

## PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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## INVESTOR ADVISORY GROUP

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## MEETING

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TUESDAY  
OCTOBER 24, 2017

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The Advisory Group met in the Westin City Center, National Ballroom AB, located at 1400 M Street, Northwest, Washington, D.C., at 9:00 a.m., Steven B. Harris, Chairman, presiding.

INVESTOR ADVISORY GROUP

STEVEN B. HARRIS, Chairman; PCAOB Board Member  
 MARY M. BERSOT, CEO and Chief Investment Officer,  
 Bersot Capital Management LLC  
 T. GRANT CALLERY, Principal, Oversight and  
 Governance Solutions LLC  
 KEVIN G. CHAVERS, Managing Director, BlackRock  
 LINDA de BEER, Former Chair, Consultative  
 Advisory Group, International Auditing and  
 Assurance Standards Board (IAASB)  
 NORMAN J. HARRISON, Managing Director, Duff &  
 Phelps LLC  
 MICHAEL J. HEAD, Lecturer, Texas A&M University  
 AMY McGARRITY, Chief Investment Officer, Colorado  
 Public Employees' Retirement Association  
 LAWRENCE M. SHOVER, Co-Founder and Chief  
 Investment Officer, Solutions Funds Group

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Governance, California Public Employees'  
Retirement System

MICHAEL A. SMART, Co-Founder and Co-Managing  
Partner, CSW Private Equity

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

JUDGE STANLEY SPORKIN, Retired District Judge,  
U.S. District Court for the District of  
Columbia; Ombudsman, British Petroleum North  
America

ROBERT M. TAROLA, President, Right Advisory LLC

LYNN E. TURNER, Managing Director, LitiNomics;  
Former SEC Chief Accountant

GARY G. WALSH, Principal and Portfolio Manager,  
Luther King Capital Management

PCAOB BOARD MEMBERS

JAMES R. DOTY, Chairman  
JEANETTE M. FRANZEL, Board Member

SECURITIES AND EXCHANGE COMMISSION

JAY CLAYTON, Chairman

OBSERVERS

WES BRICKER, Securities and Exchange Commission  
MARC PANUCCI, Securities and Exchange  
Commission

PCAOB STAFF

MARTIN F. BAUMANN, PCAOB, Chief Auditor and  
Director of Professional Standards

CONTENTS

Welcome and Introductions . . . . .	4
Introductions of Working Group Topics . . . . .	33
Report from the Working Group on Non-GAAP Financial Measures . . . . .	33
Open Discussion: Non-GAAP Financial Measures . . . . .	97
Report from the Working Group on Auditor's Consideration of a Client's Noncompliance with Laws and Regulations . . . . .	150
Open Discussion: Auditor's Consideration of a Client's Noncompliance with Laws and Regulations . . . . .	180
Report from the Working Group on Audit Quality Initiatives . . . . .	206
Open Discussion: Audit Quality Initiatives . . . . .	239
Closing Remarks . . . . .	306
Adjourn . . . . .	323

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

2 8:59 a.m.

3 MR. HARRIS: Okay, well, let's get started. I'd  
4 like to welcome everyone to the eighth annual meeting of  
5 the Investor Advisory Group.

6 This is an especially important forum for the  
7 PCAOB because it provides the Board with an opportunity  
8 to hear directly from our primary constituency, namely  
9 investors and investor representatives.

10 At the outset, I'm required to issue a  
11 disclaimer, which I do for all the board members and  
12 staff who are participating today. Under our board  
13 policy, the views we express are our own, and do not  
14 necessarily reflect the views of other Board members or  
15 the staff of the PCAOB.

16 Having said that, I believe I speak for the Board  
17 and this Investor Advisory Group in welcoming you,  
18 Chairman Clayton, and expressing our deep appreciation  
19 for the Commission's action yesterday in approving the  
20 new standard on the audit reporting model, and for your  
21 personal strong support for the objective of the rule.

22 Adoption of this rule has been a longstanding,

1 very high priority of this group, so I want to thank not  
2 only you and your staff, but all the Investor Advisory  
3 Group members here today, and those who have participated  
4 over the years in advocating so strongly for its  
5 adoption.

6           These changes to the auditors' reporting model,  
7 I believe, will launch a new era in investor transparency  
8 into the audits of public companies in the United States.

9           I also want to welcome Wes Bricker and Marc  
10 Panucci, Chief Accountant and Deputy Chief Accountant.

11           In order to achieve the best results for  
12 investors, the PCAOB works closely with the Commission,  
13 and particularly with the Commission's Office of Chief  
14 Accountant. The close, cooperative relationship that  
15 exists between our two organizations is, in large part,  
16 a result of the efforts of Wes and Marc.

17           So thank you, Wes, and thank you, Marc, for your  
18 interest and assistance.

19           In a moment, I will ask everyone at the table to  
20 introduce themselves, and the organizations you are with.  
21 But for now, I would like to express my appreciation to  
22 all of you for participating in today's meeting, and for

1 your hard work on your respective working groups.

2 I want to especially thank the working group co-  
3 leaders for their time and effort. And we'll be hearing  
4 from them, as well as all of you, during the course of  
5 the session.

6 We'll also have a brief presentation about  
7 digital financial statements, their growing importance,  
8 and what, if any, role auditors should play in this  
9 arena.

10 Next, we will turn to the auditor's consideration  
11 of a client's noncompliance with laws and regulations,  
12 and conclude with a discussion of audit quality  
13 initiatives, a topic which is also of ongoing interest  
14 to this group.

15 The Investor Advisory Group was formed to provide  
16 a public forum specifically for the board to obtain the  
17 views of, and advice from, the broad investor community  
18 on audit oversight, and matters affecting investors.

19 This group and these meetings allow the board to  
20 hear directly from investors, as more often than not,  
21 regulators hear from the regulated more than they hear  
22 from the investing community.

1           The way this group operates, they select the  
2 topics they would like to bring to the board's attention,  
3 organize themselves into subgroups, and then present  
4 their findings and recommendations for the board's  
5 consideration.

6           Over the past seven years, this group has focused  
7 on such topics as the need to update the audit reporting  
8 model, which I just mentioned; greater transparency of  
9 individuals and other auditors involved in audit  
10 engagements, which the Commission has also improved; a  
11 greater transparency of -- no, the need for clarification  
12 of FASB, F-A-S-B, and PCAOB.

13          Going concern standards in light of past  
14 financial crises, and the very view opinions that were  
15 issued during these crises; and a variety of other  
16 concerns relating to independence, subjectivity, and  
17 professional skepticism; the role of audit committees;  
18 the audit firm business model and incentives; greater  
19 transparency and governance of audit firms; and lessons  
20 learned from the financial crisis.

21          Each of these topics has prompted subsequent  
22 meaningful consideration by the board, and in a number

1 of instances, board action.

2           In a moment, Chairman Doty will provide a brief  
3 summary of some of the board's recent activities, and I  
4 hope all of you in this group will recognize how much you  
5 have helped to influence the board's priorities.

6           Just as in the past, the board intends to  
7 carefully consider the views you express throughout the  
8 day.

9           And now, I would like to turn to Chairman Clayton  
10 for any remarks he may wish to make -- and I know, Mr.  
11 Chairman, that you've got limited time here. We very  
12 much appreciate your making the time to be with us.

13           And then I'll turn to Chairman Doty, and then to  
14 other board members who may wish to make statements. So  
15 thank you, Chairman.

16           MR. CLAYTON: Thank you. Thank you, Steve, and  
17 I'm going to associate myself with your disclaimer. I  
18 also add another disclaimer, which is I often depart from  
19 my prepared remarks.

20           (Laughter.)

21           MR. CLAYTON: But I try not to do so with a  
22 material misstatement or omission, because that would be



1 inconsistent with our brand.

2           Anyway. And the first departure is, thank you  
3 for that list of past items because they're all very  
4 important. And I'll come back to that. But I also want  
5 to thank Chairman Doty, and Board member Jeanette  
6 Franzel, who, along with Steve, I know worked very hard  
7 to advance the mission of the PCAOB.

8           And I want to especially thank you for your  
9 continued leadership of this group, including your  
10 commitment to seeking the views of the investor  
11 community. That's important to us here, that's important  
12 to us across the landscape of what we regulate.

13           And I'd be remiss if I didn't thank the entire  
14 PCAOB staff for their dedication to the PCAOB mission and  
15 commitment to improving audit quality.

16           And I want to thank all of you, the members of  
17 the IAG. I know that you have day jobs, and are very  
18 busy -- and your commitment involves not just these  
19 meetings, but preparing for them as well. We are  
20 grateful that you take the time to contribute your  
21 knowledge and expertise on topics important to high-  
22 quality audits and reliable financial reporting.

1           The PCAOB's mission is critical because auditors  
2 serve a vitally important role in our markets. Financial  
3 statements audited by ethical, independent, and skeptical  
4 auditors who apply consistent standards as well as  
5 necessary diligence are essential to inform decision-  
6 making. And as we all know, informed decision-making is  
7 essential to the proper functioning of our capital  
8 markets.

9           Investors are the ones who make capital  
10 allocation decisions, and you have a keen sense about  
11 whether you have an appropriate mix of information,  
12 including financial information. Your input is critical  
13 for the PCAOB to achieve its mandate.

14           In this respect, I'm pleased by the level of  
15 coordination that occurs between the SEC and PCAOB in  
16 advancing our respective missions, including, most  
17 significantly, our shared investor protection goals.

18           This coordination is also important for the other  
19 tenets of the SEC's tripartite mission: to facilitate  
20 capital formation, and maintain fair, orderly, and  
21 efficient markets.

22           In that regard, maintaining and enhancing the

1 U.S.'s position in the world's deepest, most dynamic, and  
2 most liquid capital markets with the most robust investor  
3 protection requires, among other things, rooting out  
4 misconduct that harms investors and impairs market  
5 integrity, including accounting fraud, and circumvention  
6 of established professional and regulatory standards.

7           Therefore, I look forward to the SEC continuing  
8 to work together with the PCAOB as we pursue our mission.

9           Moving to today's agenda -- you have a full  
10 agenda. You've already gone over it, so I won't repeat  
11 that, but I know that the Board, the PCOAB staff and our  
12 staff are looking forward to your input on these matters.

13           One item that the IAG has discussed at previous  
14 meetings, as you mentioned, is the auditor reporting  
15 model. As you're all aware, yesterday we took action in  
16 this regard, including the CAMs.

17           The requirement to disclose CAMs in the audit  
18 report is intended to be provided investors and other  
19 financial statement users, with the auditor's perspective  
20 on a set of matters discussed with the audit committee.

21           I'm going to depart again from my prepared  
22 remarks. And I've said this to Steve. I've said it to

1 Jim. Jeanette, as well, this morning.

2 In my experience in the markets, the audit  
3 committee, and the emergence of the audit committee as  
4 a focal point for discussion of critical disclosure  
5 matters, is one of the single best developments for  
6 investors in the markets in the last 20 years.

7 When I go to see a company for the first time,  
8 that's where I focus initially. What are the matters  
9 that have risen to the level of audit committee  
10 attention? Because you get a feel for the issues that  
11 management cares about, that the audit, both from a  
12 tension point of view, and from a "how do we run the  
13 business" point of view.

14 I think that this measure, and its intent to  
15 capture that dialogue and provide it in a reasonable way  
16 to investors, is very important.

17 You will note that in my prepared statement  
18 yesterday there was some skepticism, because I could see  
19 this not working out the way we intend it to.

20 I will be vigilant, I know Wes will be vigilant,  
21 Marc will be vigilant in trying to ensure that it does  
22 work out in a way that investors have a feel for that

1 dialogue without creating boilerplate, or a pullback in  
2 audit, auditor-audit committee communications.

3 So back to my remarks.

4 (Laughter.)

5 MR. CLAYTON: I believe well-functioning audit  
6 committees provide substantial value to shareholders.  
7 I commend the Board and their staff for their dedication  
8 to this rulemaking, and I'd also like to acknowledge the  
9 input that this group provided to the project, which  
10 undoubtedly improved the final product.

11 While I cannot be here for the whole day, Wes  
12 will be here, Marc will be here to join in your  
13 discussion. And we look forward to the PCOAB's progress  
14 on the initiatives you will be discussing today and in  
15 the future.

16 Again, thank you for your commitment to assisting  
17 the PCOAB in its vital mission, and thank you for  
18 inviting me to be here today. It is truly beneficial for  
19 both the SEC and the PCOAB.

20 MR. HARRIS: Well, thank you very much, Chairman  
21 Clayton. And I also want to recognize the leadership of  
22 Chairman Doty in sponsoring the initiatives of both the

1 transparency, the audit reporting model, and so many  
2 others. So we very much appreciate, Mr. Chairman, your  
3 dedicating yourself to the advancement of so many of the  
4 issues which are topical to this particular group.

5 And with that, I turn it over to you.

6 MR. DOTY: Well, thank you, Steve. First, I'm  
7 going to invoke Chairman Clayton's rule and depart from  
8 text.

9 To say that this would be an unusual day, an  
10 important day, for the Public Company Accounting  
11 Oversight Board and its Investor Advisory Group would be  
12 something of an understatement.

13 We have Chairman Clayton's statement regarding  
14 the release to the public of the audit reporting model.  
15 And we have his presence. He has come for the first  
16 meeting with the Investor Advisor Group. So it's a very  
17 important day.

18 And I want to reconstruct a bit of the record  
19 here. First, what you have heard cannot be emphasized  
20 enough. This could not have happened without the  
21 diligence and the attention and the hard work of Marc  
22 Panucci, and Wes Bricker, and Chairman Clayton, and the

1 staff.

2           Anything like this requires an attention to the  
3 details. When Chairman Clayton arrived, on arrival, he  
4 was faced with this issue. This was one of the issues  
5 that was going to have to be decided on a tight timeline.  
6 It wasn't the only one he had.

7           But the first thing he said to me about the audit  
8 reporting model was that he had a very simple goal. He  
9 wanted to understand it. He wanted to understand the  
10 details. He wanted to get it right, and he wanted to  
11 feel good that it was the right thing to do.

12           What a wonderful charter from a lawyer heading  
13 the Securities Exchange Commission about, about the goal  
14 of standard-setting and rule-setting in an  
15 administrative society. He wanted to know the details  
16 and to feel good about them, because heads of agencies  
17 are accountable for the details. If the drafting isn't  
18 good, if the rule doesn't work, we're expected to have  
19 some responsibility for that.

20           With that, I also commend you to the release  
21 yesterday. The release is, in my humble view as a  
22 lawyer, a model of concision, a model of analysis that

1 represents the best kind of drafting that the SEC has  
2 produced over 80-odd years, and that it carefully and  
3 meticulously takes on every comment that's received,  
4 every issue that's raised in the comment process, and it  
5 disposes of them, or deals with them, or acknowledges  
6 them with elegance and with accuracy.

7           This was all done at a time when there was other  
8 work before the Commission and the staff, and I'll  
9 allude to that in a minute.

10           But here, I will stop in my extemporaneous remarks.  
11 They always make our general counsel and our chief  
12 auditor a bit nervous, and I will go back to what we had  
13 planned to discuss, except to say, also, with our deep  
14 appreciation to Chairman Clayton, and to all of you here  
15 present. Our colleague, Lewis Ferguson, is under the  
16 weather. He joins us, so this is not the last time  
17 you'll hear that.

18           The other standard-setting that we have going is  
19 very important. It is not, perhaps, as controversial or  
20 as challenging as the audit reporting model. But it may  
21 be even -- it certainly is important for the quality of  
22 the audit.



1 First, we have a proposal out regarding other  
2 auditors and their responsibility in -- especially in  
3 international audits -- for the role of the lead  
4 auditor, and the conduct and the supervision of other  
5 firms participating in the audit.

6 And that links, in a way, with our auditor search  
7 website, and the material we are causing to be  
8 accumulated under the transparency release on other  
9 participants in the audit and the engagement partners.

10 That database is building. It's building  
11 rapidly, and we think that, a proposal on other  
12 auditors, it makes clear this is the responsibilities of  
13 a lead auditor. It's very important for spreading the  
14 evenness and the quality of the audit throughout a  
15 global system.

16 We have a proposal on estimates, fair value, and  
17 specialists, and that's gone through a lot of work. And  
18 we hope that we will get these projects.

19 After consultation papers and proposal, and  
20 discussions with advisory groups, we hope to have fair  
21 market value estimates and the use of specialists come  
22 to fruition early in 2018. And those will be, we think,

1 useful for investors and users of financial statements,  
2 but also for the auditors.

3           We have a research agenda. It includes a  
4 research project on quality control standards. Quality  
5 control standards has been a longstanding concern of the  
6 community that involves users and preparers, and, and  
7 auditors.

8           And here we had to dedicate substantial focus to  
9 the need for it, why it was something that should be  
10 addressed, and the alternatives. And whether and why  
11 standard-setting was the appropriate approach to  
12 elevating quality control standards. That is well  
13 along. We hope that you will hear more of it.

14           We will be researching changes in the use of data  
15 and technology, the auditor's role regarding other  
16 information, non-GAAP metrics, and others. And this, of  
17 course, will be research that we will be sharing with  
18 and coordinating with the SEC, because of their keen and  
19 public interest in this area.

20           Auditors' consideration of the noncompliance of  
21 auditors, of management, the noncompliance of issuers  
22 with laws and regulations.

1           The auditor's duty, and the limits of the  
2 auditor's duty, and the auditor's opportunities to  
3 improve this area are a consistent, longstanding problem  
4 for the corporate bar, for the investor community, for  
5 all of us who are concerned, not just in good financial  
6 reporting, but in the extent to which good financial  
7 reporting and good auditing has a knock-on or an  
8 ameliorative effect on corporate conduct in the  
9 boardroom. And this is part of that.

10           So those research projects are all going to be  
11 underpinned by in-depth economic analysis. We will use  
12 both external research and our own analysis of the data  
13 that is in our file and is accumulating.

14           And as you know, we have worked hard to build an  
15 Office of Economic and Risk Analysis that combines both  
16 independent academic analysis and research and our own  
17 risk analysis for our purposes of selecting and  
18 inspecting audits.

19           So we will continue to work on that. One of the  
20 first projects that is coming out of that will be, I  
21 think, of interest to this group, is our first post-  
22 implementation review of our Engagement Quality Review

1 standard.

2           It once was called AS 7. It was adopted in 2007.  
3 As one who's not yet mastered the new categorization of  
4 the standards, but it is the Engagement Quality Review  
5 standard. The analysis, and the depth of the analysis,  
6 and the extent of consideration of variant conduct, I  
7 think it is sweeping, it is important.

8           It relates to what Chairman Clayton has just said  
9 about the willingness, or the ability to go in and  
10 consider the conduct which is unintended, and which  
11 should be perhaps the subject of fine-tuning and of  
12 adjustment.

13           We will have, I think, soon, a public report out  
14 on the results of our post-implementation review. And  
15 the insights and the changes in the EQR process, we  
16 think, will be useful.

17           It takes a lot of time to measure the impact of  
18 an inspection program, but we are now beginning to see  
19 the fruits of review of that program. We now have  
20 research that is academically based, in that it's out  
21 there, it is open to peer review, and it confirms that  
22 issuers and auditors that work in regimes that are

1 subject to audit oversight enjoy additional access to  
2 capital, they enjoy premiums, and they engage in  
3 enhanced investment opportunities.

4           So, the research is beginning to come in that  
5 confirms the value to the capital formation process  
6 around the world, in jurisdictions where there are U.S.  
7 issuers and non-U.S. issuers. They're inspected by  
8 PCOAB registered firms, and confirming the fact that  
9 has, again, a spillover, a positive spillover, and  
10 knock-on effect on the capital formation process there.

11           We will, this year, look at portions of more than  
12 270 audits of the six largest U.S. firms. We will look  
13 at portions of 140 engagements by other affiliates of  
14 those firms. We'll examine portions of 400 audits by  
15 conducted by 150 smaller firms here and abroad that are  
16 not part of the big network.

17           And internationally we can do this now because we  
18 now have the ability to inspect in 50 other countries.  
19 Local regulators in 20 countries conduct joint  
20 inspections with us. We will look at 60 foreign firms,  
21 foreign audit firms that are registered with us.

22           We've concluded 22 bilateral cooperative

1 agreements. Fourteen of these are in Europe. We have  
2 narrowed the list of European jurisdictions with which  
3 we don't have these arrangements to a very few, less  
4 than a handful. We've added Italy this year. We are  
5 soon going to have Ireland. We have Ireland inked, or  
6 prepared to be inked.

7           These relations are established, they're  
8 maintained through the hard work of our Office of  
9 International Affairs. That office works closely with  
10 our Enforcement Division. Those two offices work very  
11 closely with the Office of International Affairs and  
12 Division of Enforcement of the SEC, and with our  
13 counterparts in these other jurisdictions. So this has  
14 become an established, well-rooted network of sharing of  
15 information and techniques.

16           Last year was the most productive in the history  
17 of the PCOAB for enforcement. We had a record number of  
18 settled actions. An increasing percentage of these --  
19 40 percent last year -- involved foreign firms, which I  
20 think is part of our commitment to assuring that there  
21 is uniformity, that there is a level playing field among  
22 auditing firms and the issuers who use them, and the

1 issuers who have good audits, and the issuers who may  
2 leave something to be desired.

3           We think that we're on track for another high  
4 percentage of foreign firms who appeared in our  
5 enforcement file this year. But as I say, that's going  
6 to be coordinated closely with the SEC's Division of  
7 Enforcement. And these are, of course, confidential  
8 until they are concluded.

9           With that, I think I'll turn it back over to  
10 Steve. Thanks, again, to both of you.

11           MR. HARRIS: Well, it's quite a pleasure to be  
12 sitting next to two Washington lawyers' lawyers. I  
13 guess, a New York and a Washington. I mean, it's just  
14 nice to hear them both, I guess, speak extemporaneously,  
15 and with ---

16           MR. CLAYTON: Hold your wallet.

17           (Laughter.)

18           MR. HARRIS: It's held, alright. Believe me.  
19 It's tightly fastened.

20           (Laughter.)

21           MR. HARRIS: But now I'd like to recognize  
22 Jeanette Franzel. And Mr. Chairman, Jeanette has played

1 a lead role in terms of our outreach to audit  
2 committees.

3 MS. FRANZEL: Thanks, Steve. Steve, I want to  
4 thank you for your leadership of this group, over so  
5 many years, and I want to thank all of you for being  
6 part of this.

7 I know that this group does some very heavy  
8 lifting, in terms of brainstorming and research and  
9 input. And the topics that we're covering today are  
10 going to be so important to our current research agenda.  
11 So I was very happy when I saw the current agenda for  
12 today, because it aligns very well with some very  
13 difficult questions that we are taking up -- you know,  
14 specifically dealing with the auditor's role.

15 And over the years and decades, there's been a  
16 problem with an expectations gap, you know, in auditing.  
17 And, unfortunately, often the way that expectations gap  
18 was dealt with was to just more clearly delineate what  
19 is the responsibility of the auditor versus what is not.

20 But I think on the non-GAAP measures, and the  
21 auditor's consideration of an auditee's noncompliance  
22 with laws and regulations, we need to really take a



1 fundamental look at the auditor's responsibilities. Are  
2 they appropriate in today's day and age, and based on  
3 what investors need and expect?

4           And so, in that regard, these will be very  
5 difficult standard-setting efforts for us. And so your  
6 input today will be very important.

7           Also, the audit quality initiatives, I've been a  
8 big fan of audit quality indicators and the  
9 conversations between audit firms and audit committees  
10 -- and even from the demand side, with audit committees,  
11 you know, wanting to know what firms are doing to track  
12 their own quality.

13           And so I think we need to figure out: What is the  
14 next step here? And what's the current state of affairs?

15           Again, very important topics, and we will be very  
16 anxious to hear your input and the discussion today.

17           I was also happy to see the digital financial  
18 statements added in as a topic, so I'll be interested in  
19 hearing that.

20           And I think that the pace of change in financial  
21 reporting and auditing is happening so quickly that  
22 we're, this group and the PCAOB, will be faced with a

1 lot of difficult issues going forward on what is the  
2 auditor's role. And we're looking at the use of  
3 technology and other changes that are happening in  
4 financial reporting.

5 So I think how we approach these topics that  
6 we're dealing with now, where we're looking at the  
7 auditor's role, it'll be a very important model for the  
8 future, as I think we're going to have to be doing  
9 analysis and standard-setting at a much quicker pace  
10 than we ever have in the past.

11 And in that regard, I'm very happy that we've  
12 moved so many of our standard-setting projects, because  
13 we do have some very important and fundamental issues to  
14 work on going forward.

15 So, again, I welcome you, and thank you, and I  
16 look forward to the discussion today.

17 MR. HARRIS: And now if we could just quickly go  
18 around the table and I would ask everybody to introduce  
19 themselves. And as you participate throughout the day,  
20 please give your name before commenting so the listening  
21 audience knows who is speaking.

22 And why don't we start, Kevin Chavers, with you.

1 And I know you're testifying tomorrow before Congress,  
2 so I appreciate your making the time to be with us  
3 today.

4 MR. CHAVERS: No, it's my pleasure. Thank you,  
5 Steve. I'm Kevin Chavers, with the public policy group  
6 at BlackRock, and pleased to be with you this morning.

7 MS. BERSOT: I'm Mary Bersot from Bersot Capital  
8 Management, and I'm from the San Francisco area. And  
9 I'm delighted to be here.

10 MR. SONDHI: I'm Tony Sondhi. I run a financial  
11 consulting and investment advisory firm. Glad to  
12 participate.

13 MS. DE BEER: Good morning, everybody. I'm Linda  
14 de Beer. I'm from South Africa, and I'm a non-executive  
15 director on a couple of listed company boards where I  
16 often chair the audit committee. I have a fairly long  
17 background and history in international auditing  
18 standards. I've chaired the Advisory Group of the IAASB  
19 for quite a few years.

20 MR. HARRIS: And thank you for making this long  
21 trip. I know there's quite a bit going on in South  
22 Africa at the moment, and we might want to pick your

1 brain a little bit about what we can learn from that.

2 Norman?

3 MR. HARRISON: Thank you, Steve. I'm Norman  
4 Harrison, based here in Washington as a managing  
5 director with Duff & Phelps, where my practice includes  
6 consultation with investment advisors on a variety of  
7 compliance and regulatory and litigation support,  
8 regulatory support issues.

9 MR. PANUCCI: Marc Panucci, Deputy Chief  
10 Accountant at the SEC.

11 MR. WALSH: Gary Walsh with Luther King Capital  
12 Management where I'm a principal and portfolio manager.

13 MR. SHOVER: Larry Shover, CIO of an institutional  
14 commodity pool in Chicago and a contributor to News  
15 Corp. And I just want to say thank you to new Chair  
16 Clayton, a fellow Penn grad. So we're in good hands.

17 MR. TAROLA: Good morning. I'm Robert Tarola. I  
18 have a turnaround consulting, financial consulting firm  
19 here in Washington, D.C., but I was a former partner of  
20 a Big Four firm. I've been the CFO of several public  
21 reporting companies, and I'm the chair of three audit  
22 committees of public companies.

1 MS. SIMPSON: Good morning. My name's Anne  
2 Simpson, and I work for CalPERS, where I'm an investment  
3 director. I'd like to say that we've written not once,  
4 but several times in support of these reforms to the  
5 audit model, and can't stress how important it is for  
6 the quality of markets, not just for capital allocation,  
7 but for our stewardship role.

8 And although we think of CalPERS as being this  
9 enormous, great, \$330 billion-plus fund, we're investing  
10 on behalf of ordinary working people -- the police, the  
11 firefighters, the janitors, the judges of California.  
12 So ensuring that the flow of information markets is high  
13 quality, relevant, and reliable is essential, and the  
14 auditor's role in that cannot be overstated.

15 So we'd just like to record today thank you very  
16 much for yesterday's announcement.

17 MR. HEAD: My name is Michael Head, and I'm  
18 currently a lecturer at Texas A&M University, and a  
19 retired chief audit executive at TDAmeritrade, with  
20 primarily background in risk management, internal  
21 controls, and internal and external auditing.

22 MR. TURNER: I'm Lynn Turner, and thank you, Mr.

1 Chairman, for the vote yesterday.

2 MR. CLAYTON: It's great to see you.

3 MR. TURNER: Yeah, it is, Jay. So I think the  
4 kudos to you and Wes and Marc can't be enough. And I've  
5 been in the profession for four-plus decades, and it's  
6 actually nice to finally get a new audit report. So.  
7 Give them something to test on the CPA exam next time.

8 (Laughter.)

9 MR. TURNER: So, at any rate, I sit on the board  
10 of a \$50 billion state pension plan at the behest of the  
11 governor, and we have the good fortune of having an  
12 outstanding chief investment officer that does a great,  
13 great job for us, and keeps our risk managed, anyway.  
14 So, with that --

15 MR. SMART: Good morning. I'm Michael Smart. I'm  
16 managing partner of CSW Private Equity. I'm also vice  
17 chairman with the National Association of Investment  
18 Companies, an association representing more than \$90  
19 billion AUM of private equity and hedge funds.

20 Thank you, Mr. Chairman, for inviting me to  
21 participate in this forum, and thank you for your  
22 leadership over the years, particularly as it relates to

1 the most recently released SEC documentation.

2 MR. BRICKER: Good morning. Wes Bricker from the  
3 SEC, Chief Accountant. Wanted to do just a few things  
4 before we started. One, associate both myself and Marc  
5 with the disclaimer.

6 (Laughter.)

7 MR. BRICKER: That may be important.

8 Also, to reiterate, and associate, Jay, your  
9 comments about the appreciation and thanks for the input  
10 from this group, which is valuable. Also, the  
11 collaboration and cooperation that we've enjoyed working  
12 on tough issues with the PCOAB. So, really appreciate  
13 the collaboration there, and certainly look forward to  
14 the dialogue throughout the day.

15 MS. MCGARRITY: I'm Amy McGarrity. I'm the Chief  
16 Investment Officer for Colorado PERA, the board that  
17 Lynn just spoke about.

18 So, for those of you who don't know us as well as  
19 Lynn does, we're a \$47 billion plan in Colorado. And I  
20 think one of the things that makes us a bit unique is  
21 that we run more than half of our assets internally, so  
22 we have a relatively large investment staff managing

1 assets on behalf of the membership of Colorado PERA,  
2 picking stocks and bonds on a daily basis.

3           And so, these issues that we discuss here we're  
4 very familiar with, and keen on helping to be part of  
5 the conversation. So I appreciate the opportunity to be  
6 here. Thank you.

7           MR. CALLERY: I'm Grant Callery. I spent the bulk  
8 of my career working for NASD and FINRA. Retired five  
9 years ago as General Counsel there, and since that time,  
10 have been working with them on their financial education  
11 foundation, and also in some areas with higher ed  
12 governments, with the Association of Governing Boards of  
13 Universities and Colleges.

14           MR. BAUMANN: Good morning. I'm Marty Baumann,  
15 the Chief Auditor and Director of Professional Standards  
16 at the PCAOB.

17           And as someone who has worked many, many hours  
18 over several years trying to craft a new auditor's  
19 report with a very talented team of people, I want to  
20 express my appreciation to the IAG for your support for  
21 the need for a new auditor's report over many years, and  
22 express my appreciation to the SEC for the hard work you



1 put in in coming up with the approval order yesterday.

2           It was a very good day for our team, and I think  
3 for investors in the capital markets. So thank you very  
4 much.

5           MR. HARRIS: And now, if we could get on with the  
6 schedule, we've arranged it, Mr. Chairman, that we have  
7 our working groups, and they'll speak up to 10 minutes  
8 on the various topics. And I know you've got to leave  
9 at around 10:00, so I think that fits in perfectly with  
10 the timing.

11           So, first of all, I'd like to recognize Tony  
12 Sondhi and Amy McGarrity, who will summarize their  
13 slides on non-GAAP financial measures.

14           MR. SONDHI: Thank you, Steve and Chairman  
15 Clayton. We began work with the non-GAAP measures and  
16 key performance indicators. We presented perspectives  
17 of our team on that. And we're continuing this year.

18           The use of non-GAAP measures and other key  
19 performance indicators has grown over the years. There  
20 are really a plethora of research studies that talk  
21 about that, show you how much they've grown, and so on.

22           Management has long insisted that non-GAAP

1 measures better reflect the way they manage the company,  
2 the way they reward performance, than most GAAP metrics  
3 do.

4           Investors, for many years, have also used, and  
5 they continue to demand non-GAAP measures, just as well  
6 as any of the GAAP information that they use. Many  
7 investors find it quite useful to get management's  
8 perspective with respect to those non-GAAP measures.

9           The standard-setters, both the FASB and the  
10 IAASB, in its issuance of IFRSs, have not effectively  
11 kept up with this demand or need for performance metrics  
12 -- at least, not in the way that management has been  
13 talking about them.

14           We also find, over the last several years, that  
15 there's a much better -- a much higher association with  
16 management compensation, for example, of these non-GAAP  
17 measures. But the research, both academic and street  
18 research, continues to find it very difficult to show  
19 any value or relevance to those non-GAAP measures.

20           Their predictive ability, their correlation, or  
21 their ability to inform us about market prices in the  
22 long run is still suspect, with respect to, as I said,

1 the academic research, and much of the street research.

2           Very recently, for example, there was a study  
3 that showed that non-GAAP measures are more highly  
4 associated with companies that have normally reported  
5 lower earnings and excess management compensation.

6           But don't get me wrong, as an investor, I do want  
7 management to tell me what they're doing, how they're  
8 managing their business, and how they look at  
9 performance.

10           Now, going back to the standard-setters -- and I  
11 don't want to understate the, the amount of work that  
12 the SEC has done, with respect to non-GAAP measures,  
13 over the last few years. And I think there's been  
14 tremendous progress there as well.

15           And yet, we find that non-GAAP measure, as  
16 provided by companies, the amount of time that's devoted  
17 to non-GAAP measures in the earnings calls, for example  
18 - the information that's provided in the earnings  
19 releases - there's a lot of non-GAAP information there.  
20 In fact, at times, I think it, sort of, just about  
21 drowns out any GAAP information that's provided in these  
22 earnings conference calls.

1           So fundamentally, the question is, what is it  
2 that we need to do about this? Management, as I said,  
3 continues to use it. Investors continue to demand that  
4 information. There is some evidence that there is at  
5 least a short-term reaction to the announcement of non-  
6 GAAP measures. I haven't seen research that shows that  
7 that has a lasting effect.

8           So what we're doing today, is we're going to talk  
9 about what we think ought to be done. One possibility  
10 that we will discuss is that the standard-setters ought  
11 to define performance metrics, and then require that  
12 they be part of the financial statements, which would  
13 therefore result in their being audited, and so on.

14           One of the most difficult problems with respect  
15 to that is simply the fact that if you look at the most  
16 commonly used non-GAAP measures, for example EBITDA,  
17 adjusted EBITDA, and so on, earnings before interest,  
18 taxes, depreciation, amortization, what's very important  
19 to understand is that they, these measures often leave  
20 out those costs of running a company that are probably  
21 the most critical.

22           Companies leave out stock compensation expense,

1 for example. They leave out the amortization of  
2 intangibles. It's very difficult to see how that is  
3 irrelevant, when a company relies on stock compensation,  
4 when it relies on acquisitions to stay ahead of the  
5 technology.

6 So our problem, therefore, is very difficult.  
7 It's complex in the sense that we need management to  
8 tell us which non-GAAP measures they're using, what  
9 matters to them. And yet, we find that they're leaving  
10 out information that seems critical to managing the  
11 company.

12 And that brings a dilemma with it, in other  
13 words, that, you know, if you, if you audit a number  
14 that's not reflective of the cash-generating ability, or  
15 it's not reflective of the value, then what is it that  
16 you're doing, with respect to that?

17 So as I said, we're proposing that the FASB and  
18 the IAASB, the standard-setters, define these. However,  
19 we're concerned that that may be outside the remit of  
20 these organizations. And there is very little evidence  
21 that they're actually doing any of that.

22 The IAASB has recently proposed an EBIT measure.

1 But at the same time, they're not talking about going  
2 any further than that.

3           The FASB, in its most recent plan for the next  
4 couple of years, doesn't talk about discussing, or doing  
5 anything about performance measures.

6           An alternative that we've, we're also going to  
7 suggest today, is that the standard-setters ought to  
8 define the location, the disclosure requirements, the  
9 reconciliation, and presentation requirements for non-  
10 GAAP measures and key performance indicators that would  
11 be defined and selected by management.

12           And therefore, it continues, in other words, to  
13 allow management to tell us what they think is really  
14 important. But it then puts a framework around it that  
15 allows us to get the kind of information that we need  
16 from an investment perspective.

17           In addition, we think that management, once they  
18 select a non-GAAP measure or key performance indicator,  
19 ought to provide that information for at least three  
20 years.

21           In effect, therefore, we can track that. Even if  
22 they decide, after a year, let's say, not to do it

1 anymore, or not to use that particular indicator  
2 anymore, they still would have to continue providing  
3 that information.

4 Management would clearly define the indicators,  
5 and why they're using them. They would also provide  
6 comprehensive reconciliations. It's important that the  
7 reconciliation that they provide be traceable back to  
8 the GAAP information that we have.

9 The last point, with respect to, that we're going  
10 to discuss today, is also the issue of the proliferation  
11 of these non-GAAP numbers in earnings conference calls  
12 and earnings releases.

13 And so, we're going to propose that those be  
14 reconciled to the information that's provided in the  
15 financial statements as well. And if that could be  
16 placed in a footnote, then that could be audited as  
17 well.

18 Thank you. Thank you, Steve.

19 MR. HARRIS: Amy, do you have --

20 MS. MCGARRITY: No.

21 MR. HARRIS: All right, well then, thank you very  
22 much, Tony. Look forward to the discussion throughout

1 the day, and your leadership on this.

2 Grant and, and Mary, let me turn it over to you  
3 on the auditor's consideration of the client's  
4 noncompliance with laws and regulations.

5 MS. BERSOT: Thank you. Mary Bersot speaking.  
6 Chairman Clayton, thank you for joining us today. I  
7 think it's a very important topic, and thank you to the  
8 board and the staff.

9 We know the staff is working on this issue as we  
10 speak, and we decided to focus our efforts on, really,  
11 two things. One: defining what it is investors expect.

12 And thank you for your comments. Kind of took  
13 away my comments, but --

14 Investors have very high expectations of  
15 auditors. High is a nice word to use. Maybe  
16 unrealistic in some cases. When you hear about these  
17 high-profile incidents, such as the Wells Fargo, the  
18 first comment is: Where were the auditors?

19 So auditor expectations need, investor  
20 expectations need to be realistic, and at the same time,  
21 the standards need to be written so that it's very clear  
22 to the auditor what their role is in auditing non-GAAP



1 -- non-conformance with financial measures.

2           Independence and objectivity, I think, are the  
3 two things that are key. Investors do expect that.  
4 They expect their auditor to be divorced from management  
5 in the issue, and they also expect the auditor, when  
6 they discover material information, to report this  
7 information in a timely fashion to management, to the  
8 audit committee, or perhaps to the authorities.

9           The PCAOB standards with regard to illegal acts  
10 is Standard 2405, which was written in 1989, and adopted  
11 by the PCAOB in 2003. So it is being updated. It  
12 doesn't reflect the world as we know it today. A lot of  
13 things have transpired.

14           And we also, as a group, felt that the standard  
15 today is not strong enough. It needs to be strengthened  
16 in terms of defining the auditor's responsibility with  
17 regard to these issues.

18           It also needs to enhance the steps the auditor  
19 needs to take, they must perform when they've discovered  
20 a material illegal act related to the financial  
21 statements.

22           And what are our investor concerns? Investors

1 are very concerned. We've had some high profile  
2 incidents most recently -- namely Wells Fargo. It's not  
3 clear, it's not, it's, it isn't completely clear that it  
4 was a financial matter in the beginning, but at a \$1  
5 billion reserve for liability, and a -- an effect on  
6 their reputation does impact the stock price. There is  
7 a financial effect.

8 So auditors expect, I mean, investors expect  
9 auditors to detect these problems, and report them in a  
10 timely manner. So our, our goal today is really to  
11 strengthen -- make recommendations to strengthen these  
12 standards, as the staff goes through the review process.

13 And what have we done? We've, we've, we've taken  
14 the comparative standards around the world, and we've  
15 compared them to the PCAOB standard.

16 I'll let Grant pick it up from here, and talk  
17 about what our group did, and what our recommendations  
18 are.

19 MS. BERSOT: Thank you, Mary. Mary's covered it  
20 pretty well, so I'll just add a, a few points.

21 One of the things that we wanted Chair Clayton to  
22 have, you and the SEC staff have available to you is

1 sort of the work product. And so, in, in putting  
2 together our slide deck, we also had put together a  
3 comparative set of the standards from the PCAOB, the GAO  
4 Yellow Book, the, sort of the statutory basis, and  
5 international accounting, auditing standards, and AICPA  
6 recommendations.

7 So I think that is a helpful document, and  
8 hopefully helpful to the staff working group.

9 As Mary said, we, we took our focus here through  
10 the eyes of investors. And obviously, I think like the  
11 audit reporting model and CAMs, this is going to be  
12 something that's going to be kind of a tough slog.

13 I wouldn't anticipate that all the constituencies  
14 are going to say, oh, yeah, let's just do a lot more  
15 and, you know, require the auditors ---

16 So, but we looked at it from the pure investor's  
17 perspective, understanding that there are limitations.  
18 I mean, you can't make the, the auditor the be-all and  
19 the end-all for helping investors, and finding out  
20 everything.

21 But what we thought we would do is try to, you  
22 know, get a framework that the working group could go

1 through.

2           And Chairman Doty, going back to the Wells Fargo,  
3 which we really didn't want to make the focus of this,  
4 because there -- there's a lot of factors there. But  
5 there was a letter that came to both KPMG, and the PCAOB  
6 from Senators Warren and Markey.

7           And Chairman Doty's response talked about that,  
8 and he said late last year, we, the standard-setting  
9 staff commenced a review of PCAOB standards,  
10 specifically related to the consideration of illegal  
11 acts, and that they're weighing recent public events and  
12 observations from the Board's oversight activities in  
13 considering whether the standards should be  
14 strengthened.

15           And then he went through and said that we're  
16 going to take input from a lot of different areas,  
17 including this group, to help that staff working group  
18 get through their work.

19           So I think, you know, that that's important,  
20 because as Mary said, there is a lot of focus on this.  
21 And the question from an investor's perspective is  
22 clearly, frequently, where were the auditors? Why

1 didn't people catch stuff like this?

2           So what we did was review the current  
3 requirements, which is Section 10A of the Securities and  
4 Exchange Act, and AS 2405, which is the PCAOB rule,  
5 compared it to international and GAO standards with  
6 great --- Mary and I, neither Mary and I are auditors or  
7 accountants. So, but we did have Lynn and Bob Tarola,  
8 who are highly expert on that, and the other members of  
9 the group who worked on this as well, to keep us a  
10 little in bounds.

11           The standard has not been changed in a long time.  
12 I mean, this was adopted by the PCAOB at its founding,  
13 as I understand it, and it was a previously existing  
14 professional standard, and has not been modified.

15           So our conclusions, basically, are it's time to  
16 really take a close look at this. It's time to update  
17 it. The language is pre-SOX, pre-Dodd-Frank, but SOX  
18 being the most relevant there, because the things that  
19 SOX tried to address were not even in play at the time  
20 this standard was written.

21           And that as we looked at the standard, the  
22 current standard, there were a lot of shoulds, and not

1 too many musts. And we think that that sort of  
2 dichotomy ought to be looked at closely.

3 We found that, in some ways, the international  
4 and the Yellow Book standards from the GAO are more  
5 stringent, and we think that the staff ought to consider  
6 those areas.

7 And there are a couple of things, you know,  
8 whistleblowers. There is no real focus in the current  
9 standard on whistleblowers. But in a post-SOX world,  
10 that landscape has changed dramatically.

11 So we really think that that's part of what  
12 should be done. And then there's some other things that  
13 we have in there from the international standards. And  
14 so, that's the approach we've taken, and we hope we've  
15 come up with some useful recommendations for the working  
16 group.

17 MR. HARRIS: Well, Mary and Grant, thank you very  
18 much. And also, thank you very much for the specific  
19 recommendations that you're putting forward today. I  
20 don't think anybody's under any illusions about how  
21 tough a slog this will be.

22 But in reading your analysis of the comparison

1 with respect to other standard-setters, and the fact  
2 that in this area the U.S. is behind the international  
3 community in many respects, I'm glad you're taking on  
4 this issue, bringing it to our attention, and I hope it  
5 doesn't take quite as long for us to address it as maybe  
6 some of the other issues that, you know, we've now  
7 reached a conclusion on.

8           With that, let me turn it over to Norman on audit  
9 quality initiatives.

10           MR. HARRISON: Steve, thank you. Good morning,  
11 everyone. Chairman Clayton, on behalf of our working  
12 group, I would like to add our thanks and appreciation  
13 for your being here this morning. I think it's very  
14 important, and we know you have a lot on your plate. We  
15 appreciate you being generous with your time.

16           Wes and Marc, as always, really important to have  
17 you here, and we enjoy this dialogue every year. I  
18 think it's important for, for all of us that you're  
19 here.

20           I co-chair, along with my friend Lynn Turner, the  
21 working group on audit quality initiatives, and it's an  
22 interesting topic, because if you think about it, audit

1 quality is the foundational purpose for which the board  
2 was created.

3           It's an express charge or mandate in SOX, that  
4 the board was created to improve the quality of audit  
5 services offered by professional accounting firms, and  
6 if you think about it, everything the board does has  
7 that as its ultimate objective.

8           And all of its standard-setting, and regulatory  
9 activities, its inspection and enforcement mechanisms --  
10 everything that happens here has the ultimate goal of  
11 improving the quality of, of audit services offered by  
12 professional accounting firms.

13           And our working group this year takes that as its  
14 starting point, and suggests as our foundational premise  
15 that, as is true in the private sector, we think it's  
16 true in the regulatory domain also, that you can better  
17 manage what you measure.

18           And we believe that there are significant public  
19 and investor interests in the development of specific  
20 indicators of audit quality. There's a strong public  
21 interest in greater transparency regarding the audit  
22 process, and the performance of audit firms.



1           We believe that in the age of publication,  
2 measurement tracking of AQIs would better inform the  
3 annual decision that public companies make about  
4 engagement of an auditor.

5           Anne mentioned earlier that, Anne Simpson  
6 mentioned earlier that the, that the, yesterday's action  
7 by the Commission is an important step forward for  
8 investors because of the additional information it  
9 provides to people like Anne, and Amy, and others who  
10 invest in a fiduciary capacity.

11           We think very much the same is true of audit  
12 quality initiatives. You know, the annual process of  
13 interviewing and proposing, and proposing to  
14 shareholders the election of an auditor should not be a  
15 pro-forma process. It is an election, and we believe  
16 that the audit quality initiative framework will  
17 provide, would provide important information to the  
18 people who are charged with proposing and electing  
19 auditors.

20           In addition, the AQIs could provide ongoing  
21 indicators and early warning signs of issues relating to  
22 auditor capacity, resource constraints, competence

1 issues. And that, in turn, I think, would better inform  
2 and serve as an important complement to the PCAOB's  
3 inspection regimen.

4 And then lastly, and as we, as we point out, and  
5 provide to the working group, in, an, an appendix to our  
6 report this year, the results of the PCAOB's own  
7 inspection process show that there's a lot of room for  
8 improvement here.

9 The, the deficiency rates in your examinations of  
10 audit firms remain quite high, well north of 30 percent  
11 in most cases. For some audit firms, for some years,  
12 higher than 50 percent. And that's, you know, we think,  
13 very clearly, room for improvement.

14 And that AQIs, again, would provide an important  
15 tool in addressing that issue.

16 We'll spend a little time during our presentation  
17 on the history of this initiative. It traces, as you  
18 all know, I assume, that the, the, the, the proposal to  
19 develop and measure audit quality initiatives was a  
20 product of the Paulson Commission Report in 2008, which  
21 further recommended that the, if the PCAOB determined it  
22 to be feasible, and that it promulgated audit quality

1 indicators, that it monitor them -- again, with one of  
2 the fundamental purposes to be to facilitate shareholder  
3 decision-making about the appointment of an auditor.

4           The Board's actions on this issue have a long,  
5 and we believe, unfinished history.     First, the  
6 discussions of, of AQIs really relate back to 2013, when  
7 both the standing advisory group and this investor  
8 advisory group considered the issue.

9           Many of us in the room this morning were on the  
10 working group back then, including yours truly.   So  
11 we're -- we're glad to have an opportunity to raise it  
12 again.

13           In 2015, the Board published a very thoughtful  
14 concept release, in which it proposed 28 audit quality  
15 indicators for consideration.   Comments were due on that  
16 release later that year.   And also, in the fall of that  
17 year, the issue was discussed again at the SAG.

18           And at least from the public perspective, the  
19 trial seems to have gone cold from there.   So we're  
20 hoping that today, in our discussions, we can encourage  
21 the Board to revisit and complete its work on this  
22 important issue with a sense of urgency -- at least in

1 part because, again, it's been nine years since the  
2 Paulson Report was published, and as we'll discuss  
3 during our presentation later today, audit regulators  
4 and professional organizations in other countries have  
5 been moving forward on this issue, and I think there's  
6 a risk here that we'll fall behind, which we certainly  
7 don't want to do.

8           Specifically, we will have a number of  
9 recommendations to the Board, again, to move with a --  
10 with a sense of urgency to complete its work in this  
11 area.

12           We'll recommend the proposal of the new standard  
13 that would require audit firms to disclose to their  
14 audit committees their PCAOB inspection grades, and  
15 identify the issuers with respect to which those grades  
16 were assigned.

17           And we will, we will urge the final adoption of  
18 a set of audit quality indicators that are supported by  
19 the investor community.

20           With respect to the indicators themselves, we  
21 will spend some time today revisiting the work of the  
22 2013 working group, where we went into this topic in

1 great detail. I think the members of our group believe  
2 that those recommendations are as valid today as they  
3 were at the time - that a principal focus of audit  
4 quality indicators should be on, first of all,  
5 capturing, capturing data at the engagement-specific  
6 level, and making sure that the indicators measure the  
7 outputs, or the end results of the audit process at  
8 least as much as they measure inputs.

9           We'll recommend a number of priority areas for  
10 AQIs, including firms' compliance with independent  
11 standards. Again, as I mentioned, we'll recommend that  
12 the indicators require disclosure of PCAOB inspection  
13 results and grades to audit committees. We'll recommend  
14 that there be indicators that go to the issue of  
15 restatements, and the frequency of a firm's undetected  
16 financial statement errors, and internal control  
17 weaknesses.

18           And then, we do believe, also, that there are  
19 several input-oriented indicators that are important as  
20 well: staffing level, leverage, workload, professional  
21 competence of members of the audit team, things of that  
22 nature.

1           We are also going to urge that the board expedite  
2 the release of its annual inspection reports. We have  
3 noticed there's been perhaps a little slippage on that  
4 front of late. And also, that the Board work to ensure  
5 timely release of, of the part two inspection reports.

6           As you probably know, Chairman Clayton, the part  
7 two reports report to, to audit firms on instances in  
8 which the PCAOB inspectors identify weaknesses in the  
9 firm's internal controls over the quality of their audit  
10 process.

11           And if the firm doesn't address those to the  
12 PCAOB's satisfaction within 12 months of the issuance of  
13 the report, that part two report is supposed to be made  
14 public under the statute.

15           And then lastly, we're going to, if time permits,  
16 we're going to encourage some discussion of some broader  
17 systemic or structural issues that we also believe have  
18 very direct effects on audit quality, independence  
19 issues, and, and, and conflicts being one of those.  
20 We're seeing again, including most recently, in, in  
21 Linda's home country, in South Africa, the, the too big  
22 to fail issue continues to come up in conversation and

1 in events.

2           And, and lastly, and fundamentally, some  
3 discussion of the overall efficacy of the, of the user  
4 pays model, and the inherent tension or conflict that  
5 that creates, which undoubtedly has at least some  
6 bearing on, on audit quality.

7           So that's a quick overview, and again, thank you  
8 so much for your time, Chairman Clayton, Steve. Thank  
9 you.

10           MR. HARRIS: Well, Normal and Lynn, thank you very  
11 much for your excellent work. And, and believe me, we  
12 all know that more work needs to be done in this area.

13           And, and finally, to wrap up this session, Bob  
14 Tarola, you've done some work on digital financial  
15 statements. So, turn it over to you.

16           MR. TAROLA: Yes, thank you, Steve, and good  
17 morning, again. First, I want to thank Steve for his  
18 leadership. Throughout the seven years you said, I  
19 thought it was eight, but maybe ---

20           MR. HARRIS: It's eight.

21           MR. TAROLA: It's eight, yeah. I was there from  
22 the beginning, when he dreamed this up, and it's been a

1 -- it's been an honor to work with you and the rest of  
2 the members of the Investor Advisory Group.

3 Chairman Clayton, I think you'll find that  
4 there's two themes that come from this group on a  
5 regular basis. One is transparency for investors, and  
6 the other one is enhancing the relevancy of the auditor.

7 And, and I'm going to deal with a topic that's  
8 really emerging, and that's the auditor's role with  
9 respect to digital financial statements. Now, that's,  
10 that's code for structured data that's under the SEC's  
11 proposal to move information from human-readable format  
12 to machine-readable format in a way that is inseparable.

13 Today, the, the machine-readable format is filed  
14 as an exhibit, so-called XBRL filings. Moving forward  
15 with the adoption of in-line XBRL, that, that data will  
16 be inseparable. And, and indeed -- I'll use my hand as  
17 an example -- a person could read the front of my hand,  
18 and a machine could read the back of my hand, and there  
19 is no other information.

20 I'll be proposing that the auditing profession,  
21 and the PCAOB, and the SEC look at how the, how the  
22 auditor could add a quality element to that machine-



1 readable information, in order to protect investors, and  
2 again, enhance the relevancy of the auditor.

3 I'll do a little demonstration on how that, how  
4 that works, in terms of the technology, talk about  
5 what's going on in the rest of the world, with respect  
6 to the implementation of digital financial statements,  
7 and the quality control over them.

8 And also, we have some statistics on how  
9 investors are using them, and some investors around this  
10 table -- Amy in particular -- indicated that, that she  
11 insists that it be used by her analysts. So that'll be  
12 that presentation.

13 MR. HARRIS: Well, thank you all very much.  
14 Chairman Clayton, I know that you've got to leave. But  
15 we appreciate very much your ---

16 MR. CLAYTON: Do you mind if I say just a few  
17 things?

18 MR. HARRIS: I wish you would. I was mindful of  
19 the clock, but take it away.

20 MR. CLAYTON: No, no, look. This is an important  
21 group, and I want to be respectful of your time, and  
22 also react to where you are here.

1           Before I do that, I want to say something about  
2 Wes and Marc and the work that led up to today. I'm  
3 very happy to take responsibility, because I know the  
4 quality of work that was put in here.

5           And it's not just on the audit reporting, you  
6 know, the auditor model, the CAMs, it's on the day-to-  
7 day work of the Commission, and everything that the  
8 Office of the Chief Accountant brings to that.

9           So I would be remiss not to thank both of you,  
10 and not to let this group know what I let virtually  
11 everyone that we meet with, is that on these types of  
12 matters I have complete confidence in Wes and Marc. And  
13 if they speak, they're speaking for the --- they're  
14 speaking for me. So let me say that.

15           On the topics that are before you, I want you to  
16 know how I look at these things. First of all, I think  
17 that the value of high-quality financial disclosure  
18 across the portfolio of public companies cannot be  
19 overstated.

20           And audit quality is a part of that. The data  
21 set that that provides to not just the investing public,  
22 but our economy as a whole, is unbelievably valuable,

1 and having had experience in many different markets, the  
2 level of confidence that is ascribed to those numbers  
3 in the U.S. markets is greater than anywhere else in the  
4 world.

5           You know, when you benchmark, when you value  
6 companies, and going to different metrics, you know,  
7 they drive company valuations, and whether it's an M&A  
8 transaction or anything else, it's extremely important.

9           With respect to the matters before you today,  
10 non-GAAP financial matters, unfortunate occasions where  
11 there are questions about noncompliance with law, and  
12 audit quality generally, for good or for bad, I have  
13 specific experiences with all of these. In the private  
14 sector.

15           MR. HARRIS: Makes you dangerous.

16           MR. CLAYTON: It does. It does. And I would  
17 encourage you to think - and I don't like to overburden  
18 them, but I would encourage you to dialogue with  
19 responsible audit committees and think about how the  
20 audit committee can facilitate moving forward.

21           I recognize that financial reporting is not  
22 static. It needs to continually improve to reflect

1 developments in our economy. These are the people on  
2 the front lines who are tasked with basically being a  
3 liaison between how management runs the business --  
4 which we all want to know, how they look at the business  
5 -- and how you comply with the reporting standards.

6           So I would encourage you, in your role, to  
7 dialogue with responsible members of audit committees,  
8 because I think they will not only better help you  
9 formulate your ideas, they'll probably better help you  
10 get them adopted, because they're the ones who have to  
11 live with them.

12           So, thank you for having me here today, and I  
13 really appreciate it.

14           MR. HARRIS: Mr. Chairman, thank you very much.

15           (Applause.)

16           MR. HARRIS: Well, why don't we wait for a minute  
17 or two and see whether or not the Chairman returns in a  
18 timely fashion, and if not, we'll move ahead.

19           And then I would also encourage everybody to  
20 think about their parting comments at the end of the  
21 day, because, as in the past, we'll go around the table  
22 and ask each of you what you would most like to bring to

1 the PCAOB's attention, and to the attention of Wes and  
2 Marc.

3           Actually, why don't we go ahead, Tony and Amy,  
4 and get on with the fuller presentation, since we do  
5 have certain limited time.

6           MR. SONDHI: Thank you, Steve. Okay. I wanted to  
7 start with what we had to -- what we talked about last  
8 year.

9           And the recommendations from last year, initially  
10 -- well, one of our recommendations was that maybe we  
11 should prescribe the definitions of non-GAAP measures or  
12 key performance indicators.

13           But the concern there was that it's probably very  
14 difficult to come up with non-GAAP numbers that would  
15 fit all business models. It's not really something that  
16 is easy to do. And even within a company that has more  
17 than one business model, you may, we really didn't feel  
18 that it made sense to prescribe, and therefore proscribe  
19 what they were doing.

20           The second recommendation was to consider  
21 limiting the number and the use of non-GAAP measures.  
22 But the problem with this, of course, is the loss of

1 information, because management tells us that they  
2 better reflect the way they run the companies.

3           They reward their staff that way, and therefore  
4 it makes sense to allow them to continue doing that,  
5 rather than limiting the use, and the types of non-GAAP  
6 numbers.

