.

Now, what kind of demands should we make? Here, I had no intention of saying anything like this, but I really have to respond to the very first person who spoke, which was Peter. Peter said something that I think is, while I appreciate many things Peter says, I think this is absolutely and completely inaccurate. And that is that there was some kind of meaningful legal difference between the conduct that produced the events that gave rise to the Sarbanes-Oxley Act and the conduct that produced the financial crisis of 2008.

In my view, and I have studied this greatly, both at the time and afterwards, the only difference in the moral or legal quality of the conduct was that the institutions and people involved in what occurred in 2008 were so powerful they could not be held to account. That is the only difference. And I could spend literally the next hour itemizing for you action after action by the executives of the firms involved, by the auditors and by the regulators they suborned that produced the crisis.

Act after act which consisted of breaches of fiduciary duty and financial fraud and bank fraud. Violation of dozens of statutes.

With time, and with the diminishment of the stark fear that those people's conduct brought on the nation's economy, some modest steps have been taken to hold those who did these things to account, largely at an institutional level.

But I will just mention one because, in the context of auditing, it's so amazing. And that is that the mortgage system which produced the crisis, right, was founded on a series of transactions which on their face were fraudulent. Which is that the liens underpinning the home loans were not in the hands of the securitization trusts. Now, think about what we all know an audit is supposed to be about. Now, those trusts were at the heart of a network of financial relationships underpinning the nation's largest banks. The liens were not where they were supposed to be. It's clear that auditors either knew it or should have known it and no one said a word. And it did not become known to the general public that was true until 2011.

And, now, eventually that fact gave rise to tens of billions of dollars in liability on the part of the large banks once the legal system got around to not being paralyzed with fear to do anything about it. Now, it's only the fact that the failures were so large and so comprehensive that no one has bothered to ask where the auditors were during this period. That is just one example, do you want to hear 20 more? I think not.

That's where you've got to start because the reality is -- and I'm sorry to say this, because I was one of the people involved in helping to frame Sarbanes-Oxley -- Sarbanes-Oxley failed in the sense it did not prevent the next financially-driven crisis. And the question now was, will anybody take the sorts of steps necessary to help further diminish, beyond what Dodd-Frank did, the likelihood of another round?

MR. HARRIS: Damon, thank you.

Tony?

MEMBER SONDHI: Thank you. I won't go into in any great detail, but I'll tell you one thing -- my doctoral thesis was on the economics of securitizations, so I certainly agree with what Damon just said.

I would also point out that I think it's a failure of our standard setters in accounting, financial reporting. We've had, I think, five attempts at trying to figure it out for securitizations and it's just never worked. They don't understand it and I don't know whether they will.

And that's actually -- the reason I bring that up is simply because I want to point out that I think, in this case, and in what you have to do and what I would like to help you do, incrementalism won't work. I think we'll have to fight to get somewhere and we may have to do something fairly big in order to get there.

In terms of specific recommendations, I think it's about time we had the partners named and signed and so on. I used to teach in Sweden 25, 30 years ago. They've had that system for a long time. I know there are differences in litigation regimes and so on, but they haven't had the kinds of problems that we seem to be worried about.

I think we need to ensure that audit quality indicators are actually going to work, but I made comments on it last year as part of my committee report.

And I'm looking forward to seeing what Marty was talking about, because I'd like to see if there's something in there that's actually going to help us do something about audit quality.

And, finally, I think it's about time we did something about the independence of the auditors and so on, and that's the work that Bob and our group did. I think, from an investor perspective, it's absolutely critical that we get something done there, as well. Otherwise, as some people have said, Lynn in particular, and I agree with him to a large extent, as well, we're not doing enough for the investors if we don't get there with respect to independence. And if there are things that we can do to help you, ask.

MR. HARRIS: Thank you very much.

Ann?

MEMBER YERGER: Steve, thank you. And to your staff, particularly Nina, and to all the Board members for gutting out this long day. Really appreciate it.

Marty, thanks for the description of what I think is a really ambitious agenda, and I guess I wish you godspeed and I look forward to seeing the releases and commenting. And I think if I'm -- my only recommendation, really, to the Board is to just move some things across the finish line. And if I may close the loop, I think, Jeanette, your observation at the beginning about maybe developing some sort of a framework for evaluating sort of where the Board is and what's off the agenda, I think it would be extremely helpful. And for this group, as well, because obviously our goal here is to be helpful. And I think when things are sort of finally over it's good for us to know and we'll move on to other topics.

MR. HARRIS: Thanks, Ann. Curt?

MEMBER BUSER: So I, too, want to thank the Board and all of the staff for really good work that's been done over the last ten years. I mean, I think the quality of audits in the U.S. in particular is far better than it was before. By no means perfect, hence why we're continuing this process.

And you particularly see, at least in my seat, when I look at quality of information from international sources, especially certain areas of the world, and the quality of information that comes out of U.S. companies is far better than what comes out of other places that you can rely upon.

The recommendation that I'd have for the Board is to think about your communications outward. Not so much to auditors, not so much to preparers. But think about it in terms of communication to investors. So, what do you think is the quality of the audit profession? And you may not want to talk about that, but then think about what are the questions that you would ask investors or audit committee members to be asking?