7           The third recommendation that we discussed was  
8 whether they should be independently validated through,  
9 say, self-regulation, and so on.

10           But it was really unconvincing that that could  
11 actually work if we left it to the self-regulators --  
12 the self-regulating systems.

13           Our next approach, then, was, you know, maybe  
14 what we should do is require disclosure in presentation  
15 of the non-GAAP measures in financial statements to  
16 ensure that they're consistently calculated, the  
17 disclosures are uniform, and that they can provide us  
18 with the information. And therefore, of course, they  
19 would also have been audited.

20           The problem was that it wasn't clear to us that  
21 the standard-setters would be able to do that on a  
22 timely basis. Generally speaking, it takes the

1 standard-setters a fairly long period of time, you know,  
2 long period to come up with these accounting standards,  
3 and so on.

4           And part of it makes sense, because it does make  
5 sense to allow the public to comment on them, to have  
6 these discussions, roundtables, et cetera. So the  
7 concern was that the need is far more immediate, and yet  
8 it's not clear that the standard-setters could do that.

9           An alternative that we discussed was maybe we  
10 should require that non-GAAP measures be included in  
11 supplementary information, and therefore could be  
12 audited that way.

13           So that's where we left it. We had, I believe,  
14 a fairly lively debate last year, fairly extensive  
15 discussion as well.

16           So here's what we want you to think about, and  
17 what we would like you to keep in mind today. So in  
18 essence, we find that the financial reporting models of  
19 both the U.S. and the international standard-setters --  
20 you know, whether we are talking about the IFRS, or any  
21 of the other countries, you know, significant players in  
22 the capital market, such as China, and so on -- whether

1 they are providing or, you know, a leading role with  
2 respect to non-GAAP measures.

3           And part of our problem with that, in essence, is  
4 very simple, is that they currently don't require these  
5 performance metrics. And obviously, therefore, those  
6 performance metrics that are available in financial  
7 statements are not audited.

8           Now, the other side of that, of course, is the  
9 problem that management continues to argue -- and  
10 they've been very consistent with this -- that the non-  
11 GAAP measures, the key performance indicators that they  
12 use better reflect the way they operate their  
13 businesses, the way they reward performance, and so on.

14           And so from that perspective, clearly, we need  
15 this information, management wants to provide it, but  
16 the fact is that there's a lack of standardization in  
17 the way they're defined, there's a lack of consistency  
18 in their disclosures. And when I talk about lack of  
19 consistency in disclosures, it's not just comparative  
20 information that can't be -- that's not available.

21           Even within a company, over a period of time, you  
22 don't get consistency. You don't have consistency in



1 definitions. You often don't have consistency in the  
2 reconciliations. There are times when the  
3 reconciliations are not that straightforward to follow,  
4 and find where the information is coming from.

5 So effectively, keeping all of that in mind, we  
6 find that the proliferation of non-GAAP measures, and  
7 the lack of adequate information about them, is a  
8 problem. It's dangerous with respect to the capital  
9 markets, and I think, from an investor perspective,  
10 that's something that is of very serious concern.

11 I also wanted to point out that the validity, the  
12 value relevance, the utility of non-GAAP measures and  
13 entity-specific KPIs continues to be debated. There's  
14 an enormous amount of research, both academic and  
15 practical, or practitioner research from the street, for  
16 example. And we provided a very extensive bibliography  
17 of all of this last year. And a little of that, and  
18 we've added this year, as well.

19 But the problem is that that debate has not yet  
20 settled anything. So it's not clear that there is value  
21 or relevance, it's not clear that it lasts for any  
22 length of time.

1           The other issue that I wanted to mention is that  
2 it certainly appears that non-GAAP measures affect  
3 market prices in the short term. It is also clear to  
4 me, and to the team, from observations, that there are  
5 analysts and others who do use this information. They  
6 ask for the information as well.

7           And as I pointed out last year, and will  
8 certainly emphasize this year, I don't want to give up  
9 this information. I need it because it gives me a  
10 window into the way management thinks.

11           The question is: How do I get comparability,  
12 consistency? And so that's the issue.

13           The other problem that I, that we've, we've  
14 noticed, is that the data aggregators require that  
15 analysts follow certain rules and make certain  
16 adjustments to their earnings forecasts. And if they  
17 don't follow those, then they're not included.

18           And there isn't an analyst who would like that,  
19 and therefore, the, the problem there is that if they  
20 emphasize certain types of non-GAAP measures, without  
21 the consistency that one could get from a standard-  
22 setter or a regulator, then it's unclear that those

1 forecasts are helpful. And that emphasis that the data  
2 aggregators do on that, that may actually create more  
3 problems than it resolves for us.

4           The next thing, then, is that there are issuers,  
5 and there are some investors, who focus on certain types  
6 of non-GAAP measures that are leading us down a slippery  
7 slope simply because of the types of adjustments that  
8 they either require and/or condone. And that is also a  
9 very serious concern.

10           The, and by the way, as I said before in my  
11 summary earlier, I think that the SEC has done a very  
12 good job the last couple of years working on this, and  
13 the comment letters, and so on.

14           Some of the more recent comment letters, just in  
15 the last few months, have been very, very helpful in  
16 pointing out and asking very specific questions as to  
17 why things were left out, why they were defined in  
18 certain ways, or asking for additional clarity there.

19           The other point I wanted to make was that it  
20 really is clear to us that both the regulators and the  
21 standard-setters need to do more, and they need to find  
22 a way -- particularly, the standard-setters need to find

1 a way to provide the types of performance metrics that  
2 people are actually using, and get some additional  
3 clarity on that.

4 My next point, then, is that, let's take a look  
5 at some of the recommendations. So our principal  
6 recommendation is that regulators and standard-setters  
7 should get together, and then they ought to define these  
8 industry-specific key performance indicators, non-GAAP  
9 measures, which would then be audited for assurance.

10 Given the concern that some of us have with  
11 whether that is actually possible, whether that falls  
12 within the remit of these standard-setters, the FASB,  
13 the IFRS, an alternative that we're suggesting is that  
14 the standard-setters and regulators should actually  
15 provide a framework.

16 So they should tell us, and require companies to  
17 follow certain guidelines with respect to display,  
18 reconciliation, disclosure, and provide that guidance  
19 for performance indicators, which would be defined by  
20 management.

21 All right, so if a management has -- a company  
22 has three different business models, and they want us,

1 they want to use three different sets of non-GAAP  
2 measures, they're welcome to do it, because that does  
3 provide us with information.

4           However, they have to be consistent. They have  
5 to be clearly defined, they have to be transparent, and  
6 they have to follow the guidance provided with respect  
7 to, as I said, location, display, presentation,  
8 disclosure, reconciliation.

9           The additional recommendation that we make with  
10 respect to that is that the non-GAAP measures should  
11 actually be defined, as I said, by management. They  
12 should be transparently defined. And then, once they  
13 are, they follow those, and they could be, then,  
14 audited.

15           We also recommend that companies, once they've  
16 selected a non-GAAP measure, they should provide  
17 information for it for at least three years. Even if  
18 they choose, after a year, let's say, to no longer  
19 provide that information, they have to continue  
20 providing it.

21           So at any given point in time, in other words, if  
22 you use a non-GAAP measure, it would be very critical

1 that you provide it for three years at a time. And  
2 therefore, that information gives you, that gives the  
3 investors the trend information with respect to that  
4 non-GAAP measure, and the disclosures would help them  
5 better understand.

6           Okay, so we took a two-pronged approach this  
7 year, and we've actually added, we've done some  
8 additional research on how investors and management uses  
9 non-GAAP measures. And that's the basis for the  
10 recommendations that we've developed here.

11           Now, the non-GAAP measures and key performance  
12 indicators that are used by industrial and investment  
13 management, let's take a look at what they are. And  
14 probably the most common measure is some kind of an  
15 EBITDA.

16           As you, everybody knows what EBITDA stands for,  
17 right? Earnings before interest, taxes, and debits that  
18 we abhor this year. And, I'm sorry, it's actually ---

19           So, and the reason I say that, actually, is it,  
20 you know, it's not really facetious. The problem is  
21 that EBITDA does get defined differently from period to  
22 period.

1           The debits that are adjusted change from one  
2 period to the other, and that inconsistency, and the  
3 lack of transparency about that lack of consistency, is  
4 the real problem.

5           So what is it that EBITDA actually is used for?  
6 It's -- as management tells us that they use it to track  
7 and report performance.       They also use it for  
8 acquisition decisions, and that's not just in the  
9 industrial world.   Even in the financial markets, the  
10 assets under management, very often companies tell us  
11 that's what they're doing, that they're using some kind  
12 of an EBITDA, or some sort of an adjusted EBITDA, some  
13 sort of an adjusted EPS.

14          So very often, in other words, EBITDA, in  
15 addition to being a performance metric, is also actually  
16 a proxy for cash flows.   In a sense, it's a proxy for  
17 the cash-generating ability of the company.

18          But here's the problem.   You know, if you are  
19 using capital a great deal, if your asset is intensive,  
20 if you have a lot of debt, then leaving out the demands  
21 of interest, and the cost that you recognize as a result  
22 of depreciation and amortization, that certainly cannot

1 help get a good sense of where things are.

2           Stock compensation is another very, very common  
3 adjustment that companies make. But if you look at the  
4 companies that adjust, I mean, many companies adjust for  
5 this compensation expense. A common argument is that  
6 it's non-cash.

7           The problem is that they rely very heavily on  
8 stock compensation to pay their employees, to reward  
9 their employees. So it's very hard to see why that's  
10 not a relevant indicator of how they're going to do in  
11 the future.

12           Companies that rely significantly on acquisitions  
13 to acquire technology, to stay ahead of technology  
14 needs, those are the kinds of companies that often  
15 adjust for the amortization of intangibles. And that,  
16 again, is a very significant problem, because you're  
17 leaving out the key indicators that'll tell us how  
18 you're going to do what you're going to do in the  
19 future.

20           The other problem, I think, is that there are  
21 many free cash flow proxies. Sometimes companies use  
22 revenue and EBITDA growth as metrics for measurement.



1 Part of the problem, I think, the reason why companies  
2 opt for the cash flow, or free cash flow proxies, is  
3 that our cash flow statements are badly out of date.

4           We still require companies - or allow companies,  
5 I should say - to use the indirect method.

6           Both US GAAP and IFRS, as the IAS 7, were written  
7 a very, very long time ago. The emerging issues  
8 taskforce, which I'm a member of, has received more than  
9 120 inquiries about cash flows in the last 12 years.

10           Three months ago - or six months ago, rather, was  
11 the first time we talked about cash flow issues at the  
12 emerging issues task force in 12, actually in 15 years.  
13 So we've avoided talking about cash flow statements.  
14 And as a result, managers and investors are looking for  
15 other information about cash flows.

16           There are some other problems, as well. The  
17 indirect method that I mentioned earlier? Both the US  
18 GAAP and IFRS will tell you that the direct method  
19 provides better information. But then the next line,  
20 they also, both of them say that you're encouraged to  
21 use the direct method.

22           And I submit that if you look up the glossary for

1 both standard-setters, that both standard-setters  
2 provide, encouraged is defined as, you don't have to do  
3 this. And as a result, we don't get companies using the  
4 direct method.

5 So I think that it, it's time the standard-  
6 setters did something about that, because cash flow  
7 metrics are very, very important indicators of  
8 performance.

9 Okay. The, the other issue that I wanted to  
10 mention is that investors and management are not the  
11 only users. The rating agencies tend to use non-GAAP  
12 measures as well.

13 By the way, I, you know, I acknowledge that  
14 rating agencies have periodically issued documents that,  
15 for example, a few years ago, Moody's published a paper  
16 written by their Chief Credit Officer that was titled  
17 Ten Reasons Why You Should Never Use EBITDA. And,  
18 however, at the same time, many, many rating agencies  
19 and rating analysts continued to use EBITDA as part of  
20 the work that they use, and part of the information they  
21 use for credit ratings.

22 Many credit investors use it. Banks use it for

1 the evaluation, for example, of loans, credit lines.  
2 The US Federal Reserve, as I pointed out last year, uses  
3 it to determine how much you can borrow in acquisitions.

4           And I also pointed out last year, we found, our  
5 research showed that although the Federal Reserve does  
6 have limits, and says you can't borrow more than six  
7 times, there's at least anecdotal evidence that at the  
8 time companies make acquisitions, if you compared their  
9 EBITDA, the period immediately preceding the acquisition  
10 to the prior years, sometimes the differential was three  
11 to four times, or even more.

12           So there's, in other words, there's a burst in  
13 EBITDA just around the time that you acquire other  
14 companies. And that allows you to then go out and  
15 borrow more money.

16           So I think the Federal Reserve, one of our very  
17 key regulators, would also find it helpful if there was  
18 consistency in the way EBITDA was defined.

19           The data aggregators and analysts - as I said  
20 before, the analysts who contribute to consensus  
21 earnings estimates - the data aggregators require  
22 specific definitions. And we really think that that

1 exacerbates the whole issue, because of the way they  
2 define it, because of the types of practices that  
3 they're effectively promulgating. And that, I think,  
4 makes a very, very, it contributes to the problem here.

5         The, so some of our concerns fundamentally are  
6 that the academic and street research has rarely found  
7 value relevance or predictive ability.

8         And a fairly recent study at, I think it was the  
9 American Accounting Association Conference, found that,  
10 very little relationship to value, but did find that  
11 non-GAAP financial measure users were companies that  
12 generally reported lower GAAP earnings and excess  
13 management compensation.

14         There's a fair amount of research that shows that  
15 the, the differential between GAAP earnings and non-GAAP  
16 measures continues to grow. I know last year, that some  
17 people noticed a slight decrease in that differential.  
18 But it's still fairly significant.

19         There are others who have pointed out that, you  
20 know, if you look at the stock market today, and you  
21 think about the multiples, you would be alarmed, because  
22 they are at a high. But the problem is that when you

1 look at non-GAAP PE multiples, they are significantly  
2 higher than what you have.

3           So those are other areas, or other issues, why we  
4 have concerns as well.

5           And then, finally, a, I wanted to point out that  
6 there is selective reporting. So there are, at times,  
7 adjustments that companies make to the EBITDA, or any  
8 other KPI, or any other kind of non-GAAP measure.

9           In fact, for example, I recall not too long ago  
10 seeing a couple of companies in the cloud computing  
11 world trying to adjust their deferred revenues. And a,  
12 and those are significantly concerning, the way they're  
13 calculated.

14           I do understand, by the way, and I wanted to  
15 point out, that the SEC does have a backlog disclosure  
16 requirement in Reg S-K. I have said in the past that I  
17 wish they came up with a firm definition of firm orders.  
18 We don't have that at the moment.

19           And if you're going to leave the definition that  
20 way, it would be great if you asked companies to tell us  
21 what their cancellation rates were. That sort of thing.

22           I think that it's an important indicator for

1 software companies, for IT companies. And I noticed  
2 that in 2016, you did start working towards that, which  
3 I commend you for.

4 I think that --- Of course, there's another  
5 thing, too. The new revenue accounting standard will  
6 require a disclosure of the transaction price that's  
7 included in performance obligations that have not yet  
8 been satisfied. So that's a type of a deferred revenue,  
9 type of a backlog disclosure.

10 The combination of the SEC disclosure and the 606  
11 disclosure, I think, are going to be very helpful. Of  
12 course, it remains to be seen how much information, what  
13 kind of disclosure we get, what kind of qualitative  
14 disclosure we get along with that information.

15 And then finally, you know, as I said, this one-  
16 time adjustment, or the continued adjustment for  
17 restructuring charges that are designed to make core  
18 operations look more favorable, or to show their  
19 performance better, we think that is significantly  
20 misleading.

21 And Amy, I'll move the slides, if you like.

22 MS. MCGARRITY: Okay. Thanks, Tony. So the next

1 slide really just details some of these material and  
2 unusual adjustments that may be made, that Tony just  
3 touched upon.

4           But really, these are generally, obviously, two-  
5 sided in, in certain, in most circumstances, and we feel  
6 we're really only seeing one side of those adjustments -  
7 the side that really impacts core operations, making  
8 them look more favorable, not necessarily the, the  
9 adjustment that would make them look less favorable.

10           Wherein, for example, the supplier may adjust  
11 their financial measures, whereas the customer is not  
12 making the adjustment to their disclosures. But in  
13 actuality, it's potentially material to both. So we  
14 believe this, this practice is misleading, and should be  
15 addressed.

16           This is just some of the examples that we wanted  
17 to lay out for you.

18           Tony touched on this a bit earlier as well, but  
19 generally speaking, companies are adjusting their GAAP  
20 metrics for recurring or essential expenditures, which,  
21 you know, as analysts, we can potentially add back in.  
22 They probably shouldn't be taken out; they are

1 potentially non-cash. But they're often real, and  
2 impactful on a company's economics.

3 So, for example, stock comp interest and  
4 depreciation expense by debt and capital intensive  
5 companies, and inconsistently defined and non-comparable  
6 use of restructuring charges. So these, you know,  
7 contain varying items from one period to the next, and  
8 lack consistency in their disclosure.

9 On the next page, you know, there are already  
10 some statutes in place, which exist, which should  
11 discourage this type of selective disclosure, such as  
12 the Exchange Act Rule 12b-20, and Sarbanes-Oxley Act,  
13 Section 401. However, we believe these are still  
14 happening.

15 So jumping ahead, really, to our punchline, which  
16 we've already alluded to, we believe using FASB-defined  
17 KPIs would restrict a user's ability to selectively  
18 disclose within their financial statements, non-GAAP  
19 financial, non-GAAP financial measures, which are  
20 material and unusual non-recurring items.

21 Issuers would have to follow the defined rules,  
22 thus mitigating the use and risk of selective



1 disclosures.

2           So I'll just go ahead and detail our preferred  
3 path recommendation, as stated. We recommend that FASB  
4 define, develop and define new relevant KPIs, Key  
5 Performance Indicators, to replace non-GAAP financial  
6 measures. These could then be included in the financial  
7 statements, and audited alongside the rest of the  
8 financial statements.

9           In addition, as just mentioned, all material,  
10 unusual, and non-recurring transactions should be  
11 disclosed in the footnotes of the financial statements  
12 to discourage issuers from using non-GAAPs to  
13 selectively report one-time items.

14           Just to note, these three points are the most  
15 important parts of our recommendation in my view. They  
16 allow for standardized definitions, and auditing of  
17 them.

18           If the FASB is unwilling or, to create KPIs, then  
19 we believe, potentially, the SEC could consider taking  
20 up this project.

21           On the next page, just, you know, again, to  
22 reiterate the backdrop. Investors generally desire

1 these business-level metrics beyond what is provided  
2 using current GAAP, and we believe these metrics can be  
3 provided through GAAP defined, non-GAAP financial  
4 measures and KPIs.

5           You know, as investors, we encourage  
6 comprehensive disclosures by companies, and believe that  
7 there exist non-GAAP financial measures or KPIs which  
8 are relevant to our investment decisions. We believe  
9 non-GAAP financial measures and KPIs can be developed at  
10 the industry level, recognizing each industry's unique  
11 operating environment, and relevant key performance  
12 indicators.

13           These may more comprehensively incorporate the  
14 investors' desired metrics to review.

15           Now, there was some feedback from the working  
16 group, you know, which was very supportive, and, and  
17 collaborative in our, in our, on our research project.  
18 But there was really some feedback from them that the,  
19 there was a lot of complexity surrounding developing  
20 these industry-level classifications, KPIs.

21           And so, you know, we, we researched this a bit,  
22 and we think that there's a possible consideration of

1 using the Sustainability Accounting Standards Board  
2 roadmap, where they have worked to define industry  
3 categories from which companies can then choose which  
4 industry fits their organization, and they also allow  
5 conglomerates, or companies with multiple business  
6 lines, to report on multiple industry groups.

7           So, so the SASB has worked at length to define  
8 industry groups that they believe are relevant  
9 categorizations, and companies can choose which ones  
10 they believe they, they, they fall into. And we think  
11 this is a roadmap from which the FASB could consider  
12 reviewing to develop KPIs.

13           So once the FASB has developed these industry-  
14 specific KPIs, then the auditors would be required to  
15 test and give an opinion on those defined KPIs within  
16 the auditor's report.

17           These KPIs should be audited with the same level  
18 of scrutiny as the rest of the financial statements.

19           Tony, I'll turn it back over to you to discuss  
20 concerns.

21           MR. SONDHI: Thank you, Amy.

22           So significant concern with the FASB and the

1 IAASB developing the KPIs, as our preferred path  
2 suggests. The, the problem is that the FASB, in its  
3 current plan, has not talked about doing anything with  
4 respect to non-GAAP measures.

5 In fact, one of the more surprising things that  
6 I saw in the plan that they issued - not too long ago,  
7 just a few weeks, I believe - is even their discussion  
8 of what they're going to do with segment reporting  
9 doesn't talk very much about this. They've, they're not  
10 emphasizing the presentation document that they've been  
11 working on for very long.

12 The IAASB, on the other hand, has. They, they  
13 have actually proposed an EBIT measure. But they're not  
14 talking about doing anything with EBITDA, or anything  
15 like that, or any other non-GAAP measure, either.

16 EBIT is certainly not one of those. I mean, it's  
17 actually fairly straightforward; it's right there. But  
18 they're talking about putting it in as a subtotal, or  
19 requiring it as a subtotal.

20 So given that concern, and also when you look at  
21 the revenue recognition standard, the lease accounting  
22 standard, and CECL, the credit loss standard, the three

1 most recent ones, you'll find, you'll see that the FASB  
2 and the IAASB, the, the two work together, to a large  
3 extent on these.

4 I don't really think that they're converged, the  
5 three standards. There are substantive differences in  
6 recognition, measurement, and disclosure requirements  
7 across these three. And of course, we'll have to see  
8 what practice actually brings to us.

9 But the point is that there is a common thread,  
10 and these are one-size-fits-all types of standards. So  
11 if that's where they're going, then expecting the FASB,  
12 or the, and the IAASB to come up with industry-specific  
13 KPIs or non-GAAP measures seems, at least, unclear at  
14 best. Okay.

15 The other problem, also, is that performance  
16 metrics like non-GAAP measures, at least the way they're  
17 characterized by management, these performance metrics  
18 are sort of analytical tools, and the accounting  
19 standard-setters do not actually provide information.

20 They clearly, you know, I mean, I, I certainly  
21 understand, and I've always acknowledged that one  
22 primary reason for the existence of accounting standards

1 is to provide useful information to investors, because  
2 that's how they make their investment decisions. That's  
3 what, that information is critical.

4 I realize, by the way, that, you know, social  
5 media is not all that conducive to providing financial  
6 information in, in bites, right?

7 However, the point is that it is useful  
8 information, but it is accounting. It's financial  
9 reporting. So the question is whether performance  
10 metrics are within the remit of the financial, the  
11 accounting standard-setters.

12 So if you keep that in mind, our alternative  
13 suggestion is that the standard-setters and the  
14 regulators ought to get, to work together, to  
15 collaborate, and then they ought to define, in essence,  
16 the framework - so the display, the reconciliation, and  
17 the disclosure requirements - for non-GAAP measures and  
18 KPIs.

19 And those would also be audited, would then be  
20 audited. However, the measures themselves would be  
21 selected and defined by management. So that sort of  
22 takes care of the fact that, you know, you need

1 individual and specific, industry-specific, or business  
2 model-specific performance metrics.

3           So I think having management define those, and  
4 then prove that framework, would be one, would be  
5 another way to go.

6           The, at the same time, I think that it's also  
7 important to say, or to require that companies provide  
8 these reconciliations, and the information on any  
9 selected non-GAAP measure for at least a three year  
10 period, right? So that we have the trend information  
11 that we need - and this includes, by the way, the  
12 disclosure requirements, it includes the reconciliation  
13 requirements, all of it with respect to any measure that  
14 you've selected, right?

15           Amy?

16           MS. MCGARRITY: Yeah, thanks, Tony.

17           I think the only new information on this next  
18 page is really, you know, based on just following up on  
19 what Tony is talking about - our interim path, our  
20 expansion of the audit. Essentially, we're recommending  
21 that the SEC utilize its authority from Sarbanes-Oxley  
22 to update Reg G, and require issuers to disclose how

1 they define non-GAAP financial measures.

2           So explicitly define them to a detail that, that  
3 can be, then, audited, and then the PCOAB then requiring  
4 that the reconciliations from non-GAAPs to GAAP be  
5 audited based on each issuer's definition of the non-  
6 GAAP financial measures.

7           We believe there are some benefits to this  
8 approach - consistency, mainly, or disclose differences  
9 in reporting and the ability to audit these non-GAAP  
10 financial measures, the audit then providing reasonable  
11 assurance that the numbers are accurate.

12           We believe that requiring the three year lookback  
13 prevents firms from changing their non-GAAP financial  
14 measures from year to year without disclosing those  
15 changes to investors.

16           We believe the audit, and the detailed  
17 disclosure, will be more useful to investors, and may  
18 actually provide the framework and the information for  
19 financial modernization reporting initiatives, such as  
20 the FASB and IAASB-defined KPIs.

21           So one of the pushbacks on the FASB, defining  
22 them is, you know, what are the right ones to, to, to



1 define, and this could help regulators get an insight  
2 into what companies believe are the most relevant key  
3 performance indicators to help with that project  
4 potentially.

5           So on the, the next slide, auditing of issuer-  
6 defined non-GAAP financial measures - audit procedures  
7 already in place, as defined in AS 1105, and AS 2701,  
8 could serve as the basis for, for this new audit  
9 standard.       Reconciliations of non-GAAP financial  
10 measures in the financial statements and MD&A should be  
11 audited, and materiality should be measured relative to  
12 the GAAP metric on a line item basis.

13           So lastly, we really wanted to touch on the  
14 earnings releases. There was a lot of, of really strong  
15 feedback from the working group on this somewhat gaping  
16 hole in our recommendations.

17           There remain significant concerns by members of  
18 the group, related to non-GAAP financial members in  
19 earnings releases. The timeliness of earnings releases  
20 makes auditing these prior to release potentially  
21 undesirable, in that investors, some investors are  
22 clamoring for their release sooner rather than later.

1           However, some investors admittedly to react to  
2 earnings releases. So this is obviously a, a potential  
3 risk, and area of inefficiency.

4           So as such, we recommend to consider requiring a  
5 reconciliation to GAAP of non-GAAP financial measures  
6 used in quarterly earnings releases as a footnote to the  
7 financial statement. Knowing that that footnote, with  
8 the reconciliation of the prior quarterly releases will  
9 be audited may mitigate poor disclosure in these  
10 currently unaudited releases.

11           We understand this is a very difficult issue for  
12 regulators to solve, but it is also one of the most  
13 important related to non-GAAP financial measures, due to  
14 their prevalence in these releases.

15           So I guess that sort of concludes our formal  
16 presentation. There's obviously a lot of issues we  
17 discussed within the presentation, but our overarching  
18 message is that investors want defined non-GAAP  
19 financial measures that can and will be audited.

20           That's the punchline.

21           MR. HARRIS: Well, that raises a large number of  
22 questions, but we'll, before we go to the break, Bob,

1 why don't you briefly go through your presentation  
2 slides, and then we'll take a break. And then we'll  
3 open it up to what I envision to be a fairly,  
4 significant discussion.

5 MR. TAROLA: Tony, if you could pass the, the  
6 slide advancer, please? Okay.

7 Okay. Thank you again. I'll, I'll try to go  
8 through these quickly, Steve, so that we can stay on  
9 time.

10 This segment focuses on the changes in technology  
11 for business reporting, including how financial  
12 statements are, are prepared, and makes a case for  
13 auditor assurance to promote continued trust in the  
14 information available to investors.

15 As technology advances to allow, allow investors  
16 to access financial statements in a structured digital  
17 format, it's important for that information to be  
18 subjected to the quality control system that the  
19 auditing profession represents.

20 Today, the digital financial statements are  
21 outside of that system. We will argue and propose that  
22 it come inside, in the interest of protecting investors,

1 and enhancing the relevancy of the audit.

2           Technology is driving change in financial  
3 reporting. For over a decade, the SEC, and many other  
4 regulators around the world, have used eXtensible  
5 Business Reporting Language, or XBRL, to standardize  
6 information from market participants.

7           I was one of the early implementers, as a CFO  
8 participating in the SEC pilot program. It was clear to  
9 me that this reporting standard offered dramatically new  
10 capability in gathering, reporting, and analyzing  
11 business information, including benefits for preparers,  
12 regulators, and investors.

13           But - and this is a big but - because the digital  
14 financial statements are not official, they are filed as  
15 an exhibit, or furnished as an exhibit, to SEC filings,  
16 auditors have been missing from the equation.

17           Today, again through the vision and leadership of  
18 the SEC, the use of digital technology for business  
19 reporting is moving to the next level. That new  
20 technology is called inline XBRL, which combines the  
21 human-readable information with the machine-readable  
22 information into one data element.

1           Thus, there will no longer be separate documents  
2 submitted by registrants. There will be only one  
3 document, and that presents an opportunity to leverage  
4 auditor capabilities to foster trust in digital  
5 information becoming widely used by investors. The  
6 protection of investors is paramount, and should not be  
7 any less important if they obtain information digitally.

8           Investors rightly expect digital financial  
9 statements to be subjected to audit; indeed, they are  
10 surprised that it is not now the case. This is not  
11 theoretical or future-looking. A full 50 percent of CFA  
12 members believe digital information should be  
13 incorporated into the standard financial statement  
14 audit.

15           So let me give you an, an example of how this  
16 works. This is right out of the SEC test example of  
17 financial statements under inline XBRL. You'll see that  
18 it looks like a normal balance sheet, except for those  
19 orange underlines.

20           If we click on one of those, we'll see what's  
21 being disclosed. Underneath that number is a data tag,  
22 and that data tag, in this case, is actually four

1 layers. It could be even more layers.

2 But it discloses what's been tagged by the  
3 issuer. The information is machine-readable. The tag  
4 includes a wealth of information, such as value,  
5 currency, reporting period, and links to authoritative  
6 literature.

7 And, if you can think, in a forward-looking way,  
8 it can also contain an auditor imprimatur, and link the  
9 audit guidance reference to report, reported clinical  
10 audit, critical audit matters.

11 So it can be, that tag goes with that number, no  
12 matter where it travels - whether it travels into an  
13 analyst investment model, or, or into any other data  
14 set.

15 The problem is that the, the front, if you will,  
16 the front of my hand is audited, whereas the back of my  
17 hand, the one that's machine-readable, is not now  
18 audited.

19 I also want to point out the, the power of this  
20 technology. It, that graphic shows that the dollars  
21 spent on share repurchases by quarter. This information  
22 was gathered almost instantaneously from digital, from

1 structured information available from the SEC.

2           If, if this were not the case, you can imagine  
3 taking hundreds of hours, if you will, to collect that  
4 kind of information. So it's a very powerful tool.

5           Let me also describe the world, worldview. I  
6 want to emphasize that, that the digital transformation  
7 in business reporting is a global phenomenon, and  
8 regulators around the world are expanding its use, and  
9 debating the quality control system that needs to be in  
10 place.

11           The SEC is not alone in this shift to inline  
12 XBRL. Avoiding so-called dual filings, and having one  
13 financial statement that can be both consumed by systems  
14 and read by people makes sense to policymakers and major  
15 regulators around the world.

16           In my role as a board member of XBR  
17 International, which is a US nonprofit that owns and  
18 freely makes available these standards, I have observed  
19 that this, that the security regulators in Europe and  
20 Japan are following the SEC's lead.

21           The acceptance around the world of digitized  
22 reporting begins to mainstream its use.

1           This statement points out that users want  
2 independent assurance over digital financial statements.  
3 The chart points out that those involved or currently  
4 use digital information furnished by registrants want  
5 assurance that it is correct information.

6           An excerpt from the comment letter on in-line  
7 XBRL from the American Institute of CPAs reads: Users  
8 are very likely to incorrectly assume that such  
9 information was subjected to procedures by the auditor.

10           And then, the AICPA goes on to say: Because it  
11 may be more efficient for auditors to perform procedures  
12 on XBRL tags in conjunction with financial statement  
13 audit, it would be helpful for the PCAOB to develop  
14 standards.

15           So in summary, digital business reporting is  
16 here, and will continue to evolve. We can expect that  
17 every market participant will expand their reliance on  
18 these filings, both directly, as well as indirectly,  
19 through data providers who already source their  
20 information from XBRL exhibits.

21           Ensuring that registrants' digital disclosures  
22 match their human-readable ones is a vital part of



1 maintaining accuracy and confidence. The expectation of  
2 investors is that all information provided by  
3 registrants under the SEC disclosure system is correct,  
4 and can be trusted.

5 The relevancy of the audit is at stake if this  
6 expectation is not met for digital financial statements.

7 I'll end there, Steve.

8 MR. HARRIS: Well, thank you very much, Bob, and  
9 I, and I think both presentations raise a number of  
10 issues. And so, why don't we take a 15 minute break,  
11 come back at five after 11:00, and then open it up for  
12 discussion?

13 (Whereupon, the above-entitled matter went off  
14 the record at 10:52 a.m. and resumed at 11:10 a.m.)

15 MR. HARRIS: All right, why don't I start with the  
16 first softball question to Tony and Amy. And that deals  
17 with the short versus the long-term orientation of  
18 investors, and given the short-term orientation of so  
19 many of today's investors, my highly simplistic, basic,  
20 fundamental question is: how would you compare the  
21 importance of GAAP versus non-GAAP measures in their  
22 decision-making? Which one is more important, and why?

1           And aggressively, if you would, reiterate the  
2 answer to the question that we're always asked by the  
3 Commission and others: What exactly is the need, and  
4 what's the problem that we're seeking to address?

5           MS. MCGARRITY: Do you want me to kick it off?  
6 Okay.

7           So thanks for the question, Steve. I think it's  
8 a relevant one.

9           I think that, in general, non-GAAP financial  
10 measures are viewed as maybe a, more of a short-term  
11 investor phenomenon, wherein shorter-term investors are  
12 reacting to those measures in earnings releases, such as  
13 the non-GAAP financial measures that we've talked about  
14 today, whereas potentially the perception is that  
15 longer-term investors are, are not really paying  
16 attention to those, as they're not, they're not reacting  
17 to quarterly releases as much, and as such, are more  
18 focused on GAAP, GAAP metrics.

19           I think that, you know, in general, there is a  
20 lot that's said about short-term investing, but I think  
21 long-term investors use non-GAAP financial measures as  
22 pieces to the overall investment puzzle, part of the

1 mosaic that goes into the long-term investment  
2 decisions.

3           So I, as such, I think that they are important to  
4 both long- and short-term investors. And I think that  
5 any sort of quarterly releases, or short-term phenomenon  
6 in, in a company, and/or a stock, you know, create that  
7 long-term path.

8           And so I think it's important to both long-term  
9 and short-term investors, and, and shouldn't really  
10 necessarily differentiate the need for non-GAAP, or the,  
11 the relevance of non-GAAP financial measures for both  
12 types of investors.

13           As it relates to the ask, I think, you know, just  
14 to reiterate, we're asking for clearly defined non-GAAP  
15 financial measures that can be consistently, and, and,  
16 make comparability amongst companies, facilitate  
17 comparability, and we would like those to be audited,  
18 just for assurance of appropriate and proper calculation  
19 of those numbers.

20           MR. SONDHI: Steve, may I?

21           MR. HARRIS: Yes.

22           MR. SONDHI: I remember being, I had just started

1 serving on the faculty at New York University when some  
2 research was released, academic research that showed  
3 that there was very little market reaction to the  
4 release of the annual report.

5           And a lot of people were talking about, at that  
6 point, this was in the early, this was 1980, and they  
7 were saying that, you know, it suggests that GAAP is  
8 really not useful.

9           And I remember reading an analysis by another  
10 researcher, actually the chairman of our accounting  
11 department, George Sorter, who pointed out that what  
12 investors are doing, short-or long-term, is they have a  
13 model. They look at a company, they think about what  
14 it's going to do.

15           And then the information that the company  
16 releases - quarterly, annual, GAAP, non-GAAP, all of  
17 that information is then taken in, and then the investor  
18 determines whether they need to adjust their model.

19           So from that perspective, I think that, I prefer  
20 to think of it as being information that's going to tell  
21 me what I need to do about my own understanding of that  
22 particular company.

1 MR. HARRIS: Anne Simpson?

2 MS. SIMPSON: Thank you very much. And thank you  
3 very much to the working group, and to Tony and Amy.  
4 That was an excellent, an excellent piece of work.

5 I wanted to flag that I think this question about  
6 non-GAAP measures is one sign of a bigger shift of  
7 what's going on in the economy, which has quite profound  
8 implications for corporate reporting overall, and  
9 thereby, for the role of the auditor.

10 I, I want to flag, as many of you know, CalPERS  
11 was one of the signatories to a petition to the SEC  
12 recently, asking for a roundtable looking at how  
13 companies could and should be reporting better on human  
14 capital. And, you know, one of our observations is that  
15 the, we've got sort of 1970s reporting for an economy,  
16 that in the meantime since then, has been quite,  
17 transforming in quite dramatic ways, as, as Bob was  
18 saying with the digital reporting.

19 So, you know, just as, as one data point, you  
20 know, in the early 1970s, the balance sheet was 85  
21 percent tangibles. And it's now about 85 percent  
22 intangibles.

1           So this question about non-GAAP reporting, I see  
2 it in part as a way of companies scrambling to  
3 communicate to the market what they drivers of value  
4 are, and for us, also, what might be the sources of  
5 risk.

6           So I'd like us to maybe put some bigger economic  
7 context around this when we're thinking about it.

8           I mean, one other example on that, on our mind at  
9 CalPERS, is the Financial Stability Board's recent  
10 recommendations through its taskforce regarding  
11 financial-related climate change disclosure, of which  
12 there are several categories of risk and, they rightly  
13 say, opportunity.

14           We're encouraging companies strongly to pick up  
15 this framework, and start reporting. But how it's going  
16 to connect in with the audit committee oversight, what  
17 the role for the auditor might be on these data points,  
18 is an open question.

19           So I guess my comment is, thank you for the work.  
20 My question is, could we expand it to start looking at  
21 the real nature of the economy, the real nature of what  
22 drives corporate business, because I think that poses

1 bigger questions on reporting and audit.

2           So that's my big question, if you like, and maybe  
3 you've thought about that one.

4           And a specific question is, what in this realm of  
5 improvement - because we don't want to constrain and  
6 stifle companies in reporting. That would be really a  
7 backward measure, a backward step.

8           But what could, or should, be the role of the  
9 audit committee? Because on the investor side, there's  
10 the capital allocation question, which is rightly  
11 remembered. But I do want to flag that shareowners like  
12 CalPERS, which are large and long-term, also take very  
13 seriously our voting responsibilities.

14           And in this sense, we're looking at board  
15 quality. We're voting on audit committee members. We  
16 may well be ratifying, often ratifying the appointment  
17 of the auditor.

18           So the question of how we can improve our own  
19 responsibility for stewardship, I think, is relevant.

20           So thank you for the work, and a big question,  
21 and maybe a smaller question for you. Thanks.

22           MR. HARRIS: Kevin Chavers.

1           MR. CHAVERS: Thank you, and I'd also like to  
2 thank the, the work that Amy and Tony have done on the  
3 committee.

4           I'd actually like to sort of reiterate, or  
5 associate myself with the comments that Amy made about  
6 the, the sort of, the, the dichotomy you posed in the  
7 question between sort of long-term and short-term  
8 investors, and suggest that these indicators are as  
9 equally as important for people focused on the long-  
10 term, that they, they provide, you know, sort of,  
11 feedback, and also indication of long-term value - and  
12 frankly, give you some indication about management, and  
13 evaluation of management stewardship, if you will, of  
14 creating value in those, those enterprises.

15           I'm, I'd also like to sort of pick up on what,  
16 on, on Anne's comment. We didn't, sort of, focus within  
17 this context, because it was narrowly, we're narrowly  
18 defined on non-GAAP financial measures. But I would  
19 respectfully submit that the same, some of the same  
20 challenges, even though it is more, sort of, emerging,  
21 are applicable as we begin to look at, sort of, ESG  
22 indicators.



1           And I thought it was instructive that one of the  
2 parallels suggested, in looking for some standardization  
3 by industry, was to look at some of the work SASB, SASB  
4 has done.

5           But instead, to, but also, to incorporate that  
6 burgeoning group of metrics along, sort of, the, the ESG  
7 indicators as indications of long-term value creation,  
8 and how to think about those, and bring standardization  
9 there.

10           Again, while not directly in the scope of what,  
11 the working group, it strikes me that it makes a lot of  
12 sense for the group to perhaps, sort of, look at that  
13 going forward as well.

14           MR. HARRIS: But I don't sense that there's any  
15 SASB-type equivalent that's looking at these issues.  
16 What's the process moving forward, in terms of, of  
17 addressing the issue?

18           And with respect to, you know, industry-specific  
19 criteria, how do you envision that being set, if it's  
20 not set by the FASB? I mean, what's the mechanism for  
21 moving ahead with what you're talking about?

22           Mary, I didn't mean to cut you off. Keep it up.

1 All right.

2 MS. MCGARRITY: You know, Steve, you know,  
3 frankly, I guess I'm naive to the actual process. We  
4 made the recommendation that, that the FASB consider  
5 defining industry-specific KPIs. If they're not willing  
6 to do so, maybe the SEC could take it up as a project.

7 I think, you know, first and foremost, I'm happy  
8 to be a part of the conversation in whatever way you  
9 think is the appropriate path forward. I think it's  
10 important to, that, I think each of the groups have,  
11 have working groups just like ours, working on this  
12 particular issue. And I think we could all benefit from  
13 collaboration, and, and sharing of ideas.

14 Maybe it's going on, and I'm just naive to it on  
15 the staff level. But I think that, you know, start now,  
16 if it's not already started, and, and start the  
17 collaboration, working together to come up with a common  
18 solution that is feasible to all parties is, is the  
19 right approach.

20 But Tony, you may have some better, better ideas.

21 MR. SONDHI: No, just different. I, I don't  
22 necessarily ---

1           See, the, the issue, as I've mentioned earlier,  
2 the problem is, can a standard-setter necessarily come  
3 up with a set of indicators that everybody could use?

4           I'm not convinced of that. I think, therefore,  
5 I've said that I think we should allow management to do  
6 that. But we do need to provide a framework within  
7 which that information is presented, and that, once it  
8 is presented within that framework, it ought to be  
9 audited there. In that framework.

10          So display, reconciliation, definition,  
11 disclosure, definition requirements, and so on. And  
12 we've, at the CFA Institute, we've often spent our time  
13 trying to figure out, where do we draw the line between  
14 accounting and analysis? And what is it we think the  
15 FASB ought to be doing as a standard-setter, or the  
16 IAASB? And what should, you know, we look for from  
17 management, and so on.

18          And I think, the other problem I have is that I  
19 really don't want to curb management providing me that  
20 information about how they think they're running the  
21 company, what they feel is important.

22          And I don't, really don't think that it's going

1 to be possible for us to come up with, or for a  
2 standard-setter to come up with that sort of thing.

3           And I, you know, I, I sort of, in a sense, I'm,  
4 I'm in both camps, because for the last almost 18 years,  
5 I have been part of the standard-setting process,  
6 starting with the asset, continuing with the emerging  
7 issues task force - even though I clearly, you know, I,  
8 I spend my time there representing the investor, and I'm  
9 interested in understanding what the numbers we're  
10 asking them to provide are telling us.

11           But at the same time, with respect to non-GAAP  
12 financial measures, and/or KPIs, in, I could expand the  
13 argument, although, you know, I'll take Kevin's point  
14 that this was very narrowly defined, and I, so I'd, let  
15 me stay with the non-GAAP numbers, the, I find it  
16 difficult to see that the standard-setters will be able  
17 to do it.

18           And as I said, I don't really have evidence right  
19 now that they're working on it.

20           MR. HARRIS: Right. Linda de Beer, South Africa  
21 is taking quite an enlightened approach to the ESG and  
22 integrated reporting. And so we welcome your subjects

1 on this subject, in relation to what you've done or  
2 otherwise.

3 MS. DE BEER: Thank you very much, Jane. And  
4 thank you, I thought the document was really useful to  
5 make me think about a, a lot of things. And it's useful  
6 that it's the second year in the row that we're  
7 discussing it.

8 I think it's important to take a step back, and  
9 consider what the objective is. And I've, I thought  
10 Anne put it quite nicely to say that investors are  
11 looking at the ability of an organization to create  
12 sustainable value - which is very much in line with the  
13 integrative reporting framework objective, and by the  
14 way.

15 So I guess the question, then, is: Is it possible  
16 for FASB, or any other standard-setter, to come up with  
17 a so-called silver bullet, of these are the two or three  
18 indicators, or one, that will actually give in ways that  
19 answer. I'm not convinced that a single indicator can do  
20 that.

21 In South Africa, for about 15, 20 years, we had  
22 this concept of headline earnings per share, which was

1 originally started in the UK. And our listed companies,  
2 our public companies, have to disclose the number.

3           It's a very, very rules-based number, because  
4 that's the only way in which you get that level of  
5 consistency. And what it basically does, is it splits  
6 the, what we refer to as the platform, the engine room  
7 that creates the, the value, from the value that it  
8 creates.

9           So headline earnings is really that sustainable,  
10 hopefully sustainable value creation, or, or profit, or  
11 earnings number.

12           Having said that, despite that, companies want to  
13 disclose lots of other things, because they know that  
14 that single number is not necessarily giving investors  
15 what they want.

16           I would be very concerned if, sitting as the  
17 chairman of an audit committee, if we are boxed into a  
18 standard-setting, setter, telling us which KPIs to  
19 disclose.

20           I will give you one example. I'm on the board of  
21 a, of a property company. Now, there are 20 or so other  
22 property companies in that specific sector, listed in

1 that sector, but they're all very different.

2           So we're hotel owners, but we're hotel owners  
3 that use other operators. There's no one else like us  
4 in that sector. There are other property companies in  
5 that sector that are in the retail space, the shopping  
6 centers. There are companies that are in the commercial  
7 space, office space.

8           How do you develop, as a standard-setter, KPIs to  
9 indicate value, or earnings, or whatever the appropriate  
10 measures are, across such a wide spectrum in a single  
11 sector?

12           I think, Anne's point, I thought was very valid,  
13 that you want to not stifle. You want to make sure that  
14 there's adequate freedom for companies to do what, what  
15 they have to, to explain their business model - which,  
16 by the way, also changes over time.

17           So you might actually, over time, do want to  
18 change, and I think the suggestion to keep some of those  
19 KPIs for a while, just to avoid manipulation, is  
20 sensible. I think the, the value that, that the PCAOB  
21 can add is, how do you deal with making sure that  
22 whatever they choose to do is reliable?

1           The, the audit aspect of it, I think, is quite  
2 important - and the disclosure aspect. And I think  
3 therein, standard-setters have a very important role to  
4 play, is make sure that there's proper reconciliation  
5 back to the, to the financial numbers, that there is  
6 proper disclosure of the definitions of how numbers are,  
7 are determined.

8           But to say, you know, even within an industry,  
9 you all do this, I think that's difficult and  
10 problematic.

11           MR. HARRIS: Tony?

12           MR. SONDHI: Yeah. Thank you, Steve. I, you  
13 know, Linda reminded me of a, another aspect of this.

14           You know, just to give you a sense of what she  
15 was talking about, the, the property management, or the  
16 property type of companies. You know, as a particular  
17 class of those is, in the US, is called REITs, the real  
18 estate investment trusts.

19           And I find it fascinating, because I was looking,  
20 you know, thinking about them not too long ago, and data  
21 center REITs are competing, you know, in a sense, for  
22 attention in the marketplace, while you're talking about



1 these property REITs, the ones that own malls, where  
2 people are leaving, the, the stores are walking away  
3 from them.

4 But data center REITs are growing differently.  
5 Is it really going to be possible for somebody to say  
6 that for a REIT, this is the way to look at it?

7 So I think from that perspective, it's very, very  
8 important to keep in mind that it's not going to be  
9 possible to do that.

10 And, and, but I, another point that Linda makes,  
11 and Anne made earlier, is, as I said also in 2016, one  
12 of the things our committee, our teams had said was that  
13 we really don't want to stifle management. We'd like to  
14 encourage them to provide this information.

15 But what we want is some kind of a framework  
16 within which it is provided, and I do worry about  
17 auditing these, because a, if, for example, I believe  
18 that a particular non-GAAP financial measure is  
19 misleading, then does having it audited make it any  
20 better?

21 MR. HARRIS: Mike Head.

22 MR. HEAD: Not to repeat what everybody else has

1 just said. One, I think we just said why it's going to  
2 be virtually impossible to define the KPIs and metrics  
3 outside of management defining them. I think that's  
4 almost a foregone conclusion because of what everybody  
5 has said.

6 I'm a little pragmatic about this, in that I,  
7 and, and to add, audit committees already are  
8 responsible for approving the earnings releases before  
9 they're released. So we're not talking about management  
10 review, board responsibility, audit committee  
11 responsibilities, all, limited quarterly reviews. All  
12 that stuff is there.

13 We're just saying the metrics aren't being  
14 subjected to audit procedure, and that's a risk that we  
15 think is too high, because of how they're being used by  
16 the investors.

17 I don't see any way out of this without making  
18 the management define metrics, as they define in their  
19 terminology listed in their 10-K. They're there  
20 already; they have to be. They have to be disclosed.

21 Incorporating them, like we went the direction  
22 with segment reporting, it maybe even could be an

1 expansion of segment reporting, but incorporating them  
2 as footnote disclosure that automatically requires  
3 auditors, then, to audit it. If it's a footnote, it has  
4 to be audited.

5           And it, and therefore, the framework, the  
6 display, the reconciliation, all that format being  
7 defined by the SEC as enhancements either to segment  
8 reporting requirements, or as a separate disclosure in  
9 the footnotes, and then automatically, then, all the  
10 audit requirements are already in place.

11           MS. DE BEER: Right.

12           MR. HEAD: They have to audit it then. I, maybe  
13 that's way too pragmatic, but that's the way I would go.

14           MS. DE BEER: No such thing.

15           MR. HARRIS: So, so Mike, just, just to close the  
16 loop. What do you see as the next steps, that you would  
17 like to see from the ---

18           MR. HEAD: Oh ---

19           MR. HARRIS: --- SEC, FASB, or ---

20           MR. HEAD: --- you know, if I was king of the  
21 world, and could, I would ask our partners at the SEC to  
22 seriously consider making the disclosures in a standard

1 format, either part of an existing footnote or in a new  
2 footnote, issue that, go forward, and then the auditors  
3 have to audit it.

4           Now, I make that sound real simple. I know it's  
5 not. But that's where the power is. That's where the  
6 leverage is. That's what gets it done quicker versus  
7 slower, and gets it out of the academic, intellectual  
8 discussions into something that can be acted up, in my  
9 humble opinion.

10           MR. HARRIS: Lynn Turner.

11           MR. TURNER: I think some historical perspective  
12 is helpful here, because this is an issue that's been  
13 ongoing for over three decades. It's got, really got  
14 started with the REITs, with their funds flow from  
15 operations, back in the 80s.

16           And by the time I was back at the Commission in  
17 '98 to '01, the non-GAAP stuff had taken on a life of  
18 its own, and gotten fairly bad at that point in time.

19           I knew it when one morning I woke up and read a  
20 public high-tech company's non-GAAP disclosures, and  
21 they had subtracted out all marketing costs, just taken  
22 the line out, and, you know, they looked a lot better

1 when they didn't have to include any of their marketing  
2 expenses.

3           So, but it, it's taken on a life of its own now,  
4 and I actually think it's grown much worse now than even  
5 how bad it was when I was chief accountant.

6           The, the, as Tony mentioned, the multiples are  
7 definitely being impacted. And as I read analyst  
8 reports and see what's going on, it's very clear that  
9 Wall Street and the companies are using the different  
10 measures to justify higher valuations than what are  
11 probably realistic for companies.

12           In fact, I saw one yesterday, it had something  
13 like 91 non-GAAP items in its reconciliation.

14           So it's, they're being used for a very bad reason  
15 that I think is actually going to have a worse outcome  
16 than what was here when we had the Dot Com Crash. At  
17 that point in time, the inflated valuations were  
18 occurring when we had a 4.5 percent GDP growth rate, and  
19 now the GDP growth rate's only 2 percent, so the  
20 likelihood of higher risk and a worse outcome are very,  
21 very real today, and in today's market.

22           And once investors sense that there's trouble,

1 and start to pull the money, we'll find out just how big  
2 that risk is, because as money rushes in, money also  
3 rushes out.

4           As I look at this, so in '92, the AICPA had a  
5 project to look at this type of reporting called the  
6 Jenkins Report, and they came out with a report about  
7 '96. And then the FASB followed on with what they call  
8 a business reporting model, which actually did get into  
9 KPIs. If you go back and read it, it does have KPIs for  
10 specific industry.

11           And the FASB showed, and demonstrated an ability,  
12 in that report, to reach out to industry, bring in  
13 industry task groups, which helped them define the KPIs  
14 by industry. So I think, they clearly demonstrated an  
15 ability to do it.

16           Their problem was, they publicly announced at the  
17 time they did the business model, with the FEI  
18 absolutely didn't want them to do. They announced  
19 publicly that they'd reached an agreement with the FEI  
20 that when they did the project, they would not go into  
21 standard-setting afterwards, and adopt any standards  
22 surrounding it, which was a very, very bad policy

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1 decision. And I don't think the current Board is in any  
2 way fenced in by that.

3 And I think the FASB has demonstrated they've got  
4 the ability to go bring in the expertise, and the  
5 industry groups to develop those standards.

6 So I think they very, they've done the work.  
7 They've got a good foundation.

8 I've been a CFO every one of these industries.  
9 I was in the semiconductor industry. We all knew what  
10 the top six were, and we all knew how we defined them.

11 And you will, if you look at them, there's  
12 usually an outlier in each industry where people have  
13 gone off the deep end in how they define it, and it  
14 seems that's where the problem is.

15 No one's really, in the slides, we didn't define  
16 what the problem is. And as our friends at the SEC have  
17 said from time to time, the first thing we should do is,  
18 what is, let's go define the problem, and then try to  
19 find a solution. What is the objective, as Linda said,  
20 that we're trying to get to here?

21 And so I think the problem, as I listen to  
22 people, is that: One, they don't trust management in how

1 they determine which ones will or will not be in, and,  
2 and have to kind of pick and choose them. Well if I  
3 have a problem trusting management to start with, I'm  
4 not going to trust them to define them. I mean, that's  
5 kind of going to take you down ---

6 MR. HARRIS: Fox in the henhouse?

7 MR. TURNER: Yeah, fox in the, yeah, some would  
8 say that. Yeah.

9 MR. HARRIS: I didn't say that.

10 (Laughter.)

11 MR. TURNER: So I'll, I'll say it, then. But  
12 yeah, so I think the FASB is the right group. If you  
13 don't trust management, they're a, they're a group, and  
14 I think they can do it. I think they've proven that  
15 they can do it.

16 At the same time, since the FASB seems to be  
17 dinking around with all their resources on improvement  
18 projects, which don't do a whole lot for investor  
19 protection, maybe the SEC then, in the meantime, waiting  
20 for them, needs to go in and require - as Amy laid out -  
21 that since management are picking and choosing them  
22 these days, at least have management disclose how they



1 defined, and what determined which ones they did or did  
2 not pick.

3           And, quite frankly, whether there were other  
4 large nonrecurring items that, oh, they forgot to leave  
5 out of there, or put in the reconciliation.

6           So I think that would be good disclosure, and,  
7 and perhaps even a red herring on top of that, that says  
8 these results don't necessarily reflect the actual  
9 business results for the business, because they are,  
10 there's no question, they're picking and choosing what  
11 they put in there.

12           And they're doing it to support inflated  
13 valuations. So I think that would be a good move.

14           Ultimately, Tony is right. The problem here is  
15 the FASB has got a horrendous cash flow statement. They  
16 went and did that project many years ago, over two  
17 decades ago now. The investors at the time told them  
18 they weren't going far enough.

19           Nothing's changed; the investors were right then,  
20 and they're right now.

21           And ultimately, if we're going to fix this, this  
22 is about the long-term cash flow-generating capability

1 of the business, and the FASB could do a very, shoot, if  
2 they wanted to do a real improvement project, and get  
3 serious about serving investors, and investor  
4 protection, they could very quickly go in and modify the  
5 old Statement 95 to say: You have to use the direct  
6 method of cash flow.

7           And that would solve most of these problems. And  
8 it could be a very short-term limited improvement  
9 project, because all they had to do is change one  
10 sentence in that statement that says, you have to use  
11 the direct statement. And that's where I think they  
12 need to go.

13           And the, the KPIs would be a good project,  
14 because if you know the, those six or eight key  
15 performance indicators, if I laid out the six key  
16 performance indicators for me at this semiconductor  
17 company, I could tell you almost to the penny what the  
18 next quarter was going to be, and I could tell you  
19 certainly, to a very small number, what the next year or  
20 so was going to be, and it's the, true for each of the  
21 industries.

22           So having the KPIs is very valuable information,

1 but it's only valuable if they got the right items. And  
2 I have actually seen cases where auditors audited and  
3 tested, and gave a report on non-GAAP disclosures and  
4 reconciliations, and they just missed it hugely, and it  
5 cost investors a ton of money.

6           So the notion of, you're going to have an audit,  
7 unless they, if they can't do any better than what  
8 they're doing at the regular financials - and we've  
9 seen, not only in the US, but around the globe now, a 30  
10 to 40 percent defect rate from following GAAPs - if they  
11 can't do any better than that for me, I'm not sure I  
12 want to give the false assumption that the non-GAAP  
13 numbers can be trusted, when they've got that far an  
14 error rate.

15           So I'd like to see them show me they can improve  
16 on that before I turn around and spend a lot of money  
17 having the audit on this area, because at 30 to 40  
18 percent, I don't trust the numbers.

19           MR. HARRIS: Mike, sorry, I know your tent card's  
20 been up and down, and up and down, but having said that,  
21 even if you, even if you repeat what's been said by  
22 others here, I think it's important to get whatever you

1 want on the record, because Wes and Marc, we know that  
2 this area is not specifically directly targeted within  
3 our jurisdiction.

4           But when we went out, and vetted the subject  
5 matter that we wanted this group to talk about,  
6 virtually everybody here said that they wanted to talk  
7 about non-GAAP.

8           And so in terms of the working group, there was  
9 a resounding majority that thought this issue ought to  
10 be brought up.

11           So Michael, I'll turn to you, and then Mary, and,  
12 and Tony.

13           MR. SMART: I'll be brief, because my card's been  
14 up and down, and up and down, because many of the points  
15 I wanted to make have been made. Emphatically.

16           (Laughter.)

17           MR. SMART: In some cases. But, from my  
18 perspective, I think that a standard could be set,  
19 either by FASB, or the encouragement of the SEC, as it  
20 relates to, specifically, EBITDA, I think most of us in  
21 the room who are long-term investors, or investors in  
22 general, we all use that measure to a very large extent.

1           It can vary from industry to industry, but  
2 there's pretty much a baseline. And I think that if  
3 that baseline could simply be standardized, that's sort  
4 of the foundation that all these adjustments can be  
5 built upon.

6           I was discussing with Amy beforehand, you know,  
7 when they lay out the adjustments - and this is sort of  
8 coming from management, and the old comment, "the fox in  
9 the henhouse." When all the adjustments are put on top  
10 of that baseline, at least we know exactly what that  
11 baseline is.

12           And if we want to fall back to that, as  
13 institutional investors, we can fall back on that.  
14 That's an audited number, and if we choose, that can be  
15 the basis of our decision-making.

16           I think it's also important that all the  
17 respective adjustments that are put on top of that  
18 baseline be laid out succinctly, and, and explain what,  
19 exactly, do they entail, what exactly -- why they're  
20 there, and why they're being added to this baseline  
21 number.

22           I think that if we could have some movement on

1 that issue, I think the fact that 90 percent of  
2 investors are looking at EBITDA, but EBITDA is not an  
3 audit number, I mean, kind of, it doesn't quite make  
4 sense to me.

5           And this has been going on for years and years  
6 and years. And Amy will tell you, we know what some of  
7 the adjustments are, and we can decide whether we want  
8 to accept those adjustments or not.

9           But at the very least, we have a baseline issue  
10 there, baseline number there.

11           MR. HARRIS: Thank you. Mary?

12           MS. BERSOT: Thank you, Steve. I want to go back  
13 to your question, your first question, which was long-  
14 term, short-term.

15           MR. HARRIS: Right.

16           MS. BERSOT: And from an investor perspective, I  
17 really think long-term investors - and I think most of  
18 us are long-term investors - know our companies, and we  
19 can look at some of these KPIs, some of these  
20 adjustments, you know, fairly realistically.

21           It's the short-term investors, it's the technical  
22 analysts. Anyone under 34 years of age today doesn't

1 even remember the last downturn. So we have a lot of  
2 short-term reactions to earnings announcements, and I  
3 use FactSet, and a lot of those announcements are  
4 basically the non-GAAP number.

5           You know, you have to kind of dig to find that  
6 GAAP number. And I, personally, take advantage of that  
7 volatility around those short-term numbers. And I think  
8 long-term investors who are well-informed can.

9           That said, I want to go back to the ESG, and I  
10 think we're, I, we're getting more pressure from clients  
11 to consider these factors. They want us to be thinking  
12 about these factors.

13           And going back to earlier comments, and that, I  
14 think, reflects the changes in our economy. I mean, we  
15 are evolving. And companies like Hewlett-Packard don't  
16 know whether they're hardware or software.

17           So I, I do think we have challenges ahead of us,  
18 but I do think if a, if a company can say, these are the  
19 key performance indicators for our company, they stick  
20 with them for a few years - I love that concept - it  
21 will give the long-term investor more of a basis for  
22 understanding the company.

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1           The short-term, I think we're overstating  
2 earnings, so when people talk about next year's earning  
3 of the PE being at 18 times, I'm not sure that's really  
4 true. I'd like to see the GAAP number be used in that  
5 PE ratio. I think we'd be faced with a far more  
6 overvalued market today.

7           So I think you do have this dichotomy between the  
8 old and the new, and the short-term and long-term. The  
9 fundamental investor, the technical investor.

10          I don't know if this project will solve the  
11 problem, but I do believe it will make manager,  
12 managements more consistent, and I think it will help  
13 for people, all people, all investors to understand what  
14 the metrics were that are being used to evaluate these  
15 companies.

16          So I really like your, your question about short-  
17 term or long-term. I think it's a real issue in our  
18 markets today.

19          Thanks.

20          MR. HARRIS: Okay, thank you. Gary? Gary Walsh.

21          MR. WALSH: Yeah, there we go. I was prepared to  
22 talk about the difference between the KPIs by industry,



1 and then I was also prepared to talk about the  
2 differences between growth-oriented KPIs versus value-  
3 oriented KPIs.

4 And what I wasn't prepared to talk about was some  
5 of the things that Anne and Mary have talked about, and  
6 now I realize there's a difference between California  
7 KPI interest, and Texas interest in KPIs.

8 So had I listed 500 different KPIs, I wouldn't  
9 have come up with some of the things we've heard, and it  
10 just brings to mind that I think it's going to be  
11 impossible to come up with a group that everyone is  
12 going to center on.

13 I also worry about having KPIs that are  
14 management-directed, but I think that's a better step.  
15 And the one thing that I'm really drawn to is having  
16 some consistency. And so if management were to lay out  
17 their KPIs, and they were to be consistent with things,  
18 I think that moves the ball forward, and that's an  
19 enhancement.

20 I think that we're all longing for more  
21 consistency, and a reduction of the selective metrics  
22 that management teams are using. So.

1 MR. HARRIS: If management does it on an industry-  
2 by-industry basis, how's there comparability? How do  
3 you ensure comparability between the KPIs?

4 MR. WALSH: I'm sorry. If they do it by industry?

5 MR. HARRIS: Yeah, if this is ---

6 MR. WALSH: Even that doesn't get you there,  
7 because I was just looking at my -- I'm responsible for  
8 the telecommunications sector, analyzing those stocks  
9 for my firm. And that's a very narrow, small part of  
10 the S&P, really only four investable companies.

11 Each one of them have a different set of metrics  
12 that would be necessary to fully appreciate what's going  
13 on with their businesses.

14 So I don't -- if it's that difficult with that  
15 narrow a group of companies, I don't think you can do  
16 that broader. So, but having each one of those  
17 management teams say, these are the, I don't know, five,  
18 ten metrics that we think we're managing the business  
19 towards, I think that gives you more insight than what  
20 we have now.

21 MR. HARRIS: Robert? Bob Tarola.

22 MR. TAROLA: Yes, thanks, Steve. I'd like to put

1 a plug in for audit committees.

2 MR. HARRIS: The Chairman of the SEC, just,  
3 earlier, did.

4 (Laughter.)

5 MR. TAROLA: But please go ahead and value-add.

6 MR. TAROLA: So, let me tell you what comes before  
7 an audit committee. The earnings release will come  
8 before the audit committee. Someone said it must. I  
9 don't think it is a must. I think it's basically  
10 company practices.

11 That release likely will contain a whole slew of  
12 KPIs and non-GAAP measures, because the audience for  
13 that earnings release are the current investors of that  
14 company, generally. And those current investors are  
15 telling the company, here's what we want to know.  
16 Here's how we value you, here's how we report on you,  
17 here's how we analyze you.

18 And if you read their analyst reports, that's  
19 basically all they talk about, are those KPIs or non-  
20 GAAP measures. And then you go to the financial  
21 statement audit and the filing of the 10-K, and those  
22 measures are nowhere to be found.

1           So the question, I think, on the table is, you  
2 know, are these measures relevant? Some people, I  
3 think, are questioning the relevancy. And then the  
4 other question is whether they are or not -- should they  
5 be subject to some quality control process?

6           I think investors are indeed defining what they  
7 want to know. But it's outside of the quality control  
8 process. It doesn't get into the 10-K. It doesn't get  
9 into the audit cycle.

10           In fact, you know, audit, audit firms generally  
11 gloss over when you're talking about non-GAAP measures,  
12 because it's not in their scope.

13           So, connecting the two, I think, is the big,  
14 could be a big win for investors, particularly to make  
15 sure that what they think is important is indeed  
16 subjected to some validation by an independent party.  
17 And let investors decide what they want to know.

18           MR. HARRIS: Lynn Turner.

19           MR. TURNER: Steve, I'm not sure about your  
20 question. You seem to be asking if, wouldn't all  
21 companies have the same KPIs, and whether or not they'd  
22 be different by industry. Is that your question?

1 MR. HARRIS: Well, there's a variation on a theme.  
2 First of all, I look at the SASB model. And in terms of  
3 the SASB model, there's no equivalent model that I see  
4 in this area.

5 And so if management is setting the KPIs, how do  
6 you ensure comparability with respect to the various  
7 issuers, in the various setting of management KPIs?

8 MR. TURNER: Well, let me respond, then. First of  
9 all, KPIs are different for each industry. What drives  
10 a business to be successful, the critical success  
11 factors for each industry are significantly different.  
12 They can be very different within an industry.

13 The high-tech company that I managed had a lot of  
14 fixed-plant, large semiconductor manufacturing  
15 companies. Our KPIs were different than a semiconductor  
16 company who operated by outsourcing all the  
17 manufacturing at the time to someone. And night and day  
18 difference, because it all, a lot revolved around, not  
19 only the R&D, which was the same for both of us, but in  
20 terms of utilization of that fixed asset that we had.  
21 That was major difference.

22 So our KPIs, even though we were in the same

1 industry as another semiconductor company, may be  
2 different. And you're going to have that with every  
3 different industry. For car companies, if you go out  
4 and look at their website, they'll give you the top KPIs  
5 out on the website, in terms of production, and what  
6 they're running through the plants, and what they got  
7 out there retail.

8           That's the same thing, if I look at the  
9 retailers, absent Amazon, the biggest one, they will  
10 turn around and give you sales per square foot, sales  
11 per register, that type of stuff that are key to those.

12           So they are different. And it is not a SASB-type  
13 model. Do not expect it to be a SASB-type model.  
14 That's a false expectation, and the two won't be the  
15 same.

16           As far as quality control goes, I agree with Bob  
17 that it'd be nice to have some quality control. But if  
18 I'm going to have quality control on a digital  
19 information check, I'm not sure I would use our  
20 independent CPAs for that check.

21           I may very well go to some type of organization  
22 that spends, and has a lot more competency in terms of

1 computer programming, and the ability to check those  
2 numbers as they translate from one and, and the other  
3 electronically.

4           And that's not our CPA firms. As we've seen  
5 recently, they're not top-notch on cybersecurity. I  
6 would not go to them for cybersecurity.

7           And if that's the case, I'm not sure that looking  
8 to them to give us quality assurance on the digital  
9 numbers, which would be helpful - I mean I've dealt with  
10 FactSet. You know, FactSet data is good, but any of us  
11 that have used it, or Capital IQ knows that if you don't  
12 FactSet the stuff, when you put out a research report,  
13 you're probably going to have an error to it.

14           It'd be nice to avoid that, but I don't think I'd  
15 hire a Big Four to do that data check for me. And I  
16 think you've got to seriously get back to what is the  
17 problem, and who are the best people to solve that  
18 problem.

19           And when I look at that, it's probably not a Big  
20 Four Firm.

21           MR. HARRIS: Chairman Doty,

22           MR. DOTY: Well, in order to prove that I've been

1 listening, but at the risk of making clear I've  
2 misunderstood, I, I really see, it's a very interesting  
3 thing that two different, quite different approaches to  
4 standard-setters and regulators emerge here - I think.

5         One is slide 16 of the, of the presentation.  
6 Gary, Bob, Mike, have all, in one way or another,  
7 spoken to, or, or outlined a kind of, a single leap  
8 approach. The regulator does, the regulator does such  
9 outreach, and gathers such information as the regulator  
10 needs, and then they take a single leap - not, not  
11 confusing KPIs and non-GAAP financial metrics, which I  
12 now understand, from Wes, and Marc, and Marty, are  
13 really quite different, and, and require different  
14 approaches.

15         Nevertheless, what you're suggesting is to start  
16 studying a single leap, or to think about what that  
17 involves. And it's, it's a challenge for regulators.

18         The other, I would characterize as a kind of  
19 convening approach, and that, Kevin, Linda, Anne, Mary,  
20 Lynn. There's, there's, and Lynn's granulated KPIs.  
21 You, you are, without endorsing SASB, you're  
22 nevertheless suggesting a kind of convening approach.



1           The regulators call together industries, and  
2 industry groups. And you say, okay, you tell us. You,  
3 you tell us what the KPIS, or the non-GAAP financial  
4 measures are. We're then going to tell you what you can  
5 do with them, and what you have to do about consistency,  
6 and about presentation and disclosures.

7           And you've got here a kind of in intergrade of a  
8 private standard-setting that we're familiar with, and  
9 government oversight.

10           These are, they're very interesting approaches.  
11 The latter one resembles a little bit more FASB and  
12 financial standard-setting. The former, a little bit  
13 more the '33 Act disclosure regime.

14           Neither of them seem to me, obviously, easy to  
15 implement. They're both, both have challenges.

16           But I don't think what we've heard is any  
17 approach to the how that Steve is reaching for. How to  
18 get there, unless we come up with some combination of  
19 what seem to be, conceptually, two different approaches  
20 to standard-setting for disclosure.

21           I don't know, I just, I find this fascinating.

22           MR. HARRIS: Tony, before I, I turn to you to, to

1 wrap up. Kevin, I saw you nodding when the, when we  
2 brought up the subject of ESG, and that, that more  
3 institutions are looking at ESG criteria. And, and you,  
4 representing BlackRock, or, or being here, could you  
5 talk a little bit about what you look at in the ESG,  
6 and, and where you see that moving?

7 MR. CHAVERS: Sure. So this is largely being  
8 driven by ---

9 Well, let me, let me take a step back. So one of  
10 the interesting things you find about ESG is, ESG is in  
11 the eye of the beholder. That is, it defies a common  
12 set of definitions and circumstances. It is beginning  
13 to evolve. But one of the things we sort of alluded to  
14 in the, the conversation about SASB sort of moving down  
15 the path, to try to help define some standards. But ESG  
16 is sort of the broad rubric, runs the gamut from or -  
17 this is how we think about it at BlackRock, anyway.

18 And looking at ESG-related factors, just as part  
19 and parcel of our investment decision-making. That is,  
20 what do, do those factors indicate about how we think  
21 about the long-term value creation of a particular  
22 entity, and the management.

1           And so, ESG factors are being incorporated into  
2 our investment processes across the board. And then as  
3 you sort of migrate down the path of what that means  
4 relative to our stewardship responsibilities, and then  
5 what that means in relation to very explicit investment  
6 decisioning, either affirmatively to include certain  
7 types of activities or industries, or, you know, what we  
8 historically have thought about the early evolution of  
9 ESG, and had the sort of, screening certain types of  
10 activities.

11           And so, we actually think it's sort of a very  
12 holistic approach that doesn't sort of lend itself to  
13 any, but imbues the entirety of our responsibilities.  
14 It's being largely driven, initially, by clients,  
15 because it's increasingly become more important from  
16 clients' perspectives.

17           And you have Anne here in the room. I'm sure she  
18 will echo those, as, as well as Amy, from wearing their  
19 client hat.

20           And we see not as much in the US, particularly  
21 not of late, but certainly on a global basis, it has  
22 also made its way into the regulatory fabric in various

1 jurisdictions in either evaluating or measuring these  
2 kinds of criteria, and in some instances, even sort of  
3 mandating certain.

4           So we see that in sort of the, the government's  
5 framework, right, where there are initiatives to  
6 mandate, or at least monitor the level of women, for  
7 example, on corporate boards.

8           So this is, you know, it is sort of, sort of  
9 earlier days in the US context. It is increasingly more  
10 important to clients. And it's increasingly more  
11 important not only to institutional clients, but even to  
12 sort of individual clients, as you begin to look at some  
13 of the surveys that have been done of, of the  
14 significance of this for some of those investors who've  
15 never seen a downturn before, but increasingly these are  
16 criteria in which they are looking to evaluate  
17 investment decisions.

18           And, you know, for those of us who act as  
19 fiduciaries for those clients, increasingly in how they  
20 evaluate how well their fiduciaries are acting on behalf  
21 of their interest.

22           MR. HARRIS: Thank you. Tony, first of all, thank

1 you, and I'll let you wrap up --- I'm sorry, Wes.  
2 Please. Wes Bricker.

3 MR. BRICKER: I'll certainly let Tony have the  
4 last word on an important topic.

5 Maybe just a few observations from my  
6 perspective. One, the value and the diversity of the  
7 dialogue I think has been helpful. It certainly  
8 reflects the diversity of investor approach to  
9 evaluating performance. It also reflects the diversity  
10 of management approaches.

11 That diversity, I think, is reflective of a  
12 quality of our capital markets, that there isn't  
13 necessarily a singularity of investor approach, or a  
14 singularity of management approach. We wouldn't want  
15 that.

16 Nonetheless, we do have accounting standards,  
17 which have, at their heart, comparability among other  
18 objectives. The measure produced in that context is net  
19 income, resulting in earnings per share for public  
20 companies.

21 And so I wanted to use the opportunity of a rich  
22 discussion to make a point, which I appreciate is

1 slightly beside the point of this discussion, that the  
2 prominence of GAAP-comparable reporting comes, you know,  
3 ahead of non-GAAP reporting.

4           So, I emphasize it's, you know, the placement of  
5 non-GAAP reporting, and the placement of KPIs is  
6 important to our overall approach here.

7           Secondly, the FSAB, of course has wrapped up a  
8 multi-year consultation and survey-taking process about  
9 the important areas for its agenda going forward. I  
10 would, I would certainly commend the, the investor user  
11 community to, to the outreach that they've done, and  
12 what they've published on, on the basis of that  
13 outreach.

14           Third, for audit committees, I do think audit  
15 committees play an important role in this area, focusing  
16 on things that they can do immediately, like asking  
17 management for more information about the policies that  
18 management has for non-GAAP reporting, inquiring about  
19 the nature of process and control, that it is embedded  
20 in company reporting today, and asking for outside  
21 perspectives regarding that - whether it's the auditor's  
22 outside perspective, other advisors, or other

1 perspectives.

2           There's an opportunity for audit committees to  
3 continue to focus in this area, particularly for  
4 companies where there are concerns about quality.

5           So separating quality from standards and  
6 standard-setting in the discussion, I think is  
7 important. But thank you.

8           MR. HARRIS: Thank you, Wes. Tony, thank you.  
9 And, you know, thank Amy, and Bob, and the last word is  
10 yours.

11           MR. SONDHI: Is that singular?

12           (Laughter.)

13           MR. HARRIS: Thank you, Tony. Is that it?

14           MR. SONDHI: Thank you, Steve. You know, I'm  
15 struck by a couple of things. I was looking, thinking  
16 about what Lynn has been saying, and, and I really don't  
17 think there's a very big difference between what he and  
18 I are talking about.

19           If you go back, and take a look at my book on  
20 financial analysis, the first line says that in order to  
21 be an investor and an analyst, you have to be cynical.

22           So I think, with respect to management

1 definitions, I'm going to follow that first line. But  
2 I don't know that it can be done otherwise.

3 I'm not convinced that the FASB can do it. I do  
4 accept and, I agree, several years ago, the business  
5 reporting model was a very good exercise. But I don't  
6 think that, in the last few years, the boards have shown  
7 that ability again.

8 I think, for example, we're finally at a point  
9 where we understand, and therefore now have a standard  
10 that says an operating lease, the right to use an asset,  
11 the right to access it, et cetera is the same as buying  
12 it. We're finally acknowledging the economic  
13 equivalency.

14 And two weeks ago, I was encouraged, because at  
15 the emerging issues taskforce, we finally acknowledged  
16 the economic equivalency of selling the license to cloud  
17 computing, the subscription, pretty much. And we're  
18 finally on a move where I think we're going to make a  
19 difference.

20 I do believe that the cash flow statement is a  
21 very critical issue; the direct method is important.  
22 I'll confess, I served on the committee that helped the



1 IAASB write IS 7, and I still remember the two and half  
2 hours that I spent trying to convince David Cairns, who  
3 was then the Chairman of the IASC, to adopt the direct  
4 method. But it didn't work. So I hope one day we'll  
5 have that.

6 My final point is that I do believe that we're  
7 going to need - and Chairman Doty, I think I come back  
8 to your point about those two issues, you're saying, and  
9 how do we bridge that gap. And I think the way to do it  
10 is to have standard-setters and regulators provide us  
11 with a framework, but let the managers define, but stay  
12 consistent with it. And that, I think, is going to be  
13 the way to do it.

14 Thank you.

15 MR. HARRIS: Well, with that, let's take the lunch  
16 break, and be back at 1:00. Thank you.

17 (Whereupon, the above-entitled matter went off  
18 the record at 12:09 p.m. and resumed at 1:07 p.m.)

19 MR. HARRIS: Okay. Could we ask everybody to  
20 take their seat? And we'll get this session going with  
21 Mary and Grant.

22 (Pause.)

1 MR. HARRIS: Okay. Mary and Grant, first of all,  
2 thank you very much for the work that you put into this.  
3 And I think, you know, clearly this is going to be a  
4 very interesting session because you have some specific  
5 recommendations, which I think is extremely important to  
6 get placed into the marketplace of ideas and hopefully  
7 implemented, you know, at some point.

8 And so I very much look forward to the discussion  
9 and then also the questions that I know a number of us  
10 will want to ask related to it.

11 So, Mary, if you kick it off, we'd appreciate it.

12 MR. CALLERY: Can I just say one thing?

13 MR. HARRIS: Sure.

14 MR. CALLERY: It's not just Mary and Grant.

15 MS. BERSOT: Right.

16 MR. CALLERY: We had a pretty collaborative  
17 effort in putting these things together. And Linda and  
18 Norm and Larry and Bob and Lynn were all very actively  
19 involved in it.

20 So I think once we get past the affirmative  
21 presentation we should think of ourselves as a larger  
22 group to be addressing the things, because all these

1 ideas came from different places.

2 MR. HARRIS: Right. And at the outset, let me  
3 indicate also that Marty and his team in Standards have  
4 been working on this. This is on the board's agenda.  
5 So this is, by no means, a fresh topic for us. And so  
6 we appreciate very much the, your discussion, your  
7 contribution.

8 Marty, I don't know whether you want to say a  
9 word or so. But, at the outset, we are focused on this.

10 MR. BAUMANN: No, I would have just ---  
11 appreciate what you said there that we did identify this  
12 as a potential problem area and put it on our research  
13 agenda last year with the board's concurrence.

14 So we are studying this right now to determine  
15 the need for standard setting and what direction we  
16 might go. So this input is very, very valuable to us.  
17 Thanks.

18 MR. HARRIS: So, therefore, your recommendations  
19 are extremely important. So thank you.

20 MS. BERSOT: Thank you.

21 MR. HARRIS: Mary.

22 MS. BERSOT: Thank you. I'd like to introduce

1 our working group and our project from the standpoint of  
2 investors. We tackled this, which could have been an  
3 enormous project. We could have gone down all kinds of  
4 rabbit holes in looking at past cases and so forth.

5 But we looked at it strictly from the viewpoint  
6 of the investor. So our comments and our  
7 recommendations are really geared to what we feel the  
8 investor wants and expects from the auditor.

9 First of all, we've had a lot of fairly high  
10 profile cases recently of situations, corporate  
11 situations where it's debatable whether the auditor  
12 should have been more involved or not.

13 But the first thing that happens when there's an  
14 event is investors say where were the auditors. It's  
15 possible that investors, especially unsophisticated  
16 investors, really don't understand the role of the  
17 auditor, that the auditor's role is limited to financial  
18 matters, and they're not the policemen for the entire  
19 corporation.

20 Investors have extremely high expectations for  
21 auditors. And this is really consistent with the high  
22 level of assurance discussed in the auditing standards.

1           Auditors also, I mean, investors also expect  
2 their auditors to be independent and objective. And the  
3 independence plays into a bit in terms of their role  
4 with management, the audit committee.

5           But I think the value that investors perceive in  
6 the audit is this independent view of the financials.  
7 If the auditor becomes aware of material information  
8 with respect to the financial statements or financial  
9 operations, investors expect the auditor to ensure that  
10 this information is disclosed in a timely and complete  
11 manner.

12           There's a couple words in this sentence that I  
13 think are really, really valuable. One is material.  
14 The auditor really isn't going to move forward, you  
15 know, someone who steals supplies from the supply  
16 cabinet.

17           But there are situations that they become  
18 familiar with that are material. And they may not be  
19 material at the moment. But they may have a material  
20 impact on the financials down the road, in other words,  
21 reserves for liability, reputation risk.

22           These are things -- and there are so many shades

1 of gray here that we recognize that this isn't going to  
2 be an easy topic for the Standards Committee to tackle.

3           The auditor is expected to report any findings to  
4 management and the audit committee, and if need be, to  
5 the authorities.

6           The PCAOB standards of compliance with laws and  
7 regulations, in our opinion, need to be updated and  
8 enhanced. And we're happy to see that you're working in  
9 that direction.

10           So what we decided to do was focus our attention  
11 on 2405, which was drafted in 1989, correct me if I'm  
12 wrong, and adopted in 2003. It is in need of updating.

13           We feel it's not strong enough to protect  
14 investors. And it needs to better define the auditor's  
15 responsibility.

16           We also feel it needs enhanced language regarding  
17 the audit steps required, in other words, what must they  
18 do, what should they do, what must they perform.

19           When auditors become aware of material, and  
20 again, that's the key word, material information that is  
21 expected to have an impact on the financial statements  
22 or operations of the company, they must act on that

1 information. Again -- oh, sorry.

2           These are actually the views of our group. We  
3 really feel strongly that the auditor must act rather  
4 than should act.

5           Investor concerns and expectations. What are  
6 some of the things investors are concerned? Why are  
7 they concerned?

8           There's been incidents recently where investors  
9 feel that illegal acts are not detected or they're not  
10 reported in a timely manner by the auditors. These  
11 include securities law violation, illegal account  
12 openings, and we all I think know what we're referring  
13 to there, and violations of federal environmental laws.

14           What are the expectations? What do investors  
15 expect from their auditors? And what do we expect?

16           And we really I believe I think reflect what  
17 investors expect. And we expect a strengthening of the  
18 audit standards for the auditor's duty to identify and  
19 report suspected and confirmed illegal acts.

20           We also expect clarity to be taken by, clarify  
21 the auditor's role to audit and report suspected or  
22 confirmed illegal acts to the board and to the audit

1 committee. These communications are critical in moving  
2 forward in protecting investors.

3 We also expect to require the auditor to report  
4 confirmed illegal acts to appropriate entities and  
5 authorities if need be.

6 I'm going to stop there. That's our  
7 introduction. Linda, if you have any comments, anybody,  
8 I'm going to turn it over to Bob down at the other end.  
9 Would you like the clicker?

10 And then what we'd like to do is open this up for  
11 questions as soon as we're through with the  
12 presentation.

13 MR. TAROLA: So thanks, Mary. Online here.  
14 Thank you, Mary.

15 My job is to walk through a few charts that  
16 describes the current state of audit guidance for non-  
17 compliance with laws and regulations.

18 This chart 6 and chart 7 are the good work of  
19 Lynn Turner. So thanks, Lynn. They summarize the  
20 current guidance from the SEC, the PCAOB, the Government  
21 Accountability Office, International Auditing Standards,  
22 and the American Institute of CPAs.



1           These are charts for reference. In fact, there's  
2 a much more readable set in your handouts. But I will  
3 summarize the charts in the next few slides.

4           So U.S. financial statement audits for public  
5 companies are governed by a combination of Section 10A  
6 of the Securities Exchange Act and the PCAOB Auditing  
7 Standard 2405.

8           So let's start. Section 10A was enacted in 1995  
9 as part of the Private Securities Litigation Reform Act.  
10 It's main requirements are for auditors to detect acts  
11 that have a direct and material, quote/unquote, effect  
12 on financial statements and to notify regulators when  
13 issuers fail to take appropriate action. There is a lot  
14 of interpretation and judgment in those two  
15 requirements.

16           The PCAOB standards for detecting non-compliance  
17 with laws and regulations are a carryover from the  
18 AICPA. They lack clarity and need to be updated, as  
19 Mary pointed out, for instance, what is material and  
20 direct, when inquiries must be conducted versus should  
21 be conducted.

22           And as already has been acknowledged, the board

1 has commenced a process to do this. Guidance from the  
2 GAO standards and International approach could be  
3 informative in those deliberations.

4           The PCAOB standard focuses on materiality  
5 assessments on the current financial statements, both  
6 the recording and disclosure. The problem is that most  
7 illegal acts take a long time to develop, from many  
8 months to often years. This gives managements and  
9 auditors an excuse for non-disclosure until the matter  
10 is sufficiently developed to be reasonably measured.

11           Moreover, the standard ignores potential material  
12 impacts on investors when acts are identified that  
13 question the reputation of the issuer, even if financial  
14 statement materiality can be rationalized as okay. We  
15 know a couple of those have already been mentioned.

16           The Government Accountability Office goes a bit  
17 further in its audit requirements to include describing  
18 the scope of the work and details of findings as part of  
19 the public audit report. This could be adopted as part  
20 of an auditor's CAM reporting in the normal course.

21           And then, finally, International Auditing  
22 Standards provides added guidance and examples of the

1 types of matters that could lead to a material issue.  
2 It's important to note, please note that most of the  
3 areas listed on this chart are not related to normal  
4 business transactions.

5           So, in summary, our task group concluded that the  
6 current standards over financial statement audits could  
7 be improved. Investors expect auditors to uncover  
8 situations of non-compliance. Clarity can be provided  
9 in areas of what constitutes adequate inquiry, for  
10 instance, the must versus should question.

11           And materiality should be judged not just from  
12 the current balance sheet, but from the potential impact  
13 on investors from reputation surprises, in other words,  
14 the bad news on the front page risk.

15           The objective would be that any situation known  
16 to management, regardless of stage of legal development,  
17 be disclosed to auditors. Auditors then, on behalf of  
18 investors, could be the independent party deciding what  
19 and to whom non-compliance matters should be disclosed.

20           A good example of this is situations where an  
21 event occurs but the legal assessment has not been  
22 developed. In many of those cases, those matters are

1 kept private, even from auditors, until managements,  
2 particularly general counsels, believe they can make  
3 informative disclosures.

4           The other issue with respect to development of  
5 non-compliance is a question of privilege and whether or  
6 not privilege could be compromised if disclosed to  
7 auditors.

8           So those two issues I think are important when  
9 assessing at what point in time matters become disclosed  
10 to auditors.

11           With that, I'll turn it over to Grant for our  
12 recommendations.

13           MR. CALLERY: Okay. As I mentioned before, these  
14 recommendations come from the composite group that was  
15 working on these slides. And I invite all of the  
16 members to chime in and also to work to respond to some  
17 of the questions.

18           You know, I think that the, if you look at the  
19 10A and 2405, there are three components. There's  
20 detection. There's investigation. And there's  
21 reporting.

22           And the detection issue is one where it's divided

1 between things that have a direct and material effect on  
2 the financial statement numbers basically. And then  
3 there, there is an affirmative obligation to build in  
4 processes to the audit to find those things.

5 I think our overriding feeling is that the second  
6 piece, which is if you detect, then things go into  
7 place, is not strong enough and that there should be a  
8 more affirmative obligation on the auditors to look into  
9 certain areas where there are violations of law or  
10 regulation.

11 I think we recognize that there's a slippery  
12 slope here and that defining where on that line the  
13 obligation comes in is going to be a tricky one. And  
14 it's one of the things that I think the staff working  
15 group is probably going to struggle with before you come  
16 up with specific proposals.

17 But the slides here, our thoughts that -- and  
18 we've said this a number of times, is the must versus  
19 should. I think there are a number of places in 2405,  
20 particularly, where the guidance is a little squishy.  
21 And, you know, it's not telling the auditors this is  
22 what you must do. It's leaving more to discretion.

1           And again, you know, the age, this is a 1996/2003  
2 composite of requirements before Sarbanes-Oxley. There  
3 have been a lot of changes in the way audit committees  
4 function, corporations function. And it needs a more  
5 current look.

6           We think that the auditors should be required to  
7 assess the risk of an illegal act and the procedures to  
8 be performed, that there is a responsibility for, as I  
9 said, detecting illegal acts which could have a material  
10 effect on the financial statements.

11           And then we liked, the last bullet on this page  
12 is something that comes out of the International  
13 Standards, which gives some guidance as to areas, and it  
14 certainly should be non-exclusive because you don't want  
15 to create a safe harbor that if you look in.

16           But, you know, things, another thing that has  
17 become a current thing for a lot of corporations is  
18 Foreign Corrupt Practices Act, money laundering, things  
19 relating to securities trading and the environment,  
20 taxes and pension, a number of areas that should just be  
21 highlighted for the auditors as areas where they ought  
22 to be thinking about things.

1           But again, they really need to take a look at and  
2 ask the right questions. And there are a couple of  
3 recommendations later that will touch some of those  
4 areas.

5           On the next page, we have the idea of  
6 expectations for documentation of illegal acts, the  
7 steps that the auditor perform when an act has come to  
8 its attention in order to resolve or confirm.

9           And the next one we thought was very important,  
10 which is the whistleblower portion. Again, post-SOX the  
11 whole approach to whistleblowers is different than it  
12 had been.

13           And we really think that the auditor ought to  
14 understand its client's whistleblower program, the types  
15 of things that come up, and ought to be probing a little  
16 more rather than just simply asking the audit committee  
17 have you heard anything bad, you know, that these  
18 programs are fairly detailed programs, and that the  
19 auditor ought to understand them, ought to know what  
20 resources are there, and ought to be able to leverage  
21 that.

22           That reporting is the second part. And this

1 comes from the GAO Yellow Book substantially, where  
2 there is a more direct and affirmative reporting  
3 obligations for the auditor as in the previous slide.

4           You know, they have to report the scope of  
5 testing for violations. They have to report on their  
6 internal controls, including non-compliance with laws.  
7 And we think that a written report to the audit  
8 committee on these types of issues is a good idea  
9 because it sort of puts everybody's feet to the fire.

10           It's one thing to have a conversation in an audit  
11 committee meeting with no paper trail of it. But once  
12 the audit committee has something from the auditor  
13 saying we have detected this, and we think it's, you  
14 know, we need to raise it with you, and that's in the  
15 written record, so to speak, it's an inducement for the  
16 audit committee to be more, take it more seriously and  
17 to make sure that they have touched the right buttons  
18 internally to be sure that things are, you know, that  
19 they are not missing something.

20           And then -- oops, wrong slide. Consideration of  
21 disclosures, whether disclosures are misleading or not,  
22 and when assessing the materiality, the auditor should



1 consider a qualitative factor, taking -- and this is a  
2 little bit of Wells Fargo.

3           It's, you know, what -- let's not just take a  
4 totally, by the numbers is it, you know, is it 5,000  
5 branches out of 100,000 branches? Well, does that leave  
6 a -- is that material? Is that non-material? But there  
7 are, you know, things that you have to take a, they  
8 should be taking a little broader picture.

9           I think we understand that these are not easy  
10 issues to deal with because there are lines to be drawn.  
11 I mean, when something is inconsequential, as Mary said,  
12 I think somebody, you know, stealing some paper clips,  
13 even if you know about that, I'm not sure it's, it's not  
14 something that needs to go anywhere.

15           But there is a line somewhere I think between  
16 where the current standards is and an absolute  
17 liability, because the auditor can't be responsible. I  
18 mean, that would be unrealistic.

19           If a recommendation that seemed like it was an  
20 absolute liability standard were to come out of the  
21 working group here, which I'm sure it won't, you know,  
22 it would, its chance of success would be slim and none.

1 So I think the, it's important to do that balancing.

2           And one of the things that I, as we talk about it  
3 here, that I think it would be helpful would be for  
4 people who have been in this situation where they've  
5 been dealing with it, raise some of the issues that will  
6 be raised by the other side here if the PCAOB goes  
7 forward with recommendations, because unlike a number of  
8 the topics that we've discussed over the years I've been  
9 here, this is probably the one where there is the  
10 clearest path within the jurisdiction of the PCAOB to do  
11 something, because other than requiring SEC approval,  
12 it's pretty much an internal PCAOB thing and is, I  
13 think, there's similarity in many ways to the audit  
14 reporting model and the CAMs because you could actually,  
15 if you look at CAMs you could almost expand it into this  
16 area.

17           So those are the things that we have been  
18 thinking about and think that the internal working group  
19 ought to consider in their coming up with proposals.

20           And I would just open it for questions,  
21 discussion. And again, everybody on our working group,  
22 please chime in. In fact, if anybody who's been working

1 on this has thoughts that they want to get out on the  
2 table before we start going around to others, please  
3 take this opportunity to do so.

4           MR. HARRISON: I might just add a quick comment  
5 actually on the last bullet point, because I think even  
6 though it's the last one I think it's a particularly  
7 important one, because this issue of qualitative  
8 assessments around matters, I think it is important in  
9 its own right. But in this context, I think it leads to  
10 other areas that are more traditionally within the scope  
11 of an audit.

12           And I think that we've seen a number of  
13 situations where, when frauds have occurred at companies  
14 and there may be a debatable point as to whether it was  
15 material from a financial statement point of view, what  
16 we've learned upon further examination either via an  
17 audit committee or independent committee or by an  
18 independent monitor or others is that the conduct that  
19 came to light was fostered by or condoned by a culture  
20 and a business model that incentivized taking imprudent  
21 risks or engaging in appropriate behaviors.

22           And I think that cultural component, we talk

1 about business culture, and sometimes it sounds like  
2 kind of a touchy-feely kind of stuff that's hard to kind  
3 of get your arms around.

4           But there are circumstances in which a company's  
5 culture and behaviors and outcomes that are valued are  
6 exemplified by incentive structures it has in place,  
7 particular as they relate to compensation.

8           And I think that's one area where there's a  
9 linkage here between the more qualitative elements and  
10 work that an auditor does in the ordinary course as it  
11 looks at that compensation metrics and models and the  
12 like.

13           And then there's also, you know, very likely  
14 occasions in which for those same reasons, as an auditor  
15 examines incentive structures, I mean, incentive  
16 structures are sometimes designed to circumvent internal  
17 controls.

18           And so, as one would think or one would hope that  
19 as part of an auditor's assessment of the adequacy of  
20 internal control over financial reporting that inquiries  
21 of the type that we're talking about here today would be  
22 a relevant factor.

1 MR. HARRIS: Well, I guess I have two questions  
2 to kind of kick it off. One, I think you did a terrific  
3 job on the comparability of the standards.

4 And I'm wondering, first of all, whether it's a  
5 fair conclusion with respect to the working group that  
6 you view our current standards as being weaker in  
7 comparison to the Yellow Book or the International  
8 Auditing Standards.

9 And then also, in terms of doing the comparisons,  
10 I thought that was an excellent appendix. And I think  
11 it highlights some of the differences between those  
12 standards and ours. I think that would be helpful.

13 MS. BERSOT: Lynn, would you like to answer that?

14 (Laughter.)

15 MS. BERSOT: Lynn, you will answer this.

16 (Simultaneous speaking.)

17 MR. HARRIS: No, that was -- whoever put together  
18 the chart, that was an impressive chart.

19 MR. TURNER: On the first question, I think our  
20 standards are weaker, and we have fallen behind the rest  
21 of the world in this respect. And I think that the rest  
22 of the world has over the course of the last ten years,

1 because it really goes back that far, have spent  
2 considerably more time in thinking about it and  
3 developing standards and working on it.

4           And if you look at the new International Ethics  
5 Standard that's laid out in the comparison chart to what  
6 our standards are, they aren't even close. The new  
7 Ethical Standards are eons ahead of us. So, once again,  
8 we're falling behind, which I think is not a good  
9 commentary on what's happening here.

10           In terms of comparison, the Ethical Standards is  
11 well behind. NASBA is doing some good work in this. I  
12 think you've all seen the NASBA comment letter. The  
13 AICPA unfortunately seems to be dragging their feet and  
14 digging their heels in to limit their responsibility.

15           And hopefully, NASBA will shake them up some next  
16 week. NASBA is holding a discussion on this issue in  
17 New York City.

18           The chair of NASBA has indicated he's got a  
19 couple of excellent people to talk about this, Richard  
20 Fleck, who some of you might know from, I believe, the  
21 U.K., and has done excellent work in the international  
22 arena, and, of course, from the U.S., Michael Young, a

1 great attorney I've worked with at Willkie Farr.

2           And so, hopefully, the NASBA will be able to put  
3 a noose around the AICPA and get them headed in the  
4 right direction, rope them in. But the ethical stuff,  
5 if we could get to where the International was at least  
6 to that point, that would be very positive.

7           In terms of the auditing standards, you know, our  
8 standards for all practical purposes are the same that  
9 were written in the 1970s in a response to the Moss-  
10 Metcalf hearings that were held at that point in time  
11 and really haven't progressed.

12           And there was no standard before that. Then we  
13 came up with the standard on illegal acts and fraud, as  
14 if fraud's not an illegal act. The profession has  
15 always had a difficult time saying fraud in the word, in  
16 the standard on illegal acts.

17           And I think only accountants, even though they're  
18 not attorneys, most anyway, you know, everyone but  
19 accountants seem to understand that fraud is an illegal  
20 act. And so we need to get them past that.

21           But our standards since those original ones were  
22 written in the '70s, even though they've been updated

1 once, not much progress. They keep using this direct  
2 and material effect, which the auditors use to hide from  
3 obligation. That needs to be gone, and then, as the  
4 slides highlight, the materiality.

5 But interestingly enough, the other piece of  
6 where our standards are behind not only the  
7 International, and they're behind the International in  
8 the concept of what is an illegal act. They do an  
9 excellent job of laying out some examples, which are  
10 very clear, very concise, which should be in our  
11 standard and aren't.

12 But they go further in defining what you need to  
13 do. But perhaps the best is the standards -- actually  
14 if you took the standards that the General Accounting  
15 Office have prepared, GAO, which Jeanette would know  
16 very well, as well as the International, and kind of  
17 combine those two, I think it would be excellent.

18 The GAO is brilliant in dealing with the  
19 confidentiality matter. The GAO requires a report.  
20 It's a negative assurance report. But it's, quite  
21 frankly, a very good report.

22 We get that report, by the way, every year at the



1 pension board that Amy and I work with. Because we're  
2 a governmental unit, we have to have that Yellow Book  
3 typed report. And we get it every year. And it gets  
4 sent to the audit committee. It's a great report.

5 That report should go to every audit committee of  
6 every public company. It's simple, that just should  
7 happen. Whether it should go on to investors, which I'd  
8 prefer, or not is a debatable issue.

9 But if that report -- all too often we've seen  
10 the auditors were aware of these illegal act, fraud, and  
11 didn't say anything to the audit committee. And the  
12 audit committee, unfortunately, couldn't do their job  
13 because they didn't have the info. So we need that  
14 audit report, negative assurance type thing, on every  
15 single audit of a public company.

16 But you talk about the confidentiality. I know  
17 Bob brought that up. The GAO turns around and says, if  
18 there's something confidential, and it certainly could  
19 be because in this area we get into black box government  
20 contracts and other things that are confidential, then  
21 they have you say in the report, we found some problems.  
22 We can't, because of the law or nature of it, we can't

1 tell you what they are. But we at least are aware of  
2 them and know about them. And so we're going to inform  
3 you.

4           So, at least in that scenario, the audit  
5 committee is given a heads up, knows that there's a  
6 problem. If they weren't aware of it, then they can go  
7 delve into it. And they're certainly in a position to  
8 delve into most of those confidential matters. And no  
9 one is surprised. And it can't be hidden from anyone.  
10 And the auditors can't cop out on it.

11           So the GAO Yellow Book is excellent, miles ahead  
12 of our current standards. Kudos to Jeanette for that.  
13 And you pulled the GAO and the International's Auditing  
14 Standards, along with the Ethical Standard, in. And  
15 you're headed in the right direction.

16           And what happened at Wells Fargo never could have  
17 happened then, assuming they did their, followed the  
18 standards. It just simply could not have happened. So  
19 --

20           MR. CALLERY: And then you add something specific  
21 about whistleblowing provisions and programs, and those  
22 three pieces together I think would go a long way.

1 MR. TURNER: Yes, the one thing I've noticed, and  
2 this is from an audit committee role, on the  
3 whistleblower is the auditors haven't always got a good  
4 understanding of how the whistleblower program is  
5 working and if it's really working independent. And  
6 I'll give you some examples.

7 You might recall about a half dozen years ago  
8 there was a problem in Washington D.C. here. And some  
9 whistleblowers had blown some of the stuff. I think it  
10 had to do with the tax revenue issue.

11 And they had a whistleblower hotline. As it  
12 turned out, no one would call it, because at the end of  
13 the day, where did the whistleblower complaints all end  
14 up at? General counsel for the city.

15 And there is no one at, there is no employee in  
16 their right mind ever going to blow that whistle then,  
17 because that general counsel's job is to defend the  
18 entity and go after the employees.

19 So I actually saw another one on a public entity  
20 where I was on the audit committee, great partner on it,  
21 good -- I liked the audit people. But they came in, and  
22 they wanted to get into the whistleblower program. And

1 they're bringing in a specialist to do it.

2           And so I was talking to the specialist. And he  
3 explained what he was going to do. And he was going to  
4 go talk to the CEO. And he was going to go talk to the  
5 CFO about it.

6           And I said, well, let me ask you a question.  
7 Isn't it true that research shows that in SEC  
8 enforcement cases 85 percent of the time it's the CEO  
9 and CFO that are involved? And he said yes.

10           So I said you're going to go ask about the  
11 whistleblower to the two guys that are most likely to be  
12 involved and ask them if it's working. So, and you  
13 think they're going to tell you if they were committing  
14 a fraud or not. I mean, this is ridiculous.

15           I said let's go do it. But let's go look at this  
16 in a more meaningful and reasoned way so it's not just  
17 that they go look at it, but they consider it and  
18 consider the independence, see how the reporting, what's  
19 happening with the actual files and what happens when  
20 they get a complaint and how it gets resolved and if it  
21 actually works.

22           And so, when you get into the whistleblower

1 thing, you have to get behind it. Just saying go  
2 understand the whistleblower program, given my several  
3 experiences with this, it ain't going to be enough.

4 MR. CALLERY: The other confidentiality thing  
5 that Bob mentioned is privilege and with the audit  
6 committee. And I got to admit I don't get that.

7 I don't know what's privileged from the audit  
8 committee, that the audit committee can't see. It just  
9 doesn't compute to me, the audit committee, the  
10 corporation. So, I mean, I can see the general counsel  
11 not wanting to tell them. But I'm not sure privilege  
12 works.

13 MR. TURNER: Actually, Grant, in the U.S. Supreme  
14 Court case of Arthur Young on the, they addressed the  
15 privilege in there and actually cite to the fact that  
16 there is a difference between privilege for auditors and  
17 the importance of auditors being able to do their work  
18 without having privilege asserted. And so I think if  
19 people looked at that U.S. Supreme Court case, they'd  
20 have a different view on privilege.

21 MR. HARRIS: Chairman.

22 MR. DOTY: This, of course, is a research project

1 near to my heart because of what I've seen in practice,  
2 as I know many of you have.

3           It seems to me the analysis here falls into three  
4 and possibly four parts, though, and one of which is the  
5 enhancement of the notion of the analysis, the risk  
6 analysis and the detection techniques that you would  
7 expect of auditors.

8           And that clearly is something that I think the  
9 PCAOB needs to look at, can look at, and can develop  
10 from.

11           The whistleblower notions seem to be low-hanging  
12 fruit. In other words, that's an area where, as you're  
13 suggesting, it's low-hanging fruit because there are  
14 mechanisms now. And it's just an investigation notion.

15           It seems to me where this becomes very difficult,  
16 it's the one where you just left off, the more you  
17 require written reports, the more you get into  
18 protecting the legal privilege.

19           And I agree, Grant, that none of us think that  
20 there should be something that's significant that the  
21 audit committee doesn't know. Much of the theology of  
22 our standards has been based on the fact that audit

1 committees should know about material witnesses and  
2 things.

3           Written reports, though, and other issues leads  
4 you into the areas which I would think that Michael  
5 Young would be the most concerned with, which is what is  
6 the exposure of third-party litigants and the  
7 discoverability of these.

8           I don't think there's a written, there's not an  
9 easy, current solution to that. And whatever the  
10 Supreme Court may have said in Arthur Young, I think we  
11 would have to take account of how courts have  
12 interpreted and moved away from what may have seemed  
13 bright-line issues at one time.

14           And I think that there are people in the room,  
15 including our distinguished interlocutor, Lynn, who  
16 would believe that probably there shouldn't be, that  
17 what the report says or delivers up by way of detected  
18 illegal acts should be available to litigants and the  
19 public, because here's the Rubicon that you bring it up  
20 to.

21           Where the process cuts off under 10A is that 10A  
22 and the SEC rules still, and the rules of professional

1 practice still permit the auditor to form a judgment as  
2 to whether or not there has been an adequate response to  
3 an illegal act.

4           And if that adequate response is current, it need  
5 not lead to public disclosure. It may lead to something  
6 other than public disclosure.

7           And I recognize that's a problem. But it seems  
8 to me that's why it's there. You've got to go back to  
9 the historiography of this. That's why 10A takes that  
10 turn. It's because of private civil litigation.

11           And what happens if that legal, if there's a  
12 written report and documentation raises this issue to  
13 the extent you've documented illegal acts, where's the  
14 privilege of that? Well, it is privileged. If it's a  
15 documentation that the, that counsel creates, that  
16 counsel can manage, that can be managed.

17           It can't be, though, that any report that goes to  
18 the audit committee is going to enjoy that privilege  
19 under the law that we now have. And maybe this is  
20 illegal.

21           Some of our reports have a clear standard in the  
22 protection, a statutory standard that protects them from



1 being subpoenaed and used in private civil litigation.

2           And maybe that is what would have to happen to  
3 fundamentally change the 10A channel, the flow of that  
4 channel, and divert some of that information to the  
5 audit committee instead of confining it to legal  
6 channels and a satisfactory response that essentially  
7 invokes, it gives the auditor the out that worries some  
8 of you here.

9           A difficult problem, but I think that is the  
10 problem with getting to a new standard under NOCLAR.  
11 And that's going to be the most, one of the most  
12 challenging.

13           MR. HARRIS:     Well, you mentioned that the  
14 whistleblower was low-hanging fruit.   So, in terms of  
15 getting a standard, I'm a big believer in low-hanging  
16 fruit.   So maybe this is one that could be taken up  
17 fairly rapidly and get done.

18           (Off-microphone comments.)

19           MR. HARRIS:   Well, no, but it seems to be self-  
20 evident.   But, Jeanette Franzel.

21           MS. FRANZEL:   Thanks, Steve.   Yes, I agree that  
22 this standard is outdated, and we need to take a very

1 hard look at it. There are a lot of different  
2 directions this could go. And it gets very complicated.

3 I do want to compliment the team on its  
4 recommendations. And the recommendation that we require  
5 the auditor to assess the risk of illegal acts, you  
6 know, I think that the auditors could really leverage  
7 some of the testing already happening in ICFR, so  
8 control environment, tone at the top, incentives that  
9 don't make sense. You know, that's all part of what  
10 auditors should be looking at in terms of control  
11 environment and tone at the top.

12 Interestingly, we don't see many weaknesses,  
13 material weaknesses with control environment or tone at  
14 the top until or unless there has been a big major  
15 blowup. And so I think this would also help focus  
16 auditors in this area, which is so important.

17 And so I think we could really leverage some of  
18 the work that's already happening on an audit and maybe  
19 even focus the auditors more in this risk assessment.

20 And then referring back to the GAO requirements,  
21 it's interesting, because GAO also has a term that it  
22 uses as abuse that it pulls into illegal acts, fraud,

1 and abuse.

2           And the reason that term is used is because you  
3 might not know if an act is illegal or fraud. But you  
4 might see something that appears improper. And so that  
5 would fall under that type of category. And the auditor  
6 has responsibilities there.

7           And there is actually an affirmative requirement  
8 in the GAO standards for auditors to test compliance  
9 with selected provisions of laws and regulations.

10           It would probably look different in a public  
11 company. And we'd have to evaluate that, because I do  
12 recall that on some of our very large agency audits, you  
13 know, we could meet the requirements by testing about a  
14 dozen laws and regulations. You know, when an agency's  
15 purpose is to pump money out, you know, it's an easier,  
16 I think in some cases it's easier to do that level of  
17 testing.

18           But I tell you that that testing really focuses  
19 the auditor, even though we were putting out negative  
20 assurance reports on compliance. When you're putting  
21 out a report, it really does focus the auditors.

22           So I want to compliment the team on this. This

1 is a difficult area. But I think we really do need to  
2 do something here.

3 MR. HARRIS: Linda, before recognizing you, let  
4 me recognize the chief auditor, because I think that  
5 given the situation in South Africa, I've got a question  
6 that just might lead to a fairly long answer. Marty.

7 MR. BAUMANN: Thank you very much, Steve. And  
8 thanks for this group task force and the entire IAG for  
9 the recommendations here.

10 As was mentioned, we have a project on this. And  
11 getting your input and advice is very, very useful to us  
12 as we think through solutions and the challenges.

13 I do have a question, and just wondering about on  
14 slide 14 where you say investors expect auditors to  
15 uncover non-compliance with laws and regulations. I'd  
16 like to know where, how far you think that line really  
17 goes.

18 And, I mean, even the new International Standard  
19 has the following sentence. The auditor cannot be  
20 expected to detect non-compliance with all the laws and  
21 regulations. So the International Standard really  
22 hasn't gone very far in this regard in terms of meeting

1 that expectation.

2           So just wondering if anybody wants to comment on  
3 that. I mean, there are -- I hate to talk about  
4 situations. But let's just say a company violated some  
5 emissions, testing requirements and tampered with their  
6 equipment such that they could get around some  
7 environmental laws. And that could cost that company a  
8 lot of money, so that type of a situation or pollution  
9 or whatever else.

10           There are inquiry type procedures that one can  
11 perform about what are your compliance procedures in the  
12 company to comply with laws and regulations. But that  
13 probably wouldn't get at that.

14           How much, have you thought about how much work  
15 you really want auditors to do to really detect those  
16 kinds of violations of laws that could result from,  
17 could result in large dollars that are really completely  
18 outside of financial accounting, reporting, financial  
19 statement matters, deal with the operations of the  
20 company?

21           And interested in your views as to how far you  
22 think our standard could go in requiring auditors to

1 perform procedures in that regard.

2 MR. TAROLA: I wrote that, if I could respond.

3 PARTICIPANT: Sure, very interested.

4 MR. TAROLA: The issue, as I see it, is where  
5 information is withheld from auditors under the context  
6 of not direct or not material. So let's take your  
7 example of an environmental, you know, fraud or a data  
8 breach. And we can think of others.

9 In my view, if executive management knows about  
10 it, then the auditors should be made aware of it and  
11 then either together or with the audit committee or  
12 general counsel decide whether or not anything should be  
13 done, said, accounted for relative to it.

14 But it's untenable if executive management knows  
15 of an event that could develop into a problem and the  
16 auditors weren't even told because the direct and  
17 material excuse was available to management.

18 MR. HARRIS: Linda de Beer.

19 MS. de BEER: Maybe just, and I agree with that,  
20 but maybe just a little bit of insight, Marty, on your  
21 question on the discussion that we had as well.

22 And I think there are two specific elements. And

1 the one that you're alluding to is more in an instance  
2 where it's not so directly linked to the accuracy of the  
3 financial statements, like an environmental piece of  
4 legislation, even though I think ultimately just about  
5 every non-compliance issue ultimately will have some or  
6 other financial penalty it would affect.

7           But we did have the discussion that there are  
8 certain aspects where, certainly if the auditors stumble  
9 across a non-compliance issue because they've been  
10 informed by management whether, even if it doesn't  
11 affect the financial statements, they should have a duty  
12 to report it to the audit committee. That's the one  
13 that they literally just, you know, find out about it by  
14 accident. And that's the one element.

15           The other element, which is I think also what we  
16 were trying to point out here, and I think the  
17 difficulty is where does that line, where should that  
18 line be drawn is in the risk assessment on the risk of  
19 material misstatement of the financial statements and  
20 the auditor determining that risk and determining the  
21 risk of fraud or other irregularities.

22           What we're saying is it's probably necessary to

1 relook what those indicators are and how much audit  
2 effort should go into that, because maybe at the moment  
3 that effort is too low and maybe it should be elevated.

4           And let me, if I may, just draw it back to the  
5 situation that we have in South Africa at the moment  
6 with our auditing profession and the specific issue  
7 around a firm.

8           There is, you spoke about it a couple of times  
9 really today, Jeanette. There is a massive expectation  
10 gap. I think it's probably a cliff by now.

11           But there is this massive expectation gap from  
12 the, not just the public at large, but fairly  
13 sophisticated business people, that they do believe that  
14 there is a duty, a public interest duty bestowed upon  
15 auditors to identify and to expose instances of fraud or  
16 other non-compliance with laws, some of the things that  
17 we're looking at in the South African scenario or around  
18 money laundering and reporting on all sorts of things  
19 like that.

20           So it's a very hard line to draw. And I'm glad  
21 it's going to be you and your team that have to do it  
22 and not me.



1           But I think it is important that that line should  
2 potentially be shifted and that the net should be cast  
3 a little bit wider, because ultimately what I've now  
4 seen happen in South Africa, and that's my perception or  
5 my perspective of it, is that the credibility of  
6 auditors can very easily be tainted if something seems  
7 obvious to people out there. You know, there's this  
8 massive fraud, and why didn't the auditors pick it up.

9           So maybe the work effort should be expanded. To  
10 how far, we'll leave up to you.

11           MR. HARRIS: Thank you. Mike Smart.

12           MR. SMART: You know, I'm trying to determine and  
13 better understand how far the auditor's responsibility  
14 goes, because, you know, I think some of the cases that  
15 were brought up, I think they were very good examples.  
16 But I think that times have changed somewhat.

17           I know in the audit committees or at least one of  
18 the audit committees that I sit on, as it relates to  
19 whistleblowers, there's a free rein in terms of the  
20 auditor's ability to go through the whistleblower's  
21 reports.

22           There is a set process already in place that

1 management has established that the CEO and CFO are  
2 effectively removed from. And the whistleblower sort of  
3 reports up to the audit committee. But the auditors  
4 have sort of free range as to what has transpired, if  
5 anything. That's one.

6 Two, in the instance where just by chance there  
7 is an incident, there is an issue, there is a challenge,  
8 and the auditors bring it to the audit committee, they  
9 bring it to management. And now who makes the  
10 determination as to how important is this issue? How  
11 material is this issue?

12 Management may feel that, well, from our  
13 perspective in running the business and knowing our  
14 competitors, this may not be as relevant as you think it  
15 is. The auditors, they may have a different  
16 perspective.

17 So how do you solve for that equation? And where  
18 do the auditors go in a situation like that? So it's  
19 more of an example of a situation and a question.

20 MR. HARRIS: Yes, and I'd like you both to  
21 address the issue of this expectation gap, which is nine  
22 years later remains. And the question is where were the

1 auditors. I mean, in my career, I was front and center  
2 during the S&L debacle, during Sarbanes-Oxley, and then  
3 2007, 2008.