So, Marty walked through a great litany of topics. That would be, I think, relatively easy to put that into hot buttons for audit committees and investors to be asking. And then essentially kind of put it in the arms of investors to be able to carry the ball forward in terms of seeking audit quality. Otherwise all we're going to ask for is lower fees.

Thank you.

MR. HARRIS: Jim and Brian?

MR. CROTEAU: Thanks very much. I very much enjoyed the discussion today. Obviously, you've got a list of very interesting and complex topics, many of them relate to areas that we're currently exploring either at the SEC or at the PCAOB or together. I was particularly encouraged by the discussion relative to audit committee disclosures, given the remarks Chair White gave this morning on a project we're working on relative to our concept release. And we're excited about the work that we're doing there, and, again, we're encouraged by the feedback that we're hearing.

I would just want to step back and say that I know today was really not about getting into the details of the performance standards or the quality control standards, but I think a few people have now mentioned those and those are really critical that we stay focused on, as well. And I know that we're working together with the PCAOB on that front. And so while these other topics which are also important for us to be focused on are being worked on, we need to make sure that we're moving forward on the basic nuts and bolts of the underlying audit performance standards.

The discussion relative to the audit quality indicators, I think, is another very important area and we're also encouraged by the work that's being done there and look forward to the concept release that the PCAOB's working on.

So, with that, again, thank you. I very much enjoyed the discussion and appreciate everyone's attendance.

MR. SCHNURR: Steve, thanks very much for the opportunity to sit here on my tenth day.

You know, I've made only one comment earlier but I do think that the topics today, at least from my perspective, were very relevant in terms of, you know, kind of the issues. I do think they require additional, you know, research and fact-finding, because I think that they can be complicated. And in order to identify what you want to do in order to be effective, you know, a good example is around consulting creep. So is the issue around consulting creep the fact that the non-audit services to an audit client are creating pressure? Or is it the fact that consulting is getting so big it's changing the tone at the top and the performance of the firm on a macro basis, and the incentives and things like that? So I think it's important to define some of these issues within the topics we talked about today.

Having said that, I am very excited about taking on my new role in working with Jim and the Board and the staff here collaboratively, within the limitations of my office. We've got a Chairman and four Commissioners that Brian and I have to deal with, you know, as well. But we are in this together from the standpoint of investor protection, and we look forward to trying to move the needle in terms improving audit quality.

MR. HARRIS: Well, Jim, thank you very much. And then I want to recognize our Board and then we'll close up. Jay?

MR. HANSON: I just want to thank everybody for all the hard work and the stimulating discussion and look forward to getting to work.

MR. HARRIS: Lew?

MR. FERGUSON: Yeah, I agree with this. We find these meetings tremendously valuable and we deeply appreciate the time you put into them. You know, they influence our thinking in major ways, so thank you.

MR. HARRIS: Jeanette?

MS. FRANZEL: I just want to thank everybody for the time and thought that you've put into these topics. And I'm just going to go back to some of the comments I made when we opened.  And I think that after sitting through today's discussion I think that it's really important that we synthesize this, the input, analyze it, maybe come up with some priorities and preliminary conclusions.

Some of the things mentioned today, we're going to have to just say we're going to put this on the back burner for a while. Others, I think, we've got activities in process, and we just need a framework for analyzing this, putting it all together, communicating back and forth with you all, holding ourselves accountable for actions and just creating a record so that, you know, five years from now we don't have members saying we keep talking about the same topic for now fifteen years.

But let's create a record so that, in the future, future boards and future investor advisory group, can look at what we've done and continue to take this into the future.

So, thank you very much.

MR. HARRIS:  Mr. Chairman?

CHAIRMAN DOTY:  I'm always impressed by the range of talent on this group.  You've got people who invest real money. I will always remember what Pete Nachtwey said in the first of these gatherings that I sat in, which is that I look at this, Pete, not only from the standpoint of an investor but from the standpoint of a preparer and a board member. We have people who are on audit committees, who sit on boards, who make decisions for issuers and preparers, and also those who use financial statements. We have public servants, people who represent non-profit, major non-profit institutions in our country, such as the AFL-CIO. We have advocates of investor and corporate governance interests. It's a rare group.

I'm delighted to know that we have one corporate lawyer. Mercer is the -- no advisory committee can work without a corporate lawyer. But we have a wonderful spread of accounting professors, as well, and this has been an extraordinary day I think for all of us. And think you.

MR. HARRIS: Gee, I thought we had two corporate lawyers right here but maybe I'm missing something.

In any event, Jim and Brian, if you would thank Chair White, we very much appreciate her coming today.

It means a great deal to this group.

And then I want to particularly thank Grant and Ann and Joe and Bob and Tony for their leading the various sections that they did. I think they did an outstanding job.

Although I don't know where she is, but the person that did all the work in setting this up and the substance is Nina Moriji-Azad. If any of you see her -- I don't think she's in the back of my head -- please tell her that I said these things, glorious things about her. She's done a terrific job and I thank her very much in front of all these -- same thing with Tope Folarin.

And I just part by saying I, for one, think that this Investor Advisory Group performs an invaluable service to the PCAOB, whether you're satisfied with the progress or lack of progress that we make, I think it's extremely important that we hear your views and that we take them under consideration. And they're invaluable. So thank you very much and safe travels, everyone.

(Whereupon, the meeting in the above-entitled matter was concluded at 4:41 p.m.)

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**C**

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: 10-20-14

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

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Court Reporter