4 And the question is where were the auditors and  
5 what is the auditor's responsibility. And what, Linda,  
6 do you view the auditor's responsibility in a real-life  
7 example now?

8 And if these recommendations were put into place,  
9 should they have been aware of? And how do you narrow  
10 this gap?

11 MS. de BEER: Maybe a couple of comments. I'm  
12 working on this book on the future of the auditing  
13 profession. And it's very interesting to learn that if  
14 you look at why auditors were established, the audit  
15 function was established initially by the merchants of  
16 Venice was to detect fraud.

17 So it seems as we almost have gone full circle.  
18 And there's a very strong detection of fraud expectation  
19 again.

20 So, Jim, and I think you're not going to feel  
21 much more comfortable if I tell you, and I think that's  
22 responding to maybe your comment as well, Mike, that in

1 South Africa we actually have legislation on reportable  
2 irregularities.

3           It's written within our auditing act, that  
4 requires auditors to, when they identify instances of  
5 non-compliance with laws that, and that's linked to your  
6 question, and there's a --- measurement criteria around  
7 it that would knowingly cause financial loss to the  
8 company or to anybody else, in other words, a creditor  
9 or shareholder or somebody like that, then they have a  
10 duty to report it to the audit committee practically.

11           And it links to the question or the comment that  
12 Chairman Doty made earlier on, then if it's resolved and  
13 they're comfortable of the 30 days that it was  
14 appropriately dealt with and the risk of that loss has  
15 been circumvented, then they don't have to do anything  
16 further.

17           But if not, they have a duty to report it to the  
18 audit regulator. And the audit regulator, depending on  
19 the issue, will then report it further, for example, to  
20 the tax authorities or to the stock exchange, depending  
21 on what it is.

22           Some of those reports or those reporting aspects

1 are very administrative around tax, late submission of  
2 tax returns and so on, which obviously not, it won't  
3 necessarily cause any material loss. But some of them  
4 are really significant issues.

5           So will these rules necessarily avoid instances  
6 like we now have in South Africa? Clearly not, because  
7 we have that legislation.

8           But I think a lot of it links back to the comment  
9 also that Jeanette made earlier on around risk  
10 assessment.

11           And by their own admission, the firm that's  
12 experiencing all these difficult issues in South Africa  
13 at the moment said that in hindsight they didn't  
14 appropriately assess risk. They didn't appropriately  
15 assess the risk of fraud, the risk of client onboarding,  
16 and the reputation of the specific group of companies,  
17 and so on.

18           So I think strengthening the requirements, and  
19 there was a point that Grant pointed out earlier on, I  
20 think it was Grant if I recall, about giving a list of  
21 some examples at least, just making it a lot more  
22 practical would hopefully assist auditors in really just

1 applying their mind a bit more thoughtfully around these  
2 aspects.

3 I don't think any rule will necessarily always  
4 prevent anything from going wrong. But there certainly  
5 is, in my view, a need to strengthen it.

6 MR. HARRIS: Norman Harrison.

7 MR. HARRISON: Thank you, Steve. I'd second  
8 that. And then to get back also to Marty's question,  
9 I'm always reluctant to weigh in on these technical  
10 questions around audit process since I'm one of the  
11 members of this group who's not a CPA and has never been  
12 an auditor. So take that as a disclaimer.

13 But I think it's not an answer per se to your  
14 question, Marty, but I think just for reference or in  
15 terms of thinking of a framework with which to approach  
16 that question of where do you draw the line or where do  
17 you establish some boundaries or definitional framework  
18 around the duty to be on the lookout for misconduct or  
19 other forms of wrongdoing is to bear in mind that I  
20 think a properly planned audit, financial statement  
21 audit, and a properly planned review of internal  
22 controls should itself be a risk-based exercise.

1           The auditors should know those areas of the  
2 issuer's operations where there is the greatest  
3 potential for, whether it be due to the nature of the  
4 industry, if it's the pharmaceutical industry where a  
5 large proportion of the sales volume occurs in face-to-  
6 face interactions where there is pressures for off-label  
7 sales of pharmaceutical products and there's a key risk  
8 area in terms of revenues, whether it's, you know, to go  
9 back to a WorldCom type situation, a business that  
10 builds out network and infrastructure and is capital-  
11 intensive and there may then be some gray areas. Not  
12 that WorldCom is a gray area, but there may be some gray  
13 areas around which types of expenses are capitalized,  
14 which should be expensed in the current period.

15           There are aspects of the issuer's operations that  
16 give rise to uncertainties, risks around how results are  
17 recorded. And I think that that should at least be a  
18 starting point for an assessment or a development of  
19 procedures around potential misconduct or fraud, because  
20 it is, of course, it is itself a risk-based inquiry.

21           So I think that it's, what maybe you should think  
22 in terms of is building on what should already be good

1 practices or best practices in audit firms around the  
2 work they already do.

3 MR. HARRIS: Chairman.

4 MR. DOTY: What I find really interesting around  
5 the analysis that's come out is that I don't think I'm  
6 hearing from the investors the notion that as investors  
7 you think you need to know all of the illegal acts.

8 What you seem to be seeking is the assurance that  
9 you can have confidence in the audit because the auditor  
10 has scoped, has assessed risk, and has had a reasonable  
11 chance of finding all of the illegal acts and has  
12 brought them to the attention of the audit committee and  
13 made the audit committee focus on these without regard  
14 to artificial standards of financial materiality.

15 That I get. And I find that quite thoughtful,  
16 because it seems to me it leaves hanging -- it does  
17 partly answer Marty's question. How much do you want  
18 the auditor to do? Do you want the auditor to scope in  
19 areas of jurisdictions or in areas where, corrupt  
20 jurisdictions or places where there are compensation  
21 incentives that are unusual?

22 You want the scope to pick that up, to grind that



1 auditor down below the artificial materiality thresholds  
2 of financial reporting.

3           But then it does leave hanging this fundamental  
4 question of, when the auditor brings it to the audit  
5 committee, audit committees being we are told of  
6 differing levels of energy and expertise, and the audit  
7 committee is then sitting there possibly with the  
8 chairman and they're dealing with the auditor, you have  
9 the moral hazard still of whether there will be an  
10 adequate response under the rules that we all operate  
11 under, whether there will be a credible, adequate  
12 response to the illegalities that are found or whether  
13 there will be a compromise that is not in the interest  
14 of a company.

15           That I suggest, ladies and gentlemen, is very  
16 hard to resolve. I'm not sure you can resolve it. But  
17 what you've done in this discussion I think is focus on  
18 the fact that what you need, what we need to do as a  
19 regime is to be sure that the auditor is not using  
20 blinders that enable them not to look at certain areas  
21 and then not following the leads that may exist.

22           I may have misinterpreted you. But I think it's

1 a much more disciplined approach. It does not solve the  
2 issue of the weak auditor or the weak audit committee.

3 MR. HARRIS: Yes. Linda de Beer.

4 MS. de BEER: I think that's where the South  
5 African legislation actually comes in handy, because as  
6 an audit committee member, if I get into the situation  
7 where I now need to assess this and decide is it serious  
8 enough, do we need to do something or not, the fact that  
9 I know that if this is not resolved to the satisfaction  
10 of the auditor, he's going to report it to the audit  
11 regulator in 50 days, it sort of focuses the mind.

12 We have another requirement as part of our stock  
13 exchange rules that, by the time a company reports its  
14 results and there's an outstanding reportable  
15 irregularity, the auditor needs to flag it in its audit  
16 report.

17 So it doesn't give the detail at all. It just  
18 flags that there's a reportable irregularity that hasn't  
19 been resolved. And it gets annotated on the board of  
20 the stock exchange. So there's immediately a little  
21 yellow flag for it. And they might not know the detail,  
22 but they know there's some other issue.

1           And that solves a lot of problems, because no  
2 audit committee can afford to get the company into that  
3 situation.

4           MR. HARRIS: Grant, do you have -- your light's  
5 on. I'm just wondering.

6           MR. CALLERY: Oh, no, I was just thinking about,  
7 you know, this drawing the -- I mean, as a practical  
8 matter, you can't let the perfect get in the way of the  
9 good.

10           And you're never going to -- I mean, if you got  
11 a real bad guy somewhere in the mix and they're willing  
12 to lie and they're willing to, you know, falsify  
13 documents and things like that, you can't get there.

14           So you have to -- and you have to do some degree  
15 of cost benefit analysis because, you know, an audit --  
16 actually, maybe this would make audits a bit more  
17 profitable than the consulting part of the firm if they  
18 have to uncover everything.

19           But, you know, so I think you have to strike a  
20 balance along the lines of what Jim was saying, because  
21 you just can't say, you know, every, you have to turn  
22 every stone. And, but we can make progress without

1 going that far.

2 MR. DOTY: And there's a point that comes out of  
3 Bob Tarola's last bullet on 14. And he says the  
4 standard must make it impossible for a situation known  
5 to management to exist and not be disclosed to the  
6 auditors.

7 I agree. That is extremely troubling. It's  
8 outside the area of audit standards. But what you're  
9 doing, Bob, is challenging the current interpretation of  
10 the law of aiding and abetting. I mean, you're  
11 suggesting that the law of aiding and abetting does  
12 facilitate something which is corrosive of auditing  
13 standards.

14 MR. TAROLA: Yes, if I may, Chairman Doty, let me  
15 just give you a type of decision tree. And then I'll  
16 use an environmental fraud as an example.

17 That might have taken place some level down in  
18 the organization and didn't get up to executive  
19 management. And I consider executive management anyone  
20 with a C-suite title, so even general counsel. It  
21 doesn't get up there until much farther into, in time.

22 Is the auditor required to find that? I would

1 say no. On the other hand, if executive management is  
2 made aware of it, is the auditor required to be told and  
3 assess? I would say yes.

4 So, to me, it's more of a requirement of candid  
5 communication between auditors and executive  
6 managements. And right now some of the rules get in the  
7 way of that.

8 So, for instance, I was telling Jeanette last  
9 night the representation letter gets in the way of that  
10 because it allows managements to say to auditors we've  
11 told you everything that could be direct and material.  
12 We didn't tell you everything that might in the future  
13 be material. But we told you everything that is now  
14 direct and material. And I think that's a gap that,  
15 Steve, that's a gap that can be narrowed.

16 MR. HARRIS: Lynn, is your tent card up? Or I  
17 got one. Well, all right, go ahead.

18 MR. TURNER: Responding to Marty's comment and  
19 then coming back to Jim.

20 Marty, on Wells Fargo, the software that they  
21 were using they received in 2007 and from Baushen were  
22 told don't use it illegally. So someone in the company

1 was aware of it. That's not -- unless it was at the  
2 top, that's not necessarily something that I would  
3 expect the auditors to find.

4           But by the time we got to 2014, there had been  
5 testing performed by the EPA. And the EPA was going  
6 back to management and saying you got problems with your  
7 missions. And it wasn't just the EPA. The State of  
8 California was also having similar findings. And if I  
9 recall right, the State of California was even well  
10 ahead of the EPA on the matter.

11           Once a regulatory agency reaches out to the  
12 company in that manner, then that company should have  
13 controls in place to ensure that that gets feds up to  
14 the top, to Bob's point. And at that point in time, the  
15 auditor should be aware.

16           The auditor should have tested the controls, to  
17 Jeanette's point. This, what's in the Yellow Book, you  
18 got to test controls over that process. Whereas, now  
19 they just kind of like beg off.

20           But that information came out a year before. In  
21 September of 2015, Volkswagen never fessed up.

22           So, when I look at the different cases, there's

1 information out there that, if auditors had have been  
2 testing and focused on it -- you know, you look back to  
3 the Lehman and the Repo 103 or 105, whatever it was,  
4 transactions, there was a whistleblower.

5           The E&Y partner interviewed the whistleblower.  
6 Fifteen minutes before the partner interviewed the  
7 whistleblower, he sent an email to a fellow partner  
8 saying, hey look, nothing's going to come out of this,  
9 let's just move ahead, even before he interviewed the  
10 guy.

11           I mean, that's outrageous. I mean, why even do  
12 the interview if you already made up your mind?

13           And in the case of Wells, the auditors -- you  
14 know, I've been told by congressional people that the  
15 OCC was in three years before it became public. The  
16 auditors had said they were aware of it. The  
17 investigation reported the audit committee, though, says  
18 no one told them.

19           And this, Jim, is why there does have to be a  
20 negative assurance report. I disagree with you strongly  
21 about this notion of let's hide this stuff from the  
22 investors.

1           And I don't buy into the privilege notion  
2 whatsoever, because in Wells if the auditor had have  
3 known that, they would have had to report it to the  
4 audit committee. And in cases like Wells and Lehman,  
5 the audit committee is left in the blind.

6           And the only way you get to that is you ensure in  
7 the standard that there's adequate documentation  
8 requirements, which are now in the GAO and the federal  
9 auditing, or, I mean, the International Auditing and  
10 International Ethics Standards. Both of those have the  
11 documentation requirement. The GAO has the negative  
12 assurance. And it's negative assurance for a reason, a  
13 good reason.

14           But when you get back to you said you tried to  
15 characterize what investors are looking for, I think  
16 you're wrong. Investors time and time again say the  
17 same thing. Where were the auditors? They don't say  
18 where were the auditors because it was okay, just tell  
19 the audit committee and don't put it in writing.

20           They say that because it blows up, and then  
21 people look back in hindsight and say what the heck were  
22 you guys doing and what the heck did you know. And out



1 comes KPMG, and they knew all about it.

2           It needs to be a negative assurance. And if  
3 there's litigation, let there be litigation. Litigation  
4 is for justice in this country, not to try to hide  
5 things from the people who own the business.

6           MR. HARRIS: So, Lynn, there's an awful lot of  
7 subjectivity here. And in terms of the recommendation  
8 or should have been aware of, what you should have been  
9 aware of is probably quite different from what another  
10 auditor should be aware of. How do you write a standard  
11 dealing with clarifying what should be aware of?

12           MR. TURNER: The way the GAO did.

13           MR. HARRIS: Jeanette, the ball's in your lap.

14           (Laughter.)

15           MR. HARRIS: All right. Well, I think this has  
16 been an excellent discussion. I don't see any more tent  
17 cards up. Well, I do. But --

18           (Laughter.)

19           MR. HARRIS: I always give the Chairman the last  
20 word with respect to any confrontation or difference of  
21 opinion between Lynn Turner and Jim Doty.

22           (Simultaneous speaking.)

1           MR. TURNER: We'll settle this over a fishing  
2 trip and a boat.

3           MR. DOTY: No, what I said is I didn't think that  
4 the investors that I was hearing, we were hearing from  
5 today wanted to know all of the illegal acts. They  
6 didn't want to know what the auditors may have seen by  
7 way of illegal acts so long as they have some reasonable  
8 confidence that the auditors had seen to it that the  
9 audit committee knew about those acts and that there had  
10 been an appropriate response under the rules of those  
11 illegal acts.

12           That is very different from the audit, from a  
13 public, an investing public that is dismayed when an  
14 audit comes in and then there is something which could  
15 have been covered by a negative assurance and which  
16 disappoints them.

17           A negative assurance question is a, that's a very  
18 different question. But I can write a negative  
19 assurance clause that I think a lot of auditors ought to  
20 be able to give. Would they do it? I don't know. But  
21 negative assurances could cover a multitude of sins if  
22 they are appropriately done.

1 MR. TURNER: Yes, I drafted the first draft of  
2 Section 10A and what then eventually went into Markey's  
3 bill. I was in the chief accountant's office at PAF  
4 when we didn't have a chief accountant or deputy at the  
5 time.

6 So myself and Bob Burns, who you all know well,  
7 went up and met with Jack Dingell's staff and Consuela  
8 and the crew, Wyden and Ed Markey's staff, who  
9 eventually put it into law.

10 And I think your characterization is right at the  
11 time as far as, okay, we'll have the auditors do  
12 whatever in accordance with the standards, and then if  
13 things get fixed, things get fixed and no need to  
14 report.

15 But what we found then was all too often, and  
16 Dingell later on asked the GAO to follow up on this in  
17 a separate report, what we found all too often -- not  
18 all the cases. In some of those cases that's exactly  
19 what happened.

20 But we also found cases where, when things  
21 started to get bad and dicey and it looked like there  
22 was an illegal act, the auditor, rather than report

1 that, would just resign. And then there was never any  
2 reporting and who know, no one knew then if it got fixed  
3 or not.

4 So that was a, that's a huge hole in Section 10A.  
5 So I think the way we all designed it, the way we all  
6 drafted it, it worked. It was good on a piece of paper.  
7 But in practice, it fell short.

8 And unless you have the documentation  
9 requirements of the International Standard and the  
10 reporting requirement of the GAO, you will not fix this  
11 problem. And you'll still have people back at this  
12 table in ten years saying where were the auditors.

13 MR. HARRIS: I give you the last word, Mr.  
14 Chairman.

15 MR. DOTY: This has led to a discussion that I  
16 think is fascinating. I go back to Bob's chart. I  
17 mean, I think you do have, you've identified a situation  
18 in which aiding and abetting theory now in practice does  
19 shield someone in the C-suite who knows something and  
20 doesn't disclose. That's a big issue. It's a  
21 legislative one, but it's a big issue.

22 You've advanced the argument here to the question

1 of what do you do about the fact that we only have, we  
2 don't have noisy withdrawal. We have not mandated noisy  
3 withdrawal, big issue at the time of, that you and I  
4 remember in the '90s.

5           And you're suggesting, though, by your comments,  
6 which I think is an interesting one, that we have passed  
7 the time in which noisy withdrawal is sufficient.

8           And I think that's a very interesting issue that  
9 you posed, when, in other words, if we had a requirement  
10 of noisy withdrawal and not just permissive withdrawal,  
11 noisy withdrawal and something more than the 8-K  
12 process, would that be enough. And you're suggesting  
13 you think not. And I think this is a big issue, a very  
14 difficult one.

15           MR. HARRIS: Well, to conclude this session, Mary  
16 and Grant, I think you've put an issue on the table, and  
17 I think that Marty and his team and the board, given the  
18 comments at the table, will be taking this up. I think  
19 the whistleblower is clearly low-hanging fruit.

20           From my perspective, there wasn't a single  
21 auditor. There was one auditor in the senate when  
22 Sarbanes-Oxley was passed. And so I think there's the

1 front page test. And laws have been broken. And the  
2 auditors were not present in terms of transparency and  
3 being held accountable.

4 I think there's a tremendous expectation gap.  
5 And I think that work has to be done in this area. And  
6 whether a must criteria is doable or not I think  
7 considerably more work has to be done.

8 And so I very much appreciate the specific  
9 recommendations of this particular session, which gets  
10 to something which is very doable within the  
11 jurisdiction, clear-cut jurisdiction of the PCAOB.

12 So thank all of you who were involved. Marty,  
13 thank you for the work that you've done already and  
14 hopefully will continue to do.

15 And why don't we take a 15-minute break and  
16 reconvene at quarter of three?

17 (Whereupon, the above-entitled matter went off  
18 the record at 2:27 p.m. and resumed at 2:44 p.m.)

19 MR. HARRIS: All right. Well, the last session  
20 deals with the subject of audit quality initiatives.  
21 And the choice of the word initiatives was deliberate so  
22 that we did not necessarily want to focus completely on

1 audit quality indicators. We wanted to focus not only  
2 on audit quality indicators, but in terms of  
3 initiatives, any other areas that the working group  
4 would like to bring up.

5           So, having said that, Norman, if you'd like to  
6 start off the conversation, we'd appreciate it.

7           MR. HARRISON: Okay. Thank you, Steve. It's my  
8 pleasure. It's always tough being last, especially on  
9 a day like today when the two panels that proceeded us  
10 did such a great job with their material, their  
11 presentation, and the ensuing discussions. I hope we'll  
12 be able to do the same.

13           First, I want to recognize the other members of  
14 our group. Lynn was our co-lead, Linda, Anne, Gary, who  
15 are here. Parveen, unfortunately, who couldn't be with  
16 us today, was also a member of our group. And as the  
17 others have indicated, this too was very much a  
18 collaborative effort. And the front tents are those of  
19 the group as a whole, not only of those of us who are  
20 presenting.

21           Lynn and I are going to toggle back and forth  
22 over the course of the presentation. So I'll just give

1 you a quick overview of where we're going to go over the  
2 next 30 or 45 minutes or so.

3 I mentioned in my overview comments when Chairman  
4 Clayton was here this morning that there was a theme or  
5 a principle underlying our message today, and that is  
6 that you manage what you measure or you regulate, assess  
7 what you measure.

8 And we believe that audit quality indicators, as  
9 concrete measures, but the broader category of audit  
10 quality initiatives provides an opportunity for the  
11 board to gather, collect, and analyze information in a  
12 variety of forms that we all strongly believe would  
13 enable you to better discharge your obligation to  
14 protect and ensure high quality audits.

15 So we're going to take it in a few steps today  
16 beginning with articulation of some principles, some  
17 foundational principles about why this topic matters to  
18 investors.

19 We'll take then a little bit of a look down  
20 memory lane and, you know, revisit where the origins of  
21 this topic rest and the work that the board and the  
22 staff have done to date.



1           We'll then turn to take a look at what regulators  
2 and other market participants, standard setters in other  
3 jurisdictions have been doing of late on the topic of  
4 audit quality.

5           We're then going to take a look back. As I  
6 mentioned this morning, this topic was on the agenda at  
7 our 2013 IAG meeting. And in fact, several of us who  
8 are here today, including myself and Lynn, along with  
9 Tony, who was the chair of the working group that year,  
10 and Mike and Gary were on that working group.

11           This year's working group would like to summarize  
12 for you some of the highlights or key points of the  
13 material recovered and the recommendations we made in  
14 2013 and really embrace them and re-advance them, if you  
15 will, because we think they're of continuing relevance  
16 today.

17           And then we'll finish with some additional or  
18 specific recommendations from this year's working group  
19 and as you indicated, Steve, not only on audit quality  
20 indicators but more broadly on the topic of other  
21 initiatives that we believe the PCAOB should consider in  
22 the interest of advancing audit quality.

1           So, first point, and again, this probably could  
2 have been a ten-page portion of our presentation. But  
3 we wanted to at least highlight a few key issues or  
4 areas where, why we believe that this topic is of  
5 substantial importance.

6           You know, as I briefly described this morning,  
7 you know, it's important we all remember in this context  
8 that the process of interviewing, qualifying, proposing,  
9 re-proposing an auditor in the public company context is  
10 really the most important or one of the most important  
11 duties an audit committee discharges and is actually,  
12 perhaps, the most or one of the most important decisions  
13 with respect to which shareholders are invited to  
14 exercise their franchise.

15           And it should be much more than a formulaic or a  
16 rubber stamp process. It should be an election, a  
17 decision that's governed by a variety of helpful and  
18 relevant information on the quality of the auditor to do  
19 the job.

20           And we strongly believe that the development of  
21 audit quality indicators, at the least, would add  
22 considerable value to the flow or the repository of

1 information that's available to better inform that  
2 decision, not only with respect to the quality and  
3 capability of the firm as a whole or the firm with  
4 respect to the industry in which the issuer is in, but  
5 indicators that relate specifically to audit level  
6 indicators for that company as well as for others that  
7 we think investors should have access to as they make  
8 this decision every year.

9           Audit quality indicators can also serve as red  
10 flags.     If they're monitored, as Sarbanes-Oxley  
11 recommended, that the PCAOB track and monitor them year  
12 to year, you could well envision situations in which  
13 trends develop which might indicate issues around the  
14 capacity or resources available to particular audit  
15 firms or an audit firm's competence in a particular  
16 industry or subject matter that might better inform the  
17 board's investigation review processes, as well as  
18 provide information to investors again.

19           And in that and other ways, we believe that the  
20 publication and tracking of audit quality indicators  
21 could be an important complement to what we know is the  
22 terrific job you do in monitoring and inspecting audit

1 firms.

2           It's a big job. Resources are limited. Time is  
3 limited. I'm sure that there is a lot more you would do  
4 and could do if you had, if resources were unlimited.

5           This could be, completing your work on this  
6 initiative we believe could provide additional  
7 information to better inform your inspection processes  
8 and provide additional pools of information that relate  
9 to the sufficiency and the fitness of audit firms to do  
10 their work.

11           We'll point out also there is -- I'll let  
12 everyone know if you haven't seen it already. We've  
13 provided an appendix to our, to the presentation that  
14 we'll review this afternoon that provides summaries of  
15 the published results of PCAOB inspection reports from  
16 the 2012 to 2015 period, 2015 year being the most recent  
17 year of which data was available.

18           And I think those, you'll see in those tables and  
19 in the summaries that have been prepared that, you know,  
20 there's reason for a concern about audit quality. And  
21 I'm not telling you anything you don't already know.

22           I mean, there are regularly deficiency rates from

1 the high 20s to the high 30 percents on an annual basis,  
2 one Big Four firm in recent years with a deficiency rate  
3 of 54 percent, another one nearing 50 percent in two of  
4 the four years that are captured here. Firms in the  
5 next tier or category of firms have in some years in  
6 some cases deficiency rates that are even higher.

7           So I don't think it's an arguable proposition  
8 that there's room for improvement. And this is an area  
9 that's very much deserving of the board's and the  
10 staff's attention.

11           We'll note also that, you know, that audit, the  
12 quality or the outcome or the output of an audit is to  
13 a large degree dependent on the professionalism and the  
14 attitude of professional skepticism with which it is  
15 approached.

16           And, you know, we certainly acknowledge that the  
17 topic or the concept of professional skepticism has been  
18 the subject of many efforts and initiatives over many  
19 decades including PCAOB's own standards and your 2012  
20 practice alert on this issue.

21           But, you know, the results of your inspection  
22 regimen and other measures of audit quality do not seem

1 to indicate that continuing focus or education or  
2 guidance on professional skepticism will itself without  
3 more will likely have an impact on improving audit  
4 quality in any meaningful respect.

5           We also want to note, and we'll get back to this  
6 later, that it is, it's been nine years since the  
7 Paulson Commission report was published with some fairly  
8 specific guidance on the process around this topic. And  
9 yet we're still not at the finish line.

10           And I think one of the fundamental points or the  
11 core messages of our group today is we would strongly  
12 urge the board to move with dispatch to complete your  
13 work in this area. It's time.

14           And I also want just to make note of the fact  
15 that, you know, we've seen, in fact, in 2013 when we,  
16 when our working group discussed this topic, the point  
17 was raised, including by one of your former colleagues  
18 who's no longer on the board, that there is other  
19 information in the public domain that the firms  
20 themselves voluntarily publish annual reports on audit  
21 quality in various forms.

22           And they describe measures that they are taking

1 to provide additional education and training and  
2 resources to support their audit practices. And those  
3 also often usually contain certain measures of audit  
4 quality, AQIs, that the firms report or track over time.

5 I don't think any of us would dispute the fact  
6 that any information that's in the public domain about  
7 steps firms are taking or the results of their audit  
8 processes are not important.

9 But I think we're all very much of the view that  
10 these types of voluntary reports, which often have more  
11 of a promotional aspect to them than simply a data  
12 reporting aspect, that they're not an adequate  
13 substitute for a uniform set of indicators with  
14 definitional uniformity, directed reporting  
15 requirements, and the ability of the board to track and  
16 measure them.

17 So with that by way of introduction, just a few  
18 points on background, again, just a reminder that the  
19 mandate to consider and develop measures to improve  
20 audit quality traces back, of course, to Sarbanes-Oxley.  
21 As I discussed this morning in the brief introduction  
22 for Chairman Clayton, it's the reason we're all here.

1 It's the reason the board is here.

2           Everything you do, everything in your mission,  
3 everything you do across your various areas of oversight  
4 and guidance and standard setting, all of your  
5 activities are in one way or another done with, to  
6 fulfill your mandate to improve audit quality.

7           And I think the working group members, you know,  
8 formally believe that, by not yet having taken final  
9 action on audit quality indicators, you're depriving  
10 yourselves of potentially valuable information to  
11 further fulfill your, or enable you to fulfill your  
12 duties.

13           As a reminder, this is really the genesis of the  
14 audit quality initiative concept. The excerpts from the  
15 Paulson Commission report took the form of a  
16 recommendation to the PCAOB in consultation with various  
17 constituencies to determine the feasibility of  
18 developing key indicators of audit quality and  
19 effectiveness and requiring audit firms to publicize  
20 them, and assuming that those things occur, then to  
21 establish a mechanism for the board and staff to monitor  
22 the indicators.



1           And we wanted to emphasize the language in the  
2 third bullet point because it really goes to the  
3 objectives or goals of developing an AQI regime and, in  
4 particular, as we discussed a minute ago, the  
5 significant benefit that it could provide to  
6 shareholders in connection with their decision-making  
7 process around auditor selection or ratification and as  
8 an enhancement to the board's role as the supervisor of  
9 the audit profession.

10           All that, of course, is not to say that the board  
11 hasn't been attentive to this topic, as you certainly  
12 have. Just a reminder for the benefit of the members of  
13 the working group that the board's activity in this area  
14 really dates back to late 2012, when in the setting of  
15 goals or initiatives for 2013 the board identified the  
16 AQI initiative as a priority project for 2013 with the  
17 goal of developing initiatives that would be reported  
18 over time.

19           The topic was discussed in 2013 both in May with  
20 the SAG, and as I mentioned, in October of that year,  
21 this group had a detailed discussion on the topic  
22 involving many of the people in the room today, further

1 discussion in the summer of 2014 with the SAG.

2           And then, of course, in July of 2015 the board  
3 issued its concept release which proposed 28 potential  
4 AQIs, a very thoughtful and well-formulated discussion  
5 and analysis in my view. There was a comment period, of  
6 course, and a deadline.

7           And then in November of that year, the AQI  
8 initiative was again taken up with the SAG. And at  
9 least as far as we know, those of us who aren't within  
10 the building, that's about where the trail went cold.

11           So we're here today, as I said, to urge and  
12 perhaps now that the, that you have a gust of wind in  
13 your sails as a result of yesterday's very good news,  
14 that perhaps we return to this topic as one that's been  
15 lingering for quite a while and we believe is worthy of  
16 some final work and completion.

17           As I mentioned in the introduction, there are  
18 activities occurring in other forms, other standard  
19 setting bodies. Other international regulators have  
20 been active in this regard. And I'm going to turn it  
21 over to Lynn now to take us through that issue.

22           MR. TURNER: So there are a lot of activities

1 going on with respect to audit quality. This is another  
2 area where the international community is actually ahead  
3 of us and has taken a lead on work on audit quality.

4           The international group of PCAOB regulators, if  
5 you will, got together in '14, discussed it, met the  
6 following year with the six largest firms, said it's way  
7 too high, 47 percent, got it down to 42 percent. But  
8 when you think about it, 42 percent of the audits are  
9 not following GAAS.

10           And it's interesting. I hear from the firms two  
11 comments. One comment is, well, it's because the PCAOB  
12 picks high risk audits. And my response to that is,  
13 well, if they're the high risk audits, they're the ones  
14 you ought to be doing the better job on.

15           And we also find in a number of the litigation  
16 cases that the auditors had said they were high risk,  
17 and they failed there, too.

18           And then, you know, so it doesn't, it really  
19 doesn't fly, those arguments. And it's 42 percent here.  
20 IFIAR went out and set a goal of trying to get a 25  
21 percent reduction in the number of those deficiencies by  
22 2018, 2019, 2020, right in that timeframe someplace.

1           But if you get a 25 percent reduction, you're  
2 still at a 30 percent error rate. I mean, what if your  
3 iPhones that you bought all had a 30 percent error rate?  
4 People would be, you know, chunking them into the trash  
5 can.

6           So any rate, and IFIAR has commented on the  
7 international proposals, which are very good. And it's  
8 just not IFIAR. The U.K. has been into this issue for  
9 some time here, almost ten years. And again, they're  
10 seeing the same type of problems, 31 percent in their  
11 most recent report.

12           It's kind of like a disease that's kind of gotten  
13 in and got hold of everyone. It's every place. It's  
14 not just here in the U.S. It's the U.K. It's Europe.  
15 You saw the IFIAR. IFIAR has a great website that shows  
16 it for every country. And Australia has had similar  
17 type problems, Singapore.

18           One of the interesting things about where the  
19 U.K. has gone with it in their Financial Reporting  
20 Council is they now grade each of these inspections,  
21 good, bad, or whatever the grading scheme. It would  
22 almost be nice to be A, B, C, D, and F because everyone

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1 knows what that means. But they do grade. And they  
2 give that grade to each audit committee.

3           So you talk about litigation, Jim. How about you  
4 have your regulator comes in and gives you a failing  
5 grade, you know, and everyone knows that grade goes in,  
6 I think the U.K. is dead right. I think this would be  
7 great to see in our inspection reports.

8           And as they say, currently we use the grade to  
9 inform public reports on each firm. So good things  
10 going on in the U.K. Click.

11           Singapore, again, they're trying to get down to  
12 that 25 percent reduction. The question becomes what's  
13 your starting point and how far does 25 percent if we're  
14 up at 40 percent. You know, saying it's okay to have a  
15 30 percent error rate in the audits, not real comforting  
16 from an investor perspective.

17           You know, the goal should be getting down to  
18 zero. We know we'll never hit zero. But if our goal is  
19 only to get down to 30 percent, doesn't instill  
20 confidence in the system at all.

21           Interesting thing here, it says from inspections  
22 commencing on and after 1st of April, the names of

1 public accountants imposed with hot review or  
2 restriction orders, articles or revisit inspection will  
3 be published.

4 So the name of the partner is going to go out  
5 there, you know. It's kind of like going home with the  
6 report card that had an F on it, you know. You always  
7 hoped there was a dog you could feed it to on the way  
8 home. Click it.

9 Again, Netherlands actually got started in it in  
10 2008. They've been working on it. The Swiss are  
11 working on it.

12 Interesting thing about what the Swiss has said,  
13 we've all talked about the audit committees and the  
14 importance of audit committees and how they can be good.  
15 I think some are good, some are bad, some are in  
16 between.

17 But here, it says AQI were either not supplied to  
18 audit committees or only sparingly. So it's very clear  
19 that information is not getting to the audit committee.  
20 If that information doesn't get to the audit committee,  
21 the audit committee cannot manage and oversee audit  
22 quality. They don't have the information.

1           Again, you measure. You manage what you measure.  
2 If there's no measurement and no disclosure of the  
3 information, if you think the audit committees are doing  
4 their job, you're a fool. It just can't happen. And  
5 see the Swiss find this is most interesting. So let's  
6 flip up.

7           The IAASB, these guys have been, ladies have been  
8 hard at work jumping ahead of us here. 2011, get out  
9 the paper on audit quality, do some consultation, come  
10 back again, issue more for comment, publishes where  
11 they're trying to go with it by 2015.

12           After that, the Center for Audit Quality, the  
13 profession really, the professional's group here in the  
14 U.S., they put out a paper as well. I don't know that  
15 the IAASB, even though they put great heads on it, that  
16 it gets to where it needs to go. But at least they've  
17 been doing a lot of work on it.

18           The Federation of European Accountants, again  
19 over in Europe, they're putting stuff out as well.

20           I give a shout-out to Deloitte. They put out now  
21 an annual audit quality report separate from their  
22 annual report. I think that's good. It's got some

1 useful firm-wide metrics in it. It doesn't get down to  
2 what we need as investors, though, to vote on individual  
3 audits and individual company audits. We need that  
4 detail.

5 But at least Deloitte has shown the courage to  
6 get out, form an advisory group. They form an advisory  
7 group of a number of people I know, respected. And not  
8 that DT always takes everything that they say and goes  
9 with it, but they use it as a good sounding board. And  
10 they put out their report.

11 I wish the other three would get on the bandwagon  
12 and join them in this effort. That would be a good move  
13 and show that the other three actually do give a hoot  
14 about audit quality as Deloitte has, so shout-out to  
15 them. And so --

16 MR. HARRISON: Okay. Yes, I think it's -- thank  
17 you, Lynn. I think it's back to me.

18 So, again, just by way of recap, we've covered  
19 some of this. The first two points we've touched on.  
20 We're now at the point of a nine-year period having  
21 passed since the Advisory Committee's recommendation was  
22 first published. Work remains incomplete or undone.



1           There is activity abroad that we do not want to  
2 be, the view of our group is that we don't want the  
3 board to be in the position of catching up if  
4 jurisdictions overseas are getting ahead of us.

5           And then lastly, you know, again, the third  
6 bullet, some of these issues have been touched upon  
7 today. Others have been the topic of discussion in this  
8 group in prior years. And that is that there are other  
9 industry professional factors, market factors at work  
10 that in recent years have further raised concerns about  
11 audit quality.

12           And some of those have to do with investments and  
13 culture in the firms. As the firm's consultants see  
14 practices continue to grow and expand, audit firms are  
15 in some jurisdictions now in the legal business, forming  
16 law firm affiliates, M&A advisory businesses and the  
17 like.

18           And those raise questions about the priority of  
19 the audit practice and willingness or ability to invest  
20 in audit quality when there are increasing demands for  
21 capital investment in other practices, which frankly may  
22 be more lucrative or higher margin. And those same

1 issues raise questions about independence rules in that  
2 and other contexts.

3           And then, again, we've discussed this already  
4 today, but the too big to fail phenomenon or mindset  
5 continues to appear as we've seen most recently in South  
6 Africa and the issue with, and the banking situation  
7 there.

8           MR. TURNER: Norm, if I could just --

9           MR. HARRISON: Yes, please.

10          MR. TURNER: -- comment on that. We have now  
11 seen in South Africa where KPMG is looking at an Arthur  
12 Andersen type outcome where the central bank has had to  
13 go out and tell the other bankers, despite how lousy  
14 their audits were, you need to stay with KPMG or they  
15 will fail.

16          The federal reserve chair there equivalent has  
17 had to go out there to try to save them. It is a  
18 bailout.

19          If people think you cannot have a too big to fail  
20 situation today, the answer is we do have one. It is  
21 occurring. And it will occur in the U.S. just as it has  
22 in South Africa.

1           MR. HARRISON: The next thing that we want to  
2 spend a few minutes on is a review of the work done by  
3 the working group in 2013 and an overview of the  
4 principles and recommendations we made at that time, not  
5 because we didn't want to do any additional work this  
6 year. There are some new and updated recommendations  
7 coming toward the end.

8           But nonetheless, as I said, you know, several of  
9 us were involved in the work at that time and believed  
10 that the analysis and the survey results presented  
11 there, as well as the recommendations, are still  
12 relevant and vital today. So we'll take just a minute  
13 to recap those.

14           The 2013 working group urged the board to  
15 prescribe a set of audit quality indicators that measure  
16 actual output quality, not only resources, not only  
17 measures having to do with workloads or hours of  
18 investment, but measures of the actual quality of the  
19 output, additional measures that would more directly  
20 establish accountability.

21           And there's been, obviously, some movement in  
22 that regard by the board in the intervening years and

1 indicators that would be forward-looking in nature and  
2 have meaningful information or ideally predictive  
3 aspects to them as well.

4           We urge that the board focus its attention  
5 primarily on audit quality indicators more so than  
6 indicators which relate more to the quality of the firm  
7 as a whole or the process it conducts. Again, outcomes  
8 we believe should be the principal criteria and the  
9 principal quality that is measured by the indicators.

10           And that's for the simple reason, although it  
11 does bear repeating, that investors are most concerned  
12 about the reliability and credibility of the audits of  
13 the companies that they're either invested in or are  
14 considering an investment in.

15           It is not enough to prescribe report standards  
16 that talk in general terms about steps that firms take  
17 or measures that provide some indication of investment  
18 in audit training, investment in audit processes.

19           At the firm level, the real issue for investors  
20 is what has been the quality of the audits of specific  
21 companies that we're looking at.

22           And again, as an audit committee member, the same

1 concern, the same issue, what measures can we have apart  
2 from our auditors on representations, what quantitative  
3 criteria, what measuring posts can we have to give us  
4 some further sense of the quality of the work that our  
5 auditor is doing for our company, and therefore, for our  
6 shareholders.

7           The key elements of our recommendations at that  
8 time had to do with -- the first two bullets I've  
9 already really described. I'll pick it up with the  
10 third bullet where, you know, we strongly believe that  
11 audit quality indicators and audit quality initiatives  
12 should include publication and greater transparency  
13 around the outcomes of PCAOB inspection reports and also  
14 that -- and again, we will reiterate this year, but it  
15 was certainly our recommendation in 2013 that the board  
16 promulgate an initial set of regulations that, again,  
17 provide indications of audit quality both at the firm  
18 level, but more importantly at the engagement level.

19           We've provided several specific recommendations  
20 in each of those categories in 2013, but I -- and I  
21 won't repeat all those. I think that the presentation  
22 is still available on the board's website.

1           Some of those, for example, were, you know,  
2 tracking a number of restatements by industry group, the  
3 number of instances in which the PCAOB independence  
4 rules were violated, the disclosure of inspection  
5 reports and grades with issuers identified,  
6 identification of key risk areas and hours spent on  
7 those areas in the course of a specific audit, and  
8 disclosure of issues that with which, the audit team  
9 found it necessary to consult with the national office.  
10 What were the technical issues in which they felt they  
11 needed further guidance with respect to a particular  
12 audit?

13           And again, we strongly urged at that time and we  
14 really think the whole purpose of this initiative would  
15 be to enable, to require reporting of those indicators  
16 and that the results be subject to review and  
17 verification by the PCAOB in the course of your  
18 inspection processes and that there be public comment  
19 and feedback as well.

20           And in terms of where you are today, we realize  
21 that the concept release and the proposal came a year  
22 and a half or two years after the last time the Investor

1 Advisory Group considered the issue.

2           And, you know, as I said, I guess the view of our  
3 group that the indicators proposed covered a number of  
4 these areas. There was very thoughtful discussion and  
5 analysis around it.

6           And I think, you know, my closing remark before  
7 handing it back over to Lynn would be to echo Grant's  
8 comment in the, from the last panel. And that is we'd  
9 strongly urge you not to let the perfect become the  
10 enemy of the good here either, that it's important to  
11 start and to develop an initial set, and always with the  
12 option to revisit and to tweak or to introduce new ones  
13 as, when informed by experience.

14           But I think the most important message from us  
15 today is that we believe it's, that there's been more  
16 than sufficient discussion, debate, and dialogue. The  
17 board's done a lot of very important work. And it's  
18 time to bring it to fruition.

19           So, with that, I'm going to turn it back over to  
20 Lynn, who's going to take you through. As I mentioned,  
21 we didn't simply want to reaffirm our 2013  
22 recommendations and call it a day. We do have some

1 thoughts to share this year. And Lynn's going to finish  
2 up for us.

3 MR. TURNER: I think, as Norm said, he spoke to  
4 the first two points. One thing that came out of our  
5 discussions, though, was transparency was extremely  
6 important. People consistently talked about  
7 transparency in the inspections, what came out of  
8 discipline and what came out in the annual reports from  
9 the firms.

10 And I'd have to say, if you go back and look at  
11 the slides we did on the inspection results over the  
12 last four years -- and we actually looked at inspections  
13 before then, too; we're tracking this now -- the  
14 inspection results are, as we talked about before, not  
15 good.

16 They're actually -- I was surprised, though.  
17 There's enough transparency in the inspection reports  
18 you can actually start doing some slicing and dicing  
19 here that is useful.

20 The deficiency rates of the next three largest  
21 firms after the Big Four were significantly worse than  
22 what they were for the Big Four.



1           We've argued, and on ACPA we tried to deal with  
2 the competition issue. But if you're going to compete  
3 on quality, given those inspection results, you, as an  
4 audit committee, would never select those, that second  
5 tier of three because the audit results are  
6 significantly worse.

7           And so it does give us some data. And, Jim, I  
8 give you, I give Helen, the other board members  
9 tremendous kudos, because the transparency of that  
10 information we've seen in some of those inspection  
11 reports is better and has improved from what it was  
12 before you got here. So kudos to you for that.

13           But I'd encourage everyone to look at that  
14 because it does give you a chance to start looking at,  
15 if you're an audit committee, where you go if you're  
16 choosing based on quality.

17           There could be better transparency if you give us  
18 the name of the companies, but you're headed there.  
19 Anyway, next slide.

20           It was interesting. We asked everyone in the  
21 subgroup to give us their top six or eight items out of  
22 the list that you had put out in the concept release,

1 Marty. It was a dumb request because people either gave  
2 me all of them or none. Actually, there were some that  
3 gave me the six.

4 But Anne was the first one to come back and I  
5 think gave me 25 of your 28. She loved your concept  
6 release. And when I went back and looked over it, it  
7 was very good. Those, what was in the concept release,  
8 as far as the audit quality indicators, was extremely  
9 well done.

10 But one thing that came out was again as it was  
11 a few years back, both firm-specific and audit  
12 engagement-specific are important.

13 We vote on -- and as we look at voting, I chair  
14 the committee that oversees the voting in PERA. We're  
15 voting on how well they're doing on that particular  
16 audit. So we need the information on that. That's why  
17 we need the company name.

18 And so if we could, go on. Here were some of the  
19 things where there did seem to be some consistency. If  
20 you go back to your AQIs, Marty, and your concept  
21 release, this will sync up with some of those in there.  
22 That's not to say that we'd say just do these, because,

1 again, I think there was some reception that a lot of  
2 those are very good.

3           And also, but here are the ones that people --  
4 independence seem to keep coming up in the conversation  
5 at the top of the list. If we have problems or concern  
6 with independence, and certainly we've seen that in the  
7 broker-dealer reports, then there are problems. And  
8 we've seen it in a number of the litigation cases as  
9 well.

10           I've actually now seen I think two cases where  
11 judges actually ruled against the auditors, didn't even  
12 let it go to trial on the independence issues. So next  
13 slide.

14           Again, looking for information that allow us to  
15 vote on and allow the firms to manage both the  
16 engagement. It was amazing. As we all started down  
17 this path and as we did the ACAP report, how the firms  
18 came back and said, well, no one's defined audit quality  
19 indicators, no one knows how to measure that, which gets  
20 back to the lead slide, you manage what you measure.

21           It was clear the firms were not measuring it by  
22 their comments. And so they just flat out could not be

1 managing their quality.

2           And we found that to be true now when we look at  
3 the inspection results around the world. They're not  
4 managing it around the world, because inspectors around  
5 the globe have found the same type of problems.

6           It raises this concern with the too big to fail  
7 then and the lack of independence and the independence  
8 issues. We see the firms, once again, growing their  
9 consulting practices.

10           I've had lead partners in firms come up to me and  
11 tell me that they're having trouble with the interaction  
12 with the consultants who want them to do things that the  
13 audit rules don't allow them to do.

14           We see now PwC starting to buy and bring in legal  
15 practices into the U.S., which we prohibited when I was  
16 there at the SEC. And that's very concerning because an  
17 attorney is an advocate. And you can never be an  
18 advocate and be independent.

19           And ultimately, it probably gets down to we may  
20 not be able to fix not only this problem but the other  
21 ones that we've been talking about today, certainly the  
22 non-compliance issue, until we ultimately deal with what

1 is the elephant in the room, which relates to  
2 independence, and that's who pays the auditor.

3           If people think that the people at the top who  
4 set the tone are paying the auditor and then they're  
5 still going to get an independent audit, I rewrote those  
6 independence rules and thought it would work. I just  
7 don't think until we get to this last slide we'll ever  
8 fix a lot of these problems.

9           Next slide. It speaks for itself.

10          MR. HARRIS: Chairman Doty.

11          MR. DOTY: Again, fascinating discussion. There  
12 is here a suggestion that it would help investors if a  
13 specific grade on audit quality indicators, on the basis  
14 of the quality of the audit of each issuer, were  
15 assigned.

16          Now, that's a departure from the inspection  
17 process and practice. But we couldn't do that under the  
18 statute now.

19          And I know Lynn has a different view of this, but  
20 there's a long-established principle to the Board that  
21 we can't, we cannot engage, we cannot disclose in our  
22 firm report the specific engagements. And we talk about

1 engagements rather than firms.

2           But do I hear from the investors that a U.K.  
3 grading system, engagement by engagement, would be  
4 useful if it were required to be disclosed to the audit  
5 committee?

6           In other words, that's different from coming out  
7 to investors you see. That's not a disclosure to the  
8 public.

9           But is the investor confidence and the audit  
10 enhanced, if you know that the audit committee is going  
11 to get a grade from the divisions of inspections that  
12 says, we found on the following six, eight, I choose  
13 eight because Singapore has eight, could be 20, the  
14 following firms, the following engagement specific, all  
15 audit quality indicators, we give the following grades  
16 to this engagement.

17           Because that is, that avoids the disclosure to  
18 the public, it is a step beyond what we now do. And  
19 that's why I ask the question.

20           MR. HARRIS: Well, does anybody care to respond?  
21 I mean, the tent cards, well, these are all for  
22 questions. Are these for responses or for questions?

1 PARTICIPANT: Yes.

2 MR. HARRIS: Okay. Anne, you go first.

3 MS. SIMPSON: Thank you. We didn't discuss this  
4 in the working group so please treat this as just a  
5 little personal comment.

6 The issue here is about the whole framework of  
7 the government's arrangement. So share owners, are  
8 meant to hire and fire the audit committee, which hires  
9 and then asks for ratification in this country, election  
10 in the U.K. So there's a much stronger framework of  
11 accountability in the U.K.

12 I was talking earlier with Linda that until quite  
13 recently, in the U.S., it was very difficult for share  
14 owners to be able to vote anything other than yes, to  
15 the state of candidates put forward. So I think we're  
16 in the foothills in the U.S. of understanding what share  
17 owner oversight looks like, this is a famous majority  
18 voting. Which many of us have been involved in.

19 So, the point about the -- so, we rely on a  
20 disclosure much more in this market. And arguably the  
21 U.S. is very strong on the disclosures because sell or  
22 sue has been the basis of the oversight. There's been

1 much less by way of ownership and stewardship because of  
2 very weak shareholder rights.

3           But that is the backdrop. It suggests that it's  
4 now that we have one hard fought abilities to vote for,  
5 as well as against, Board Members, how do we know if the  
6 audit committee is doing its job, unless we are also  
7 party to the information, which you're suggesting.

8           I'm very sympathetic to what you're suggesting on  
9 these grounds that if you know you got to hang something  
10 in the front window for all to see, it may have an  
11 inhibiting effect. Make it more difficult for the  
12 regulator to be frank.

13           But on the other hand, maybe we just have to get  
14 over that. Because unless shareholders start to  
15 understand how, you know, as opposed to the high  
16 expectations, part of it is things go wrong and then  
17 it's not clear who is living in a world of consequences.

18           But partly, I think, it's because the investor  
19 community doesn't yet know how to assess whether the  
20 audit committee has done a good job or the auditor has  
21 done a good job, until things have gone horribly wrong.  
22 And then you're stuck with very little choice for



1 exactly the reasons that Lynn just said.

2           So, my thought is that the more that we can  
3 encourage or persuade the regulatory bodies to share  
4 with investors, the better equipped we are to carry out  
5 our own oversight responsibilities. And regulators  
6 can't be everywhere.

7           Really we need, in all circumstances, that the  
8 investor community is better informed. And right now,  
9 the investment community is rather sleepy on these  
10 issues.

11           Is that fair, fellow investors? I don't know who  
12 has voted against audit committees or audit ratification  
13 in recent years, but that would be worth looking at as  
14 well.

15           MR. HARRIS: Mike Head. We'll just go around the  
16 room. And skip Lynn for the time being, since he's --

17           MR. HEAD: I agree with everything that was  
18 presented. I am, kind of directly to where you were  
19 talking, Chairman Doty, I actually would be okay with  
20 individual audit ratings from the inspections going to  
21 audit committee, if there was somehow that there could  
22 be a public rating that was at the firm level.

1           Which would be some kind of conglomeration of the  
2 individuals. However, you guys would do that behind the  
3 scene and I have no idea how that would work.

4           But if the public had a firm rating and the audit  
5 committees had their individual ratings and there was,  
6 behind the scene some logical way that the individual  
7 inspections came together in the firm rating, I think  
8 that could be a win-win, both sides.

9           I do feel, and I was obviously involved in the  
10 2013, so this is an area that I am passionate about like  
11 a lot of others, I think we're still stopping short,  
12 even with quality indicators. I do think that until the  
13 United States addresses who truly should hire and pay  
14 the auditors, that's not part of the company, it's  
15 always going to be a challenge.

16          And you can always go to the regulatory  
17 environment and say they assess. And then that's how  
18 FINRA and other agencies get paid.

19          I'm not saying that's a perfect model, but if  
20 PCAOB was hiring the firms instead of the companies  
21 hiring the firms, I think there would be a lot different  
22 outcome on your inspections. But that's just my

1 personal opinion.

2           And the elephant that's always been in the room  
3 that we in the United States just can't get our arms  
4 around, is mandatory rotation of auditors.

5           And I would be remiss to go through this process  
6 and not say, that still needs to be on the table. I  
7 don't like it as being an auditor, past auditor CPA,  
8 that I like self-regulation, but when are we going to be  
9 honest with ourselves if we continue to have the high-  
10 level rates that we do, that our system seems to not be  
11 working. And continuing to do the same things is "the  
12 definition of insanity."

13           MR. HARRIS: Mike Smart.

14           MR. SMART: I just have two questions. First of  
15 all, it was a very informative, actually, some of the  
16 information was actually somewhat shocking, surprising.  
17 Especially the percentage of failures or fractions.

18           But to that point, the 42, 43 percent, I was  
19 curious as to sort of the degree of severity of some of  
20 the infractions were, are the infractions sort of just  
21 all put into one pile or are they broken up in terms of  
22 the degree of severity associated with the infraction?

1 I'd be curious to know that I'm not sure whether  
2 that's possible, but I'd be very curious. Especially  
3 with a percentage that high. That's one.

4 Two, just as it relates to the disclosabilty of  
5 the infractions to the audit committee, just to sort of  
6 put them on notice, I'm curious, and I'm not an attorney  
7 or an auditor, but I'm curious that if an audit  
8 committee was told that your audit had X number of  
9 infractions and we're putting you on notice, as an  
10 investor, would that be a disclosable issue? Just  
11 curious.

12 Because if you got all of these infractions,  
13 you're on the audit committee and PCAOB is making you  
14 aware of it, me, as an investor, I'd be pretty curious  
15 about something like that. So once the cat's out of the  
16 bag, I would think that it might be, again, I'm not a  
17 lawyer, a disclosable item or issue.

18 MR. DOTY: Yes. Just to clarify, our findings  
19 are clearly stated in our firm report. Our firm report  
20 says, the findings do not constitute a correlate to  
21 audit quality.

22 In other words, the fact that we have made

1 findings against a firm, in its engagements, does not  
2 mean that we are also making an ultimate determination  
3 as to the audit quality. This is very important.

4           Because the finding is simply a determination by  
5 the Board that in some area that is described in our  
6 annual report, for the firm, that the firms the auditors  
7 fail to obtain the confident evidential matter that  
8 would have supported their opinion. Now that's  
9 important.

10           It's important if you have an audit of X, Y, Z  
11 company. Even if there is one instance in which the  
12 firm didn't have support for its opinion, that's  
13 something we think the firm and the audit committee  
14 should know. This is Part 1 of the report.

15           The big issue here has been the fact that we  
16 don't have agreement on what audit quality indicators  
17 are or should be. We have had SAG meetings on these,  
18 and there is a view that we should not promulgate them,  
19 that we should not require them.

20           So whether it's a firm audit quality indicator or  
21 an engagement audit quality indicator, there's not been  
22 same consensus as to whether we have the right one.

1 But in this case, it is open to an audit  
2 committee and any engagement to say, has the PCAOB  
3 inspected our engagement, if so, what were its findings.  
4 And that an audit committee should know.

5 It does not mean that the audit firm has poor  
6 audit quality overall, it doesn't mean that the  
7 engagement itself reflects a poor firm quality or poor  
8 engagement quality. You will find out though whether in  
9 any specific audit that the audit committee inquiries  
10 about, whether the auditor had all the evidence it  
11 needed to support its opinion.

12 Because if the inspection did not result in Part  
13 1 findings, that's what an audit committee wants to  
14 know. If it did result in Part 1 findings, that also is  
15 what we want to know.

16 And the second, then the next question is, what  
17 about Part 2 findings? What about your quality control  
18 findings? What has the PCAOB said to you about that?

19 If an audit committee starts getting into that  
20 with an auditor, and then the question become, well,  
21 what are you doing about it, what are you going to do  
22 about these things. That's where an audit committee

1 activism, in our view, is fostered and takes over and it  
2 springs out of our findings.

3           It's the kind of thing we think Jay Clayton is  
4 talking about. We need to be confident -- we need to be  
5 conscious of what we can do that makes our reports  
6 useful to audit committees.

7           MR. HARRIS: Tony.

8           MR. SONDHI: And I appreciate very much the fact  
9 that the group has reiterated the 2013. I think the  
10 team had done a very good job.

11           And I'd like to emphasize that our interest  
12 really is in output indicators. Because I don't find  
13 the process indicators or the firm indicators that  
14 helpful, from an investor's perspective.

15           So I think that's very good. I think we ought to  
16 focus on those kinds of, on the various output  
17 indicators that we had mentioned. And some of these  
18 things are very important.

19           So as you were asking earlier, Chairman Doty was  
20 asking about, that, you know, I look at what we get and  
21 it would be very helpful, at least as a start, to  
22 provide that grade to the audit committees.

1           But I do agree with Anne that sooner or later we  
2 need to know about them as well. Because simply having  
3 it out there with the audit committee isn't sufficient.  
4 Because we need a lot of progress in the audit  
5 committees before we can start finding that they're  
6 beneficial for the investors as well.

7           The other thing I wanted to mention was something  
8 that just struck me. I was thinking back to one of the  
9 output indicators, which we had said, tell us about the  
10 number of restatements and those kinds of things, and I  
11 was thinking also along the lines of the number of  
12 restructuring.

13           And I remember that in the 1990's research study  
14 that I had done, over a six year period I found that the  
15 average number of restructuring charges announced,  
16 impairments announced by the firms was 3.2. 3.2 in six  
17 years. That should tell you something that there's  
18 something going on.

19           And by the way, what was also interesting was the  
20 second one was normally at least twice the size of the  
21 first one. And the third one very often was bigger than  
22 the first two combined.



1           So when you start thinking about that any, you  
2 know, what's going on in the audit where that in a six  
3 year period this is permitted to escalate in this way.

4           And my last point is that I'm also struck by the  
5 fact that when I look at and think about the new revenue  
6 standard, I can find a number of places where it's  
7 actually really unlikely that we're going to see a  
8 reversal of revenue.

9           If we look at the contract modifications, for  
10 example, the majority of the adjustments are  
11 prospective. So even if there is something going on  
12 there we're only going to find out it's not going to be  
13 a backward-looking thing, it's going to be, if we look  
14 at a whole bunch of other places, the estimation  
15 process, et cetera, these are all prospective  
16 adjustments.

17           So if there are errors, we're not going to know  
18 about them. And that, in a sense I think, should be  
19 worrisome. And that should give us more, you know, of  
20 an incentive to do something about audit quality as soon  
21 as we can.

22           You remember by the way that, or at least the

1 last 15 years or so, most of the time the findings have  
2 been that the majority of restatements have been related  
3 to revenue. And I think this new revenue standard  
4 effects that adversely, the way it's structured.

5 MR. HARRIS: Linda de Beer.

6 MS. DE BEER: Thank you. A couple of things.  
7 And I'm thinking back about the question that Chairman  
8 Doty asked about the, where must the right things be  
9 published or who must get the right things.

10 I thought it was a really important comment that  
11 Chairman Clayton made this morning about the role of  
12 audit committees and the issue. And the point has come  
13 up so many times today.

14 If you read the IAASB's audit quality framework,  
15 it specifically talks about the different role players  
16 when it comes to audit quality. Between the regulator,  
17 the audit regulator and the auditor can't be the only  
18 two players, you won't get the right level of audit  
19 quality if it's only those two players.

20 Audit committees play a really important role and  
21 investors play a really important role. And it's very,  
22 I think it's really important that people play in their

1 governing spaces, whether you're the audit committee  
2 versus the investor and so on.

3           So, I know this is not within the brief of the  
4 PCAOB, but I definitely think there is space to  
5 strengthen the role and the responsibility of audit  
6 committees when it comes to also audit independence and  
7 when it comes to the duties and the liability of  
8 auditors.

9           We've had quite significant changes in our  
10 companies acting recently in our stock exchange rules  
11 for audit committees to, firstly get acquainted by  
12 shareholders. And then I think that's where investors  
13 play a very important role in making sure you've got the  
14 right people as your audit committee members.

15           And then for audit committee staff specific  
16 duties around audit independence. And now in our new  
17 stock exchange rules, also around audit quality and how  
18 do you assess audit quality.

19           And I think then it is for the audit committee to  
20 actually report to the investors to whom they recommend  
21 that this audit gets reappointed. What they had done,  
22 as an audit committee, to base their recommendation

1 answer.

2 I think I'm more in your camp where I think that  
3 reporting must go to the audit committee. I think there  
4 is a real risk if there's reporting that just goes out  
5 without the necessary contacts to investors that on this  
6 specific company there was not so good rating, an F  
7 rating or maybe a D rating, for this auditor.

8 It doesn't necessarily indicate, and I thought  
9 that's the point that you alluded to Jim, that the audit  
10 opinion is wrong. But it does allude to the fact there  
11 are gaps in the documentation, there are gaps possibly  
12 in compliance with the standard.

13 So yes or no, the opinion might or might not be  
14 wrong. Sometimes it's clearly not an issue of wrong  
15 opinion.

16 And I think if that information gets in the hands  
17 of the investors without context, we also have a broad  
18 base of investors, it doesn't get further than process.  
19 And I think it's an issue for the audit committee to  
20 process.

21 So maybe there is space for the SEC potentially  
22 to start thinking where that's necessary to strengthen

1 the composition requirements, the duty responsibilities  
2 of an audit committee, so that they can also play that  
3 important role, or even a stronger role, in adding to  
4 audit quality.

5           Just one other point, if I may, Chair, and that  
6 is the point on transparency. Because it is a bit of a  
7 hobby-horse for me. And I really think it's something  
8 that came so clearly through the issues we had in South  
9 Africa now, around audit firms and the level of  
10 transparency.

11           I think as an audit committee member, it's also  
12 important for me to understand not just the inspection  
13 findings, but to understand where the firm is making  
14 their money. Are they actually making losses on audit  
15 and making audit profits out of consulting.

16           We, as the bulk of these skills and resources, if  
17 some of those indicators that were alluded to earlier,  
18 that is really important information because that sort  
19 of helps me, as an audit committee chairman, to see  
20 what's driving behavior.

21           For example, is there enough non-audit services,  
22 consulting services, that's actually paying for the loss

1 that they're making on this audit. That type of  
2 information I think is really what regulators can start  
3 thinking about in transparency reporting.

4 I agree with what Norman said earlier on, yes,  
5 there's a lot of information, voluntary information out  
6 there. Personally for me, as an audit committee  
7 chairman, that doesn't really help me to assess audit  
8 quality of that firm or of the individuals. Because it  
9 doesn't really talk to the heart of what you need to  
10 know to make an assessment. Thank you.

11 MR. HARRIS: Bob Tarola and then Judge Sporkin.

12 MR. SPORKIN: It seems to me that if you sign up  
13 for an audit, it has to meet certain standards,  
14 otherwise you're not getting your bargain. And if  
15 that's the fact and they don't meet certain standards,  
16 then the remedy should be that they give you the money  
17 to go and get another audit. But I don't understand why  
18 a deficient audit should be accepted. And I don't even  
19 know why the SEC should accept it.

20 I think the SEC should say, go get another audit,  
21 you didn't meet the standards. And I think the problem  
22 is that you've been waiting for all these years to get

1 the standards.

2           But there is something here that is not -- you're  
3 required to have an audit, but there isn't any  
4 requirement as to what that audit, what standard that  
5 audit should be. What standard it should meet. And I  
6 think that's where you got to, I think you can do it.

7           From the SEC, why don't you, if they don't meet  
8 these standards, why do you accept it?

9           MR. HARRIS: Wes is looking to answer.

10          MR. BRICKER: We require standards to be done  
11 according to PCAOB standards. So we do not accept  
12 deficient audits nor do we accept deficient, or just the  
13 same as, we don't accept misleading financial  
14 statements.

15          The reconciliation to the discussion about  
16 deficiencies identified in the inspection process is  
17 fully made by Chairman Doty's comments about the  
18 objective of the inspection process and the  
19 communication of what a deficiency represents.

20          MR. SPORKIN: So do you turn down audits by the  
21 Big Four? How many Big Four audits has the SEC turned  
22 down?

1 MR. BRICKER: So where we find in the enforcement  
2 context --- so our enforcement files reflect the work of  
3 the commission in reaching conclusions about where  
4 auditors have responsibilities that they have not fully  
5 met.

6 (Off-microphone comment.)

7 MR. BRICKER: The objective of -- again, the  
8 context in which this arises in our agency, as you know,  
9 Judge, is in the context of review of filings. Both for  
10 compliance with the securities laws and PCAOB standards.  
11 And to the extent that we find noncompliance, it's  
12 addressed through the enforcement division.

13 MR. SPORKIN: I assume it's sufficient in a  
14 certain area, and in that area, you say do this over  
15 again, it's all the same, or affirm the duty, the same  
16 thing over again, is that what you do?

17 MR. PANUCCI: Judge, I mean, as Wes said, we  
18 require an audit under PCAOB standards. So whenever  
19 there is a deficient audit, the auditor knows that there  
20 is now a deficient audit. As part of those standards,  
21 they actually have to run it again themselves. There's  
22 still a standard in accordance with those standards.



1 MR. SPORKIN: How do they know?

2 MR. PANUCCI: They've got to do more additional  
3 work in order to cover for that deficiency. If there is  
4 something that comes out of the financial statements  
5 that it's wrong, that is through the correction of the  
6 financial statement process, of whether there is a  
7 restatement or a revision. But that's all part of the  
8 PCAOB standards when they know there's a deficiency,  
9 they'll remedy it.

10 MR. HARRIS: Well, Judge, I think we ought to  
11 take this offline because there are a number of other  
12 tent cards up. The point is well heard and I think it  
13 ought to be discussed offline. But we understand the  
14 point. Bob.

15 MR. TAROLA: Yes. Back to the audit committee's  
16 role for a minute. This is a very serious and important  
17 question.

18 Annually audit committees reappoint auditors.  
19 And at least every five years they're assessing what new  
20 audit partner to put on the account or maybe even new  
21 audit firm to put on the account.

22 And to the extent to which the PCAOB can give

1 audit committees information that will allow them to  
2 make better decisions, that would be a very positive  
3 aspect of improved corporate governance.

4 But it has a downside. So imagine, I'm going to  
5 put us back in the 2003/2004 time frame when audit  
6 failures were becoming the norm.

7 And at that time, no audit committee in their  
8 right mind would appoint the cheap auditor. You would  
9 always want to make sure you could say, we hired what we  
10 thought was the best situation.

11 In this case, I'm going back to Lynn's  
12 statistics, you also have to ask yourself how can you  
13 appoint the poorest rated auditor. So that comes into  
14 the equation as well.

15 So there's a positive and I think a potential  
16 consequence to all this. But I think in general, the  
17 more you can provide audit committees about their  
18 auditing firm, the better off the system will work.

19 MR. HARRIS: Let me follow-up on a question, or  
20 a point, that Linda made. She talked about the right  
21 people being on the audit committee. I'm concerned  
22 about the right people being on the audit engagement.

1           And one of your slides brought up the issue of  
2 competence. And as I review some of the statistics, the  
3 audit partners incur around five percent of all audit  
4 hours, the managers about ten percent and the other 85  
5 percent is put in by junior staff.

6           And I'm wondering about the pyramid, the current  
7 pyramid structure, the apprenticeship model and whether  
8 the right people have the right experience to engage in  
9 the engagements they're currently engaged in.

10           I was wondering if anybody had any views on that  
11 because some of these engagements are terrifically  
12 complex. And I'm not sure that auditors are  
13 appropriately trained through the apprenticeship model.

14           And I bring this up in the context of, I think it  
15 was within the first four hearings of Sarbanes-Oxley,  
16 Lee Seidler, who was the staff director, deputy staff  
17 director of the Cohen Commission, raised the issue of  
18 the educational level. And that was in 2002. Or I  
19 guess the hearings were probably in 2001.

20           And it struck me then, and strikes me now, that  
21 whether we got the proper educational system in place,  
22 and even though that's a AAA issue, I'd be very

1 interested in the views of the people around this table,  
2 in terms of whether that's a fundamental issue in terms  
3 of improving audit quality. Linda.

4 MS. DE BEER: I'm probably going to stick my neck  
5 out, by I'm going to say, Steve, I think it is an issue.  
6 I have, in many instances over the years that I've  
7 chaired audit committees, had CFOs come to me when we  
8 debrief after the audit themselves, saying that the  
9 partner was hardly here.

10 Or because the partner spent a lot of time, a lot  
11 of issues were actually solved and addressed and  
12 identified early on. So I think a lot of the success of  
13 the audit or the audit quality hangs on how much time  
14 the more senior people, the manager or the partner,  
15 spend at the audit.

16 So I agree with you. I think there is something  
17 that needs to be looked at when it comes to the whole  
18 training model. And I think a lot of it does also  
19 effect the result of fee pressure.

20 So realistically I think auditors end up, the  
21 firms end up putting more junior people on. And some of  
22 those junior people just don't have the experience.

1 They just don't even know what to look for.

2           And I think the transparency around that, and  
3 information around that, as an audit committee chairman  
4 I don't believe I've ever actually seen the breakdown of  
5 hours spent. And that might be a really useful audit  
6 quality indicator.

7           I think you've given me ideas here but I think it  
8 would be useful to see what percentage of time was spent  
9 by the partner, by the technical IFRS or US GAAP person,  
10 by the manager and then by the more junior people  
11 because that in itself gives the message.

12           But I do think there is potentially an underlying  
13 concern when it comes to the training model.

14           MR. HARRIS: I think the level of experience is  
15 an audit quality indicator that I think would be  
16 extremely worthwhile. Lynn Turner, do you have any  
17 comments?

18           MR. TURNER: Let me respond to your question then  
19 I want to come back to Jim's comments. But the ---

20           (Off-microphone comments.)

21           MR. TURNER: As far as the education model and  
22 the experience, on the PERA board, on the pension board,

1 all of our audit committee meetings are held in public.  
2 There is no private, no confidentiality, we go into  
3 executive committee session.

4           One of the things I always ask the auditor to  
5 provide me, is the schedule that shows across the top,  
6 all the major audit risk areas. Starting with the top  
7 five risk areas and others I control, or whatever.

8           Then down the left-hand side is the titles.  
9 Partner, manager, in-charge staff. And they have to  
10 populate that with the hours, and then I circle back  
11 around at the end of the audit and get the audit partner  
12 to give me that detail.

13           And we discuss that in a public meeting. It's  
14 scary at first but once you've done it you get used to  
15 it and it's not that big of a deal.

16           But in looking at those schedules on various  
17 audit committees that I've sat on, the experience level  
18 is just way too low. The pyramid that is in these firms  
19 doesn't work. Because it does leave 85 percent of the  
20 hours being done by typically people with zero to four  
21 years of experience.

22           In running a business, I was at a business, you

1 know, 365 days around the year. So I lived it, I  
2 breathed it, I knew what was going on. As a CFO you  
3 really understood it.

4 To expect, say a person with two years of  
5 experience out of college to come in and understand that  
6 and get it right, is way too much. These are talented  
7 kids.

8 They're probably not the best and the brightest,  
9 because when we started to look at SAT scores and where  
10 the top people go, it's into law school, it's into  
11 medicine, it's into engineering these days. So the  
12 firms are getting very good people, but they're not the  
13 best and the brightest.

14 It's a great job, it's a very rewarding job and  
15 I'd do it again tomorrow. But when you look at the  
16 experience, when you look at the education, and many  
17 come out without masters still, and the complexity of  
18 business today, they're just not up to it.

19 We have got to go to a legal model where you have  
20 a pair of professionals in there that are there year  
21 after year after year and have got that experience  
22 behind them. Where in this up or out type motion where

1 most people come in and are gone within three to four  
2 years.

3           It doesn't work. It doesn't serve the firms well  
4 and we've got to adjust that model because the  
5 competency just isn't there and it shows up time and  
6 time again on these audits.

7           And the partners are only spending five percent.  
8 I remember the PCAOB inspection that cited one partner  
9 for only spending one percent of the time on the audit.

10           You just can't get your hands around a huge  
11 complex organization when that type of leverage is used  
12 in your business model. Put that together then with the  
13 top people paying the paycheck, it doesn't work.

14           But quickly, Judge, or Jim, back to your point  
15 about grading and providing grading to the audit  
16 committee versus to investors. As investors, we own the  
17 business, why is it the people keep trying to keep  
18 information from getting it to us?

19           Is it that they're so troubled that the  
20 information is not good information? I'm sure if the  
21 information was good information the firms would say,  
22 disclose it all. But it's like people are trying to



1 hide it.

2           It's like when you got the report card and you  
3 got a bad grade and it's okay to give it to mom but you  
4 don't want dad to see it, it's the same type of  
5 scenario.

6           And so I think maybe as an interim step. You  
7 start out with going to the audit committee, but  
8 ultimately that stuff needs to get up and people need to  
9 get over this lack of transparency in this profession.  
10 It's what's cost it time and a time again problems.

11           And people need to get honest and put that  
12 information out. If they're doing a good job, it  
13 shouldn't be a problem.

14           MR. DOTY: Well, actually Linda makes a point.  
15 There's a matter of context here. A letter grade in the  
16 five tier or four tier system, a letter grade without  
17 context would be, in some minds, misleading.

18           I'm not sure we could do it. I do think what  
19 we're putting out are the percentages of findings we  
20 have in each firm and the annual report.

21           And as you all have been saying today, a 42  
22 percent finding, or if that 42 percent or 37 percent of

1 your high-risk audits failed to, in some respect support  
2 the audit opinion, is not a good statistic. So if you  
3 start looking at what we put out on the firm, I think  
4 that is in fact the starting point for an audit  
5 committee dialogue.

6 I don't think we could grade firms A through F  
7 reliably and be sure that we're doing justice to the  
8 competitive market or to what people take away from  
9 that. And we try not to do that.

10 We do try to be sure that we have put in the  
11 report, in Part 1, all the information that an audit  
12 committee could use to see how their audit was done. If  
13 their audit was inspected.

14 I can't resist pointing out, you can go to  
15 auditor search, Bob. We have under, Form AP now  
16 provides an auditor search facility, on our website, in  
17 which you can look up your engagement partner, you can  
18 look up your issuer.

19 You can find out how many other issuers your  
20 engagement partner is engagement partner for, lead  
21 partner for. That's for audit committees. We have the  
22 standard, which requires the communications be made to

1 audit committees.

2           Finally, I can't stress enough the importance of  
3 the interview with the firm, both on what the Part 1  
4 findings may mean if it's your firm that's inspected,  
5 your issue that's inspected, or an interview on what  
6 their Part 2 results are if you're not inspected.

7           In other words, if you start talking about the  
8 auditors about what Part 2 has been for them, what we  
9 have told them about Part 2, about their overall audit  
10 quality, they should tell you that. And the firms will  
11 say, we'll send somebody and we'll have someone  
12 available to explain that to you.

13           So those are three things that we have done that  
14 has their sole purpose to enable a specific audit  
15 committee, of a specific issuer, to begin to assess  
16 whether they want this firm and this engagement partner,  
17 back next year.

18           MR. HARRISON: Steve, I just briefly wanted to  
19 weigh in on the question you asked about leverage and  
20 staffing and fee pressures and impact on audit quality.  
21 I think those of us who've been in the business of  
22 working with public companies and their audit committees

1 had dealings with audit firms in various capacities,  
2 it's quite clear that the issue of fee pressure has been  
3 there for some time now, for years.

4           And it does raise, I think, serious questions  
5 about the ability of firms to maintain staffing  
6 compensation at adequate levels and to invest in  
7 training and talent development in the way that we all  
8 certainly expect them to.

9           The other thing I wanted to add is that there  
10 are, in addition to client pressures, there are other  
11 internal pressures as well, which relate back to the  
12 topic that came up during our presentation, in which  
13 we've discussed in this group in other years, and that  
14 is the issue of the breadth or scope of business of the  
15 Big Four and other public audit firms and their  
16 expansion into other higher margin lines of business, is  
17 often a drain on talent.

18           I mean, people leave the audit practice and jump  
19 over to consulting or advisory because the comp is  
20 higher there, there's a bonus structure, there's an  
21 incentive structure that's greater.

22           Or I think we've seen, certainly in my experience

1 and others probably have seen the same, that there was  
2 a time not all that long ago when the accounting  
3 profession was perhaps the last profession or business  
4 in our economy. Where someone would join out of college  
5 with a reasonably good expectation of spending a career  
6 there.

7           And I think even that aspect of the model has  
8 begun to dissolve for people who come in to a firm and  
9 are trained for two or three or four years.

10           There are now other service providers in the  
11 market place who value that training on the nickel of  
12 the accounting firm. And I think you're seeing more  
13 departures of younger professionals from audit firms  
14 just at about the time when they're starting to get  
15 their legs.

16           So there are both internal and external market  
17 pressures, all of which at the end of the day brings us  
18 back to the point Lynn raised earlier about the model.  
19 About the whole manner in which we pay auditors in our  
20 economy.

21           MR. HARRIS:    And I don't want to end this  
22 session, but we're beginning to run out of time and I'm

1 sensitive to it, but I can't help asking you, the team  
2 who worked on this. With respect to the other factors  
3 effecting audit quality, you raised the issue of  
4 independence, increasing tension between firm  
5 investments and audit quality and strategy to grow  
6 business lines, which you just mentioned, and the lack  
7 of regulation regarding too big to fail.

8           And I wish you'd take all three of those, I know  
9 that's a full day's discussion and more, but take each  
10 one if you would and indicate to what extent that  
11 threatens the audit quality and what your concerns are.  
12 And let me just, to maybe feed in the discussion a  
13 little bit.

14           The firms are now all viewing themselves as  
15 multi-disciplinary one stop shops. In terms of legal  
16 services, the legal divisions of the firms outside the  
17 U.S. put them in a par with the largest law firms in the  
18 world.

19           With respect to investment banking, the Big Four  
20 global accounting firms are going head to head with  
21 investment banks in China, also in other places.

22           With respect to one of the firms, their ad agency

1 is over a billion dollars in revenue and they employee  
2 over 6,000 employees. And it goes on and on.

3 They're into personnel recruitment, marketing  
4 campaigns, asset management. And I'm wondering, to what  
5 extent you think this is taking their eye off the ball  
6 of audit quality assurance.

7 And then I was reading, as one firm leader, KPMG  
8 in Australia stated, we need to move on from referring  
9 to us as an accounting firm. He goes on to say, those  
10 who would pigeonhole us as an accounting firm do so to  
11 avoid competition, not recognizing the broader threat we  
12 pose to the professional services industry because of  
13 the scope available to us.

14 I think that mind set is not only the mind set  
15 potentially of the leader at KPMG, but I think it's  
16 broader than that. And I'm wondering, to what extent  
17 people in this room are concerned about how audit  
18 quality may be impacted, with respect to some of these  
19 firms potentially taking their eye off the ball.

20 (Off-microphone comments.)

21 MR. HARRIS: The three what?

22 (Off-microphone comments.)

1           MR. HARRIS: Yes, there was independence, too big  
2 to fail and the increasing tension between firms,  
3 investments and audit quality and strategies to grow  
4 business lines and revenues. Right out of your slides,  
5 Lynn. Mike.

6           MR. HEAD: Well, probably it's not surprising,  
7 after my earlier comments, that I think the last one,  
8 the non-audit services.

9           You can say it a lot of different fancy ways, but  
10 they're making higher revenues and the smartest and the  
11 brightest and the most talented find the work more  
12 interesting.

13           You have a drain of the most talented resources  
14 and it's the most, contributing the most profit to the  
15 firm. I don't think it takes a rocket scientist to  
16 determine the audit quality will be affected.

17           Now, that's all anecdotal evidence, it's not  
18 statistical or research based. Though fees, and I don't  
19 think we're back there yet, I hope we aren't there, that  
20 it's still, we still have Sarbanes-Oxley with prohibited  
21 services, but it makes that client a commodity client  
22 versus aggressively going after non-audit clients. And



1 there again, you're going to put your brightest people  
2 on the higher realization and you're going to put the  
3 less talented on the commodity work.

4           And that's not really independence. I think that  
5 I'm probably less worried about independence as long as  
6 we have the prohibited services in place.

7           But I do think that there is some concerns about  
8 whose getting put on what engagements based on that.  
9 And too big to fail just needs to go away.

10           MR. HARRIS: Let me give you some -- I'd be  
11 interested in the views of how concerned we ought to be  
12 with respect to too big to fail and concentration.

13           Because currently in the U.S. market, the Big  
14 Four audit is approximately 97.5 percent of the total  
15 market capitalization. The concentration of Big Four is  
16 even more pronounced when viewed at the sector level.

17           For example, in two sectors, the consumer staples  
18 and utility sectors, the Big Four audit 99.1 percent and  
19 99.4 percent of the market capitalization. If you  
20 combine the fifth to eighth largest firms in the U.S.,  
21 the combined firm would not even be close in terms of  
22 revenue or size to the smallest of the Big Four.

1           And of course in America, we believe that nobody  
2 is too big to fail. But having said that, what would be  
3 the impact if one of these firms did go under and how  
4 concerned should we be and what, if anything, do you  
5 think we should be doing.

6           And ACAP recommended that we look at catastrophic  
7 risk, in terms of one of their recommendations. But I  
8 can't end this session without asking your views on  
9 these three issues.

10           So, Linda, you've got it right smack in your back  
11 yard.

12           MS. DE BEER: I've certainly spent very many  
13 sleepless nights out of the past couple of months, and  
14 I think so did many other people in South Africa, when  
15 it comes to this, all the issues that we've had around  
16 the audit firms and the concept of too big to fail.

17           I don't believe that any firm is too big to fail.  
18 I also think the jury is still out to see, we'll have to  
19 wait and see what happens with KPMG in South Africa  
20 because, yes, there is a little bit of a life boat,  
21 maybe what happened with some of the banks. I happened  
22 to be on the board and the chairman of the audit

1 committee of the bank that actually came out first to  
2 say we're putting our audit out on tender.

3           And I think after that there was quite a bit of  
4 a knee jerk reaction from the regulator and so on. But  
5 I don't think it's necessarily a done deal that that's  
6 enough to save a firm.

7           The question that you asked, Steve, I think is  
8 really important. Is it in anybody's best interest, is  
9 it in the best interest of investors and the companies  
10 and the country, that will be current files.

11           And it absolutely can't be because it means the  
12 competition just gets laced and it just gets harder to  
13 find appropriate auditors that don't have conflicts that  
14 are not, we've got legislation that deal with non-  
15 auditors, so the instances where you just cannot legally  
16 appoint an auditor because they've done an ID system for  
17 you.

18           And I think it links to your comment about  
19 several of the other services and the mind set where the  
20 firms see themselves as public watchdogs, auditors, or  
21 whether they seem themselves as broad business advisors.

22           And what was very clear to me in all of these

1 things is it's almost irrelevant. If they seem  
2 themselves as broad business advisors, the business  
3 world and the public at large see themselves as an audit  
4 firm and they see the name, and irrespective of what  
5 services they've provided, they expect that level of  
6 quality.

7 So what they do in the other parts of the  
8 business actually has an impact on audit quality, it has  
9 an impact on the firm's reputation whether standards say  
10 so and whether the legal regime say so, it's irrelevant.  
11 There's actually the perception, and the perception and  
12 that expectation.

13 Certainly, in our experience in South Africa is  
14 what's driving the big view of this is not acceptable,  
15 we just won't live with this as companies or as  
16 investors.

17 MR. HARRIS: Anne Simpson.

18 MS. SIMPSON: Thank you. Apologies, because I  
19 think Lynn actually put his card up first.

20 MR. TURNER: Go ahead.

21 MS. SIMPSON: I want to speak in a personal  
22 capacity because I'm sort of thinking back through

1 experience on these topics before I joined CalPERS.  
2 But, there are very few markets, if any that I can think  
3 of, where we argue to prevent competition, and we argue  
4 in a capitalist system in a free market to prevent  
5 companies or entities going bust when they fail.

6 I mean, that sort of is concerning, I think, and  
7 ultimately shows itself up in quality. And if we say  
8 lack of choice makes us a prisoner on insisting on  
9 quality or insisting that failure takes place, I think  
10 that the market itself will be prevented from evolving.

11 Now, creative destruction, thank you to the  
12 Schumpeter, the economist. If we don't allow these  
13 processes, you know, if you like gardening you  
14 understand deterioration and compost and new growth and  
15 all of that good thing, which we British love our  
16 gardens, so I would prefer not to be thinking about ways  
17 to protect failing companies but ways to reduce barriers  
18 to entry and give the opportunities for tendering, out  
19 of which one hopes high quality firms could get bigger  
20 and better.

21 And to Mike's important point, it's about  
22 competition. It seems that if you're running two

1 options in any business, you can work on the  
2 hairdressing side or you can go over here into the post  
3 office, we pay more in the post office and hairdressing  
4 is very lonely and not highly, guess what, people will  
5 want to crossover onto the post office sides of what you  
6 do.

7           So if you, whilst these firms are trying to be  
8 all things to all people, I think you'll find that  
9 problem. So that, to me, leads you to an argument of  
10 having auditors and then having business entities to do  
11 consulting, which are separate. It's a governance  
12 question.

13           So anyway, two thoughts. We shouldn't fear  
14 failure because out of failure comes new potential.  
15 Easy for me to say, I know I'm not an auditor facing  
16 this, but we do not protect other parts of the market in  
17 this way.

18           So too big to fail, to me, is not the right  
19 phrase. We're borrowing it out of the systemically  
20 important financial institutions world and I simply  
21 cannot apply that idea to a consulting service.

22           But anyway, a personal remark. Sorry, Lynn.

1 MR. TAROLA: No, go ahead.

2 MS. SIMPSON: No, you can be more inflammatory  
3 than me.

4 MR. HARRISON: We're leading up to the grand  
5 finale. I really actually was about to mine down, Anne  
6 more beautifully articulated much of what I was going to  
7 say but I echo and align myself with your comments.

8 I think, Steve, the only thing I would add, and  
9 it's related to Anne's point is, I think when you  
10 mention the phrase too big to fail and you envision the  
11 possibility of another one of the Big Four failing, you  
12 got to work it through and ask the question, well, what  
13 happens next.

14 I mean, do all the 10, 20, 40,000, pick your  
15 number of audit professionals then go to work in bicycle  
16 shops or post offices, well no, presumably they go  
17 elsewhere. When Anderson failed, they went elsewhere.

18 And you see the -- not that I'm wishing it  
19 happens, please, to be clear, but in the event that some  
20 cataclysmic event occurred when there was the prospect  
21 of a failure, whether it be in South Africa or any other  
22 country or here, if you think through the logical next

1 step in the process, you start to see the potential for  
2 perhaps a realignment, a reconfiguration of the  
3 competitive posture then the profession. Which,  
4 frankly, might not be entirely a bad thing.

5 MR. HARRIS: Kevin. I don't think that's the  
6 least bit realistic, Norman. I think if one of these  
7 firms were going to fail, I don't think there would be  
8 a competitor to the remaining three.

9 I think the dominance of the Big Four are such  
10 that there is a barrier to entry with respect to the  
11 non-Big Four. Kevin, go ahead.

12 MR. CHAVERS: Well, Steve, actually I agree with  
13 you. And let me preface my comment by saying I'm not  
14 going to help with the solution, but I can't help but  
15 sit here and listen to the conversation and recognize  
16 that, and it was alluded to earlier, that there is a  
17 challenge to the business model such as it is.

18 Because frankly, we ask auditors in public  
19 markets to play almost a utility function. And because  
20 we can't figure out who the proper alignment of  
21 interest, we think of them, certainly from the investors  
22 perspective, we think of them as operating in the best



1 interests of the markets and so there is transparency to  
2 the markets and to investors.

3 But as was alluded to earlier, but they are  
4 selected by respective management of the companies and  
5 no one wants to go to a rotational system. And so you  
6 find yourself in this conundrum. Which by the way, is  
7 the exact same dialogue that you have about the rating  
8 agencies. I mean, it literally is the same  
9 conversation.

10 I don't know the answer. If I did I might not be  
11 here. But it is the challenge. And until we sort of  
12 figure out, I mean, I think, you know, to your point, if  
13 one were to, the barriers to entry are such that I don't  
14 expect sort of the constructive destruction that we see  
15 occurring, sort of the technology front and for a host  
16 of old industries.

17 The difference in this context is, both for the  
18 large public accounting firms and for that matter, the  
19 rating agencies. They are required in the statute.

20 They have a bit of a publicly created mandated  
21 function to perform. And perhaps the old business model  
22 doesn't acknowledge that but you have a bit of no one

1 will call it a monopoly or duopoly or whatever, but in  
2 effect is granted in the statute.

3 MR. HARRIS: Linda and then Lynn and then we'll  
4 wrap up this session.

5 MS. DE BEER: Thank you. Just on Norman's point  
6 on where are those people going to work, would it be in  
7 bicycle shops or would they go to one of the other  
8 firms, it certainly is a debate that we all have in  
9 South Africa, specifically around what's happening now.

10 And we have a fairly well developed second tier  
11 of local firms that are loosely linked to, in some  
12 instances, to international networks. I'm not talking  
13 about the Grant Thorntons and so on, they are there, but  
14 there are a couple of very specific South African firms.

15 And there is a very strong school of thought that  
16 maybe that will actually solve some of the concentration  
17 risk issues. That with people potentially moving stuff,  
18 many just even partners moving to some of those firms,  
19 it would actually create the capacity and the skills  
20 that are lacking to give them the competitive edge.

21 You spoke about the barrier to entry, but because  
22 those firms are already there and established, and some

1 of them fairly well established in the public sector, it  
2 might actually be a way of dealing with the competition  
3 issue. Which may be just as a sidebar comment, is one  
4 of the benefits that the audit regulators put in forth  
5 when it comes to their recommendation, or actually their  
6 rule that came out on manage your audit firm rotation,  
7 that it's not just for the benefit of audit  
8 independence, but it would actually deal with the  
9 concentration risk, which I think is interesting.

10 MR. HARRIS: Lynn.

11 MR. TURNER: I think you're absolutely right  
12 about the concentration, or the barrier to entry issue,  
13 Steve. When you go and look at the number of offices  
14 these firms have around the globe, no one else can enter  
15 this and be competitive to the Big Four. It is the  
16 four-opoly if you will.

17 And there's just, the next three are so far down  
18 the path, which is probably the reason their audit  
19 quality isn't as good. And in fact, the Big Four, when  
20 they find that one of the other firms that developed a  
21 great office, like Grant Thornton had in Brazil or one  
22 of the firms had over in Scandinavia, they come poach

1 it.

2           So the bottom is, it's four and that's it. So  
3 when Marc or Wes go back they've got a choice of four  
4 firms. Hopefully all there.

5           But in terms of where they're too big to fail, we  
6 really don't know because we don't have any financial  
7 statements and information. They've typically been very  
8 thinly capitalized because they distribute money out so  
9 they, partners can pay tax, so they're not adequately  
10 capitalized.

11           And until you guys get financial, or ladies,  
12 excuse me Jeanette, get financial statements on them  
13 that are GAAP prepared and you can really tell what's  
14 going on, you don't know. Which is one of the  
15 criticisms you get, because if one goes down and you  
16 don't have that information, there is not a rock big  
17 enough for you guys to go hide on for not having got  
18 that information.

19           And I suspect that if they had a problem, it will  
20 be because of a large audit. Like an Enron size audit  
21 that went bust and thinly capitalized, they don't have  
22 the money.

1           If it was Jim as the chairman, I have absolutely  
2 no doubt Jim would fail it. Jim was at the commission  
3 when Drexel Burnham went under, and I have no doubt that  
4 he'd do the same thing that he and Richard Breeden did  
5 at the time, and away it went. And despite opposition  
6 from others in the administration, it was allowed to  
7 fail.

8           If there's a different person in that seat, I'm  
9 not so sure but what they wouldn't save it, provided  
10 they can get the administration to come up with the  
11 money to help them bail it out. And that's what it  
12 would take.

13           But, again, we don't know. And it's unfortunate  
14 that we find ourselves in a situation where no one can  
15 answer that question.

16           One of the things that the treasury committee  
17 recommended was that there be a plan put in place to  
18 allow for a resolution of one of the firms if they got  
19 in trouble. And to the best of my knowledge, that plan  
20 has never been put in place.

21           So think about it, never got a plan in place,  
22 don't have audited financial statements. If one of them

1 gets into a failure type situation, you guys won't be  
2 able to find a place to hide, because why did that  
3 happen.

4 MR. HARRIS: Okay, let me ask, and I want to go  
5 around the table and close this out, and we're going to  
6 start with you Bob. With respect to, hold on for one  
7 sec, just because I want to ask Lynn and others a  
8 question, but I'd like each of you to prepare, if you  
9 got any suggestions or recommendations to the PCAOB or  
10 to the Commission, Wes and Marc, we want to give you the  
11 opportunity and then we'll close it up.

12 Does anybody disagree with the suggestion, the  
13 recommendation that firms be required to have audited  
14 financial statements, and if so, why?

15 So that way we create some kind of a record in  
16 terms of how people view that issue. Or has anybody  
17 thought about it and does anybody have any  
18 recommendations?

19 Wait a second, if people agree they ought to, I  
20 mean, we're looking either for a record or a non-record,  
21 so if somebody --

22 MR. TURNER: I'll go on record --

1 (Simultaneous speaking.)

2 MR. HARRIS: Oh no, I'm sorry, I apologize. No,  
3 that's why I was so happy to have Chairman Clayton and  
4 Jim here because they're lawyers' lawyers and wordsmiths  
5 and I forgot the words to use.

6 Does everybody agree -- is there any  
7 disagreement, I'm sorry, with the recommendation that  
8 the firms be required to have audited financial  
9 statements?

10 MS. SIMPSON: Why don't you put it forward as a  
11 motion and then each one of us can be affirmative?  
12 Because sitting silently, I think, on this topic is not  
13 good enough.

14 MR. HARRIS: Well, we've never had a motion  
15 before but since it's the last time I Chair the Investor  
16 Advisory Group --

17 MS. SIMPSON: I would be happy to move a friendly  
18 motion --

19 MR. HARRIS: Okay.

20 MS. SIMPSON: -- that this house, are we, the  
21 house moves that the governance of audit firms be of  
22 such, being of such critical importance to the economy,

1 it's vital that the regulator has access to financial  
2 information necessary to perform its role.

3 MS. BERSOT: I'll second.

4 MS. SIMPSON: Oh thank you, seconded by Mary.

5 MR. HARRIS: This is a first. Is there any  
6 objection? So voted.

7 All right, moving on. Robert, if you could go  
8 ahead and take --

9 MR. TAROLA: Yes. And I'll affirmatively say yes  
10 to that motion.

11 MS. SIMPSON: Thank you.

12 MR. TAROLA: I actually think it's good for the  
13 record that we all do that.

14 MS. SIMPSON: Yes, we should --

15 MR. TAROLA: In terms of, Steve, you're looking  
16 for what's next kind of recommendations?

17 MR. HARRIS: Yes. And Kevin was just reminding  
18 me, it's by unanimous consent. Motion is passed by  
19 unanimous consent.

20 MS. SIMPSON: There you go.

21 MR. HARRIS: Of the Investor Advisory Group.  
22 Board Members not taking a position. Based upon a



1 recommendation. Robert, take it away. Thank you, we'll  
2 close up.

3 MR. TAROLA: Yes, yes, yes. So I'll stay with  
4 the topic I introduced today. This movement to  
5 structure data and accessing a financial information,  
6 electronically instead of it on paper and reading it, is  
7 a movement that's going to continue.

8 There's already a couple hundred registrants that  
9 are using it I believe, Wes, something like that. And  
10 if the SEC makes it a permanent requirement, it's going  
11 to be every registrant that has one set of financial  
12 statements instead of two.

13 And I think that the relevancy of the auditing  
14 profession needs to step up and be part of that  
15 evolution. And to the extent this group agrees, we can  
16 talk about that at another meeting.

17 MR. HARRIS: Thank you. Larry.

18 MR. SHOVER: All right. I have to start off by  
19 saying I've never been more encouraged than today. And  
20 I think part of that is we've dealt with an issue two  
21 years in a row. And I think there is something to be  
22 said to that. Like the whole NGFM.

1           And I like to propose, if I'm allowed to propose  
2 or suggest, that even one of the subjects we talked  
3 about today, be talked about in more granular detail  
4 next year. And that would be the auditor consideration  
5 of noncompliance.

6           Because there was a lot of great suggestions that  
7 came out of that. And as an institutional investor, it  
8 seems real easy on paper for me to say to you, oh, just  
9 revisit AS, what was it, 2405, and update the shoulds  
10 and the musts and all that. But I know implementing is  
11 a way different story. That said, that would be my  
12 vote.

13           MR. HARRIS: Gary.

14           MR. WALSH: I too thought it was a great session.  
15 In response to why we had a 42 percent average  
16 deficiency, you said that the firms have said, well, you  
17 took the riskiest audits. I think that's the aspect  
18 that as an investor I don't have good enough visibility  
19 into it.

20           I agree with Michael, with Mike, that I'd like a  
21 root cause analysis as to why we see a 42 percent  
22 deficiency rate. But instead of the direct answers to

1 all of that, I'd really like to know, is this a risky  
2 audit?

3 As an audit committee chairman, I think I would  
4 want to know, is this a risky audit. And maybe  
5 visibility into that would help in a lot of different  
6 ways.

7 Your question about, do we have the right people  
8 on the audit, I can't imagine what an audit would cost  
9 if you had just partner hours staffed to do it. Or the  
10 quality for that matter.

11 (Laughter.)

12 MR. WALSH: But I think the deal is that we have  
13 to staff those audits that are less risky with the more  
14 inexperienced people so that they can get up to speed on  
15 something that's not critical. And make sure that the  
16 more risky audits that are taking place are done with  
17 more, with higher caliber people. From an experience  
18 standpoint.

19 And so I think the risk is the thing that I'd  
20 like to see us identify and explain a little bit more.

21 MR. HARRIS: Norman.

22 MR. HARRISON: Steve, first of all I want to

1 thank you. I and a few others around the table today  
2 are charter members of this cast of characters who've  
3 been around a few years and it has been a privilege and  
4 a pleasure each year to work with you and Jim, Janette,  
5 your predecessors, other Board Members along the way and  
6 I want to give a shout out to Annette and the rest of  
7 your fantastic staff for all the work they do to prepare  
8 and help this be such a pleasant experience for all of  
9 us.

10 But I think by way of a final word, I have two  
11 final words. One is that, I hope the record shows also  
12 that we're here because we have respect for the audit  
13 profession and a vital appreciation, or an appreciation  
14 of the vital work they do and the central role they play  
15 in our capital markets.

16 We come and we make recommendations and there are  
17 criticisms or critical commentary along the way, but  
18 we're here to help the Board do a better job in  
19 overseeing and regulating them and to provide you with  
20 our recommendations about additional tools we believe  
21 you should avail yourselves of, to help the firm succeed  
22 and do their jobs well. I just want to be sure that

1 comes through at the end of the day.

2           And then by way of a closing suggestion, I'll  
3 also revert back to the Panel that I presented on today,  
4 and to the point we were just discussing a minute ago,  
5 about the issue of disclosing to you audit financial  
6 statements.

7           And the Big Four do enjoy a privileged position  
8 in the capital markets. They are an oligopoly or some  
9 form of a market dominance mechanism that would be  
10 permissible in other contexts.

11           And it is because of the unique role they play  
12 and a variety of other factors, but it would seem that  
13 in exchange for that status, which we've conferred upon  
14 them by statute and regulation, that there should be  
15 more offered in return. And I think disclosure of audit  
16 financials is one of those.

17           And I think making some effort to measure and  
18 report performance is another. Which is why I think  
19 AQIs are important.

20           And, Jim, I take your point that there continues  
21 to be debate and discussion around whether we know how  
22 to measure, whether we know what things to measure, and

1 we and the profession and others who have interests in  
2 this topic, and we can talk about that for the next ten  
3 years, we can debate in the absence of data, in the  
4 absence of any results.

5           Which is why I would urge you to move ahead, get  
6 started with something. Let's give it a go and let's  
7 get something out there.

8           Let's measure, let's track a few years, let's see  
9 if we can find correlations between measurements and  
10 outcomes and quality of audits. And if it isn't perfect  
11 in the first instance, so be it, we'll tweak and revise  
12 along the way.

13           I just don't think there is any reason at all not  
14 to move forward, at least get started. So, with that,  
15 thank you.

16           MR. HARRIS: Linda.

17           MS. DE BEER: Thank you. And I also just want to  
18 say, it is really great for me to be here. It is  
19 actually a privilege to be part of this debate.

20           And I know I come from a completely different  
21 jurisdiction where we clearly don't always get things  
22 right, but it is definitely worthwhile for me to come

1 here and spend the time, so thank you for the  
2 opportunity.

3           Maybe just two or three points from my side. And  
4 I've made the point a couple of times today, but it is  
5 just in our past experience, in the past couple of  
6 months in South Africa, struck me that there is still a  
7 massive gap, that expectation gap, between what  
8 investors and what the public and what companies expect  
9 of auditors and what the legal requirements and  
10 statutory duties are.

11           And that in the day and age that we live with  
12 social media and millennials that see things very  
13 differently, we're not going to bridge that gap by  
14 preaching to people what the law says. We need to  
15 actually bridge it by moving the role and the  
16 responsibility of auditors, because I honestly do think  
17 it's a profession that runs the risk of becoming extinct  
18 if they can't move with where that expectation is  
19 moving.

20           I also would just like to make the point again  
21 about working together on audit quality and the role of  
22 audit committees. I think audit committees is a key

1 governance structure to actually help, and it can't be  
2 done in isolation.

3           Echoing your point, Norman, around transparency  
4 and the governance within audit firms and we see now  
5 again in South Africa the lack of transparency, the lack  
6 of good governance structures seem to be at the heart of  
7 some of the things that went wrong.

8           And then Jim, you made the point this morning  
9 about leveling the playing field. I think it was in  
10 relation to auditor reporting and the fact that you've  
11 now also adopted the standard and there are other  
12 things, audit quality indicators and things like that,  
13 happening internationally.

14           And it is really important that auditors play at  
15 the global level and that standards across jurisdictions  
16 are sort of similar and that the quality of an audit and  
17 the value added by an audit is sort of similar whether  
18 you come to South Africa or in the U.K. or in the U.S.  
19 And I really think that is important.

20           And I think it's very encouraging to see how  
21 there is a much better alignment now between, for  
22 example, the processes of the IAASB and the PCAOB and



1 the topics. I think everybody has got their own agenda,  
2 but there also is similar topics. And I think that is  
3 really important for, not just for auditors, but it's  
4 really important for multi, companies that operate in a  
5 sort of a multi-country level.

6 And in saying so it is important for the PCAOB,  
7 I believe, to remember that there are very many smaller  
8 audit regulators that look up to you and that actually  
9 just follow your leads, because they don't necessarily  
10 have the capacity to do something like this and to do  
11 the work that you're doing.

12 So yes, you do it for the benefit of the U.S.  
13 market that you regulate, but I think there is, and  
14 there should be, a consciousness that there are others  
15 that also look to you, to follow the steps in, in the  
16 footsteps of what you're doing. And I think that's a  
17 very important and also a very responsible role.

18 MR. HARRIS: Thank you. Tony.

19 MR. SONDHI: I wanted to start, Steve, by first  
20 of course saying thank you. It has been a great  
21 pleasure being here working with you, and learning. And  
22 I hope that we've managed to provide some contributions

1 to this.

2           With respect to where we should be, I certainly  
3 think that the non-GAAP measures are something that we  
4 need to do something about. It's critical to have the  
5 transparency and the consistency, but I also want to be  
6 very clear that I think, at the moment at least, that  
7 many of the non-GAAP measures can be rather  
8 significantly and seriously misleading. And I think we  
9 need to be very, very careful about that.

10           My next point is with respect to the audit  
11 quality. I think the more we can focus on the output  
12 the better off we will be.

13           And I wanted to close with just a brief comment  
14 on what Anne was saying earlier. Anne, I agree with you  
15 about the gardening, and particularly if you try orchids  
16 and anthuriums, I think failure is one of those things  
17 that you certainly learn from very quickly.

18           But this issue of the too big to fail, Lynn had  
19 said earlier that with structured data and iXBRL and all  
20 of that coming in, one wouldn't want to go to these  
21 audit firms to ask them for that.

22           And I wonder whether our solution to this too big

1 to fail and all these problems that we have with the  
2 audit firms is going to come from the fact that there  
3 will be creative destruction and we will get a new breed  
4 of audit firms. The ones that specialize in auditing  
5 structured data in XBRL. iXBRL.

6 I think that may be our savior going forward.  
7 And don't get me wrong, I'm not saying anything about,  
8 I do believe we need the audited financials from them.

9 And I'll close by saying, after we get the  
10 accounting firms to give us audited financials, we'll  
11 also get a chance to see which non-GAAP measures they  
12 favor.

13 (Laughter.)

14 MR. HARRIS: Mary.

15 MS. BERSOT: Thank you. And thank you very much.  
16 I don't have the background that a lot of you have but  
17 I've learned a lot and I think I have somewhat of a  
18 30,000 foot view. So I do have a couple of comments.

19 One is, as I'm listening to too big to fail, and  
20 they're not providing financial statements, maybe  
21 perhaps, and this is just a wild idea, but they should  
22 have minimum capital requirements that they keep in

1 their businesses.

2 I mean, we talk about them passing out everything  
3 to partners, maybe they shouldn't. I know in the  
4 investment management business, if you're govern by a  
5 state, not the SEC, you are required to keep minimum  
6 capital. So it's just a thought. Revolutionary  
7 probably.

8 And I also, before I came, I kept thinking to  
9 myself, objectivity and independence. Being objective  
10 and independent keeps weaving its way through all of our  
11 discussions.

12 And I think, from an investor perspective, that's  
13 where the huge gap is. I think investors rely on the  
14 audit firms. And they really do believe that they're  
15 independent and objective.

16 And somehow I think adding all these other  
17 businesses reminds me of being at Citibank, right after  
18 Glass-Steagall fell, and we all started sort of coming  
19 together and cross-selling.

20 So I do feel that any effort next year, that  
21 includes the objectivity and independence, and could be  
22 pretty much anything at this point, I think would be

1 very valuable.

2 MR. HARRIS: Thank you. Kevin.

3 MR. CHAVERS: I want to join the others in  
4 thanking you, Steve, for the opportunity and thanking  
5 you for your service here. It's been, and if Mary is at  
6 the 30,000 foot level I'm probably at the 35,000 foot  
7 level. But it does afford me the opportunity to make  
8 some observations and try to connect a couple of the  
9 dots.

10 So the last conversation about sort of audit  
11 quality, and frankly the transition of that conversation  
12 to looking at the business model of auditors, it's a  
13 pretty interesting one that I had not given sort of a  
14 lot of thought to, but the discussion, particularly as  
15 we delve down the too big to fail conversation, reminded  
16 me very much of the conversations about financial market  
17 utilities.

18 And while they perform a different function, we  
19 in effect are saying they have that kind of connectivity  
20 as we've deemed for other financial market utility  
21 functions.

22 And so it's an interesting perspective in which

1 to view the role that they play in the markets. And  
2 specific, I'll comment a little bit on the, sort of the  
3 non-GAAP measures.

4 I don't think there was a great deal, or I didn't  
5 hear much disagreement about the recommendations coming  
6 out of the working group. I think there was some  
7 disagreement perhaps about the tactics to execute them.

8 I think there may have been less than uniform  
9 support for the notion that relying on the creation of  
10 transparency in the standards we would rely on  
11 management to create those. I don't know that there was  
12 a uniformity in the room around that concept.

13 But I think the chairman made a very good  
14 suggestion, in terms of a tactical effort, and I would  
15 like to encourage the steps along those lines. And that  
16 is, wearing sort of your regulatory hat and your  
17 convening authority as a regulator to work with the  
18 standard setting bodies to start thinking about and  
19 looking at how do we create some standards with some  
20 transparency. At least to start taking those initial  
21 steps.

22 Not suggesting it's going to be an easy task, but

1 I think it's a task that merits follow-up. And would  
2 encourage you to do so.

3 And the lastly, as I've said, actually I brought  
4 this topic up last year and reiterated it this year, as  
5 we start to look at non-GAAP measures, I would strongly  
6 encourage, given the evolution and increasing  
7 significance of ESG related issues, to be part and  
8 parcel of that conversation as that evolves.

9 MR. HARRIS: Grant.

10 MR. CALLERY: I guess I would raise three points  
11 probably. First, thank you, it's been great working  
12 with you.

13 And I think these sessions are of value to us,  
14 hopefully they're of value to the Board. And so thank  
15 you for that.

16 Second, I think the NOCLAR discussion today is  
17 something that I would hope that the Board could move  
18 on, at least in part with some degree of speed. It's  
19 uniquely one of the things that under your control for  
20 the most part.

21 And I think it's something that can, could help  
22 close that gap between investor expectations and

1 reality. And if you got a couple of wins out of it, it  
2 might not be the whole thing and you might continue to  
3 work on it, but I think that would be something that  
4 would be very helpful.

5           Second thing is, I continue to, and we've talked  
6 about this and it's been weaving through the discussion  
7 today, I continue to have concerns about the, sort of  
8 the business models, the consulting, the cool guys  
9 versus the non-cool guys and that kind of thing. And I  
10 don't know what the answer is but it is troubling.

11           Because the audit function is so important to so  
12 much of the investment process in the United States that  
13 to have it the poor relation, there's got to be a better  
14 answer and we need to keep thinking about it.

15           And then I guess finally, there is still some  
16 legislation out there that would take us out, I guess.  
17 And if there's anything that members of this group could  
18 do that would be helpful in that regard, and I don't  
19 really know where it's going, where it's not going, but  
20 I'm sure that everybody around the table will be willing  
21 to do what they could with either the SEC or wherever.  
22 So let us know.



1 MR. HARRIS: Thank you very much, Grant. Amy.

2 MS. MCGARRITY: Thank you. I guess I just also  
3 want to reiterate my gratitude to Steve and the rest of  
4 the PCAOB team.

5 Jeanette said something earlier that really  
6 resonated with me, I wrote it down. It's tone at the  
7 top.

8 And I just really think that you set a great  
9 tone. You and the team at the PCAOB put together a  
10 great, this has been a great experience for me for the  
11 last two years and I'm really grateful for the  
12 opportunity to have met you and worked with you, so  
13 thank you for that.

14 As it relates to potential topics for next year,  
15 Kevin, I think your comments, as it relates to non-GAAP  
16 financial measures, are on par.

17 While I think there is some frustration as to  
18 next steps and defining those, I'm happy to serve as an  
19 investor resource to the extent it's helpful at all to  
20 either the SEC and/or the PCAOB. I'm happy to do  
21 whatever I can to learn more and further the objective.

22 I think it's an important issue that a lot of

1 people are working on, and there's just not a lot of  
2 clarity on where we're going with it so I'm happy to  
3 just keep staying in the conversation, and to the extent  
4 I can, contribute. I would love to do so.

5 I think there's a lot that's been said about the  
6 expectations gap between investors and what the auditing  
7 profession is doing and the PCAOB. And I think that  
8 there are a lot of topics that we talk about as it  
9 relates to electronic statements, as it relates to the,  
10 Grant, what you and your team put together.

11 I think there's a lot of things we can weave into  
12 a topic related to closing that gap of the investor  
13 expectations and really maybe work together to  
14 collaborate on some potential solutions to try to bring  
15 that gap a little bit, to close that gap a bit. So  
16 those are just some potential ideas.

17 MR. HARRIS: Thank you, Amy. Mike.

18 MR. SMART: First and foremost I'd like to thank  
19 you, Steve, and the Board for just allowing me the  
20 opportunity to serve.

21 This is actually something I take a great deal of  
22 pride in to give something back to an institution and a

1 country that's given me so much. So first and foremost,  
2 thank you very much.

3           Second, and I think there continues to need, we  
4 continue to need to give more thought to the non-GAAP  
5 matters. I think that we put a lot on the table today.  
6 Gave us a lot to think about.

7           I think one thought, one alternative, would be  
8 maybe to narrow down our focus within the realm of non-  
9 GAAP items. And that's something I'd love to continue  
10 working on and hopefully we'll discuss again next year.

11           Second, I do believe that our auditing partners,  
12 as I like to call them, we do need to gain a better  
13 understanding of what's sort of behind the curtain in  
14 terms of their financial status and wherewithal.

15           You know, someone mentioned that most of the  
16 capital is distributed. Well, if that is the case, then  
17 the assets are really going up and down the elevator  
18 every day. Like most service businesses.

19           And with that in mind, I frankly think that, and  
20 this has to be confirmed through an audit, I hope, I  
21 actually think that if something were to go wrong,  
22 similar to an Anderson type situation or something that

1 we find our brother in South Africa going through, I  
2 actually think that competitors here, someone, or a  
3 number of someones, will step into the breach and void  
4 because it's too profitable of a business for it all to  
5 go away.

6           So those are sort of my thoughts. And I look  
7 forward to seeing you all back here next year. Without  
8 a goal.

9           (Laughter.)

10           MR. HARRIS: Lynn.

11           MR. TURNER: This is probably the last meeting  
12 that you, Steve, and Chairman Doty will be at. And so  
13 I'd just like to say thank you, thank you, thank you for  
14 all the hard work. I know it's been a tough slog during  
15 those years but the work you and Helen have done on the  
16 inspections I think has greatly improved those.

17           I don't know if you'll be back or not yet  
18 Jeanette but same thing goes for the work you've done.  
19 So I can only say, you've done a great job and thank you  
20 in light of that.

21           I'd also like to thank Nina for all of her help  
22 in getting ready for this. And to Marty and Wes and

1 Marc, thank you so much for the support on the audit  
2 report.

3 I think that's going to have a very positive  
4 outcome and consequences, so thank you for, I know  
5 you've been, you now, people in your shoes weren't  
6 always so supportive, but you guys have been great so  
7 thank you for that.

8 As far as going forward, Marty's project on  
9 estimates and judgements, we really probably haven't  
10 done what we should have done with that in this group.  
11 I think that standard has now come that could be highly  
12 positive and that project is most critical and  
13 important.

14 A lot of quality and judgments go into these  
15 audits and auditors are always saying it's our judgment,  
16 please live with our judgment. But those judgments,  
17 some of them are good and some of them are not so good.  
18 So I think that is important and I think it would  
19 behoove the group to consider that going forward.

20 And especially in the light of what Tony talked  
21 about on the revenue recognition, the new revenue  
22 recognition standard. I think it's a train wreck

1 waiting to happen.

2 I think you and I probably disagree on that one  
3 Wes, but I think the latitude in the judgment and the  
4 flexibility in that, having dealt with revenue for 40  
5 years and lived through all the problems with the tech  
6 companies in the '80's, I don't even know if you were in  
7 the profession then, and the statements we went through  
8 at the commission at that point in time, I think it's  
9 going to be deja vu all over again.

10 So I think Marty's estimates and judgment project  
11 would probably be right at the top of my priority list  
12 and hope he'll be successful in getting a timely and  
13 high quality standard out on that. But again, thanks to  
14 the three of you and Helen and Marty for the great work  
15 done.

16 MR. HARRIS: Mike.

17 MR. BRICKER: It's always harder when you're at  
18 the end because you sound like you're copying everybody,  
19 but again, thanks to the Board and Jim, you and Steve,  
20 and the privilege and honor it's been to be one of the  
21 original. And this is just a great experience and I  
22 think it has added a lot of value over the years.

1           Yes, I think the firm should provide audited  
2 financial statements. So officially going on the record  
3 for that.

4           I think we have a unique opportunity with the  
5 digital financial statements, electronic statements in  
6 line, XBRL, whatever you want to call it, that maybe we  
7 could be out ahead of that issue and get something in  
8 place instead of trying to play catchup like we seem to  
9 play a lot of times.

10           It just seems to be a no-brainer that you would  
11 want to ensure whatever auditing standards either need  
12 to be updated or revised, would reflect and hold the  
13 auditors accountable for that. In line with when SEC  
14 would say it's a must and be there.

15           And I just wrote down a little statement that  
16 it's what if. What if we separated audit from non-audit  
17 services, what if the PCAOB actually selected and  
18 appointed the firms instead of the audit committees and  
19 management, would some of those things allow the  
20 management of concentration expertise, starting to  
21 rotate auditors, starting to get the too big to fail not  
22 be an issue going forward because it could be managed in

1 a rational way and get it not to be 99.1 percent but  
2 some other percentage, what if we did something really  
3 bold that wouldn't be maybe well accepted by the firms  
4 but maybe is the right thing to do. That's where I'll  
5 end and stop there.

6 MR. HARRIS: Thanks, Mike. Anne.

7 MS. SIMPSON: Well, I want to repeat the thank  
8 you's because each time we say it it comes from a person  
9 who's worked with you, so we'll all be ringing out our  
10 hankies any minute now.

11 But special thanks to Steve. So I think you've  
12 persuaded me. I think just as I was first joining  
13 CalPERS, after the financial crisis, that this was  
14 important and to come in and just such a treat to work  
15 with you.

16 And, Jim, such a pleasure to work with you too.  
17 And the wonderful staff who have been so helpful. And  
18 also, the rest of this crowd. We've made audit  
19 interesting, think about that.

20 (Laughter.)

21 MS. SIMPSON: It's not a mean feat, we've  
22 actually had a lot of fun here. Well I have anyway.



1           So on the to do list. The first thing I've, I  
2 think is a running theme is this question of the  
3 governance of the industry. Because, to the extent it's  
4 well governed, you have an opportunity to regulate it.  
5 At the moment, you're regulating in the dark.

6           And I think the unanimous, thank you, Kevin, for  
7 the emphasis, the unanimous, by acclamation, advice on  
8 financial statements for the audit service providers is  
9 really important. Then you can take a look at it and  
10 then you can think about what next.

11           But without having the light, you know, Justice  
12 Brandeis, the electric light, we need the electric light  
13 switched on. So that's number one.

14           Number two, I'm struck that we have got, through  
15 today's discussion, a growing list of topics. You've  
16 got unfinished business, you got a full plate with the  
17 unfinished business and some new and very important  
18 topics.

19           So that leads to my second question, which is,  
20 what is it that's holding back your ability to get  
21 through the workload? I think we all have a glimpse of  
22 what some of that looks like.

1           But I think if we're not more realistic about  
2 where you have resources, where you have a mandate,  
3 where you're meeting resistance, we could meet next year  
4 and we'd still want this huge unfinished business and a  
5 growing workload.

6           So I think I would just want to finish one final  
7 note of thanks to Chair Clayton for coming and joining  
8 us this morning, but also for finishing off an important  
9 piece of business which will make a difference. And I  
10 hope in that spirit of cooperation other things can get  
11 taken off the list.

12           And I'm pondering, for this body, where we can  
13 help move things along with the audit committee.  
14 Because this is a tri-part structure.

15           You've got the Board, you got the auditor, and  
16 the shareholders. And in that tri-part structure, the  
17 regulator is there to support that three-way structure  
18 working well.

19           And maybe you don't have the mandate to do it,  
20 but we have the responsibility to really think, what are  
21 the skills and expertise to ensure the audit committee  
22 members can fulfill their role properly. And I think

1 that's a bigger debate about governance and Board  
2 quality.

3 But it's certainly given me pause for thought.  
4 And I think probably in the investor community, we've  
5 got a bit stuck on independence being defined in a  
6 rather narrow way, but we need to broaden out into our  
7 thinking about Board competence and also diversity.  
8 Because groupthink is not our friend when you're looking  
9 at audit matters, whether they be critical or not.

10 So thank you to you all, and no doubt there's  
11 much more to do. So if I'm back next year I'll look  
12 forward to hearing more from you all. Thanks.

13 MR. HARRIS: Judge Sporkin, do you have any  
14 closing thoughts?

15 MR. SPORKIN: I want to again thank you and Jim  
16 for a wonderful program. And you're doing a great job.

17 The only thing that I want to say is we've got to  
18 go away from the charade of independence.

19 And we're dealing with a model that started many  
20 years ago, and was interested in taking inventory and  
21 confirming receivables. We're past that model.

22 And we ought to break it up and come with the

1 current model and try to build something that makes  
2 sense, that relies more on the company's financial  
3 statements, gets the SEC more involved in giving  
4 whatever independence that has to be given. Maybe even  
5 selecting the auditors.

6           As you know, this is not going to last for long.  
7 We've gone from eight to four, and I will predict that  
8 we're going to go from four to two. And so we're going  
9 to get to the single payer model. And that's why the  
10 SEC has a bigger role. SEC and whatever they've  
11 delegated to the PCAOB.

12           MR. HARRIS: Thank you very much, Judge.  
13 Jeanette or Jim, do you have any closing thoughts? I'll  
14 recognize you and then the Chairman.

15           MS. FRANZEL: Yes. This has been a fantastic  
16 discussion and I thank all of you for your  
17 participation.

18           And I hope that next time we get together we'll  
19 have some progress to report, and we can get some more  
20 input and take things to the next level. So I think  
21 we've got plenty of things to think about and progress  
22 that we can make and would like to continue the

1 discussion.

2 MR. HARRIS: Mr. Chairman.

3 MR. DOTY: Thank you, Steve. The first thing  
4 that Lewis Ferguson said to me today, from his sickbed,  
5 was to thank you for joining and thanking you for  
6 leading this group.

7 I have no doubt the audit reporting model would  
8 not have come about without this group. Without the  
9 Investor Advisory Group.

10 When I think about the audited financials and  
11 started thinking about structure, it used to be said of  
12 John Kenneth Galbraith that he thought he could see  
13 forever. And of course, he couldn't on a clear day.

14 But you start thinking long-term. And it seems  
15 to me there is a, sort of a turning that the audit firms  
16 could make, or that we could go, that would not be what  
17 we want.

18 Kevin raised the public utility model, and I keep  
19 thinking about that. I'll tell you, Kevin, our  
20 economists roll their eyes when I raise the public  
21 utility model.

22 But really, public utilities have a certain

1 stability built in. They have a return on investment,  
2 on equity, which Mary mentioned.

3           Along with that goes a capital requirement. But  
4 there is a return on equity, there's a limitation of  
5 civil liability.

6           The governance structure is highly regulated and  
7 there are some people that thought if the firms adopted  
8 a true corporate structure with a holding company and  
9 corporate affiliates that that would have a lot of good  
10 effects.

11           But it isn't what is consistent with the  
12 profession, what we think of as the bright future of the  
13 profession. And so I go instead back to what the firm  
14 say their challenge is, which is trust and relevance.  
15 And that's what this group has laid out.

16           I thought Linda hit it right on. When people  
17 hire a global network firms, a consulting or data  
18 processing group, they think they're getting the same  
19 quality that they, and they should get the same quality  
20 they get from the audit franchise that it enjoys. And  
21 that's what the trust and relevance means to the firms,  
22 it's what they have to protect.

1           And to do that they got to take risk. They've  
2 got to go ahead and give us the AQIs that they believe  
3 are audit engagement AQIs and that we can in fact report  
4 on. We can inspect against and report on to their audit  
5 clients.

6           They don't want to do that now, but they will  
7 come around to it, because that's a part of risk, it's  
8 a part of trust and confidence.

9           Firms don't fail, really, because of civil, they  
10 haven't failed because of civil litigation damages. And  
11 I think that they're not going to fail.

12           The only big firm that's failed failed because of  
13 an erroneous, mistaken criminal indictment that  
14 shouldn't have been issued. They fail because  
15 profitability declines slowly.

16           They fail, and that happens because they're not  
17 hiring good people and they're not promoting them and  
18 they're not managing the business well. Just like a law  
19 firm or just like a medical practice.

20           They fail because the investment gets to be high.  
21 Data, analytics, the investment is going hockey stick  
22 high. So we're going to see more of the investment

1 requirement on the firms.

2           That could be a cause for failure but it's not a  
3 reason for the government to bail anybody out. The  
4 government has no business financing their data  
5 analytics capability.

6           So the firms can take a lot of risks here. And  
7 whether or not we see their audited financials or not,  
8 they can in fact go out and, if we tell them that we  
9 want them to solve the problem of KPIs and non-  
10 governmental performance metrics, let them tell us what,  
11 industry by industry, what issuer by issuer they think  
12 are the appropriate KPIs and audit metrics.

13           It's in their interest to do it and it's in their  
14 interest to certify that, stand behind it, validate it,  
15 tell us what you can audit. That's risky, but they've  
16 got to do that. Got to do it.

17           I thought what came out of the discussion today  
18 on each of these subjects and legal requirements was one  
19 of the best I had been in anywhere, any place, in an  
20 entire career.

21           You are a wonderful group of great strategic and  
22 long-term thinkers and you'll do great things in the



1 future. And I don't think Congress is going to shut you  
2 down.

3 (Laughter.)

4 MR. HARRIS: Well, I want to close by thanking  
5 Wes, thank you, thank you, Marc. Thank the chairman for  
6 all of us, which I think we tried to do ourselves, but  
7 if you would pass that along.

8 I think a number of you have raised the question  
9 in terms of, you hope you've made a contribution and  
10 you've hoped you added value to the Board. I think our  
11 product speaks for itself.

12 I mean, whether it be on transparency or whether  
13 it be on the audit reporting model, you've raised issues  
14 which the Board has taken seriously and the commission  
15 has taken seriously.

16 And I think you've raised issues today which,  
17 though they may take time to review and consider, I  
18 think you've put them into the marketplace and I  
19 appreciate it more than you can imagine.

20 So I thank you very much and I want to give a,  
21 actually, I want to give another shout out. He's not  
22 here, but one of our founding members of the investment

1 advisory group was Joe Carcello.

2 Joe Carcello, and I don't know whether he'll ever  
3 hear this or get it, but he made an incredible  
4 contribution with respect to transparency and the audit  
5 reporting model. And I think there ought to be some  
6 way, which we'll try to collectively express our  
7 appreciation, to him. But he was an invaluable founding  
8 member, and in absentia, somehow or other, we'll have to  
9 get a way to collectively thank him for his  
10 contribution.

11 And having said that, I don't want to  
12 particularize and individualize all of you, because I  
13 think I know who you are, I think you know who you are,  
14 who have made a contribution over the years, help make  
15 this a success for me. But I got to give the major  
16 shout out to Nina Mojiri-Azad.

17 Nina is right here. Stand up, take your  
18 applause. And I want to embarrass you as much as I can.

19 Tope Folarin, thank you. In absentia, Joanne  
20 Hindman was here and she was present at the creation of  
21 this.

22 And Mark Olson made this possible as the chairman

1 of the PCAOB and had the support of Dan Goelzer. Cindy  
2 Vaughn and Lucia Carromba also were very supportive.

3           So thank you all very much, it's totally  
4 appreciated.

5           (Whereupon, the above-entitled matter went off  
6 the record at 5:12 p.m.)

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<b>A&amp;M</b> 1:19 29:18	167:17,19 222:1	<b>actuality</b> 79:13	<b>advancer</b> 91:6
<b>A.C</b> 2:3	223:18	<b>ad</b> 270:22	<b>advances</b> 91:15
<b>a.m</b> 1:11 4:2 97:14,14	<b>accounted</b> 182:13	<b>add</b> 8:18 42:20 47:12	<b>advancing</b> 10:16
<b>AAA</b> 259:22	<b>accounting</b> 1:1 11:5	56:22 79:21 111:21	209:22
<b>AB</b> 1:10	14:10 43:5 48:5,12	114:7 163:4 170:20	<b>advantage</b> 127:6
<b>abetting</b> 196:10,11	63:2 76:9 78:5 83:1	210:21 268:9 279:8	<b>adversely</b> 250:4
204:18	84:21 85:18,22 86:8	<b>added</b> 22:4 25:18 65:18	<b>advice</b> 6:17 180:11
<b>abhor</b> 70:18	86:11 100:10 107:14	70:7 125:20 154:22	313:7
<b>abilities</b> 240:4	141:16 168:14 181:18	296:17 310:22 321:10	<b>Advisor</b> 14:16
<b>ability</b> 20:9 21:18 34:20	269:2,12 270:20	<b>adding</b> 253:3 300:16	<b>advisors</b> 28:6 142:22
34:21 37:14 71:17	271:9,10 281:18	<b>addition</b> 38:17 49:20	275:21 276:2
76:7 80:17 88:9	299:10	71:15 81:9 268:10	<b>advisory</b> 1:3,10,13,17
109:11 118:11,15	<b>accumulated</b> 17:8	<b>additional</b> 21:1 49:8	2:6 4:5,17 5:2 6:15
119:4 135:1 144:7	<b>accumulating</b> 19:13	67:18 68:2 69:9 70:8	14:11 17:20 27:11,18
185:20 215:15 225:19	<b>accuracy</b> 16:6 97:1	209:17 212:6,8 215:1	51:7,8 56:2 224:6,6
268:5 313:20	183:2	227:5,19 257:2	224:21 225:16 231:1
<b>able</b> 62:21 108:16	<b>accurate</b> 88:11	292:20	268:19 287:16 288:21
159:20 167:2 173:17	<b>achieve</b> 5:11 10:13	<b>address</b> 45:19 47:5	317:9 322:1
202:20 207:12 236:20	<b>acknowledge</b> 13:8	54:11 98:4 186:21	<b>advocate</b> 236:17,18
239:14 286:2	74:13 213:16 281:22	<b>addressed</b> 18:10 79:15	<b>advocating</b> 5:4
<b>above-entitled</b> 97:13	<b>acknowledged</b> 85:21	173:14 256:12 260:11	<b>affairs</b> 22:9,11 25:14
145:17 206:17 323:5	144:15 153:22	<b>addresses</b> 242:13	<b>affect</b> 66:2 183:6,11
<b>abroad</b> 21:15 225:1	<b>acknowledges</b> 16:5	<b>addressing</b> 50:15	<b>affiliates</b> 21:13 225:16
<b>absence</b> 294:3,4	<b>acknowledging</b> 144:12	105:17 146:22	318:9
<b>absent</b> 134:9	<b>ACPA</b> 233:1	<b>adequacy</b> 164:19	<b>affirm</b> 256:15
<b>absentia</b> 322:8,19	<b>acquainted</b> 251:11	<b>adequate</b> 65:7 111:14	<b>affirmative</b> 146:20
<b>absolute</b> 161:16,20	<b>acquire</b> 72:13 75:13	155:9 176:2,4 193:10	157:3,8 160:2 179:7
<b>absolutely</b> 118:18	<b>acquisition</b> 71:8 75:9	193:11 200:7 215:12	287:11
275:11 283:11 285:1	<b>acquisitions</b> 37:4 72:12	268:6	<b>affirmatively</b> 139:6
<b>abuse</b> 178:22 179:1	75:3,8	<b>adequately</b> 284:9	288:9
<b>academic</b> 19:16 34:17	<b>act</b> 41:20 45:4 80:12,12	<b>Adjourn</b> 3:19	<b>afford</b> 195:2 301:7
35:1 65:14 76:6 100:2	137:13 140:18 150:22	<b>adjust</b> 72:4,4,15 77:11	<b>Africa</b> 27:14,22 54:21
116:7	151:3,4 153:6,9 158:7	79:10 100:18 264:4	108:20 109:21 180:5
<b>academically</b> 20:20	158:18 159:7 167:14	<b>adjusted</b> 36:17 71:1,12	184:5 185:4 188:1
<b>ACAP</b> 235:17 274:6	167:20 168:8 169:10	71:13	189:6,12 226:6,11,22
<b>accept</b> 126:8 144:4	176:3 179:3 188:3	<b>adjusting</b> 79:19	253:9 274:14,19
254:19 255:8,11,12	203:22	<b>adjustment</b> 20:12 72:3	276:13 279:21 282:9
255:13	<b>acted</b> 116:8	78:16,16 79:9,12	295:6 296:5,18 308:1
<b>acceptable</b> 276:14	<b>acting</b> 140:20 251:10	<b>adjustments</b> 66:16 67:7	<b>African</b> 184:17 194:5
<b>acceptance</b> 95:21	<b>action</b> 4:19 8:1 11:15	77:7 79:2,6 125:4,7,9	282:14
<b>accepted</b> 254:18 312:3	49:6 153:13 216:9	125:17 126:7,8,20	<b>afternoon</b> 212:14
<b>access</b> 21:1 91:16	<b>actions</b> 22:18 51:4	249:10,16	<b>age</b> 25:2 49:1 126:22
144:11 211:7 288:1	<b>active</b> 218:20	<b>administration</b> 285:6	158:1 295:11
<b>accessing</b> 289:5	<b>actively</b> 146:18	285:10	<b>agencies</b> 15:16 74:11
<b>accident</b> 183:14	<b>activism</b> 247:1	<b>administrative</b> 15:15	74:14,18 242:18
<b>acclamation</b> 313:7	<b>activities</b> 8:3 44:12	189:1	281:8,19
<b>account</b> 151:11 175:11	48:9 139:7,10 216:5	<b>admission</b> 189:11	<b>agency</b> 179:12 198:11
257:20,21	218:18,22	<b>admit</b> 173:6	256:8 270:22
<b>accountability</b> 152:21	<b>activity</b> 217:13 225:1	<b>admittedly</b> 90:1	<b>agency's</b> 179:14
154:16 227:20 239:11	<b>acts</b> 41:9 44:11 151:9	<b>adopt</b> 118:21 145:3	<b>agenda</b> 11:9,10 18:3
<b>accountable</b> 15:17	151:19,22 152:4	<b>adopted</b> 20:2 41:10	24:10,11 142:9 147:4
206:3 311:13	153:10 154:7,12	45:12 60:10 150:12	147:13 209:6 297:1
<b>accountant</b> 2:7 5:10,10	158:9 159:6 167:13	154:19 296:11 318:7	<b>aggregators</b> 66:14 67:2
5:14 28:10 31:3 58:8	167:16 175:18 176:13	<b>adoption</b> 4:22 5:5 52:17	75:19,21
117:5 203:4	178:5,22 192:7,11	56:15	<b>aggressively</b> 98:1
<b>accountant's</b> 203:3	202:5,7,9,11	<b>advance</b> 9:7	272:22
<b>accountants</b> 45:7	<b>actual</b> 106:3 121:8	<b>advanced</b> 204:22	<b>ago</b> 32:9 73:7,10,10
	172:19 227:16,18	<b>advancement</b> 14:3	74:15 77:9 84:6

112:20 121:16,17  
 144:4,14 171:7 217:4  
 269:2 293:4 315:20  
**agree** 134:16 144:4  
 174:19 177:21 182:19  
 196:7 241:17 248:1  
 254:4 260:16 280:12  
 286:19 287:6 290:20  
 298:14  
**agreement** 118:19  
 245:16  
**agreements** 22:1  
**agrees** 289:15  
**ahead** 37:4 60:18 61:3  
 72:13 80:15 81:2  
 105:21 127:17 131:5  
 142:3 166:7 170:11  
 197:17 198:10 199:9  
 219:2 223:8 225:4  
 276:20 279:1 280:11  
 288:8 294:5 311:7  
 319:2  
**AICPA** 43:5 96:10 118:4  
 153:18 166:13 167:3  
**aiding** 196:10,11  
 204:18  
**ain't** 173:3  
**alarmed** 76:21  
**alert** 213:20  
**align** 279:7  
**alignment** 280:20  
 296:21  
**aligns** 24:12  
**allocation** 10:10 29:6  
 103:10  
**allow** 6:19 38:13 62:4  
 63:5 73:4 81:16 83:4  
 91:15,15 107:5  
 235:14,15 236:13  
 258:1 277:12 285:18  
 311:19  
**allowed** 285:6 290:1  
**allowing** 306:19  
**allows** 38:15 75:14  
 197:10  
**allude** 16:9 252:10  
**alluded** 80:16 138:13  
 252:9 253:17 280:16  
 281:3  
**alluding** 183:1  
**alongside** 81:7  
**alright** 23:18  
**alternative** 38:6 63:9  
 68:13 86:12 307:7  
**alternatives** 18:10  
**amazing** 235:16  
**Amazon** 134:9  
**ameliorative** 19:8

**America** 2:6 274:1  
**American** 76:9 96:7  
 152:22  
**amortization** 36:18  
 37:1 71:22 72:15  
**amount** 35:11,16 65:14  
 76:14  
**Amy** 1:20 31:15 33:12  
 39:19 49:9 57:10 61:3  
 78:21 83:21 87:15  
 97:16 101:3 104:2,5  
 120:20 125:6 126:6  
 139:18 143:9 169:1  
 305:1 306:17  
**analysis** 15:22 19:11,12  
 19:15,16,17 20:5,5  
 26:9 46:22 100:9  
 107:14 143:20 174:3  
 174:5,6 192:5 195:15  
 218:5 227:10 231:5  
 290:21  
**analyst** 66:18 94:13  
 117:7 131:18 143:21  
**analysts** 57:11 66:5,15  
 74:19 75:19,20 79:21  
 126:22  
**analytical** 85:18  
**analytics** 319:21 320:5  
**analyze** 131:17 208:11  
**analyzing** 92:10 130:8  
**and/or** 67:8 99:6 108:12  
 305:20  
**Andersen** 226:12  
**Anderson** 279:17  
 307:22  
**anecdotal** 75:7 272:17  
**Anne** 2:1 29:1 49:5,5,9  
 101:1 109:10 113:11  
 129:5 136:19 139:17  
 207:14 234:4 239:2  
 248:1 276:17 279:5  
 298:14,14 312:6  
**Anne's** 104:16 111:12  
 279:9  
**Annette** 292:6  
**annotated** 194:19  
**announced** 118:16,18  
 248:15,16  
**announcement** 29:16  
 36:5  
**announcements** 127:2  
 127:3  
**annual** 4:4 49:3,12 54:2  
 100:4,16 213:1  
 214:20 223:21,22  
 232:8 245:6 265:20  
**Annually** 257:18  
**answer** 98:2 109:19

165:13,15 180:6  
 190:13 192:17 226:20  
 252:1 255:9 281:10  
 285:15 304:10,14  
**answers** 290:22  
**anthuriums** 298:16  
**anticipate** 43:13  
**anxious** 25:16  
**anybody** 152:7 162:22  
 181:2 188:8 238:20  
 259:10 286:12,16,17  
 320:3  
**anybody's** 46:20 275:8  
**anyone** 39:1,2  
**anyway** 9:2 30:13  
 138:17 167:18 233:19  
 278:13,22 312:22  
**AP** 266:15  
**apart** 229:1  
**Apologies** 276:18  
**apologize** 287:2  
**appear** 226:5  
**appeared** 23:4  
**appears** 66:2 179:4  
**appendix** 50:5 165:10  
 212:13  
**applause** 60:15 322:18  
**applicable** 104:21  
**apply** 10:4 278:21  
**applying** 190:1  
**appoint** 258:8,13  
 275:16  
**appointed** 311:18  
**appointment** 51:3  
 103:16  
**appreciate** 8:12 14:2  
 27:2 31:12 32:5 47:15  
 57:15 60:13 130:12  
 141:22 146:11 147:6  
 147:11 206:8 207:6  
 247:8 321:19  
**appreciated** 323:4  
**appreciation** 4:18 5:21  
 16:14 31:9 32:20,22  
 47:12 292:13,13  
 322:7  
**apprenticeship** 259:7  
 259:13  
**approach** 18:11 26:5  
 46:14 62:13 70:6 88:8  
 106:19 108:21 136:8  
 136:19,22 137:17  
 139:12 141:8,13,14  
 142:6 154:2 159:11  
 190:15 194:1  
**approached** 213:15  
**approaches** 136:3,14  
 137:10,19 141:10

**appropriate** 10:11  
 18:11 25:2 99:18  
 106:9 111:9 152:4  
 153:13 163:21 202:10  
 275:13 320:12  
**appropriately** 188:14  
 189:14,14 202:22  
 259:13  
**approval** 33:1 162:11  
**approving** 4:19 114:8  
**approximately** 273:14  
**April** 221:22  
**AQI** 217:3,16 218:7  
 222:17  
**AQIs** 49:2,20 50:14  
 51:6 53:10 215:4  
 218:4 234:20 293:19  
 319:2,3  
**area** 18:19 19:3 27:8  
 47:2 52:11 55:12 90:3  
 123:17 124:2 133:4  
 142:15 143:3 147:12  
 162:16 164:8 169:19  
 174:12 178:16 180:1  
 191:8,12 196:8 206:5  
 213:8 214:13 217:13  
 219:2 242:10 245:5  
 256:14,14  
**areas** 32:11 44:16 46:6  
 53:9 77:3 142:9 155:3  
 155:9 157:9 158:13  
 158:20,21 159:4  
 163:10 175:4 191:1  
 191:11,13 192:19,19  
 193:20 207:3 210:4  
 216:3 230:6,7 231:4  
 262:6,7  
**arena** 6:9 166:22  
**arguable** 213:7  
**arguably** 239:20  
**argue** 64:9 91:21 277:3  
 277:3  
**argued** 233:1  
**argument** 72:5 108:13  
 204:22 278:9  
**arguments** 219:19  
**arises** 256:8  
**arms** 164:3 243:3  
**arranged** 33:6  
**arrangement** 239:7  
**arrangements** 22:3  
**arrival** 15:3  
**arrived** 15:3  
**Arthur** 173:14 175:10  
 226:11  
**articles** 222:2  
**articulated** 279:6  
**articulation** 208:16

**artificial** 192:14 193:1  
**ascribed** 59:2  
**asked** 77:20 98:2  
 203:16 233:20 250:8  
 267:19 275:7  
**asking** 67:16,18 99:14  
 101:12 108:10 132:20  
 142:16,20 159:16  
 247:19,20 270:1  
 274:8  
**asks** 239:9  
**aspect** 112:1,2,13  
 215:11,12 258:3  
 269:7 290:17  
**aspects** 183:8 188:22  
 190:2 191:15 228:3  
**asserted** 173:18  
**assess** 158:7 178:5  
 189:14,15 194:7  
 197:3 208:6 240:19  
 242:17 251:18 254:7  
 267:15  
**assessed** 192:10  
**assessing** 156:9  
 160:22 257:19  
**assessment** 155:21  
 164:19 178:19 183:18  
 189:10 191:18 254:10  
**assessments** 154:5  
 163:8  
**asset** 71:19 108:6  
 133:20 144:10 271:4  
**assets** 31:21 32:1 71:10  
 307:17  
**assigned** 52:16 237:15  
**assist** 189:22  
**assistance** 5:18  
**assisting** 13:16  
**associate** 8:17 31:4,8  
 104:5  
**associated** 35:4 243:22  
**Associates** 2:3  
**association** 1:20 30:17  
 30:18 32:12 34:15  
 76:9  
**assume** 50:18 96:8  
 256:13  
**assuming** 170:17  
 216:20  
**assumption** 123:12  
**assurance** 1:18 68:9  
 88:11 91:13 96:2,5  
 99:18 135:8 148:22  
 168:20 169:14 179:20  
 192:8 199:20 200:12  
 200:12 201:2 202:15  
 202:17,19 271:6  
**assurances** 202:21

**assuring** 22:20  
**attention** 7:2 12:10  
 14:21 15:2 47:4 61:1  
 61:1 98:16 112:22  
 150:10 159:8 192:12  
 213:10 228:4  
**attentive** 217:11  
**attitude** 213:14  
**attorney** 167:1 236:17  
 244:6  
**attorneys** 167:18  
**audience** 26:21 131:12  
**audited** 10:3 36:13  
 39:16 62:19 63:12  
 64:7 68:9 69:14 81:7  
 83:17 86:19,20 88:3,5  
 89:11 90:9,19 94:16  
 94:18 99:17 107:9  
 113:19 115:4 123:2  
 125:14 285:22 286:13  
 287:8 299:8,10 311:1  
 317:10 320:7  
**auditee's** 24:21  
**auditing** 1:17 19:7  
 22:22 24:16 25:21  
 27:17 29:21 40:22  
 43:5 56:20 81:16 89:5  
 89:20 91:19 113:17  
 148:22 152:21 153:6  
 154:21 165:8 167:7  
 170:13 184:6 187:12  
 188:3 196:12 200:9,9  
 258:18 289:13 299:4  
 306:6 307:11 311:11  
**auditor** 2:20 11:14  
 16:12 17:4,6,13 24:19  
 32:15 40:19,22 41:4,5  
 41:18 43:18 49:4,14  
 49:22 51:3 56:6,22  
 57:2 58:6 91:13 93:4  
 94:8 96:9 101:9  
 102:17 103:17 148:8  
 148:11,17 149:7,9,14  
 150:3 151:3 152:3  
 159:7,13,19 160:3,12  
 160:22 161:17 164:10  
 164:14 176:1 177:7  
 178:5 179:5,19 180:4  
 180:19 183:20 190:12  
 192:9,18,18 193:1,4,8  
 193:19 194:2,10,15  
 196:22 197:2 198:15  
 198:16 200:2 201:10  
 203:22 205:21,21  
 210:9,18 217:7 229:5  
 237:2,4 240:20 243:7  
 243:7 244:7 246:10  
 246:20 250:17 252:7

256:19 258:8,13  
 262:4 266:15,16  
 275:16 278:15 290:4  
 296:10 314:15  
**auditor's** 3:7,9 6:10  
 11:19 18:15 19:1,2,2  
 24:14,21 25:1 26:2,7  
 29:14 32:18,21 40:3  
 41:16 56:8 83:16  
 142:21 148:17 150:14  
 151:18,21 154:20  
 164:19 185:13,20  
 187:5,6  
**auditor-audit** 13:2  
**auditors'** 5:6 18:20  
**audits** 5:8 9:22 17:3  
 19:18 21:12,14 23:1  
 153:4 155:6 179:12  
 195:16 208:14 219:8  
 219:12,13 221:15  
 224:3,3 226:14  
 228:12,20 255:12,20  
 255:21 264:6 266:1  
 290:17 291:13,16  
 294:10 309:15  
**AUM** 30:19  
**Australia** 220:16 271:8  
**authoritative** 94:5  
**authorities** 41:8 150:5  
 152:5 188:20  
**authority** 87:21 302:17  
**automatically** 115:2,9  
**avail** 292:21  
**available** 42:22 64:6,20  
 91:14 95:1,18 175:18  
 182:17 211:1,14  
 212:17 229:22 267:12  
 271:13  
**average** 248:15 290:15  
**avoid** 111:19 135:14  
 189:5 271:11  
**avoided** 73:13  
**Avoiding** 95:12  
**avoids** 238:17  
**aware** 11:15 149:7  
 150:19 169:10 170:1  
 170:6 182:10 187:9  
 197:2 198:1,15  
 199:16 201:8,9,10,11  
 244:14  
**awful** 201:6

---

**B**

---

**B** 1:11,14 220:22  
**back** 9:4 13:3 16:12  
 23:9 35:10 39:7 44:2  
 51:6,10 56:18 79:21  
 83:19 94:16 97:11

109:8 112:5 116:15  
 116:16 118:9 125:12  
 125:13 126:12 127:9  
 127:13 135:16 138:9  
 143:19 145:7,16  
 166:1 176:8 178:20  
 184:4 189:8 190:8  
 191:9 197:19 198:6  
 199:2 200:14,21  
 204:11,16 207:21  
 209:5 214:5 215:20  
 217:14 223:10 224:17  
 231:7,19 232:10  
 234:4,6,11,20 235:18  
 235:20 248:8 250:7  
 257:15 258:5,11  
 261:19 262:10 264:14  
 267:17 268:11 269:18  
 272:19 274:10 276:22  
 284:3 293:3 306:22  
 308:7,17 313:20  
 315:11 318:13  
**backdrop** 81:22 240:3  
**background** 27:17  
 29:20 215:18 299:16  
**backlog** 77:15 78:9  
**backward** 103:7,7  
**backward-looking**  
 249:13  
**bad** 59:12 116:18 117:5  
 117:14 118:22 155:14  
 159:17 195:11 203:21  
 220:21 222:15 265:3  
 280:4  
**badly** 73:3  
**bag** 244:16  
**bail** 285:11 320:3  
**bailout** 226:18  
**balance** 93:18 101:20  
 155:12 195:20  
**balancing** 162:1  
**ball** 129:18 271:5,19  
**ball's** 201:13  
**Ballroom** 1:10  
**bandwagon** 224:11  
**bank** 226:12 275:1  
**bankers** 226:13  
**banking** 226:6 270:19  
**banks** 74:22 270:21  
 274:21  
**bar** 19:4  
**bargain** 254:14  
**barrier** 280:10 282:21  
 283:12  
**barriers** 277:17 281:13  
**base** 251:22 252:18  
**based** 20:20 25:2 28:4  
 87:18 88:5 174:22

233:16 272:18 273:8  
288:22  
**baseline** 125:2,3,10,11  
125:18,20 126:9,10  
**basic** 97:19  
**basically** 45:15 60:2  
110:5 127:4 131:9,19  
157:2  
**basis** 32:2 43:4 56:5  
62:22 70:9 89:8,12  
125:15 127:21 130:2  
139:21 142:12 213:1  
237:13 239:22  
**Baumann** 2:20 32:14  
32:14 147:10 180:7  
**Baushen** 197:21  
**be-all** 43:18  
**bear** 190:19 228:11  
**bearing** 55:6  
**beautifully** 279:6  
**becoming** 93:5 258:6  
295:17  
**Beer** 1:17 27:13,14  
108:20 109:3 115:11  
115:14 182:18,19  
187:11 194:3,4 250:5  
250:6 260:4 274:12  
282:5 294:17  
**beg** 198:19  
**began** 33:15  
**beginning** 20:18 21:4  
42:4 55:22 138:12  
208:16 269:22  
**begins** 95:22  
**begun** 269:8  
**behalf** 29:10 32:1 47:11  
140:20 155:17  
**behavior** 253:20  
**behaviors** 163:21 164:5  
**behest** 30:10  
**beholder** 138:11  
**behoove** 309:19  
**believe** 4:16 5:7 13:5  
23:18 48:18 49:1,15  
51:5 53:1,18 54:17  
55:11 63:13 79:14  
80:13,16 81:19 82:2,6  
82:8 83:8,10 84:7  
88:7,12,16 89:2 93:12  
113:17 128:11 144:20  
145:6 151:16 156:2  
166:20 175:16 184:13  
208:8,12 209:21  
210:4,20 211:19  
212:6 216:8 218:15  
228:8 229:10 231:15  
261:4 274:1,17 289:9  
292:20 297:7 299:8

300:14 307:11 319:2  
**believed** 227:9  
**believer** 177:15  
**benchmark** 59:5  
**beneficial** 13:18 248:6  
**benefit** 106:12 195:15  
217:5,12 283:7  
297:12  
**benefits** 88:7 92:11  
283:4  
**Bersot** 1:14,15 27:7,7,7  
40:5,5 42:19 126:12  
126:16 146:15 147:20  
147:22 165:13,15  
288:3 299:15  
**best** 5:11 12:5 16:1  
85:14 135:17 168:13  
192:1 258:10 263:8  
263:13 275:8,9  
280:22 285:19 320:19  
**bestowed** 184:14  
**better** 34:1,15 48:16  
49:2 50:1 60:8,9 62:2  
64:12 70:5 73:19  
78:19 101:13 106:20  
106:20 113:20 116:22  
123:7,11 129:14  
150:14 185:13 208:13  
211:1,16 212:7  
219:14 233:11,17  
241:4,8 258:2,18  
277:20 292:18 296:21  
298:12 304:13 307:12  
**beyond** 82:1 238:18  
**bibliography** 65:16  
**bicycle** 279:15 282:7  
**big** 21:16 25:8 28:20  
54:21 92:13 103:2,20  
118:1 132:13,14  
135:15,19 143:17  
177:15 178:14 204:20  
204:21 205:3,13  
212:2 213:2 226:4,19  
232:21,22 236:6  
245:15 255:21,21  
262:15 268:15 270:7  
270:19 272:1 273:9  
273:12,13,15,18,22  
274:2,16,17 276:14  
278:18 279:10,11  
280:9 283:15,19  
284:5,16 293:7  
298:18,22 299:19  
301:15 311:21 319:12  
**bigger** 101:6 102:6  
103:1 248:21 277:19  
315:1 316:10  
**biggest** 134:9

**bilateral** 21:22  
**bill** 203:3  
**billion** 30:10,19 31:19  
42:5 271:1  
**billion-plus** 29:9  
**bit** 14:18 16:12 27:21  
28:1 31:20 79:18  
82:21 137:11,12  
138:5 149:3 154:16  
161:2 182:20 185:3  
190:1 195:16 208:19  
253:6 270:13 274:20  
275:3 280:6 281:20  
281:22 291:20 302:2  
306:15,15 315:5  
**bites** 86:6  
**black** 169:19  
**BlackRock** 1:16 27:6  
138:4,17  
**blind** 200:5  
**blinders** 193:20  
**blow** 171:16  
**blown** 171:9  
**blows** 200:20  
**blowup** 178:15  
**board** 1:1,14,18 2:10,11  
4:7,11,12,14,16 6:16  
6:19 7:22 8:1,6,14 9:5  
11:11 13:7 14:11 30:9  
31:16 40:8 48:1,4,6  
51:13,21 52:9 54:1,4  
83:1 95:16 103:14  
110:20 114:10 119:1  
139:2 151:22 153:22  
169:1 194:19 205:17  
208:11,21 214:12,18  
215:15 216:1,21  
217:10,15 218:2  
224:9 225:3 227:14  
227:22 228:4 229:15  
233:8 237:20 240:5  
245:5 261:22,22  
274:22 288:22 292:5  
292:18 303:14,17  
306:19 310:19 314:15  
315:1,7 321:10,14  
**board's** 7:2,4 8:3,5  
44:12 51:4 102:9  
147:4,13 211:17  
213:9 217:8,13  
229:22 231:17  
**boardroom** 19:9  
**boards** 27:15 32:12  
140:7 144:6  
**boat** 202:2 274:20  
**Bob** 45:7 55:13 90:22  
97:8 101:17 130:21  
134:16 136:6 143:9

146:18 152:8 169:17  
173:5 196:3,9 203:6  
254:11 257:14 266:15  
286:6  
**Bob's** 198:14 204:16  
**bodies** 218:19 241:3  
302:18  
**body** 314:12  
**boilerplate** 13:1  
**bold** 312:3  
**bonds** 32:2  
**bonus** 268:20  
**book** 43:4 46:4 143:19  
160:1 165:7 169:2  
170:11 187:12 198:17  
**borrow** 75:3,6,15  
**borrowing** 278:19  
**bottom** 284:2  
**bought** 220:3  
**boundaries** 190:17  
**bounds** 45:10  
**box** 169:19  
**boxed** 110:17  
**brain** 28:1  
**brainstorming** 24:8  
**branches** 161:5,5  
**brand** 9:1  
**Brandeis** 313:12  
**Brazil** 283:21  
**breach** 182:8 308:3  
**breadth** 268:14  
**break** 90:22 91:2 97:10  
145:16 206:15 315:22  
**breakdown** 261:4  
**breathed** 263:2  
**breed** 299:3  
**Breeden** 285:4  
**Bricker** 2:16 5:9 14:22  
31:2,2,7 141:2,3  
255:10 256:1,7  
310:17  
**bridge** 145:9 295:13,15  
**brief** 6:6 8:2 124:13  
215:21 251:3 298:13  
**briefly** 91:1 210:6  
267:18  
**bright** 318:12  
**bright-line** 175:13  
**brightest** 263:8,13  
272:11 273:1  
**brilliant** 168:18  
**bring** 7:2 60:22 105:8  
118:12 119:4 175:19  
186:8,9 207:4 231:18  
236:14 259:14 306:14  
**bringing** 47:4 172:1  
**brings** 37:12 58:8 85:8  
129:10 193:4 269:17

**British** 2:5 277:15  
**broad** 6:17 138:16  
 252:17 275:21 276:2  
**broaden** 315:6  
**broader** 54:16 130:16  
 161:8 208:9 271:11  
 271:16  
**broadly** 209:20  
**broken** 206:1 243:21  
**broker-dealer** 235:7  
**brother** 308:1  
**brought** 124:10 138:2  
 169:17 185:15 192:12  
 259:1 303:3  
**build** 19:14 157:3 316:1  
**building** 17:10,10  
 191:22 218:10  
**builds** 191:10  
**built** 125:5 318:1  
**bulk** 32:7 253:16  
**bullet** 109:17 158:11  
 163:5 196:3 217:2  
 225:6 229:10  
**bullets** 229:8  
**bunch** 249:14  
**burgeoning** 105:6  
**Burnham** 285:3  
**Burns** 203:6  
**burst** 75:12  
**business** 7:18 12:13  
 35:8 60:3,4 61:15,17  
 68:22 83:5 87:1 91:11  
 92:5,11,18 95:7 96:15  
 102:22 111:15 118:8  
 118:17 121:9,9 122:1  
 130:18 133:10 144:4  
 155:4 163:20 164:1  
 184:13 186:13 191:9  
 201:5 225:15 262:22  
 262:22 263:18 264:12  
 264:17 267:21 268:14  
 268:16 269:3 270:6  
 272:4 275:21 276:2,2  
 276:8 278:1,10  
 280:17 281:21 300:4  
 301:12 304:8 308:4  
 313:16,17 314:4,9  
 319:18 320:4  
**business-level** 82:1  
**businesses** 64:13  
 130:13 225:16 300:1  
 300:17 307:18  
**bust** 277:5 284:21  
**busy** 9:18  
**buttons** 160:17  
**buy** 200:1 236:14  
**buying** 144:11  
**by-industry** 130:2

---

**C**


---

**C** 220:22  
**C-suite** 196:20 204:19  
**cabinet** 149:16  
**Cairns** 145:2  
**calculated** 62:16 77:13  
**calculation** 99:18  
**caliber** 291:17  
**California** 2:1 29:11  
 129:6 198:8,9  
**call** 118:7 137:1 171:12  
 231:22 282:1 307:12  
 311:6  
**called** 20:2 92:20  
 112:17 118:5  
**Callery** 1:15 32:7,7  
 146:12,14,16 156:13  
 170:20 173:4 195:6  
 303:10  
**calls** 35:17,22 39:11  
**CalPERS** 29:2,8 101:10  
 102:9 103:12 277:1  
 312:13  
**CAM** 154:20  
**camp** 252:2  
**campaigns** 271:4  
**campus** 108:4  
**CAMs** 11:16,17 43:11  
 58:6 162:14,15  
**cancellation** 77:21  
**candid** 197:4  
**candidates** 239:15  
**capabilities** 93:4  
**capability** 92:10 121:22  
 211:3 320:5  
**capacities** 268:1  
**capacity** 49:10,22  
 211:14 276:22 282:19  
 297:10  
**capital** 1:15 2:8 10:7,9  
 10:20 11:2 21:2,5,10  
 27:7 28:11 29:6 33:3  
 63:22 65:8 71:19 80:4  
 101:14 103:10 135:11  
 141:12 225:21 292:15  
 293:8 299:22 300:6  
 307:16 318:3  
**capital-** 191:10  
**capitalist** 277:4  
**capitalization** 273:15  
 273:19  
**capitalized** 191:13  
 284:8,10,21  
**capture** 12:15  
**captured** 213:4  
**capturing** 53:5,5  
**car** 134:3  
**Carcello** 322:1,2

**card** 197:16 222:6  
 265:2 276:19  
**card's** 123:19 124:13  
**cards** 201:17 238:21  
 257:12  
**care** 86:22 238:20  
**career** 32:8 187:1 269:5  
 320:20  
**careful** 298:9  
**carefully** 8:7 16:2  
**cares** 12:11  
**Carromba** 323:2  
**carry** 241:4  
**carryover** 153:17  
**case** 91:12 93:10,22  
 95:2 135:7 173:14,19  
 199:13 246:1 258:11  
 307:16  
**cases** 40:16 50:11  
 123:2 124:17 148:4  
 148:10 155:22 172:8  
 179:16 185:14 198:22  
 200:4 203:18,18,20  
 213:6 219:16 235:8  
 235:10  
**cash** 71:16 72:21 73:2,2  
 73:3,9,11,13,15 74:6  
 121:15,22 122:6  
 144:20  
**cash-generating** 37:14  
 71:17  
**cast** 185:2 292:2  
**cat's** 244:15  
**cataclysmic** 279:20  
**catastrophic** 274:6  
**catch** 45:1  
**catching** 225:3  
**catchup** 311:8  
**categories** 83:3 102:12  
 229:20  
**categorization** 20:3  
**categorizations** 83:9  
**category** 179:5 208:9  
 213:5  
**cause** 188:7 189:3  
 290:21 320:2  
**causing** 17:7  
**CECL** 84:22  
**center** 1:10 112:21  
 113:4 129:12 187:1  
 223:12  
**centers** 111:6  
**central** 226:12 292:14  
**CEO** 1:14 172:4,8 186:1  
**certain** 61:5 66:15,15  
 66:20 67:5,18 68:17  
 79:5 139:6,9 140:3  
 157:9 183:8 193:20  
 215:3 254:13,15  
 256:14 317:22  
**certainly** 16:21 31:13  
 52:6 66:2,8 71:22  
 84:16 85:20 122:19  
 139:21 141:3,7  
 142:10 158:14 169:18  
 170:7 183:8 190:4  
 213:16 217:11 229:15  
 235:6 236:21 268:8  
 268:22 274:12 276:13  
 280:21 282:8 298:2  
 298:17 315:3  
**certify** 320:14  
**cetera** 63:6 144:11  
 249:15  
**CFA** 93:11 107:12  
**CFO** 28:20 92:7 119:8  
 172:5,9 186:1 263:2  
**CFOs** 260:7  
**chair** 1:17 27:16 28:15  
 28:21 42:21 166:18  
 209:9 226:16 234:13  
 253:5 287:15 314:7  
**chaired** 27:18 260:7  
**chairman** 1:11,14 2:11  
 2:14 4:18 8:2,9,11,13  
 8:15 9:5 13:20,22  
 14:2,7,13,22 15:3  
 16:14 20:8 23:22 30:1  
 30:17,20 33:6,14 40:6  
 44:2,7 47:11 54:6  
 55:8 56:3 57:14 60:14  
 60:17 100:10 110:17  
 131:2 135:21 145:3,7  
 173:21 188:12 192:3  
 193:8 196:14 201:19  
 204:14 208:3 215:22  
 237:10 241:19 247:19  
 250:7,11 253:19  
 254:7 255:17 261:3  
 274:22 285:1 287:3  
 291:3 302:13 308:12  
 316:14 317:2 321:5  
 322:22  
**challenge** 136:17 186:7  
 242:15 280:17 281:11  
 318:14  
**challenges** 104:20  
 127:17 137:15 180:12  
**challenging** 16:20  
 177:12 196:9  
**chance** 161:22 186:6  
 192:11 233:14 299:11  
**change** 25:20 71:1 92:2  
 102:11 111:18 122:9  
 177:3  
**changed** 45:11 46:10



121:19 185:16  
**changes** 5:6 18:14  
 20:15 26:3 88:15  
 91:10 111:16 127:14  
 158:3 251:9  
**changing** 88:13  
**channel** 177:3,4  
**channels** 177:6  
**characterization**  
 203:10  
**characterize** 136:18  
 200:15  
**characterized** 85:17  
**characters** 292:2  
**charade** 315:18  
**charge** 48:3  
**charged** 49:18  
**charges** 78:17 80:6  
 248:15  
**chart** 96:3 152:18,18  
 155:3 165:18,18  
 166:5 204:16  
**charter** 15:12 292:2  
**charts** 152:15 153:1,3  
**Chavers** 1:16 26:22  
 27:4,5 103:22 104:1  
 138:7 280:12 301:3  
**cheap** 258:8  
**check** 134:19,20 135:1  
 135:15  
**Chicago** 28:14  
**chief** 1:14,20,21 2:7,20  
 5:10,10,13 16:11 28:9  
 29:19 30:12 31:3,15  
 32:15 58:8 74:16  
 117:5 180:4 203:3,4  
**chime** 156:16 162:22  
**China** 63:22 270:21  
**choice** 206:21 240:22  
 277:8 284:3  
**choose** 69:18 83:3,9  
 111:22 120:2 125:14  
 238:12  
**choosing** 120:21  
 121:10 233:16  
**chunking** 220:4  
**Cindy** 323:1  
**CIO** 28:13  
**circle** 187:17 262:10  
**circumstances** 79:5  
 138:12 164:4 241:7  
**circumvent** 164:16  
**circumvented** 188:15  
**circumvention** 11:5  
**cite** 173:15  
**cited** 264:8  
**Citibank** 300:17  
**city** 1:10 166:17 171:14

**civil** 176:10 177:1 318:5  
 319:9,10  
**clamoring** 89:22  
**clarification** 7:11  
**clarify** 151:20 244:18  
**clarifying** 201:11  
**clarity** 67:18 68:3  
 151:20 153:18 155:8  
 306:2  
**class** 112:17  
**classifications** 82:20  
**clause** 202:19  
**Clayton** 2:14 4:18 8:9  
 8:16,21 13:5,21 14:22  
 15:3 16:14 20:8 23:16  
 28:16 30:2 33:15 40:6  
 42:21 47:11 54:6 55:8  
 56:3 57:14,16,20  
 59:16 208:4 215:22  
 247:3 250:11 287:3  
 314:7  
**Clayton's** 14:7,13  
**clear** 17:12 40:21 42:3  
 42:3 62:20 63:8 65:20  
 65:21 66:3 67:20 92:8  
 117:8 136:1 168:10  
 176:21 222:18 235:21  
 240:17 268:2 275:22  
 279:19 298:6 317:13  
**clear-cut** 206:11  
**clearest** 162:10  
**clearly** 24:18 39:4  
 44:22 50:13 64:14  
 69:5 85:20 99:14  
 108:7 118:14 146:3  
 174:8 189:6 205:19  
 244:19 252:14 253:8  
 294:21  
**click** 93:20 221:10  
 222:8  
**clicker** 152:9  
**client** 139:19 189:15  
 268:10 272:21,21  
**client's** 3:7,9 6:11 40:3  
 159:14  
**clients** 127:10 139:14  
 140:10,11,12,19  
 272:22 319:5  
**clients'** 139:16  
**cliff** 184:10  
**climate** 102:11  
**clinical** 94:9  
**clips** 161:12  
**clock** 57:19  
**close** 5:14 45:16 115:15  
 166:6 273:21 286:5  
 286:11 289:2 298:13  
 299:9 303:22 306:15

321:4  
**closely** 5:12 22:9,11  
 23:6 46:2  
**closing** 3:17 231:6  
 293:2 306:12 315:14  
 316:13  
**cloud** 77:10 144:16  
**co-** 6:2  
**co-chair** 47:20  
**Co-Founder** 1:21 2:2  
**co-lead** 207:14  
**Co-Managing** 2:2  
**code** 56:10  
**Cohen** 259:17  
**cold** 51:19 218:10  
**collaborate** 86:15  
 306:14  
**collaboration** 31:11,13  
 106:13,17  
**collaborative** 82:17  
 146:16 207:18  
**colleague** 16:15  
**colleagues** 214:17  
**collect** 95:3 208:11  
**collectively** 322:6,9  
**college** 263:5 269:4  
**Colleges** 32:13  
**Colorado** 1:20 31:16,19  
 32:1  
**Columbia** 2:5  
**Com** 117:16  
**combination** 78:10  
 137:18 153:5  
**combine** 168:17 273:20  
**combined** 248:22  
 273:21  
**combines** 19:15 92:20  
**come** 9:4 14:15 17:21  
 21:4 46:15 54:22 56:4  
 61:14 63:2 85:12  
 91:22 97:11 106:17  
 107:2 108:1,2 109:16  
 129:9,11 131:7  
 137:18 145:7 156:14  
 157:15 159:7,15  
 161:20 192:5 199:8  
 223:9 234:4 236:10  
 250:12 260:7 261:19  
 263:5,17 264:1 269:8  
 283:22 285:10 292:16  
 294:20,22 296:18  
 299:2 309:11 312:14  
 315:22 317:8 319:7  
**comes** 131:6 142:2  
 157:13 158:12 160:1  
 194:5 196:2 201:1  
 202:14 221:4 250:16  
 251:6,7 257:4 258:13

260:17 261:13 274:15  
 278:14 283:5 293:1  
 312:8  
**comfortable** 187:21  
 188:13  
**comforting** 221:15  
**coming** 19:20 33:1 65:4  
 125:8 162:19 197:19  
 227:7 235:4 238:6  
 298:20 300:18 302:5  
 314:7  
**commenced** 44:9 154:1  
**commencing** 221:22  
**commend** 13:7 15:20  
 78:3 142:10  
**comment** 16:3,4 40:18  
 63:5 67:13,14 96:6  
 102:19 104:16 125:8  
 163:4 166:12 181:2  
 187:22 188:11 189:8  
 197:18 218:5 219:11  
 223:10 226:10 230:18  
 231:8 239:5 250:10  
 256:6 275:18 280:13  
 283:3 298:13 302:2  
**commentary** 166:9  
 292:17  
**commented** 220:6  
**commenting** 26:20  
**comments** 31:9 40:12  
 40:13 51:15 60:20  
 104:5 127:13 148:6  
 152:7 177:18 187:11  
 205:5,18 208:3  
 219:11 235:22 255:17  
 261:17,19,20 271:20  
 271:22 272:7 279:7  
 299:18 305:15  
**commercial** 111:6  
**commission** 2:13,16,17  
 5:12 7:10 15:13 16:8  
 49:7 50:20 58:7 98:3  
 116:16 214:7 216:15  
 256:3 259:17 285:2  
 286:10 310:8 321:14  
**Commission's** 4:19  
 5:13  
**commitment** 9:10,15  
 9:18 13:16 22:20  
**committee's** 224:21  
 257:15  
**committees** 7:17 13:6  
 24:2 25:9,10 28:22  
 52:14 53:13 59:19  
 60:7 114:7 131:1  
 142:14,15 143:2  
 158:3 175:1 185:17  
 185:18 193:5 222:13

- 222:14,18 223:3  
241:12 242:5 247:6  
247:22 248:5 250:12  
250:20 251:6,11  
257:18 258:1,17  
260:7 262:17 266:21  
267:1,22 295:22,22  
311:18
- committing** 172:13  
**commodity** 28:14  
272:21 273:3  
**common** 70:14 72:2,5  
85:9 106:17 138:11  
**commonly** 36:16  
**communicate** 102:3  
**communication** 197:5  
255:19  
**communications** 13:2  
152:1 266:22  
**community** 6:17,22  
9:11 18:6 19:4 47:3  
52:19 142:11 219:2  
240:19 241:8,9 315:4  
**comp** 80:3 268:19  
**companies** 5:8 28:21  
28:22 30:18 35:4,16  
36:22 49:3 58:18 59:6  
62:2 68:16 69:15  
71:10 72:3,4,4,12,14  
72:21 73:1,4,4 74:3  
75:8,14 76:11 77:7,10  
77:20 78:1,1 79:19  
80:5 82:6 83:3,5,9  
87:7 89:2 99:16  
101:13 102:2,14  
103:6 110:1,2,12,22  
111:4,6,14 112:16  
117:9,11 126:18  
127:15 128:15 130:10  
130:15 132:21 133:15  
134:3 141:20 143:4  
153:5 163:13 189:16  
228:13,21 233:18  
242:20 251:10 267:22  
275:9 276:15 277:5  
277:17 281:4 295:8  
297:4 310:6
- company** 1:1 12:7  
14:10 27:15 34:1  
36:20 37:3,11 59:7  
61:16 64:21 68:21  
71:17 99:6 100:13,15  
100:22 107:21 110:21  
122:17 127:18,19,22  
131:10,14,15 133:13  
133:16 134:1 142:20  
150:22 169:6,15  
179:11 181:4,7,12,20
- 188:8 193:14 194:13  
195:2 197:22 198:12  
198:12 210:9 211:6  
224:3 229:5 234:17  
242:14 245:11 252:6  
318:8
- company's** 80:2 116:20  
164:4 316:2
- comparability** 66:11  
99:16,17 130:2,3  
133:6 141:17 165:3  
**comparative** 42:14 43:3  
64:19  
**compare** 97:20  
**compared** 42:15 45:5  
75:8  
**comparison** 46:22  
165:7 166:5,10  
**comparisons** 165:9  
**compensation** 34:16  
35:5 36:22 37:3 72:2  
72:5,8 76:13 164:7,11  
192:20 268:6  
**compete** 233:2  
**competence** 49:22  
53:21 211:15 259:2  
315:7  
**competency** 134:22  
264:5  
**competing** 112:21  
**competition** 233:2  
271:11 275:12 277:3  
277:22 283:2  
**competitive** 266:8  
280:3 282:20 283:15  
**competitor** 280:8  
**competitors** 186:14  
308:2  
**complaint** 172:20  
**complaints** 171:13  
**complement** 50:2  
211:21  
**complete** 51:21 52:10  
58:12 149:10 214:12  
**completely** 42:3 181:17  
206:22 294:20  
**completing** 212:5  
**completion** 218:16  
**complex** 37:7 259:12  
264:11  
**complexity** 82:19  
263:17  
**compliance** 28:7 53:10  
150:6 152:17 179:8  
179:20 181:11 252:12  
256:10  
**complicated** 178:2  
**compliment** 178:3
- 179:22  
**comply** 60:5 181:12  
**component** 163:22  
**components** 156:19  
**composite** 156:14  
158:2  
**composition** 253:1  
**compost** 277:14  
**comprehensive** 39:6  
82:6  
**comprehensively**  
82:13  
**compromise** 193:13  
**compromised** 156:6  
**compute** 173:9  
**computer** 135:1  
**computing** 77:10  
144:17  
**concentration** 273:12  
273:15 282:16 283:9  
283:12 311:20  
**concept** 51:14 109:22  
127:20 168:8 213:17  
216:14 218:3 230:21  
233:22 234:5,7,20  
274:16 302:12  
**conceptually** 137:19  
**concern** 7:13 18:5  
61:13 63:7 65:10 67:9  
68:10 83:22 84:20  
212:20 229:1 235:5  
236:6 261:13  
**concerned** 19:5 37:19  
42:1 110:16 151:6,7  
175:5 228:11 258:21  
271:17 273:11 274:4  
**concerning** 77:12  
236:16 277:6  
**concerns** 7:16 41:22  
76:5 77:4 83:20 89:17  
143:4 151:5 225:10  
270:11 273:7 304:7  
**concise** 168:10  
**concision** 15:22  
**conclude** 6:12 205:15  
**concluded** 21:22 23:8  
155:5  
**concludes** 90:15  
**conclusion** 47:7 114:4  
165:5  
**conclusions** 45:15  
256:3  
**concrete** 208:9  
**concurrence** 147:13  
**condone** 67:8  
**condoned** 163:19  
**conductive** 86:5  
**conduct** 17:4 19:8 20:6
- 20:10 21:19 163:18  
**conducted** 21:15  
153:20,21  
**conducts** 228:7  
**conference** 35:22 39:11  
76:9  
**conferred** 293:13  
**confess** 144:22  
**confidence** 58:12 59:2  
97:1 192:9 202:8  
221:20 238:9 319:8  
**confident** 245:7 247:4  
**confidential** 23:7  
169:18,20 170:8  
**confidentiality** 168:19  
169:16 173:4 262:2  
**confining** 177:5  
**confirm** 159:8  
**confirmed** 151:19,22  
152:4 307:20  
**confirming** 21:8 315:21  
**confirms** 20:21 21:5  
**conflict** 55:4  
**conflicts** 54:19 275:13  
**confrontation** 201:20  
**confusing** 136:11  
**conglomerates** 83:5  
**conglomeration** 242:1  
**Congress** 27:1 321:1  
**congressional** 199:14  
**conjunction** 96:12  
**connect** 102:16 301:8  
**connecting** 132:13  
**connection** 217:6  
**connectivity** 301:19  
**conscious** 247:5  
**consciousness** 297:14  
**consensus** 75:20  
245:22  
**consent** 288:18,19  
**consequence** 258:16  
**consequences** 240:17  
309:4  
**consider** 8:7 20:10 46:5  
61:20 81:19 83:11  
90:4 106:4 109:9  
115:22 127:11 161:1  
162:19 172:17,18  
196:19 209:21 215:19  
309:19 321:17  
**considerable** 210:22  
**considerably** 166:2  
206:7  
**consideration** 3:7,9  
6:10 7:5,22 18:20  
20:6 24:21 40:3 44:10  
51:15 82:22 160:20  
290:4

- considered** 51:8 231:1  
**considering** 44:13  
 228:14  
**consistency** 64:17,19  
 64:22,22 65:1 66:12  
 66:21 71:3 75:18 80:8  
 88:8 110:5 129:16,21  
 137:5 234:19 298:5  
**consistent** 10:4 19:3  
 64:10 69:4 128:12  
 129:17 145:12 148:21  
 318:11  
**consistently** 62:16  
 99:15 232:6  
**constituencies** 43:13  
 216:17  
**constituency** 4:8  
**constitute** 244:20  
**constitutes** 155:9  
**constrain** 103:5  
**constraints** 49:22  
**constructive** 281:14  
**Consuela** 203:7  
**consult** 230:9  
**consultants** 225:13  
 236:12  
**consultation** 17:19  
 28:6 142:8 216:16  
 223:9  
**Consultative** 1:17  
**consulting** 27:11 28:18  
 28:18 195:17 236:9  
 253:15,22 268:19  
 278:11,21 304:8  
 318:17  
**consumed** 95:13  
**consumer** 273:17  
**contacts** 252:5  
**contain** 80:7 94:8  
 131:11 215:3  
**CONTENTS** 3:1  
**context** 102:7 104:17  
 140:9 141:18 163:9  
 182:5 210:7,9 252:17  
 256:2,8,9 259:14  
 265:15,17 281:17  
**contexts** 226:2 293:10  
**continually** 59:22  
**continue** 19:19 34:5  
 36:3 39:2 62:4 69:19  
 96:16 143:3 206:14  
 225:14 243:9 289:7  
 304:2,5,7 307:4,9  
 316:22  
**continued** 9:9 74:19  
 78:16 91:13  
**continues** 34:18 36:3  
 38:12 54:22 64:9  
 65:13 76:16 226:5  
 293:20 307:3  
**continuing** 11:7 33:17  
 108:6 209:15 214:1  
 243:11  
**contract** 249:9  
**contracts** 169:20  
**contribute** 9:20 75:20  
 306:4  
**contributes** 76:4  
**contributing** 272:14  
**contribution** 147:7  
 321:9 322:4,10,14  
**contributions** 297:22  
**contributor** 28:14  
**control** 18:4,5,12 53:16  
 57:7 91:18 95:9 132:5  
 132:7 134:16,17,18  
 142:19 164:20 178:8  
 178:10,13 246:17  
 262:7 303:19  
**controls** 29:21 54:9  
 160:6 164:17 190:22  
 198:13,16,18  
**controversial** 16:19  
**conundrum** 281:6  
**convening** 136:19,22  
 302:17  
**converged** 85:4  
**conversation** 32:5  
 54:22 106:8 138:14  
 160:10 207:6 235:4  
 280:15 281:9 301:10  
 301:11,15 303:8  
 306:3  
**conversations** 25:9  
 301:16  
**convince** 145:2  
**convinced** 107:4  
 109:19 144:3  
**cool** 304:8  
**cooperation** 31:11  
 314:10  
**cooperative** 5:14 21:22  
**coordinated** 23:6  
**coordinating** 18:18  
**coordination** 10:15,18  
**cop** 170:10  
**copying** 310:18  
**core** 78:17 79:7 214:11  
**Corp** 28:15  
**corporate** 19:4,8 101:8  
 102:22 140:7 148:10  
 258:3 318:8,9  
**corporation** 148:19  
 173:10  
**corporations** 158:4,17  
**correct** 96:5 97:3  
 150:11  
**correction** 257:5  
**correlate** 244:20  
**correlation** 34:20  
**correlations** 294:9  
**corrosive** 196:12  
**corrupt** 158:18 192:19  
**cost** 71:21 123:5 181:7  
 195:15 265:10 291:8  
**costs** 36:20 116:21  
**Council** 220:20  
**counsel** 16:11 32:9  
 171:14 173:10 176:15  
 176:16 182:12 196:20  
**counsel's** 171:17  
**counsels** 156:2  
**counterparts** 22:13  
**countries** 21:18,19 52:4  
 63:21  
**country** 54:21 201:4  
 220:16 239:9 275:10  
 279:22 307:1  
**couple** 27:15 38:4 46:7  
 67:12 77:10 143:15  
 149:12 154:15 159:2  
 166:19 184:8 187:11  
 250:6 274:13 282:14  
 289:8 295:4,5 299:18  
 301:8 304:1  
**courage** 224:5  
**course** 6:4 18:17 23:7  
 61:22 62:18 64:8 78:4  
 78:12 85:7 142:7  
 154:20 164:10 165:22  
 166:22 173:22 191:20  
 207:22 215:20 217:10  
 218:2,6 230:7,17  
 274:1 297:20 317:13  
**Court** 2:5 173:14,19  
 175:10  
**courts** 175:11  
**cover** 202:21 257:3  
**covered** 42:19 202:15  
 224:18 231:3  
**covering** 24:9  
**CPA** 30:7 135:4 190:11  
 243:7  
**CPAs** 96:7 134:20  
 152:22  
**craft** 32:18  
**Crash** 117:16  
**create** 67:2 81:18 99:6  
 109:11 158:15 282:19  
 286:15 302:11,19  
**created** 48:2,4 281:20  
**creates** 55:5 110:7,8  
 176:15  
**creating** 13:1 104:14  
**creation** 105:7 110:10  
 138:21 302:9 322:20  
**creative** 277:11 299:3  
**credibility** 185:5 228:12  
**credible** 193:11  
**credit** 74:16,21,22 75:1  
 84:22  
**creditor** 188:8  
**crew** 203:8  
**criminal** 319:13  
**crises** 7:14,15  
**crisis** 7:20 312:13  
**criteria** 105:19 138:3  
 140:2,16 188:6 206:6  
 228:8 229:3  
**critical** 10:1,12 12:4  
 36:21 37:10 69:22  
 86:3 94:10 133:10  
 144:21 152:1 287:22  
 291:15 292:17 298:4  
 309:12 315:9  
**criticisms** 284:15  
 292:17  
**cross-selling** 300:19  
**crossover** 278:5  
**crowd** 312:18  
**CSW** 2:3 30:16  
**cultural** 163:22  
**culture** 163:19 164:1,5  
 225:13  
**curb** 107:19  
**curious** 243:19 244:1,2  
 244:6,7,11,14  
**currency** 94:5  
**current** 24:10,11 25:14  
 45:2,22 46:8 82:2  
 84:3 119:1 131:13,14  
 152:16,20 154:5  
 155:6,12 158:5,17  
 161:16 165:6 170:12  
 175:9 176:4 191:14  
 196:9 259:6 275:10  
 316:1  
**currently** 29:18 64:4  
 90:10 96:3 221:8  
 259:9 273:13  
**curtain** 307:13  
**customer** 79:11  
**cut** 105:22  
**cuts** 175:21  
**cybersecurity** 135:5,6  
**cycle** 132:9  
**cynical** 143:21

---

**D**


---

**D** 220:22 252:7  
**D.C** 1:11 28:19 171:8  
**dad** 265:4

- daily** 32:2  
**damages** 319:10  
**Dan** 323:1  
**dangerous** 59:15 65:8  
**dark** 313:5  
**data** 18:14 19:12 53:5  
56:10,15 58:20 66:14  
67:1 75:19,21 92:22  
93:21,22 94:13 96:19  
101:19 102:17 112:20  
113:4 135:10,15  
182:7 212:17 215:11  
233:7 289:5 294:3  
298:19 299:5 318:17  
319:21 320:4  
**database** 17:10  
**date** 73:3 208:22  
**dates** 217:14  
**David** 145:2  
**day** 8:8 9:17 13:11 14:9  
14:10,17 25:2 26:19  
31:14 33:2 40:1 58:7  
60:21 133:17 145:4  
171:13 207:9 231:22  
269:17 293:1 295:11  
307:18 317:13  
**day's** 270:9  
**day-to-** 58:6  
**days** 120:22 140:9  
188:13 194:11 263:1  
263:11  
**de** 1:17 27:13,14 108:20  
109:3 115:11,14  
182:18,19 187:11  
194:3,4 250:5,6 260:4  
274:12 282:5 294:17  
**dead** 221:6  
**deadline** 218:6  
**deal** 56:7 71:19 111:21  
161:10 181:19 233:1  
236:22 262:15 275:5  
275:14 283:8 291:12  
302:4 306:21  
**dealing** 24:14 26:6  
162:5 168:18 193:8  
201:11 283:2 315:19  
**dealings** 268:1  
**deals** 16:5 97:16 206:20  
**dealt** 24:18 135:9  
188:14 289:20 310:4  
**debacle** 187:2  
**debatable** 148:11  
163:14 169:8  
**debate** 63:14 65:19  
231:16 282:8 293:21  
294:3,19 315:1  
**debated** 65:13  
**debating** 95:9  
**debits** 70:17 71:1  
**debrief** 260:8  
**debt** 71:20 80:4  
**decade** 92:3  
**decades** 24:15 30:5  
116:13 121:17 213:19  
**decide** 38:22 126:7  
132:17 182:12 194:7  
**decided** 15:5 40:10  
150:10  
**deciding** 155:18  
**decision** 49:3 119:1  
196:15 210:17 211:2  
211:8  
**decision-** 10:5  
**decision-making** 10:6  
51:3 97:22 125:15  
138:19 217:6  
**decisioning** 139:6  
**decisions** 10:10 71:8  
82:8 86:2 99:2 140:17  
210:12 258:2  
**deck** 43:2  
**declines** 319:15  
**decrease** 76:17  
**dedicate** 18:8  
**dedicating** 14:3  
**dedication** 9:14 13:7  
**deemed** 301:20  
**deep** 4:18 16:13 119:13  
**deepest** 11:1  
**defect** 123:10  
**defend** 171:17  
**deferred** 77:11 78:8  
**deficiencies** 219:21  
255:16  
**deficiency** 50:9 212:22  
213:2,6 232:20  
255:19 257:3,8  
290:16,22  
**deficient** 254:18 255:12  
255:12 256:19,20  
**defies** 138:11  
**define** 36:11 37:18 38:8  
39:4 68:7 76:2 81:4,4  
83:2,7 86:15 87:3  
88:1,2 89:1 114:2,18  
114:18 118:13 119:13  
119:15,18 120:4  
138:15 145:11 150:14  
**defined** 38:11 64:17  
67:17 68:19 69:5,11  
69:12 70:21 74:2  
75:18 80:5,21 82:3  
83:15 86:21 89:6,7  
90:18 99:14 104:18  
108:14 115:7 119:10  
121:1 235:18 315:5  
**defining** 40:11 41:16  
88:21 106:5 114:3  
132:6 157:12 168:12  
305:18  
**definitely** 117:7 251:4  
294:22  
**definition** 77:17,19 88:5  
107:10,11 243:12  
**definitional** 190:17  
215:14  
**definitions** 61:11 65:1  
75:22 81:16 112:6  
138:12 144:1  
**degree** 195:14 213:13  
243:19,22 303:18  
**deja** 310:9  
**delegated** 316:11  
**deliberate** 206:21  
**deliberations** 154:3  
**delighted** 27:9  
**delineate** 24:18  
**delivers** 175:17  
**Deloitte** 223:20 224:5  
224:14  
**delve** 170:7,8 301:15  
**demand** 25:10 34:5,11  
36:3  
**demands** 71:20 225:20  
**demonstrated** 118:11  
118:14 119:3  
**demonstration** 57:3  
**depart** 8:18 11:21 14:7  
**department** 100:11  
**departure** 9:2 237:16  
**departures** 269:13  
**dependent** 213:13  
**depending** 188:18,20  
**depreciation** 36:18  
71:22 80:4  
**depriving** 216:9  
**depth** 20:5  
**deputy** 5:10 28:9 203:4  
259:16  
**describe** 95:5 214:22  
**described** 210:6 229:9  
245:5  
**describes** 152:16  
**describing** 154:17  
**deserving** 213:9  
**designed** 78:17 164:16  
204:5  
**desire** 81:22  
**desired** 23:2 82:14  
**despite** 110:12 226:13  
285:5  
**destruction** 277:11  
281:14 299:3  
**detail** 53:1 81:2 88:2  
194:17,21 224:4  
262:12 290:3  
**detailed** 88:16 159:18  
217:21  
**details** 15:3,10,15,17  
79:1 154:18  
**detect** 42:9 153:10  
157:6 180:20 181:15  
187:16  
**detected** 151:9 160:13  
175:17  
**detecting** 153:16 158:9  
**detection** 156:20,22  
174:6 187:18  
**deterioration** 277:14  
**determination** 186:10  
245:2,4  
**determine** 75:3 120:1  
147:14 185:12 216:17  
272:16  
**determined** 50:21  
112:7 121:1  
**determines** 100:18  
**determining** 183:20,20  
**develop** 50:19 81:4  
83:12 96:13 111:8  
119:5 154:7 174:9  
182:15 211:13 215:19  
231:11  
**developed** 70:10 82:9  
83:13 154:10 155:22  
282:10 283:20  
**developing** 82:19 84:1  
166:3 216:18 217:3  
217:17  
**development** 48:19  
155:16 156:4 191:18  
210:20 268:7  
**developments** 12:5  
60:1  
**devoted** 35:16  
**dialogue** 12:15 13:1  
31:14 47:17 59:18  
60:7 141:7 231:16  
266:5 281:7  
**dicey** 203:21  
**dichotomy** 46:2 104:6  
128:7  
**dicing** 232:18  
**difference** 128:22 129:6  
133:18,21 143:17  
144:19 173:16 201:20  
281:17 314:9  
**differences** 85:5 88:8  
129:2 165:11  
**different** 44:16 59:1,6  
68:22 69:1 106:21  
111:1 117:9 129:8

130:11 132:22 133:9  
 133:11,12,15 134:2,3  
 134:12 136:3,3,13,13  
 137:19 147:1 159:11  
 173:20 178:1 179:10  
 186:15 198:22 201:9  
 202:12,18 237:19  
 238:6 242:21 250:15  
 272:9 285:8 290:11  
 291:5 294:20 301:18  
**differential** 75:10 76:15  
 76:17  
**differentiate** 99:10  
**differently** 70:21 113:4  
 295:13  
**differing** 193:6  
**difficult** 24:13 25:5 26:1  
 34:18 36:14 37:2,6  
 61:14 90:11 108:16  
 112:9 130:14 167:15  
 174:15 177:9 180:1  
 189:12 205:14 239:13  
 240:11  
**difficulty** 183:17  
**dig** 127:5  
**digging** 166:14  
**digital** 6:7 25:17 55:14  
 56:9 57:6 91:16,20  
 92:13,18 93:4,8,12  
 94:22 95:6 96:2,4,15  
 96:21 97:6 101:18  
 134:18 135:8 311:5  
**digitally** 93:7  
**digitized** 95:21  
**dilemma** 37:12  
**diligence** 10:5 14:21  
**Dingell** 203:16  
**Dingell's** 203:7  
**dinking** 120:17  
**direct** 54:18 73:18,21  
 74:4 122:5,11 144:21  
 145:3 153:11,20  
 157:1 160:2 168:1  
 182:6,16 197:11,14  
 290:22  
**directed** 215:14  
**direction** 114:21 147:15  
 150:9 167:4 170:15  
**directions** 178:2  
**directly** 4:8 6:20 96:18  
 105:10 124:2 183:2  
 227:19 241:18  
**director** 1:16,18 2:1,7  
 2:21 27:15 28:5 29:3  
 32:15 259:16,17  
**disagree** 199:20 286:12  
 310:2  
**disagreement** 287:7

302:5,7  
**disappoints** 202:16  
**discharge** 208:13  
**discharges** 210:11  
**discipline** 232:8  
**disciplined** 194:1  
**disclaimer** 4:11 8:17,18  
 31:5 190:12  
**disclosability** 244:4  
**disclosable** 244:10,17  
**disclose** 11:17 52:13  
 80:18 87:22 88:8  
 110:2,13,19 120:22  
 204:20 237:21 264:22  
**disclosed** 81:11 93:21  
 114:20 149:10 155:17  
 155:19 156:6,9 196:5  
 238:4  
**discloses** 94:2  
**disclosing** 88:14 293:5  
**disclosure** 12:4 38:8  
 53:12 58:17 62:14  
 68:18 69:8 77:15 78:6  
 78:9,10,11,13,14 80:8  
 80:11 85:6 86:17  
 87:12 88:17 90:9 97:3  
 102:11 107:11 112:2  
 112:6 115:2,8 121:6  
 137:13,20 154:6  
 176:5,6 223:2 230:4,8  
 238:7,17 239:20  
 293:15  
**disclosures** 62:17  
 64:18,19 70:4 79:12  
 81:1 82:6 96:21  
 115:22 116:20 123:3  
 137:6 156:3 160:21  
 160:21 239:21  
**discourage** 80:11 81:12  
**discover** 41:6  
**discoverability** 175:7  
**discovered** 41:19  
**discretion** 157:22  
**discuss** 16:13 32:3  
 36:10 39:10 52:2  
 83:19 239:3 262:13  
 307:10  
**discussed** 11:13,20  
 51:17 62:7 63:9 90:17  
 148:22 162:8 214:16  
 215:21 217:4,19  
 219:5 226:3 257:13  
 268:13  
**discussing** 13:14 38:4  
 109:7 125:6 293:4  
**discussion** 3:5,9,14  
 6:12 12:4 13:13 25:16  
 26:16 39:22 54:16

55:3 63:15 84:7 91:4  
 97:12 141:22 142:1  
 143:6 146:8 147:6  
 162:21 166:16 182:21  
 183:7 193:17 201:16  
 204:15 217:21 218:1  
 218:4 225:7 231:4,16  
 237:11 255:15 270:9  
 270:12 293:21 301:14  
 303:16 304:6 313:15  
 316:16 317:1 320:17  
**discussions** 17:20 51:6  
 51:20 63:6 116:8  
 207:11 232:5 300:11  
**disease** 220:12  
**dismayed** 202:13  
**dispatch** 214:12  
**display** 68:17 69:7  
 86:16 107:10 115:6  
**disposes** 16:5  
**dispute** 215:5  
**dissolve** 269:8  
**distinguished** 175:15  
**distribute** 284:8  
**distributed** 307:16  
**District** 2:4,5,5  
**diversity** 141:6,8,9,11  
 315:7  
**divert** 177:4  
**divided** 156:22  
**division** 22:10,12 23:6  
 256:12  
**divisions** 238:11  
 270:16  
**divorced** 41:4  
**doable** 206:6,10  
**document** 43:7 84:10  
 93:3 109:4  
**documentation** 31:1  
 159:6 176:12,15  
 200:7,11 204:8  
 252:11  
**documented** 176:13  
**documents** 74:14 93:1  
 195:13  
**dog** 222:7  
**doing** 25:11 26:8 35:7  
 36:8 37:16,21 38:4  
 61:19 62:4 71:11 84:3  
 84:14 100:12 107:15  
 121:12 123:8 165:9  
 166:11 196:9 200:22  
 209:3 219:14 223:3  
 223:17 229:5 232:18  
 234:15 240:6 246:21  
 265:12 266:7 274:5  
 297:11,16 306:7  
 315:16

**dollars** 94:20 181:17  
 271:1  
**domain** 48:16 214:19  
 215:6  
**dominance** 280:9 293:9  
**Dot** 117:16  
**dots** 301:9  
**Doty** 2:11 8:2,13 9:5  
 13:22 14:6 44:2  
 135:21,22 145:7  
 173:22 188:12 192:4  
 196:2,14 201:21  
 202:3 204:15 237:10  
 237:11 241:19 244:18  
 247:19 250:8 265:14  
 308:12 317:3  
**Doty's** 44:7 255:17  
**doubt** 285:2,3 315:10  
 317:7  
**downside** 258:4  
**downturn** 127:1 140:15  
**dozen** 171:7 179:14  
**draft** 203:1  
**drafted** 150:11 203:1  
 204:6  
**drafting** 15:17 16:1  
**dragging** 166:13  
**drain** 268:17 272:13  
**dramatic** 101:17  
**dramatically** 46:10 92:9  
**draw** 107:13 184:4,20  
 190:16  
**drawing** 195:7  
**drawn** 129:15 161:10  
 183:18  
**dreamed** 55:22  
**Drexel** 285:3  
**drive** 59:7  
**driven** 138:8 139:14  
**drivers** 102:3  
**drives** 102:22 133:9  
**driving** 92:2 253:20  
 276:14  
**drowns** 35:21  
**DT** 224:8  
**dual** 95:12  
**due** 51:15 90:13 191:3  
**Duff** 1:18 28:5  
**dumb** 234:1  
**duopoly** 282:1  
**duties** 210:11 216:12  
 251:7,16 295:10  
**duty** 19:1,2 151:18  
 183:11 184:14,14  
 188:10,17 190:18  
 253:1 256:15  
**dynamic** 11:1

E	
<b>E</b> 2:7	76:3 186:2
<b>E&amp;Y</b> 199:5	<b>effectiveness</b> 216:19
<b>earlier</b> 49:5,6 67:11	<b>effects</b> 54:18 250:4
73:17 79:18 107:1	318:10
113:11 127:13 131:3	<b>efficacy</b> 55:3
140:9 188:12 189:9	<b>efficient</b> 10:21 96:11
189:19 239:12 247:19	<b>effort</b> 6:3 146:17 184:2
253:17 254:4 269:18	184:3 185:9 207:18
272:7 280:16 281:3	224:12 293:17 300:20
298:14,19 305:5	302:14
<b>early</b> 17:22 49:21 92:7	<b>efforts</b> 5:16 25:5 40:10
100:6 101:20 139:8	213:18
260:12	<b>eight</b> 55:19,20,21
<b>earning</b> 128:2	122:14 233:21 238:12
<b>earnings</b> 35:5,17,18,22	238:13,13 316:7
36:17 39:11,12 66:16	<b>eighth</b> 4:4 273:20
70:17 75:21 76:12,15	<b>either</b> 67:8 84:15 115:7
89:14,19,19 90:2,6	116:1 124:19 139:6
98:12 109:22 110:9	140:1 163:16 182:11
110:11 111:9 114:8	222:17 228:13 231:10
127:2 128:2 131:7,13	234:1 286:20 304:21
141:19	305:20 311:11
<b>easier</b> 179:15,16	<b>electing</b> 49:18
<b>easily</b> 185:6	<b>election</b> 49:14,15
<b>easy</b> 61:16 137:14	210:16 239:9
150:2 161:9 175:9	<b>electric</b> 313:12,12
278:15 290:8 302:22	<b>electronic</b> 306:9 311:5
<b>EBIT</b> 37:22 84:13,16	<b>electronically</b> 135:3
<b>EBITDA</b> 36:16,17 70:15	289:6
70:16,21 71:5,12,12	<b>elegance</b> 16:6
71:14 72:22 74:17,19	<b>element</b> 56:22 92:22
75:9,13,18 77:7 84:14	183:14,15
124:20 126:2,2	<b>elements</b> 164:9 182:22
<b>echo</b> 139:18 231:7	229:7
279:7	<b>elephant</b> 237:1 243:2
<b>Echoing</b> 296:3	<b>elevated</b> 184:3
<b>economic</b> 19:11,15	<b>elevating</b> 18:12
102:6 144:12,16	<b>elevator</b> 307:17
<b>economics</b> 80:2	<b>email</b> 199:7
<b>economist</b> 277:12	<b>embarrass</b> 322:18
<b>economists</b> 317:20	<b>embedded</b> 142:19
<b>economy</b> 58:22 60:1	<b>embrace</b> 209:14
101:7,15 102:21	<b>emerge</b> 136:4
127:14 269:4,20	<b>emergence</b> 12:3
287:22	<b>emerging</b> 56:8 73:7,12
<b>ed</b> 32:11 203:8	104:20 108:6 144:15
<b>edge</b> 282:20	<b>emissions</b> 181:5
<b>education</b> 32:10 214:1	<b>emphasis</b> 67:1 313:7
215:1 261:21 263:16	<b>emphasize</b> 66:8,20
<b>educational</b> 259:18,21	95:6 142:4 217:1
<b>effect</b> 19:8 21:10 36:7	247:11
38:21 42:5,7 153:11	<b>emphasized</b> 14:19
157:1 158:10 168:2	<b>emphasizing</b> 84:10
240:11 260:19 282:2	<b>Emphatically</b> 124:15
301:19	<b>employee</b> 171:15 271:1
<b>effecting</b> 270:3	<b>employees</b> 72:8,9
<b>effectively</b> 34:10 65:5	171:18 271:2
	<b>Employees'</b> 1:20 2:1
	<b>enable</b> 193:20 208:13
	216:11 230:15 267:14
	<b>enacted</b> 153:8
	<b>encourage</b> 51:20 54:16
	59:17,18 60:6,19 82:5
	113:14 233:13 241:3
	302:15 303:2,6
	<b>encouraged</b> 73:20 74:2
	144:14 289:19
	<b>encouragement</b> 124:19
	<b>encouraging</b> 102:14
	296:20
	<b>end-all</b> 43:19
	<b>endorsing</b> 136:21
	<b>enemy</b> 231:10
	<b>energy</b> 193:6
	<b>enforcement</b> 22:10,12
	22:17 23:5,7 48:9
	172:8 256:1,2,12
	<b>engage</b> 21:2 237:21
	259:8
	<b>engaged</b> 259:9
	<b>engagement</b> 17:9 19:22
	20:4 49:4 229:18
	235:16 238:3,3,14,16
	245:21 246:2,3,7,8
	258:22 266:17,20,20
	267:16 319:3
	<b>engagement-specific</b>
	53:5 234:12
	<b>engagements</b> 7:10
	21:13 237:22 238:1
	245:1 259:9,11 273:8
	<b>engaging</b> 163:21
	<b>engine</b> 110:6
	<b>engineering</b> 263:11
	<b>enhance</b> 41:18 57:2
	<b>enhanced</b> 21:3 150:8
	150:16 238:10
	<b>enhancement</b> 129:19
	174:5 217:8
	<b>enhancements</b> 115:7
	<b>enhancing</b> 10:22 56:6
	92:1
	<b>enjoy</b> 21:1,2 47:17
	176:18 293:7
	<b>enjoyed</b> 31:11
	<b>enjoys</b> 318:20
	<b>enlightened</b> 108:21
	<b>enormous</b> 29:9 65:14
	148:3
	<b>Enron</b> 284:20
	<b>ensuing</b> 207:11
	<b>ensure</b> 12:21 54:4
	62:16 130:3 133:6
	149:9 198:13 200:6
	208:14 311:11 314:21
	<b>ensuring</b> 29:12 96:21
	<b>entail</b> 125:19
	<b>enter</b> 283:14
	<b>enterprises</b> 104:14
	<b>entire</b> 9:13 148:18
	180:8 320:20
	<b>entirely</b> 280:4
	<b>entirety</b> 139:13
	<b>entities</b> 152:4 277:5
	278:10
	<b>entity</b> 138:22 171:18,19
	<b>entity-specific</b> 65:13
	<b>entry</b> 277:18 280:10
	281:13 282:21 283:12
	<b>environment</b> 82:11
	158:19 178:8,11,13
	242:17
	<b>environmental</b> 151:13
	181:7 182:7 183:3
	196:16
	<b>envision</b> 91:3 105:19
	211:12 279:10
	<b>eons</b> 166:7
	<b>EPA</b> 198:5,5,7,10
	<b>EPS</b> 71:13
	<b>EQR</b> 20:15
	<b>equally</b> 104:9
	<b>equation</b> 92:16 186:17
	258:14
	<b>equipment</b> 181:6
	<b>equipped</b> 241:4
	<b>equity</b> 2:3 30:16,19
	318:2,4
	<b>equivalency</b> 144:13,16
	<b>equivalent</b> 105:15
	133:3 226:16
	<b>era</b> 5:7
	<b>erroneous</b> 319:13
	<b>error</b> 123:14 135:13
	220:2,3 221:15
	<b>errors</b> 53:16 249:17
	<b>escalate</b> 249:3
	<b>ESG</b> 104:21 105:6
	108:21 127:9 138:2,3
	138:5,10,10,15 139:1
	139:9 303:7
	<b>ESG-related</b> 138:18
	<b>especially</b> 4:6 6:2 9:8
	17:2 148:15 207:8
	243:17 244:2 309:20
	<b>essence</b> 63:18 64:3
	86:15
	<b>essential</b> 10:5,7 29:13
	79:20
	<b>essentially</b> 87:20 177:6
	<b>establish</b> 190:17
	216:21 227:20
	<b>established</b> 11:6 22:7
	22:14 186:1 187:14

187:15 282:22 283:1  
**estate** 112:18  
**estimates** 17:16,21  
 75:21 309:9 310:10  
**estimation** 249:14  
**et** 63:6 144:11 249:15  
**ethical** 10:3 166:7,10  
 167:4 170:14  
**Ethics** 166:4 200:10  
**Europe** 22:1 95:19  
 220:14 223:19  
**European** 22:2 223:18  
**evaluate** 128:14 140:16  
 140:20 179:11  
**evaluating** 140:1 141:9  
**evaluation** 75:1 104:13  
**evenness** 17:14  
**event** 148:14 155:21  
 182:15 279:19,20  
**events** 44:11 55:1  
**eventually** 203:2,9  
**everybody** 26:18 27:13  
 60:19 70:16 107:3  
 113:22 114:4 124:6  
 145:19 162:21 287:6  
 297:1 304:20 310:18  
**everybody's** 160:9  
**evidence** 36:4 37:20  
 75:7 108:18 246:10  
 272:17  
**evident** 177:20  
**evidential** 245:7  
**evolution** 139:8 289:15  
 303:6  
**evolve** 96:16 138:13  
**evolves** 303:8  
**evolving** 127:15 277:10  
**exacerbates** 76:1  
**exact** 281:7  
**exactly** 98:3 125:10,19  
 125:19 203:18 241:1  
**exam** 30:7  
**examination** 163:16  
**examinations** 50:9  
**examine** 21:14  
**examines** 164:15  
**example** 34:16 35:2,17  
 36:16 37:1 56:17  
 65:16 74:15 75:1 77:9  
 79:10 80:3 93:15,16  
 102:8 110:20 113:17  
 140:7 144:8 155:20  
 182:7 186:19 187:7  
 188:19 196:16 230:1  
 249:10 253:21 273:17  
 296:22  
**examples** 79:16 154:22  
 168:9 171:6 185:15

189:21  
**excellent** 55:11 101:4,4  
 165:10 166:19,21  
 168:9,17 170:11  
 201:16  
**excerpt** 96:6  
**excerpts** 216:14  
**excess** 35:5 76:12  
**exchange** 2:13,16,17  
 15:13 45:4 80:12  
 153:6 188:20 194:13  
 194:20 251:10,17  
 293:13  
**excuse** 154:9 182:17  
 284:12  
**execute** 302:7  
**executive** 29:19 182:9  
 182:14 196:18,19  
 197:1,5 262:3  
**exemplified** 164:6  
**exercise** 144:5 190:22  
 210:14  
**exhibit** 56:14 92:15,15  
**exhibits** 96:20  
**exist** 80:10 82:7 193:21  
 196:5  
**existence** 85:22  
**existing** 45:13 116:1  
**exists** 5:15  
**expand** 96:17 102:20  
 108:12 162:15 225:14  
**expanded** 185:9  
**expanding** 95:8  
**expansion** 87:20 115:1  
 268:16  
**expect** 25:3 40:11 41:3  
 41:4,5 42:8,8 93:8  
 96:16 134:13 149:1,9  
 151:15,15,17,17,20  
 152:3 155:7 174:7  
 180:14 198:3 263:4  
 268:8 276:5 281:14  
 295:8  
**expectation** 97:1,6  
 134:14 181:1 184:9  
 184:11 186:21 187:18  
 206:4 269:5 276:12  
 295:7,18  
**expectations** 24:16,17  
 40:14,19,20 148:20  
 151:5,14 159:6  
 240:16 303:22 306:6  
 306:13  
**expected** 15:18 150:3  
 150:21 180:20  
**expecting** 85:11  
**expects** 148:8  
**expedite** 54:1

**expenditures** 79:20  
**expense** 36:22 72:5  
 80:4  
**expensed** 191:14  
**expenses** 117:2 191:13  
**experience** 12:2 59:1  
 231:13 259:8 260:22  
 261:14,22 262:17,21  
 263:5,16,21 268:22  
 276:13 277:1 291:17  
 292:8 295:5 305:10  
 310:21  
**experiences** 59:13  
 173:3  
**experimenting** 189:12  
**expert** 45:8  
**expertise** 9:21 119:4  
 193:6 311:20 314:21  
**explain** 111:15 125:18  
 267:12 291:20  
**explained** 172:3  
**explicit** 139:5  
**explicitly** 88:2  
**expose** 184:15  
**exposure** 175:6  
**express** 4:13 5:21 8:7  
 32:20,22 48:3 322:6  
**expressing** 4:18  
**extemporaneously**  
 23:14  
**extemporary** 16:10  
**eXtensible** 92:4  
**extensive** 63:14 65:16  
**extent** 19:6 20:6 85:3  
 124:22 176:13 256:11  
 257:22 270:10 271:5  
 271:16 289:15 305:19  
 306:3 313:3  
**external** 19:12 29:21  
 269:16  
**extinct** 295:17  
**extremely** 59:8 146:5  
 147:19 148:20 196:7  
 232:5 234:8 261:16  
**eye** 138:11 271:5,19  
**eyes** 43:10 317:20

---

**F**

---

**F** 2:20 220:22 222:6  
 252:6 266:6  
**F-A-S-B** 7:12  
**fabric** 139:22  
**face** 191:6  
**face-to-** 191:5  
**faced** 15:4 25:22 128:5  
**facetious** 70:20  
**facilitate** 10:19 51:2  
 59:20 99:16 196:12

**facility** 266:16  
**facing** 278:15  
**fact** 21:8 35:20 36:15  
 47:1 64:16 77:9 84:5  
 86:22 117:12 126:1  
 132:10 153:1 162:22  
 173:15 174:22 193:18  
 194:8 205:1 209:7  
 214:14,15 215:5  
 244:22 245:15 247:8  
 249:5 252:10 254:15  
 266:4 283:19 296:10  
 299:2 319:3 320:8  
**factor** 161:1 164:22  
**factors** 44:4 127:11,12  
 133:11 138:18,20  
 139:1 225:9,9 270:2  
 293:12  
**FactSet** 127:3 135:10  
 135:10,12  
**faculty** 100:1  
**fail** 54:22 153:13 226:4  
 226:15,19 236:6  
 245:7 270:7 272:2  
 273:9,12 274:2,16,17  
 277:5 278:18 279:10  
 280:7 284:5 285:2,7  
 298:18 299:1,19  
 301:15 311:21 319:9  
 319:11,14,16,20  
**failed** 219:17 266:1  
 279:17 319:10,12,12  
**failing** 221:4 277:17  
 279:11  
**failure** 277:9 278:14,14  
 279:21 286:1 298:16  
 320:2  
**failures** 243:17 258:6  
**fair** 10:20 17:16,20  
 76:14 165:5 241:11  
**fairly** 27:16 63:1,14,14  
 76:8,18 84:17 91:3  
 116:18 126:20 148:9  
 159:18 177:17 180:6  
 184:12 214:7 282:10  
 283:1  
**fall** 51:16 52:6 83:10  
 125:12,13 179:5  
**fallen** 165:20  
**falling** 166:8  
**falls** 68:11 174:3  
**false** 123:12 134:14  
**falsify** 195:12  
**familiar** 32:4 137:8  
 149:18  
**famous** 239:17  
**fan** 25:8  
**fancy** 272:9

- fantastic** 292:7 316:15  
**far** 63:7 121:18 123:13  
 128:5 134:16 166:1  
 180:16,22 181:21  
 185:10,13 196:1  
 203:11 218:9 221:13  
 234:8 261:21 283:17  
 309:8  
**Fargo** 40:17 42:2 44:2  
 161:2 170:16 197:20  
**Farr** 167:1  
**farther** 196:21  
**FASB** 7:12 34:9 37:17  
 38:3 68:12 81:3,18  
 83:11,13,22 84:2 85:1  
 85:11 88:20,21  
 105:20 106:4 107:15  
 109:16 115:19 118:7  
 118:11 119:3 120:12  
 120:16 121:15 122:1  
 124:19 137:11 144:3  
**FASB-defined** 80:16  
**fascinating** 112:19  
 137:21 204:16 237:11  
**fashion** 41:7 60:18  
**fastened** 23:19  
**favor** 299:12  
**favorable** 78:18 79:8,9  
**fear** 278:13  
**feasibility** 216:17  
**feasible** 50:22 106:18  
**feat** 312:21  
**federal** 75:2,5,16  
 151:13 200:8 226:16  
**Federation** 223:18  
**feds** 198:13  
**fee** 260:19 267:20 268:2  
**feed** 222:7 270:12  
**feedback** 82:15,18  
 89:15 104:11 230:19  
**feel** 12:10,22 15:11,16  
 61:17 79:5 107:21  
 148:7 150:13,16  
 151:3,9 186:12  
 187:20 242:9 300:20  
**feeling** 157:5  
**fees** 272:18  
**feet** 160:9 166:13  
**FEI** 118:17,19  
**fell** 204:7 300:18  
**fellow** 28:16 199:7  
 241:11  
**felt** 41:14 230:10  
**fenced** 119:2  
**Ferguson** 16:15 317:4  
**fessed** 198:21  
**fiduciaries** 140:19,20  
**fiduciary** 49:10
- field** 22:21 296:9  
**Fifteen** 199:6  
**fifth** 273:20  
**figure** 25:13 107:13  
 280:20 281:12  
**file** 19:13 23:5  
**filed** 56:13 92:14  
**files** 172:19 256:2  
 275:10  
**filing** 131:21  
**filings** 56:14 92:15  
 95:12 96:18 256:9  
**final** 13:10 52:17 145:6  
 216:8 218:16 292:10  
 292:11 314:6  
**finale** 279:5  
**finally** 30:6 55:13 77:5  
 78:15 144:8,12,15,18  
 154:21 267:2 304:15  
**financial-related**  
 102:11  
**financials** 123:8 149:6  
 149:20 293:16 299:8  
 299:10 317:10 320:7  
**financing** 320:4  
**find** 34:7,14,18 35:15  
 37:9 56:3 63:18 65:4  
 65:6 67:21,22 75:17  
 76:10 85:1 108:15  
 112:19 118:1 119:19  
 127:5 137:21 138:10  
 157:4 183:13 192:4  
 192:15 196:22 198:3  
 219:15 223:5 246:8  
 247:12 249:6,12  
 256:1,11 266:19  
 272:11 275:13 278:8  
 281:6 283:20 285:14  
 286:2 294:9 308:1  
**finding** 43:19 192:11  
 245:4 248:5 265:22  
**findings** 7:4 150:3  
 154:18 198:8 244:18  
 244:20 245:1 246:3  
 246:13,14,17,18  
 247:2 250:1 253:13  
 265:19 267:4  
**fine-tuning** 20:11  
**finish** 209:17 214:9  
 232:1 314:6  
**finishing** 314:8  
**FINRA** 32:8 242:18  
**fire** 160:9 239:8  
**firefighters** 29:11  
**firm** 7:18 27:11 28:18  
 28:20 54:11 77:17,17  
 130:9 135:20 184:7  
 189:11 195:17 211:3  
 211:3 213:2 221:9  
 225:16 228:6,19  
 229:17 237:22 241:22  
 242:4,7 244:19,19  
 245:1,6,12,13,20  
 246:5,7 247:13  
 253:13 254:8 257:21  
 258:18 265:20 266:3  
 267:3,4,16 269:8,12  
 270:4 271:7,9,10  
 272:15 273:21 274:17  
 275:6 276:4 283:6  
 292:21 311:1 318:13  
 319:12,19  
**firm's** 53:15 54:9  
 211:15 225:13 276:9  
**firm-specific** 234:11  
**firm-wide** 224:1  
**firms'** 53:10  
**first** 9:2 12:7 14:6,15,19  
 15:7 17:1 19:20,21  
 33:11 40:18 51:5 53:4  
 55:17 58:16 73:11  
 97:16 106:7 119:17  
 126:13 133:2,8  
 140:22 143:20 144:1  
 146:1 148:9,13 165:4  
 165:19 203:1 207:13  
 210:1 224:19,22  
 229:8 232:4 234:4  
 239:2 243:14 248:21  
 248:22 259:15 262:14  
 275:1 276:19 288:5  
 291:22 294:11 297:19  
 303:11 306:18 307:1  
 312:12 313:1 317:3  
**firstly** 251:11  
**fishing** 202:1  
**fit** 61:15  
**fitness** 212:9  
**fits** 33:9 83:4  
**five** 32:8 97:11 130:17  
 257:19 259:3 262:7  
 264:7 265:16  
**fix** 121:21 204:10  
 236:20 237:8  
**fixed** 133:20 203:13,13  
 204:2  
**fixed-plant** 133:14  
**flag** 101:5,10 103:11  
 194:15,21  
**flags** 194:18 211:10  
**flat** 235:22  
**Fleck** 166:20  
**flexibility** 310:4  
**flip** 223:6  
**flow** 29:12 72:21 73:2,2  
 73:3,11,13 74:6  
 116:14 121:15 122:6  
 144:20 177:3 210:22  
**flow-generating** 121:22  
**flows** 71:16 73:9,15  
**fly** 219:19  
**focal** 12:4  
**focus** 12:8 18:8 40:10  
 43:9 44:3,20 46:8  
 53:3 67:5 104:16  
 143:3 150:10 178:15  
 178:19 179:21 192:13  
 193:17 206:22 207:1  
 214:1 228:4 247:16  
 298:11 307:8  
**focused** 7:6 98:18  
 104:9 147:9 199:2  
**focuses** 91:10 154:4  
 179:18 194:11  
**focusing** 142:15  
**Folarin** 322:19  
**follow** 65:3 66:15,17  
 68:17 69:6,13 80:21  
 144:1 203:16 297:9  
 297:15  
**follow-up** 258:19 303:1  
**followed** 118:7 170:17  
**following** 87:18 95:20  
 123:10 180:19 193:21  
 219:6,9 238:12,14,14  
 238:15  
**fool** 223:4  
**foot** 134:10 299:18  
 301:6,6  
**foothills** 239:16  
**footnote** 39:16 90:6,7  
 115:2,3 116:1,2  
**footnotes** 81:11 115:9  
**footsteps** 297:16  
**force** 73:12 108:7 180:8  
**forecasts** 66:16 67:1  
**foregone** 114:4  
**foreign** 21:20,21 22:19  
 23:4 158:18  
**foremost** 106:7 306:18  
 307:1  
**forever** 317:13  
**forgot** 121:4 287:5  
**form** 176:1 216:15  
 224:6,6 266:15 293:9  
**formal** 90:15  
**formally** 216:8  
**format** 56:11,12,13  
 91:17 115:6 116:1  
**formation** 10:20 21:5  
 21:10  
**formed** 6:15  
**former** 1:17 2:7 28:19  
 137:12 214:17



**forming** 225:15  
**forms** 190:19 208:12  
 214:21 218:18  
**formulaic** 210:15  
**formulate** 60:9  
**forth** 148:4 207:21  
 283:4  
**fortune** 30:11  
**forum** 4:6 6:16 30:21  
**forward** 11:7,12 13:13  
 26:1,14,16 31:13  
 39:22 46:19 49:7 52:5  
 56:14 59:20 105:13  
 105:16 106:9 116:2  
 129:18 142:9 146:8  
 149:14 152:2 162:7  
 239:15 287:10 294:14  
 299:6 308:7 309:8,19  
 311:22 315:12  
**forward-looking** 94:7  
 228:1  
**foster** 93:4  
**fostered** 163:19 247:1  
**fought** 240:4  
**found** 46:3 75:4 76:6,9  
 131:22 169:21 193:12  
 203:15,17,20 230:9  
 236:2,5 238:12  
 248:14  
**foundation** 32:11 119:7  
 125:4  
**foundational** 48:1,14  
 208:17  
**founding** 45:12 321:22  
 322:7  
**four** 28:20 75:11 93:22  
 130:10 135:15,20  
 174:4 213:2,4 232:12  
 232:21,22 255:21,21  
 259:15 262:20 264:1  
 265:16 268:15 269:9  
 270:19 273:14,15,18  
 273:22 279:11 280:9  
 280:11 283:15,19  
 284:2,3 293:7 316:7,8  
**four-opoly** 283:16  
**four-plus** 30:5  
**Fourteen** 22:1  
**fox** 120:6,7 125:8  
**fractions** 243:17  
**frame** 258:5  
**framework** 38:14 43:22  
 49:16 68:15 86:16  
 87:4 88:18 102:15  
 107:6,8,9 109:13  
 113:15 115:5 140:5  
 145:11 190:15,17  
 239:6,10 250:14

**franchise** 210:14  
 318:20  
**Francisco** 27:8  
**frank** 240:12  
**frankly** 104:12 106:3  
 121:3 168:21 225:21  
 280:4,18 301:11  
 307:19  
**Franzel** 2:11 9:6 23:22  
 24:3 177:20,21  
 316:15  
**fraud** 11:5 167:13,15,19  
 169:10 172:14 178:22  
 179:3 182:7 183:21  
 184:15 185:8 187:16  
 187:18 189:15 191:19  
 196:16  
**fraud's** 167:14  
**frauds** 163:13  
**free** 72:21 73:2 185:19  
 186:4 277:4  
**freedom** 111:14  
**freely** 95:18  
**frequency** 53:15  
**frequently** 44:22  
**fresh** 147:5  
**friend** 47:20 315:8  
**friendly** 287:17  
**friends** 119:16  
**front** 54:4 56:17 60:2  
 94:15,16 155:14  
 187:1 206:1 207:18  
 240:10 281:15  
**fruit** 174:12,13 177:14  
 177:16 205:19  
**fruition** 17:22 231:18  
**fruits** 20:19  
**frustration** 305:17  
**FSAB** 142:7  
**fulfill** 216:6,11,11  
 314:22  
**full** 11:9 93:11 187:17  
 270:9 313:16  
**fuller** 61:4  
**fully** 130:12 255:17  
 256:4  
**fun** 312:22  
**function** 158:4,4 187:15  
 280:19 281:21 301:18  
 304:11  
**functioning** 10:7  
**functions** 301:21  
**fund** 29:9  
**fundamental** 25:1  
 26:13 51:2 97:20  
 128:9 193:3 214:10  
 260:2  
**fundamentally** 36:1

55:2 76:5 177:3  
**funds** 1:22 30:19  
 116:14  
**furnished** 92:15 96:4  
**further** 38:2 50:21  
 154:17 163:16 168:12  
 188:16,19 216:11  
 217:22 225:10 229:4  
 230:11 252:18 305:21  
**future** 13:15 26:8 72:11  
 72:19 187:12 197:12  
 318:12 321:1  
**future-looking** 93:11

## G

**G** 1:16 2:8 87:22  
**GAAP** 34:2,6 35:21  
 36:6 38:10 39:8 64:11  
 73:6,18 76:12,15  
 79:19 82:2,3 88:4,6  
 89:12 90:5 97:21  
 98:18,18 100:7,16  
 127:6 128:4 131:20  
 261:9 284:13 307:9  
**GAAP-comparable**  
 142:2  
**GAAPs** 123:10  
**GAAs** 219:9  
**gain** 307:12  
**Galbraith** 317:12  
**gamut** 138:16  
**GAO** 43:3 45:5 46:4  
 154:2 160:1 168:15  
 168:18,19 169:17  
 170:11,13 178:20,21  
 179:8 200:8,11  
 201:12 203:16 204:10  
**gap** 24:16,17 145:9  
 184:10,11 186:21  
 187:10 197:14,15  
 206:4 295:7,7,13  
 300:13 303:22 306:6  
 306:12,15,15  
**gaping** 89:15  
**gaps** 252:11,11  
**gardening** 277:13  
 298:15  
**gardens** 277:16  
**Gary** 2:8 28:11 128:20  
 128:20 136:6 207:14  
 209:10 290:13  
**gather** 208:11  
**gathered** 94:22  
**gathering** 92:10  
**gathers** 136:9  
**GDP** 117:18,19  
**geared** 148:7  
**general** 16:11 32:9 98:9

98:19 124:22 156:2  
 168:14 171:14,17  
 173:10 182:12 196:20  
 228:16 258:16  
**generally** 59:12 62:22  
 76:12 79:4,19 81:22  
 131:14 132:10  
**generous** 47:15  
**genesis** 216:13  
**gentlemen** 193:15  
**George** 100:11  
**getting** 127:10 177:10  
 177:15 180:11 221:17  
 222:19 225:4 246:19  
 254:14 263:12 264:18  
 273:8 308:22 310:12  
 318:18  
**give** 26:20 30:7 66:8  
 83:15 93:15 104:12  
 109:18 110:20 112:14  
 123:12 127:21 134:4  
 134:10 135:8 171:6  
 191:16 194:17 196:15  
 201:19 202:20 204:13  
 207:22 221:2 223:20  
 224:13 229:3 233:7,8  
 233:8,14,17,21  
 238:15 249:19 254:16  
 257:22 262:12 265:3  
 273:10 277:18 282:20  
 286:10 292:6 294:6  
 299:10 306:22 307:4  
 319:2 321:20,21  
 322:15  
**given** 68:10 69:21  
 84:20 97:18 170:5  
 173:2 180:5 205:17  
 233:3 261:7 301:13  
 303:6 307:1 315:3  
 316:4  
**gives** 66:9 70:2,2  
 130:19 154:8 158:13  
 177:7 221:4 261:11  
**giving** 110:14 189:20  
 316:3  
**glad** 27:11 47:3 51:11  
 184:20  
**Glass-Steagall** 300:18  
**glimpse** 313:21  
**global** 2:1 17:15 95:7  
 139:21 270:20 296:15  
 318:17  
**globe** 123:9 236:5  
 283:14  
**gloss** 132:11  
**glossary** 73:22  
**goal** 15:8,13 42:10  
 48:10 217:17 219:20

221:17,18 308:8  
**goals** 10:17 217:3,15  
**Goelzer** 323:1  
**gotten** 116:18 220:12  
**govern** 300:4  
**governance** 1:16 2:1  
 7:19 258:3 278:11  
 287:21 296:1,4,6  
 313:3 315:1 318:6  
**governed** 153:5 210:17  
 313:4  
**governing** 32:12 251:1  
**government** 137:9  
 152:20 154:16 169:19  
 320:3,4  
**government's** 140:4  
 239:7  
**governmental** 169:2  
 320:10  
**governments** 32:12  
**governor** 30:11  
**grad** 28:16  
**grade** 220:20 221:1,2,5  
 221:5,8 237:13  
 238:11 247:22 265:3  
 265:15,16 266:6  
**grades** 52:14,15 53:13  
 230:5 238:15  
**grading** 220:21 238:3  
 264:15,15  
**grand** 279:4  
**Grant** 1:15 32:7 40:2  
 42:16 46:17 145:21  
 146:1,14 156:11  
 173:13 174:19 189:19  
 189:20 195:4 205:16  
 282:13 283:21 303:9  
 305:1 306:10  
**Grant's** 231:7  
**granted** 282:2  
**granular** 290:3  
**granulated** 136:20  
**graphic** 94:20  
**grateful** 9:20 305:11  
**gratitude** 305:3  
**gray** 150:1 191:11,12  
 191:12  
**greater** 7:8,11,18 48:21  
 59:3 229:12 268:21  
**greatest** 191:2  
**greatly** 308:16  
**grind** 192:22  
**grounds** 240:9  
**groups** 6:1 17:20 33:7  
 83:6,8 106:10,11  
 118:13 119:5 137:2  
**groupthink** 315:8  
**grow** 76:16 225:14

270:5 272:3  
**growing** 6:7 113:4  
 236:8 313:15 314:5  
**grown** 33:19,21 117:4  
**growth** 72:22 117:18,19  
 277:14  
**growth-oriented** 129:2  
**guess** 23:13,14 90:15  
 102:19 106:3 109:15  
 165:1 231:2 259:19  
 278:4 303:10 304:15  
 304:16 305:2  
**guidance** 68:18 69:6  
 94:9 152:16,20 154:1  
 154:22 157:20 158:13  
 214:2,8 216:4 230:11  
**guidelines** 68:17  
**gust** 218:12

---

**H**


---

**hairdressing** 278:2,3  
**half** 31:21 145:1 171:7  
 230:22  
**hand** 56:16,17,18 84:12  
 94:16,17 197:1  
 240:13  
**handful** 22:4  
**handing** 231:7  
**handouts** 153:2  
**hands** 28:16 252:16  
 264:10  
**handy** 194:5  
**hang** 240:9  
**hanging** 192:16 193:3  
**hangs** 260:13  
**hankies** 312:10  
**happen** 169:7 177:2  
 185:4 223:4 286:3  
 310:1  
**happened** 14:20 170:16  
 170:17,18 203:19  
 274:21,21  
**happening** 25:21 26:3  
 80:14 166:9 172:19  
 178:7,18 282:9  
 296:13  
**happens** 48:10 148:13  
 172:19 176:11 274:19  
 279:13,19 319:16  
**happy** 24:11 25:17  
 26:11 58:3 106:7  
 150:8 287:3,17  
 305:18,20 306:2  
**harbor** 158:15  
**hard** 6:1 9:6 14:21  
 19:14 22:8 32:22 72:9  
 164:2 178:1 184:20  
 193:16 223:8 240:4

308:14  
**harder** 275:12 310:17  
**hardware** 127:16  
**harms** 11:4  
**Harrison** 1:18 28:3,4  
 47:10 163:4 190:6,7  
 207:7 224:16 226:9  
 227:1 267:18 279:4  
 291:22  
**hat** 139:19 302:16  
**hate** 181:3  
**hazard** 193:9  
**he'll** 310:12 322:2  
**head** 1:19 29:17,17  
 113:21,22 115:12,18  
 115:20 241:15,17  
 270:20,20 272:6  
**headed** 167:3 170:15  
 233:18  
**heading** 15:12  
**headline** 109:22 110:9  
**heads** 15:16 170:5  
 223:15  
**hear** 4:8 6:20,21,21  
 16:17 18:13 23:14  
 25:16 40:16 219:10  
 238:2 302:5 322:3  
**heard** 14:19 129:9  
 137:16 159:17 257:12  
**hearing** 6:3 25:19 192:6  
 202:4,4 315:12  
**hearings** 167:10 259:15  
 259:19  
**heart** 141:17 174:1  
 254:9 296:6  
**heavily** 72:7  
**heavy** 24:7  
**heck** 200:21,22  
**hedge** 30:19  
**heels** 166:14  
**held** 23:18 167:10  
 206:3 262:1  
**Helen** 233:8 308:15  
 310:14  
**help** 44:17 60:8,9 70:4  
 72:1 89:1,3 128:12  
 138:15 178:15 237:12  
 254:7 270:1 280:14  
 280:14 285:11 291:5  
 292:8,18,21 296:1  
 303:21 308:21 314:13  
 322:14  
**helped** 8:5 118:13  
 144:22  
**helpful** 43:7,8 67:1,15  
 75:17 78:11 96:13  
 116:12 135:9 141:7  
 162:3 165:12 210:17

247:14,21 304:4,18  
 305:19 312:17  
**helping** 32:4 43:19  
**helps** 253:19  
**henhouse** 120:6 125:9  
**herring** 121:7  
**Hewlett-Packard**  
 127:15  
**hey** 199:8  
**hidden** 170:9  
**hide** 168:2 199:21  
 201:4 265:1 284:17  
 286:2  
**high** 5:1 23:3 29:12  
 40:14,15 42:1 50:10  
 76:22 114:15 148:9  
 148:20,21 208:14  
 213:1,1 219:7,12,13  
 219:16 240:15 244:3  
 277:19 310:13 319:20  
 319:22  
**high-** 9:21 243:9  
**high-profile** 40:17  
**high-quality** 58:17  
**high-risk** 266:1  
**high-tech** 116:20  
 133:13  
**higher** 32:11 34:15  
 50:12 77:2 117:10,20  
 213:6 225:22 268:16  
 268:20 272:10 273:2  
 291:17  
**highlight** 168:4 210:3  
**highlighted** 158:21  
**highlights** 165:11  
 209:12  
**highly** 35:3 45:8 97:19  
 278:4 309:11 318:6  
**Hindman** 322:20  
**hindsight** 189:13  
 200:21  
**hire** 135:15 239:8  
 242:13 318:17  
**hired** 258:9  
**hires** 239:8  
**hiring** 242:20,21 319:17  
**historical** 116:11  
**historically** 139:8  
**historiography** 176:9  
**history** 22:16 27:17  
 50:17 51:5  
**hit** 221:18 318:16  
**hobby-horse** 253:7  
**hockey** 319:21  
**hold** 23:16 220:13  
 286:6 311:12  
**holding** 166:16 313:20  
 318:8

**hole** 89:16 204:4  
**holes** 148:4  
**holistic** 139:12  
**home** 54:21 222:5,8  
**honest** 243:9 265:11  
**honestly** 295:16  
**honor** 56:1 310:20  
**hoot** 224:13  
**hope** 8:4 17:18,20  
 18:13 46:14 47:4  
 145:4 164:18 207:11  
 272:19 292:11 297:22  
 303:17 307:20 310:12  
 314:10 316:18 321:9  
**hoped** 222:7 321:10  
**hopefully** 43:8 110:10  
 146:6 166:15 167:2  
 189:22 206:14 284:4  
 303:14 307:10  
**hopes** 277:19  
**hoping** 51:20  
**horrendous** 121:15  
**horribly** 240:21  
**host** 281:15  
**hot** 222:1  
**hotel** 111:2,2  
**hotline** 171:11  
**hours** 32:17 95:3 145:2  
 227:17 230:6 259:4  
 261:5 262:10,20  
 291:9  
**house** 287:20,21  
**how's** 130:2  
**huge** 204:4 264:10  
 300:13 314:4  
**hugely** 123:4  
**human** 101:13  
**human-readable** 56:11  
 92:21 96:22  
**humble** 15:21 116:9  
**hundred** 289:8  
**hundreds** 95:3

## I

**IAASB** 1:18 27:18 34:10  
 37:18,22 84:1,12 85:2  
 85:12 107:16 145:1  
 223:7,15 296:22  
**IAASB's** 250:14  
**IAASB-defined** 88:20  
**IAG** 9:17 11:13 32:20  
 180:8 209:7  
**IAS** 73:6  
**IASC** 145:3  
**ICFR** 178:7  
**ID** 275:16  
**idea** 159:5 160:8 242:3  
 278:21 299:21

**ideally** 228:2  
**ideas** 60:9 106:13,20  
 146:6 147:1 261:7  
 306:16  
**identification** 230:6  
**identified** 154:12  
 204:17 217:15 230:5  
 255:16 260:12  
**identify** 52:15 54:8  
 147:11 151:18 184:15  
 188:4 291:20  
**IFIAR** 219:20 220:6,8  
 220:15,15  
**IFRS** 63:20 68:13 73:6  
 73:18 261:9  
**IFRSs** 34:10  
**ignores** 154:11  
**illegal** 41:9,20 44:10  
 151:9,11,19,22 152:4  
 154:7 158:7,9 159:6  
 167:13,14,16,19  
 168:8 169:10 175:18  
 176:3,13,20 178:5,22  
 179:3 192:7,11 202:5  
 202:7,11 203:22  
**illegalities** 193:12  
**illegally** 197:22  
**illusions** 46:20  
**imagine** 95:2 258:4  
 291:8 321:19  
**imbues** 139:13  
**immediate** 63:7  
**immediately** 75:9  
 142:16 194:20  
**impact** 20:17 42:6  
 149:20 150:21 155:12  
 214:3 267:20 274:3  
 276:8,9  
**impacted** 117:7 271:18  
**impactful** 80:2  
**impacts** 79:7 154:12  
**impairments** 248:16  
**impairs** 11:4  
**implement** 137:15  
**implementation** 19:22  
 57:6  
**implemented** 146:7  
**implementers** 92:7  
**implementing** 290:10  
**implications** 101:8  
**importance** 6:7 97:21  
 173:17 210:5 222:14  
 267:2 287:22  
**importantly** 229:18  
**imposed** 222:1  
**impossible** 114:2  
 129:11 196:4  
**impressive** 165:18

**imprimatur** 94:8  
**improper** 179:4  
**improve** 19:3 48:4  
 59:22 103:18 123:15  
 215:19 216:6  
**improved** 7:10 13:10  
 155:7 233:11 258:3  
 308:16  
**improvement** 50:8,13  
 103:5 120:17 122:2,8  
 213:8  
**improving** 9:15 48:11  
 214:3 260:3  
**imprudent** 163:20  
**in-charge** 262:9  
**in-depth** 19:11  
**in-line** 56:15 96:6  
**incentive** 164:6,15,15  
 249:20 268:21  
**incentives** 7:18 178:8  
 192:21  
**incentivized** 163:20  
**incident** 186:7  
**incidents** 40:17 42:2  
 151:8  
**include** 117:1 139:6  
 151:11 154:17 229:12  
**included** 63:10 66:17  
 78:7 81:6  
**includes** 18:3 28:5  
 87:11,12 94:4 300:21  
**including** 9:9 10:12,16  
 11:5,16 44:17 51:10  
 53:10 54:20 91:11  
 92:11 160:6 175:15  
 209:8 213:19 214:17  
**income** 141:19  
**incomplete** 224:22  
**inconsequential**  
 161:11  
**inconsistency** 71:2  
**inconsistent** 9:1  
**inconsistently** 80:5  
**incorporate** 82:13  
 105:5  
**incorporated** 93:13  
 139:1  
**incorporating** 114:21  
 115:1  
**incorrectly** 96:8  
**increasing** 22:18  
 225:20 270:4 272:2  
 303:6  
**increasingly** 139:15  
 140:9,10,15,19  
**incredible** 322:3  
**incur** 259:3  
**independence** 7:16

41:2 54:18 149:3  
 172:18 226:1 230:3  
 235:4,6,12 236:7,7  
 237:2,6 251:6,16  
 270:4 272:1 273:4,5  
 283:8 300:9,21 315:5  
 315:18 316:4  
**independent** 10:3  
 19:16 53:10 96:2  
 132:16 134:20 149:2  
 149:6 155:18 163:17  
 163:18 171:5 236:18  
 237:5 300:10,15  
**independently** 62:8  
**indicate** 111:9 138:20  
 147:3 211:13 214:1  
 252:8 270:10  
**indicated** 57:10 166:18  
 207:17 209:19  
**indication** 104:11,12  
 228:17  
**indications** 105:7  
 229:17  
**indicator** 38:18 39:1  
 72:10 77:22 109:19  
 245:20,21 261:6,15  
**indicators** 25:8 33:16  
 33:19 38:10 39:4  
 48:20 49:21 51:1,15  
 52:18,20 53:4,6,12,14  
 53:19 61:12 64:11  
 68:8,19 70:12 72:17  
 74:7 81:5 82:12 89:3  
 104:8,22 105:7 107:3  
 109:18 122:15,16  
 127:19 184:1 207:1,2  
 208:8 209:20 210:21  
 211:5,6,9,20 215:13  
 216:9,18,22 227:15  
 228:1,5,6,9 229:11  
 230:15 231:3 234:8  
 235:19 237:13 238:15  
 242:12 245:16 247:12  
 247:13,13,17 248:9  
 253:17 296:12  
**indictment** 319:13  
**indirect** 73:5,17  
**indirectly** 96:18  
**individual** 87:1 140:12  
 224:2,3 241:20 242:5  
 242:6  
**individualize** 322:12  
**individuals** 7:9 242:2  
 254:8  
**inducement** 160:15  
**industrial** 70:12 71:9  
**industries** 119:8 122:21  
 137:1 139:7 281:16

**industry** 82:10 83:2,4,6  
83:8 105:3 112:8  
118:10,12,13,14  
119:5,9,12 125:1,1  
128:22 130:4 132:22  
133:9,11,12 134:1,3  
137:2 191:4,4 211:4  
211:16 225:9 230:2  
271:12 313:3 320:11  
320:11  
**industry's** 82:10  
**industry-** 83:13 130:1  
**industry-level** 82:20  
**industry-specific** 68:8  
85:12 87:1 105:18  
106:5  
**inefficiency** 90:3  
**inexperienced** 291:14  
**inflammatory** 279:2  
**inflated** 117:17 121:12  
**influence** 8:5  
**info** 169:13  
**inform** 10:5 34:21 49:2  
50:1 170:2 211:1,16  
212:7 221:9  
**informative** 154:3  
156:3 243:15  
**informed** 10:6 183:10  
231:13 241:8  
**infraction** 243:22  
**infractions** 243:20,20  
244:5,9,12  
**infrastructure** 191:10  
**inherent** 55:4  
**inhibiting** 240:11  
**initial** 229:16 231:11  
302:20  
**initially** 12:8 61:9  
139:14 187:15  
**initiative** 49:16 50:17  
212:6 216:14 217:16  
218:8 230:14  
**initiatives** 3:12,15 6:13  
13:14,22 25:7 47:9,21  
49:12 50:19 88:19  
140:5 206:20,21  
207:3 208:10 209:21  
213:18 217:15,17  
229:11  
**inked** 22:5,6  
**inline** 92:20 93:17  
95:11  
**input** 10:12 11:12 13:9  
24:9 25:6,16 31:9  
44:16 147:16 180:11  
316:20  
**input-oriented** 53:19  
**inputs** 53:8

**inquiries** 73:9 153:20  
164:20 246:9  
**inquiring** 142:18  
**inquiry** 155:9 181:10  
191:20  
**insanity** 243:12  
**inseparable** 56:12,16  
**inside** 91:22  
**insight** 89:1 130:19  
182:20  
**insights** 20:15  
**insisted** 33:22  
**insisting** 277:8,9  
**insists** 57:11  
**inspect** 21:18 319:4  
**inspected** 21:7 246:3  
266:13 267:4,5,6  
**inspecting** 19:18  
211:22  
**inspection** 20:18 48:9  
50:3,7 52:14 53:12  
54:2,5 212:7,15  
213:21 221:7 222:2  
229:13 230:4,18  
232:11,14,17 233:3  
233:10 236:3 237:16  
246:12 253:12 255:16  
255:18 264:8  
**inspections** 21:20  
220:20 221:21 232:7  
232:12 238:11 241:20  
242:7,22 308:16  
**inspectors** 54:8 236:4  
**instance** 153:19 155:10  
183:1 186:6 197:8  
245:11 294:11  
**instances** 8:1 54:7  
140:2 184:15 188:4  
189:5 230:3 260:6  
275:15 282:12  
**instantaneously** 94:22  
**instill** 221:19  
**Institute** 96:7 107:12  
152:22  
**institution** 306:22  
**institutional** 28:13  
125:13 140:11 290:7  
**institutions** 138:3  
278:20  
**instructive** 105:1  
**intangibles** 37:2 72:15  
101:22  
**integrated** 108:22  
**integrative** 109:13  
**integrity** 11:5  
**intellectual** 116:7  
**intend** 12:19  
**intended** 11:18

**intends** 8:6  
**intensive** 71:19 80:4  
191:11  
**intent** 12:14  
**interaction** 236:11  
**interactions** 191:6  
**interest** 5:18 6:13 18:19  
19:21 36:17 48:21  
70:17 71:21 80:3  
91:22 129:7,7 140:21  
184:14 193:13 209:22  
247:11 275:8,9  
280:21 320:13,14  
**interested** 25:18 108:9  
181:21 182:3 260:1  
273:11 315:20  
**interesting** 47:22 136:2  
137:10 138:10 146:4  
178:21 187:13 192:4  
205:6,8 219:10  
220:18 221:21 222:12  
223:5 233:20 248:19  
272:12 283:9 301:13  
301:22 312:19  
**interestingly** 168:5  
178:12  
**interests** 48:19 281:1  
294:1  
**intergrade** 137:7  
**interim** 87:19 265:6  
**interlocutor** 175:15  
**internal** 29:20,21 53:16  
54:9 160:6 162:12,18  
164:16,20 190:21  
268:11 269:16  
**internally** 31:21 160:18  
**international** 1:17 17:3  
22:9,11 27:17 43:5  
45:5 46:3,13 47:2  
63:19 95:17 152:21  
154:2,21 158:12  
165:7 166:4,21 167:5  
168:7,7,16 180:18,21  
200:9,10 204:9  
218:19 219:2,4 220:7  
282:12  
**International's** 170:13  
**internationally** 21:17  
296:13  
**interpretation** 153:14  
196:9  
**interpreted** 175:12  
**intervening** 227:22  
**interview** 199:12 267:3  
267:5  
**interviewed** 199:5,6,9  
**interviewing** 49:13  
210:8

**introduce** 5:20 26:18  
147:22 231:12  
**introduced** 289:4  
**introduction** 152:7  
215:17,21 218:17  
**Introductions** 3:2,3  
**invaluable** 322:7  
**inventory** 315:20  
**invest** 49:10 225:19  
268:6  
**investable** 130:10  
**invested** 228:13  
**investigation** 156:20  
174:14 199:17 211:17  
**investing** 6:22 29:9  
58:21 98:20 202:13  
**investment** 1:14,20,22  
2:1 21:3 27:11 28:6  
29:2 30:12,17 31:16  
31:22 38:16 70:12  
82:8 86:2 94:13 98:22  
99:1 112:18 138:19  
139:2,5 140:17  
225:21 227:18 228:14  
228:17,18 241:9  
270:19,21 300:4  
304:12 318:1 319:20  
319:21,22 321:22  
**investments** 225:12  
270:5 272:3  
**investor** 1:3,13 4:5,9,17  
5:2,7 6:15,17 9:10  
10:17 11:2 14:11,16  
19:4 35:6 40:19 41:22  
48:19 51:7 52:19 56:2  
65:9 98:11 100:17  
103:9 108:8 120:18  
122:3 126:16 127:21  
128:9,9 141:8,13  
142:10 143:21 148:6  
148:8 151:5 221:16  
230:22 238:9 240:18  
241:8 244:10,14  
251:2 287:15 288:21  
290:7,18 300:12  
303:22 305:19 306:12  
315:4 317:9  
**investor's** 43:16 44:21  
247:14  
**investors'** 82:14  
**invite** 156:15  
**invited** 210:13  
**inviting** 13:18 30:20  
**invoke** 14:7  
**invokes** 177:7  
**involved** 22:19 96:3  
146:19 148:12 172:9  
172:12 206:12 227:9

239:18 242:9 316:3  
**involves** 7:9 9:18 18:6  
 136:17  
**involving** 217:22  
**iPhones** 220:3  
**IQ** 135:11  
**Ireland** 22:5,5  
**irregularities** 183:21  
 188:2  
**irregularity** 194:15,18  
**irrelevant** 37:3 276:1,10  
**irrespective** 276:4  
**isolation** 296:2  
**issuance** 34:10 54:12  
**issue** 4:10 15:4 16:4  
 39:10 40:9 41:5 47:4  
 50:15 51:4,8,17,22  
 52:5 53:14 54:22 66:1  
 66:12 74:9 76:1 90:11  
 105:17 106:12 107:1  
 116:2,12 124:9 126:1  
 126:9 128:17 144:21  
 155:1 156:4,22 163:7  
 166:16 169:8 171:10  
 176:12 182:4 183:5,9  
 184:6 186:7,10,11,21  
 188:19 194:2,22  
 204:20,21 205:3,8,13  
 205:16 213:20 218:21  
 220:8 223:10 226:6  
 228:19 229:1 231:1  
 233:2 236:22 239:6  
 244:10,17 245:15  
 250:12 252:14,19  
 259:1,17,22 260:2,5  
 267:5 268:2,14 270:3  
 283:3,12 286:16  
 289:20 293:5 298:18  
 305:22 311:7,22  
**issued** 7:15 74:14 84:6  
 218:3 319:14  
**issuer** 94:3 154:13  
 211:4 237:14 266:18  
 267:15 320:11,11  
**issuer's** 88:5 191:2,15  
**issuer-** 89:5  
**issuers** 18:21 20:22  
 21:7,7 22:22 23:1,1  
 52:15 67:4 80:21  
 81:12 87:22 133:7  
 153:13 230:5 266:19  
**issues** 12:10 14:4 15:4  
 26:1,13 28:8 31:12  
 32:3 41:17 47:6 49:21  
 50:1 54:17,19 73:7,11  
 73:12 77:3 90:16  
 97:10 105:15 108:7  
 144:15 145:8 156:8

160:8 161:10 162:5  
 175:3,13 189:4,12  
 210:3 211:13 225:6  
 226:1 230:8,10  
 235:12 236:8 241:10  
 253:8 260:11 274:9  
 274:15 282:17 303:7  
 321:13,16  
**it'd** 134:17 135:14  
**it'll** 26:7  
**Italy** 22:4  
**item** 11:13 89:12  
 244:17  
**items** 9:3 80:7,20 81:13  
 117:13 121:4 123:1  
 233:21 307:9  
**iXBRL** 298:19 299:5

---

**J**


---

**J** 1:18,19  
**Jack** 203:7  
**JAMES** 2:11  
**Jane** 109:3  
**Janette** 292:4  
**janitors** 29:11  
**Japan** 95:20  
**Jay** 2:14 30:3 31:8  
 247:3  
**Jeanette** 2:11 9:5 12:1  
 23:22,22 168:15  
 170:12 177:20 184:9  
 189:9 197:8 201:13  
 284:12 305:5 308:18  
 316:13  
**Jeanette's** 198:17  
**Jenkins** 118:6  
**jerk** 275:4  
**Jim** 12:1 187:20 195:20  
 197:19 199:19 201:21  
 221:3 233:7 252:9  
 264:14 285:1,2,2  
 287:4 292:4 293:20  
 296:8 310:19 312:16  
 315:15 316:13  
**Jim's** 261:19  
**Joanne** 322:19  
**job** 30:13 67:12 152:15  
 165:3 168:9 169:12  
 171:17 207:10 210:19  
 211:22 212:2 219:14  
 223:4 240:6,20,21  
 247:10 263:14,14  
 265:12 292:18 308:19  
 315:16  
**jobs** 9:17 292:22  
**Joe** 322:1,2  
**John** 317:12  
**join** 13:12 224:12 269:4

301:3  
**joined** 277:1  
**joining** 40:6 312:12  
 314:7 317:5  
**joins** 16:16  
**joint** 21:19  
**Judge** 2:4,4 254:11  
 256:9,17 257:10  
 264:14 315:13 316:12  
**judged** 155:11  
**judgements** 309:9  
**judges** 29:11 235:11  
**judgment** 153:14 176:1  
 309:15,16 310:3,10  
**judgments** 309:14,16  
**July** 218:2  
**jump** 268:18  
**jumping** 80:15 223:8  
**junior** 259:5 260:21,22  
 261:10  
**jurisdiction** 124:3  
 162:10 206:11,11  
 294:21  
**jurisdictions** 21:6 22:2  
 22:13 140:1 192:19  
 192:20 209:3 225:4  
 225:15 296:15  
**jury** 274:18  
**justice** 201:4 266:7  
 313:11  
**justify** 117:10

---

**K**


---

**keen** 10:10 18:18 32:4  
**keep** 45:9 63:17 86:12  
 105:22 111:18 113:8  
 168:1 235:4 264:17  
 264:17 299:22 300:5  
 304:14 306:3 317:18  
**keeping** 65:5  
**keeps** 30:13 300:10  
**Kenneth** 317:12  
**kept** 34:11 156:1 300:8  
**Kevin** 1:16 26:22 27:5  
 103:22 136:19 138:1  
 280:5,11 288:17  
 301:2 305:15 313:6  
 317:18,19  
**Kevin's** 108:13  
**key** 33:16,18 38:10,18  
 41:3 61:12 64:11 68:8  
 70:11 72:17 75:17  
 81:4 82:11 89:2  
 122:14,15 127:19  
 134:11 150:20 191:7  
 209:12 210:3 216:18  
 229:7 230:6 295:22  
**kick** 98:5 146:11 165:2

**kids** 263:7  
**kinds** 72:14 140:2  
 148:3 181:16 247:16  
 248:10  
**king** 2:8 28:11 115:20  
**knee** 275:4  
**knew** 116:19 119:9,10  
 201:1 202:9 204:2  
 263:2  
**knock-on** 19:7 21:10  
**knowing** 90:7 186:13  
**knowingly** 188:7  
**knowledge** 9:21 285:19  
**known** 155:15 196:4  
 200:3  
**knows** 26:21 70:16  
 135:11 170:5 182:9  
 182:14 204:19 221:1  
 221:5 235:19 256:19  
**KPI** 77:8 129:7  
**KPIs** 65:13 80:17 81:4  
 81:18 82:4,7,9,20  
 83:12,14,15,17 84:1  
 85:13 86:18 88:20  
 106:5 108:12 110:18  
 111:8,19 114:2 118:9  
 118:9,13 122:13,22  
 126:19 128:22 129:2  
 129:3,7,8,13,17 130:3  
 131:12,19 132:21  
 133:5,7,9,15,22 134:4  
 136:11,20 137:3  
 142:5 320:9,12  
**KPMG** 44:5 201:1  
 226:11,14 271:7,15  
 274:19  
**kudos** 30:4 170:12  
 233:9,12

---

**L**


---

**laced** 275:12  
**lack** 64:16,17,18 65:7  
 71:3,3 80:8 153:18  
 236:7 265:9 270:6  
 277:8 296:5,5  
**lacking** 282:20  
**ladies** 193:15 223:7  
 284:11  
**laid** 120:20 122:15  
 125:18 166:5 318:15  
**landscape** 9:12 46:10  
**lane** 208:20  
**language** 45:17 92:5  
 150:16 217:1  
**lap** 201:13  
**large** 5:15 31:22 85:2  
 90:21 103:12 121:4  
 124:22 133:14 179:12

181:17 184:12 191:5  
213:13 276:3 281:18  
284:20  
**largely** 138:7 139:14  
**larger** 146:21  
**largest** 21:12 219:6  
232:20 270:17 273:20  
**Larry** 28:13 146:18  
289:17  
**lasting** 36:7  
**lastly** 50:4 54:15 55:2  
89:13 225:5 303:3  
**lasts** 65:21  
**late** 44:8 54:4 139:21  
189:1 209:3 217:14  
**latitude** 310:3  
**Laughter** 8:20 13:4  
23:17,20 30:8 31:6  
120:10 124:16 131:4  
143:12 165:14 201:14  
201:18 291:11 299:13  
308:9 312:20 321:3  
**launch** 5:7  
**laundering** 158:18  
184:18  
**law** 59:11 151:11 157:9  
169:22 176:19 196:10  
196:11 203:9 225:16  
263:10 270:17 295:14  
319:18  
**LAWRENCE** 1:21  
**laws** 3:8,9 6:11 18:22  
24:22 40:4 150:6  
151:13 152:17 153:17  
160:6 179:9,14  
180:15,20 181:7,12  
181:16 184:16 188:5  
206:1 256:10  
**lawyer** 15:12,22 244:17  
**lawyers** 23:12 287:4  
**lawyers'** 23:12 287:4  
**lay** 79:17 125:7 129:16  
**layers** 94:1,1  
**laying** 168:9  
**lead** 17:3,13 24:1 95:20  
155:1 176:5,5 180:6  
219:3 235:20 236:10  
266:20  
**leader** 271:7,15  
**leaders** 6:3  
**leadership** 9:9 13:21  
24:4 30:22 40:1 55:18  
92:17  
**leading** 64:1 67:6 279:4  
317:6  
**leads** 163:9 175:3  
193:21 278:9 297:9  
313:19

**leap** 136:7,10,16  
**learn** 28:1 187:13  
298:17 305:21  
**learned** 7:20 163:16  
299:17  
**learning** 297:21  
**lease** 84:21 144:10  
**leave** 23:2 33:8 36:19  
36:22 37:1 57:14  
77:19 121:4 161:5  
185:10 193:3 262:19  
268:18  
**leaves** 192:16  
**leaving** 37:9 71:20  
72:17 113:2 157:22  
**lecturer** 1:19 29:18  
**led** 58:2 204:15  
**Lee** 259:16  
**left** 62:11 63:13 67:17  
174:16 200:5  
**left-hand** 262:8  
**legal** 155:16,21 174:18  
176:11 177:5 225:15  
236:14 263:19 270:15  
270:16 276:10 295:9  
320:18  
**legally** 275:15  
**legislation** 183:4 188:1  
189:7 194:5 275:14  
304:16  
**legislative** 204:21  
**legs** 269:15  
**Lehman** 199:3 200:4  
**lend** 139:12  
**length** 65:22 83:7  
**lessons** 7:19  
**let's** 4:3 38:22 43:14  
68:4 69:18 70:13  
119:18 145:15 153:8  
161:3 172:15,15  
181:4 182:6 199:9,21  
223:5 294:6,6,8,8  
**letter** 44:5 96:6 166:12  
197:9 265:15,16  
**letters** 67:13,14  
**level** 10:14 12:9 22:21  
53:6,20 59:2 82:10  
83:17 92:19 106:15  
110:4 140:6 148:22  
179:16 196:17 211:5  
228:19 229:18,18  
241:22 243:10 250:18  
253:9 259:18 261:14  
262:17 273:16 276:5  
296:15 297:5 301:6,7  
316:20  
**levelling** 296:9  
**levels** 193:6 268:6

**leverage** 53:20 93:3  
116:6 159:20 178:6  
178:17 264:11 267:19  
**Lewis** 16:15 317:4  
**liability** 42:5 149:21  
161:17,20 251:7  
318:5  
**liaison** 60:3  
**license** 144:16  
**lie** 195:12  
**life** 116:17 117:3 274:20  
**lifting** 24:8  
**light** 7:13 163:19  
308:20 309:20 313:11  
313:12,12  
**light's** 195:4  
**liked** 158:11 171:21  
**likelihood** 117:20  
**limit** 166:14  
**limitation** 318:4  
**limitations** 43:17  
**limited** 8:11 61:5  
114:11 122:8 148:17  
212:2,3  
**limiting** 61:21 62:5  
**limits** 19:1 75:6  
**Linda** 1:17 27:13  
108:20 112:13 113:10  
119:19 136:19 146:17  
152:7 180:3 182:18  
187:5 194:3 207:14  
239:12 250:5 258:20  
260:3 265:14 274:10  
282:3 294:16 318:16  
**Linda's** 54:21  
**line** 73:19 89:12 107:13  
109:12 116:22 143:20  
144:1 157:12 161:15  
180:16 183:17,18  
184:20 185:1 190:16  
214:9 311:6,13  
**lines** 60:2 75:1 83:6  
161:10 195:20 248:11  
268:16 270:6 272:4  
302:15  
**lingering** 218:15  
**link** 94:8  
**linkage** 164:9  
**linked** 183:2 188:5  
282:11  
**links** 17:6 94:5 188:11  
189:8 275:18  
**liquid** 11:2  
**list** 9:3 22:2 189:20  
233:22 235:5 310:11  
313:1,15 314:11  
**listed** 27:15 110:1,22  
114:19 129:8 155:3

**listen** 119:21 280:15  
**listening** 26:20 136:1  
299:19  
**literally** 183:13 281:8  
**literature** 94:6  
**litigants** 175:6,18  
**litigation** 28:7 153:9  
176:10 177:1 201:3,3  
201:3 219:15 221:3  
235:8 319:10  
**LitiNomics** 2:7  
**little** 28:1 37:20 45:10  
50:16 54:3 57:3 65:17  
76:10 100:3 114:6  
137:11,12 138:5  
157:20 159:15 161:2  
161:8 182:20 185:3  
194:20 208:19 239:5  
240:22 270:13 274:20  
291:20 302:2 306:15  
311:15  
**live** 60:11 276:15  
295:11 309:16  
**lived** 263:1 310:5  
**lively** 63:14  
**living** 240:17  
**LLC** 1:15,16,19 2:4,6  
**loans** 75:1  
**local** 21:19 282:11  
**located** 1:10  
**location** 38:8 69:7  
**logical** 242:6 279:22  
**lonely** 278:4  
**long** 27:16,20 33:22  
34:22 45:11 47:5 51:4  
63:1,2 73:7 77:9 84:6  
84:11 112:20 154:7  
170:22 180:6 202:7  
269:2 273:5 316:6  
**long-** 99:4 104:9 126:13  
**long-established**  
237:20  
**long-term** 97:17 98:21  
99:1,7,8 100:12  
103:12 104:7,11  
105:7 121:22 124:21  
126:17,18 127:8,21  
128:8,17 138:21  
317:14 320:22  
**longer** 69:18 93:1  
214:18  
**longer-term** 98:15  
**longing** 129:20  
**longstanding** 4:22 18:5  
19:3  
**look** 11:7 13:13 21:11  
21:12,20 25:1 26:16  
31:13 35:8 36:15

39:22 45:16 56:21  
 57:20 58:16 60:4 68:4  
 70:13 72:3 73:22  
 76:20 77:1 78:18 79:8  
 79:9 84:20 100:13  
 104:21 105:3,12  
 107:16 113:6 118:4,5  
 119:11 126:19 133:2  
 134:4,8 135:19 138:5  
 140:12 143:19 146:8  
 156:18 157:8 158:5  
 158:15 159:1 162:15  
 166:4 172:15,17  
 174:9,9 178:1 179:10  
 187:14 193:20 198:22  
 199:2,8 200:21  
 208:19 209:1,5  
 232:10 233:13 234:13  
 236:2 247:20 249:5,9  
 249:13 261:1 263:9  
 263:15,16 266:17,18  
 274:6 283:13 297:8  
 297:15 303:5 308:6  
 313:9 315:11  
**lookback** 88:12  
**looked** 43:16 45:21  
 46:2 116:22 148:5  
 173:19 203:21 232:12  
 234:6 260:17  
**looking** 11:12 26:2,6  
 73:14 101:12 102:20  
 103:14 105:2,15  
 109:11 112:19 126:2  
 130:7 135:7 138:3,18  
 140:16 143:15 148:4  
 178:10 184:17 200:15  
 226:11 228:21 233:14  
 235:14 241:13 255:9  
 262:16 266:3 286:20  
 288:15 301:12 302:19  
 315:8  
**lookout** 190:18  
**looks** 93:18 164:11  
 239:17 313:22  
**loop** 115:16  
**loosely** 282:11  
**loss** 61:22 84:22 188:7  
 188:14 189:3 253:22  
**losses** 253:14  
**lot** 17:17 20:17 26:1  
 35:19 41:12 43:14  
 44:4,16,20 45:22  
 47:14 50:7 71:20  
 82:19 89:14 90:16  
 98:20 100:5 105:11  
 109:5 116:22 120:18  
 123:16 127:1,3  
 133:13,18 134:22

148:9 153:13 158:3  
 158:17 178:1 181:8  
 189:8,21 195:1 201:6  
 202:19 212:3 218:22  
 223:17 231:17 235:1  
 237:8 242:11,21  
 248:4 254:5 260:10  
 260:10,12,18 272:9  
 290:6 291:5 299:16  
 299:17 301:14 305:22  
 306:1,5,8,11 307:5,6  
 309:14 310:22 311:9  
 312:22 318:9 320:6  
**lots** 110:13  
**lousy** 226:13  
**love** 127:20 277:15  
 306:4 307:9  
**loved** 234:5  
**low** 184:3 262:18  
**low-hanging** 174:11,13  
 177:14,15 205:19  
**lower** 35:5 76:12  
**Lucia** 323:2  
**lucrative** 225:22  
**lunch** 145:15  
**Luther** 2:8 28:11  
**Lynn** 2:7 29:22 31:17  
 31:19 45:7 47:20  
 55:10 116:10 132:18  
 136:20 143:16 146:18  
 152:19,19 165:13,15  
 175:15 197:16 201:6  
 201:21 207:14,21  
 209:8 218:21 224:17  
 231:7,20 237:19  
 241:1,16 261:16  
 269:18 272:5 276:19  
 278:22 282:3 283:10  
 286:7 298:18 308:10  
**Lynn's** 136:20 232:1  
 258:11

## M

**M** 1:10,14,21 2:6,11  
**M&A** 59:7 225:16  
**machine** 56:18  
**machine-** 56:22  
**machine-readable**  
 56:12,13 92:21 94:3  
 94:17  
**main** 153:10  
**mainstream** 95:22  
**maintain** 10:20 268:5  
**maintained** 22:8  
**maintaining** 10:22 97:1  
**major** 95:14 133:21  
 178:14 262:6 322:15  
**majority** 124:9 239:17

249:10 250:2  
**making** 8:12 10:6 27:2  
 27:20 53:6 79:7,12  
 111:21 114:17 115:22  
 136:1 189:21 244:13  
 245:2 251:13 253:13  
 253:14,15 254:1  
 272:10 293:17  
**malls** 113:1  
**manage** 34:1 48:17  
 176:16 208:6 222:21  
 223:1 235:15,20  
 283:6  
**managed** 30:13 133:13  
 176:16 297:22 311:22  
**management** 1:15 2:8  
 12:11 18:21 27:8  
 28:12 29:20 33:22  
 34:12,16 35:5,7 36:2  
 37:7 38:11,13,17 39:4  
 41:4,7 60:3 62:1 64:9  
 64:15 66:10 68:20,21  
 69:11 70:8,13 71:6,10  
 74:10 76:13 85:17  
 86:21 87:3 104:12,13  
 107:5,17,19 112:15  
 113:13 114:3,9,18  
 119:22 120:3,13,21  
 120:22 125:8 129:16  
 129:22 130:1,17  
 133:5,7 138:22  
 141:10,14 142:17,18  
 143:22 149:4 150:4  
 155:16 182:9,14,17  
 183:10 186:1,9,12  
 196:5,19,19 197:1  
 198:6 271:4 281:4  
 300:4 302:11 311:19  
 311:20  
**management's** 34:7  
**management-directed**  
 129:14  
**managements** 128:12  
 154:8 156:1 197:6,10  
**manager** 2:8 28:12  
 128:11 260:14 261:10  
 262:9  
**managers** 73:14 145:11  
 259:4  
**managing** 1:16,18 2:7  
 28:4 30:16 31:22 35:8  
 37:10 130:18 236:1,4  
 319:18  
**mandate** 10:13 48:3  
 140:6 215:19 216:6  
 314:2,19  
**mandated** 205:2 281:20  
**mandating** 140:3

**mandatory** 243:4  
**manipulation** 111:19  
**manner** 42:10 149:11  
 151:10 198:12 269:19  
**manufacturing** 133:14  
 133:17  
**Marc** 2:17 5:9,16,17  
 12:21 13:12 14:21  
 28:9 30:4 31:4 47:16  
 58:2,12 61:2 124:1  
 136:12 284:3 286:10  
 309:1 321:5  
**margin** 225:22 268:16  
**Mark** 322:22  
**market** 11:4 17:21  
 34:21 63:22 66:3  
 76:20 92:6 96:17  
 100:3 102:3 117:21  
 128:6 209:2 225:9  
 239:20 266:8 269:11  
 269:16 273:13,15,19  
 277:4,10 278:16  
 293:9 297:13 301:16  
 301:20  
**marketing** 116:21 117:1  
 271:3  
**marketplace** 112:22  
 146:6 321:18  
**markets** 10:2,8,21 11:2  
 12:2,6 29:6,12 33:3  
 59:1,3 65:9 71:9  
 128:18 141:12 277:2  
 280:19 281:1,2  
 292:15 293:8 302:1  
**Markey** 44:6  
**Markey's** 203:2,8  
**MARTIN** 2:20  
**Marty** 32:14 136:12  
 147:3,8 180:6 182:20  
 190:14 197:20 205:17  
 206:12 234:1,20  
 308:22 310:14  
**Marty's** 190:8 192:17  
 197:18 309:8 310:10  
**Mary** 1:14 27:7 40:2,5  
 42:19 43:9 44:20 45:6  
 45:6 46:17 105:22  
 124:11 126:11 129:5  
 136:19 145:21 146:1  
 146:11,14 147:21  
 152:13,14 153:19  
 161:11 205:15 288:4  
 299:14 301:5 318:2  
**Mary's** 42:19  
**massive** 184:9,11 185:8  
 295:7  
**mastered** 20:3  
**masters** 263:17

- match** 96:22
- material** 8:22 17:7 41:6  
41:20 79:1,13 80:20  
81:9 149:7,13,18,19  
149:19 150:19,20  
153:11,19 154:11  
155:1 157:1 158:9  
161:6 163:15 168:2  
175:1 178:13 182:6  
182:17 183:19 186:11  
189:3 197:11,13,14  
207:10 209:13
- materiality** 89:11 154:4  
154:14 155:11 160:22  
168:4 192:14 193:1
- matter** 42:4 94:12 97:13  
124:5 145:17 154:9  
168:19 195:8 198:10  
206:17 211:16 245:7  
265:15 281:18 291:10  
323:5
- matters** 6:18 11:12,20  
12:5,8 37:9 58:12  
59:9,10 94:10 148:18  
155:1,19,22 156:9  
163:8 170:8 181:19  
208:17 307:5 315:9
- McGARRITY** 1:20 31:15  
31:15 33:12 39:20  
78:22 87:16 98:5  
106:2 305:2
- MD&A** 89:10
- mean** 23:13 42:8 43:18  
45:12 72:4 84:16  
85:20 102:8 105:20  
105:22 120:4 126:3  
127:14 135:9 149:1  
161:11,18 164:15  
172:14 173:10 180:18  
181:3 187:1 195:7,10  
196:10 199:11,11  
200:9 204:17 212:22  
220:2 238:21 245:2  
246:5,6 256:17 267:4  
268:18 277:6 279:14  
281:8,12 286:20  
300:2 312:21 321:12
- meaningful** 7:22 172:16  
214:4 228:2
- means** 139:3,5 147:5  
221:1 275:11 318:21
- meant** 239:8
- measure** 12:14 20:17  
35:15 37:22 38:18  
48:17 50:19 53:6,8  
69:16,22 70:4,14  
76:11 77:8 84:13,15  
87:9,13 103:7 113:18  
124:22 141:18 208:6  
208:7 215:16 223:1,1  
227:15 235:19,20  
293:17,22,22 294:8
- measured** 89:11 154:10  
228:9
- measurement** 49:2  
72:22 85:6 188:6  
223:2
- measurements** 294:9
- measures** 3:4,6 24:20  
33:13,15,18 34:1,5,8  
34:17,19 35:3,12,17  
36:6,16,19 37:8 38:5  
38:10 41:1 61:11,21  
62:15 63:10 64:2,11  
65:6,12 66:2,20 67:6  
68:9 69:2,10 70:9,11  
74:12 76:16 79:11  
80:19 81:6 82:4,7,9  
84:4 85:13,16 86:17  
86:20 88:1,6,10,14  
89:6,10 90:5,13,19  
97:21 98:10,12,13,21  
99:11,15 101:6  
104:18 108:12 111:10  
117:10 131:12,20,22  
132:2,11 137:4 208:9  
213:22 214:22 215:3  
215:19 227:17,18,19  
228:17 229:1 298:3,7  
299:11 302:3 303:5  
305:16
- measuring** 140:1 229:3  
235:21
- mechanism** 105:20  
216:21 293:9
- mechanisms** 48:9  
174:14
- media** 86:5 295:12
- medical** 319:19
- medicine** 263:11
- meet** 58:11 179:13  
254:13,15,21 255:5,7  
314:3
- meeting** 1:5 4:4 5:22  
14:16 160:11 180:22  
209:7 262:13 289:16  
308:11 314:3
- meetings** 6:19 9:19  
11:14 245:17 262:1
- member** 1:14 2:11 9:5  
73:8 95:16 194:6  
207:16 228:22 253:11  
322:8
- members** 2:10 4:11,14  
5:3 8:14 9:16 45:8  
53:1,21 56:2 60:7  
89:17,18 93:12  
103:15 156:16 190:11  
207:13 216:7 217:12  
233:8 240:5 251:14  
288:22 292:2,5  
304:17 314:22 321:22
- membership** 32:1
- memory** 208:20
- mention** 66:1 74:10  
248:7 279:10
- mentioned** 7:8 11:14  
49:5,6 53:11 73:17  
81:9 107:1 117:6  
154:15 156:13 173:5  
177:13 180:10 208:3  
209:6 217:20 218:17  
231:20 247:17 270:6  
307:15 318:2
- merchants** 187:15
- merits** 303:1
- message** 90:18 208:5  
231:14 261:11
- messages** 214:11
- met** 1:10 97:6 203:7  
219:5 256:5 305:12
- Metcalf** 167:10
- method** 73:5,17,18,21  
74:4 122:6 144:21  
145:4
- meticulously** 16:3
- metric** 71:15 89:12
- metrics** 18:16 34:2,11  
36:11 59:6 64:5,6  
68:1 72:22 74:7 79:20  
82:1,2,14 85:16,17  
86:10 87:2 98:18  
105:6 114:2,13,18  
128:14 129:21 130:11  
130:18 136:11 164:11  
224:1 320:10,12
- Michael** 1:19 2:2 29:17  
30:15 124:11 166:22  
175:4 290:20
- migrate** 139:3
- Mike** 113:21 115:15  
123:19 136:6 185:11  
187:22 209:10 241:15  
243:13 272:5 290:20  
306:17 310:16 312:6
- Mike's** 277:21
- miles** 170:11
- millennials** 295:12
- mind** 57:16 63:17 65:5  
86:12 102:8 113:8  
129:10 171:16 190:1  
190:19 194:11 199:12  
258:8 271:14,14  
275:19 307:19
- mindful** 57:18
- minds** 265:17
- mindset** 226:4
- mine** 279:5
- minimum** 299:22 300:5
- minute** 16:9 60:16  
97:10 217:4 227:12  
257:16 293:4 312:10
- minutes** 33:7 199:6  
208:2 227:2
- misconduct** 11:4  
190:18 191:19
- misinterpreted** 193:22
- misleading** 78:20 79:14  
113:19 160:21 255:13  
265:17 298:8
- missed** 123:4
- missing** 92:16 160:19
- mission** 9:7,14 10:1,19  
11:8 13:17 216:2
- missions** 10:16 198:7
- misstatement** 8:22  
183:19
- mistaken** 319:13
- misunderstood** 136:2
- mitigate** 90:9
- mitigating** 80:22
- mix** 10:11 195:11
- model** 4:20 5:6 7:8,18  
11:15 14:1,14 15:8,22  
15:22 16:20 26:7 29:5  
43:11 55:4 58:6 61:17  
94:13 100:13,18  
111:15 118:8,17  
133:2,3,3 134:13,13  
144:5 162:14 163:20  
242:19 259:7,13  
260:18 261:13,21  
263:19 264:4,12  
269:7,18 280:17  
281:21 301:12 315:19  
315:21 316:1,9 317:7  
317:18,21 321:13  
322:5
- model-specific** 87:2
- models** 61:15 63:18  
68:22 164:11 304:8
- modernization** 88:19
- modifications** 249:9
- modified** 45:14
- modify** 122:4
- Mojiri-Azad** 322:16
- mom** 265:3
- moment** 5:19 8:2 27:22  
77:18 149:19 184:2,5  
189:13 298:6 313:5
- money** 75:15 118:1,2,2  
123:5,16 158:18



179:15 181:8 184:18  
253:14 254:16 284:8  
284:22 285:11  
**monitor** 51:1 140:6  
163:18 211:11 216:21  
**monitored** 211:10  
**monitoring** 211:22  
**monopoly** 282:1  
**months** 54:12 67:15  
73:10,10 154:8  
274:13 295:6  
**Moody's** 74:15  
**moral** 193:9  
**morning** 12:1 27:6,13  
28:17 29:1 30:15 31:2  
32:14 47:10,13 51:9  
55:17 116:19 208:4  
209:6 210:6 215:21  
250:11 296:8 314:8  
**mosaic** 99:1  
**Moss-** 167:9  
**motion** 263:22 287:11  
287:14,18 288:10,18  
**move** 52:9 56:11 60:18  
78:21 121:13 144:18  
149:14 199:9 214:12  
224:12 271:8 287:17  
294:5,14 295:18  
303:17 314:13  
**moved** 26:12 175:12  
**movement** 125:22  
227:21 289:4,7  
**moves** 129:18 287:21  
**moving** 11:9 52:5 56:14  
59:20 92:19 105:16  
105:21 138:6,14  
152:1 282:17,18  
288:7 295:15,19  
**multi** 297:4  
**multi-country** 297:5  
**multi-disciplinary**  
270:15  
**multi-year** 142:8  
**multiple** 83:5,6  
**multiples** 76:21 77:1  
117:6  
**multitude** 202:21  
**musts** 46:1 290:10

---

**N**

---

**naive** 106:3,14  
**name** 26:20 29:17  
222:4 233:18 234:17  
276:4  
**name's** 29:1  
**names** 221:22  
**narrow** 130:9,15 187:9  
307:8 315:6

**narrowed** 22:2 197:15  
**narrowly** 104:17,17  
108:14  
**NASBA** 166:11,12,15  
166:16,18 167:2  
**NASD** 32:8  
**national** 1:10 30:17  
230:9  
**nature** 53:22 102:21,21  
142:19 169:22 191:3  
228:1  
**near** 174:1  
**nearing** 213:3  
**necessarily** 4:14 79:8  
99:10 106:22 107:2  
110:14 121:8 141:13  
189:3,5 190:3 198:2  
206:22 252:8 275:5  
297:9  
**necessary** 10:5 130:12  
183:22 230:9 252:5  
252:22 288:2  
**neck** 260:4  
**need** 7:7,11 18:9 24:22  
25:3,13 32:21 34:11  
36:2 37:7 38:15 40:19  
40:20,21 63:7 64:14  
66:9 67:21,21,22  
86:22 87:11 98:3  
99:10 100:18,21  
107:6 122:12 145:7  
147:15 150:4,7,12  
152:5 153:18 159:1  
160:14 167:20 168:12  
169:13 176:4 177:22  
180:1 190:5 192:7  
193:18,18 194:7,8  
203:13 224:2,3  
226:14 234:16,17  
241:7 247:4,4 248:2,4  
254:9 265:8,11 271:8  
295:14 298:4,9 299:8  
304:14 307:3,4,12  
311:11 313:12 315:6  
**needed** 230:11 246:11  
**needs** 41:15,18,19  
55:12 59:22 72:14  
95:9 120:20 136:10  
150:14,16 158:4  
161:14 168:3 174:9  
194:15 201:2 223:16  
243:6 260:17 265:8  
273:9 289:14  
**negative** 168:20 169:14  
179:19 199:20 200:11  
200:12 201:2 202:15  
202:17,18,21  
**neither** 45:6 137:14

**nervous** 16:12  
**net** 141:18 185:2  
**Netherlands** 222:9  
**network** 21:16 22:14  
191:10 318:17  
**networks** 282:12  
**never** 74:17 140:15  
170:16 190:11 195:10  
198:21 204:1 221:18  
233:4 236:17 285:20  
285:21 287:14 289:19  
**nevertheless** 136:15,22  
**new** 4:20 5:7 20:3 23:13  
28:15 30:6 32:18,21  
52:12 78:5 81:4 87:17  
89:8 92:9,19 100:1  
116:1 128:8 166:4,6  
166:17 177:10 180:18  
227:6 231:12 249:5  
250:3 251:16 257:19  
257:20 277:14 278:14  
299:3 309:21 313:17  
**news** 28:14 155:14  
218:13  
**NGFM** 289:22  
**nice** 23:14 30:6 40:15  
134:17 135:14 220:22  
**nicely** 109:10  
**nickel** 269:11  
**night** 133:17 197:9  
**nights** 274:13  
**Nina** 308:21 322:16,17  
**nine** 52:1 186:21 214:6  
**nine-year** 224:20  
**no-brainer** 311:10  
**NOCLAR** 177:10  
303:16  
**nodding** 138:1  
**noisy** 205:2,2,7,10,11  
**non-** 36:5 38:9 64:10  
88:5 131:19 152:16  
275:14 307:8 320:9  
**non-audit** 253:21 272:8  
272:22 311:16  
**non-Big** 280:11  
**non-cash** 72:6 80:1  
**non-comparable** 80:5  
**non-compliance**  
153:16 155:8,19  
156:5 160:6 180:15  
180:20 183:5,9  
184:16 188:5 236:22  
**non-conformance** 41:1  
**non-cool** 304:9  
**non-disclosure** 154:9  
**non-exclusive** 158:14  
**non-executive** 27:14  
**non-GAAPs** 81:12 88:4

**non-material** 161:6  
**non-record** 286:20  
**non-recurring** 80:20  
81:10  
**non-U.S** 21:7  
**noncompliance** 3:7,9  
6:11 18:20,21 24:21  
40:4 59:11 256:11  
290:5  
**nonprofit** 95:17  
**nonrecurring** 121:4  
**noose** 167:3  
**norm** 146:18 226:8  
232:3 258:6  
**normal** 55:10 93:18  
154:20 155:3  
**normally** 35:4 248:20  
**Norman** 1:18 28:2,3  
47:8 190:6 207:5  
254:4 280:6 291:21  
296:3  
**Norman's** 282:5  
**north** 2:5 50:10  
**Northwest** 1:11  
**note** 12:17 81:14 155:2  
155:2 213:11 214:5  
214:14 314:7  
**nothing's** 121:19 199:8  
**notice** 244:6,9  
**noticed** 54:3 66:14  
76:17 78:1 171:1  
**notify** 153:12  
**notion** 123:6 174:5,14  
192:6 199:21 200:1  
302:9  
**notions** 174:11  
**November** 218:7  
**number** 7:22 22:17  
37:13 52:8 53:9 61:21  
90:21 93:21 94:11  
97:9 110:2,3,11,14  
122:19 125:14,21  
126:3,10 127:4,6  
128:4 146:9 157:18  
157:19 158:20 162:7  
163:12 219:15,21  
224:7 230:2,3 231:3  
235:8 244:8 248:10  
248:11,15 249:6  
257:11 279:15 283:13  
308:3 313:13,14  
321:8  
**numbers** 39:11 59:2  
61:14 62:6 88:11  
99:19 108:9,15 112:5  
112:6 123:13,18  
127:7 135:2,9 157:2  
161:4

**O**

**objection** 288:6  
**objective** 4:21 48:7  
 109:9,13 119:19  
 149:2 155:15 255:18  
 256:7 300:9,15  
 305:21  
**objectives** 141:18  
 217:3  
**objectivity** 41:2 300:9  
 300:21  
**obligation** 157:3,8,13  
 168:3 208:13  
**obligations** 78:7 160:3  
**observations** 44:12  
 66:4 101:14 141:5  
 301:8  
**observed** 95:18  
**OBSERVERS** 2:15  
**obtain** 6:16 93:7 245:7  
**obvious** 185:7  
**obviously** 43:10 64:5  
 79:4 90:2,16 137:14  
 189:2 227:21 242:9  
**OCC** 199:15  
**occasions** 59:10  
 164:14  
**occur** 216:20 226:21  
**occurred** 163:13  
 279:20  
**occurring** 117:18  
 218:18 226:21 281:15  
**occurs** 10:15 155:21  
 191:5  
**October** 1:7 217:20  
**off-label** 191:6  
**Off-microphone** 177:18  
 256:6 261:20 271:20  
 271:22  
**offered** 48:5,11 92:9  
 293:15  
**office** 5:13 19:15 22:8,9  
 22:11 58:8 111:7  
 152:21 154:16 168:15  
 203:3 230:9 278:3,3,5  
 283:21  
**officer** 1:14,20,22 30:12  
 31:16 74:16  
**offices** 22:10 279:16  
 283:13  
**official** 92:14  
**officially** 311:2  
**offline** 257:11,13  
**old** 122:5 125:8 128:8  
 281:16,21  
**oligopoly** 293:8  
**Olson** 322:22  
**Ombudsman** 2:5

**omission** 8:22  
**onboarding** 189:15  
**once** 20:2 29:3 38:17  
 69:12,15 83:13 107:7  
 117:22 146:20 160:11  
 166:7 168:1 198:11  
 236:8 244:15 262:14  
**one's** 119:15 235:18  
**one-** 78:15  
**one-size-fits-all** 85:10  
**one-time** 81:13  
**ones** 10:9 60:10 83:9  
 85:1 88:22 96:22  
 113:1 120:1 121:1  
 167:21 219:13 231:12  
 235:3 236:21 299:4  
**ongoing** 6:13 49:20  
 116:13  
**Online** 152:13  
**oops** 160:20  
**open** 3:5,9,14 20:21  
 91:3 97:11 102:18  
 152:10 162:20 246:1  
**openings** 151:12  
**operate** 64:12 193:10  
 297:4  
**operated** 133:16  
**operates** 7:1  
**operating** 82:11 144:10  
 280:22  
**operations** 78:18 79:7  
 116:15 149:9 150:22  
 181:19 191:2,15  
**operators** 111:3  
**opinion** 83:15 116:9  
 150:7 201:21 243:1  
 245:8,12 246:11  
 252:10,13,15 266:2  
**opinions** 7:14  
**opportunities** 19:2 21:3  
 277:18  
**opportunity** 4:7 32:5  
 51:11 93:3 102:13  
 141:21 143:2 163:3  
 208:10 286:11 295:2  
 301:4,7 305:12  
 306:20 311:4 313:4  
**opposed** 240:15  
**opposition** 285:5  
**opt** 73:2  
**option** 231:12  
**options** 278:1  
**orange** 93:19  
**orchids** 298:15  
**order** 5:11 33:1 57:1  
 135:22 143:20 159:8  
 257:3  
**orderly** 10:20

**orders** 77:17 222:2  
**ordinary** 29:10 164:10  
**organization** 83:4  
 109:11 134:21 196:18  
 264:11  
**organizations** 5:15,20  
 37:20 52:4  
**organize** 7:3  
**orientation** 97:17,18  
**oriented** 129:3  
**original** 167:21 310:21  
**originally** 110:1  
**origins** 208:20  
**ought** 36:9,10 38:7,19  
 46:2,5 68:7 86:14,15  
 107:8,15 124:9  
 158:21 159:13,15,19  
 159:19,20 162:19  
 202:19 219:14 247:15  
 257:10,13 273:11  
 286:19 315:22 322:5  
**outcome** 117:15,20  
 213:12 226:12 242:22  
 309:4  
**outcomes** 164:5 228:7  
 229:13 294:10  
**outdated** 177:22  
**outlier** 119:12  
**outlined** 136:7  
**output** 213:12 227:16  
 227:19 247:12,16  
 248:9 298:11  
**outputs** 53:7  
**outrageous** 199:11  
**outreach** 24:1 136:9  
 142:11,13  
**outset** 4:10 147:2,9  
**outside** 37:19 91:21  
 114:3 132:7 142:20  
 142:22 181:18 196:8  
 270:16  
**outsourcing** 133:16  
**outstanding** 30:12  
 194:14  
**overall** 55:3 98:22  
 101:8 142:6 246:6  
 267:9  
**overarching** 90:17  
**overburden** 59:17  
**overriding** 157:5  
**overseas** 225:4  
**oversee** 222:21  
**overseeing** 292:19  
**oversees** 234:14  
**oversight** 1:1,15 6:18  
 14:11 21:1 44:12  
 102:16 137:9 216:3  
 239:17,22 241:5

**overstated** 29:14 58:19  
**overstating** 128:1  
**overvalued** 128:6  
**overview** 55:7 208:1,3  
 227:3  
**owner** 239:17  
**owners** 111:2,2 239:7  
 239:14  
**ownership** 240:1  
**owns** 95:17

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

4:1  
**p.m** 145:18,18 206:18  
 206:18 323:6  
**pace** 25:20 26:9  
**PAF** 203:3  
**page** 80:9 81:21 87:18  
 155:14 158:11 159:5  
 206:1  
**paid** 242:18  
**pair** 263:20  
**panel** 231:8 293:3  
**panels** 207:9  
**Panucci** 2:17 5:10  
 14:22 28:9,9 256:17  
 257:2  
**paper** 74:15 160:11  
 161:12 204:6 223:9  
 223:14 289:6 290:8  
**papers** 17:19  
**par** 270:17 305:16  
**parallels** 105:2  
**paramount** 93:6  
**parcel** 138:19 303:8  
**part** 5:15 19:9 21:16  
 22:20 24:6 32:4 36:12  
 46:11 52:1 54:5,6,13  
 58:20 63:4 64:3 73:1  
 74:19,20 96:22 98:22  
 102:2 106:8 108:5  
 116:1 130:9 138:18  
 153:9 154:18,19  
 159:22 164:19 178:9  
 194:12 195:17 240:16  
 242:14 245:14 246:12  
 246:14,17 256:20  
 257:7 266:11 267:3,6  
 267:8,9 289:14,20  
 294:19 303:7,18,20  
 319:7,8  
**participant** 96:17 182:3  
 239:1  
**participants** 17:9 92:6  
 209:2  
**participate** 26:19 27:12  
 30:21

- participated** 5:3  
**participating** 4:12 5:22  
 17:5 92:8  
**participation** 316:17  
**particular** 14:4 39:1  
 57:10 100:22 106:12  
 112:16 113:18 138:21  
 164:7 206:9 211:14  
 211:15 217:4 230:11  
 234:15  
**particularize** 322:12  
**particularly** 5:13 30:22  
 67:22 132:14 139:20  
 143:3 156:2 157:20  
 163:6 298:15 301:14  
**parties** 106:18  
**parting** 60:20  
**partly** 192:17 240:18  
**partner** 2:3 28:19 30:16  
 171:20 199:5,6,7  
 222:4 257:20 260:9  
 260:10,14 261:9  
 262:9,11 264:8  
 266:17,20,20,21  
 267:16 291:9  
**partners** 17:9 115:21  
 236:10 259:3 264:7  
 282:18 284:9 300:3  
 307:11  
**parts** 81:15 174:4 276:7  
 278:16  
**party** 132:16 155:18  
 240:7  
**Parveen** 207:15  
**pass** 91:5 321:7  
**passed** 205:6,22  
 224:21 288:18  
**passing** 300:2  
**passionate** 242:10  
**path** 81:3 84:1 87:19  
 99:7 106:9 138:15  
 139:3 162:10 235:17  
 283:18  
**Paulson** 50:20 52:2  
 214:7 216:15  
**pause** 145:22 315:3  
**pay** 72:8 242:13 269:19  
 278:3 284:9  
**paycheck** 264:13  
**payer** 316:9  
**paying** 98:15 237:4  
 253:22 264:13  
**pays** 55:4 237:2  
**PCAOB** 1:14 2:10,19,20  
 4:7,15 5:12 7:12 9:7  
 9:14,14 10:13,15 11:8  
 25:22 32:16 41:9,11  
 42:15 43:3 44:5,9  
 45:4,12 50:21 52:14  
 53:12 54:8 56:21  
 96:13 111:20 150:6  
 152:20 153:6,16  
 154:4 162:6,10,12  
 174:9 206:11 209:21  
 211:11 212:15 216:16  
 219:4,11 229:13  
 230:3,17 242:20  
 244:13 246:2,18  
 251:4 255:11 256:10  
 256:18 257:8,22  
 264:8 286:9 296:22  
 297:6 305:4,9,20  
 306:7 311:17 316:11  
 323:1  
**PCAOB's** 10:1 50:2,6  
 54:12 61:1 213:19  
**PCOAB** 11:11 13:17,19  
 21:8 22:17 31:12 88:3  
**PCOAB's** 13:13  
**PE** 77:1 128:3,5  
**peer** 20:21  
**penalty** 183:6  
**Penn** 28:16  
**penny** 122:17  
**pension** 30:10 158:20  
 169:1 261:22  
**people** 29:10 32:19  
 45:1 49:9,18 60:1  
 68:2 76:17 95:14  
 100:5 104:9 113:2  
 119:12,22 128:2,13  
 128:13 132:2 135:17  
 162:4 166:19 171:21  
 173:19 175:14 184:13  
 185:7 199:14 200:21  
 201:5 204:11 217:22  
 220:4 224:7 226:19  
 232:6 234:1 235:3  
 237:3,3 250:22  
 251:14 258:21,22  
 259:8 260:1,14,21,22  
 261:10 262:20 263:10  
 263:12 264:1,13,17  
 264:22 265:8,11  
 266:8 268:18 269:8  
 271:17 273:1 274:14  
 278:4,8 282:6,17  
 286:16,19 291:7,14  
 291:17 295:14 306:1  
 309:5 318:7,16  
 319:17  
**PERA** 31:16 32:1  
 234:14 261:22  
**perceive** 149:5  
**percent** 22:19 50:10,12  
 93:11 101:21,21  
 117:18,19 123:10,18  
 126:1 172:8 213:3,3  
 219:7,7,8,19,21 220:1  
 220:2,3,10 221:12,13  
 221:14,15,19 243:18  
 259:3,4,5 262:19  
 264:7,9 265:22,22,22  
 273:14,18,19 290:15  
 290:21 312:1  
**percentage** 22:18 23:4  
 243:17 244:3 261:8  
 312:2  
**percentages** 265:19  
**percents** 213:1  
**perception** 98:14 185:4  
 276:11,11  
**perfect** 195:8 231:9  
 242:19 294:10  
**perfectly** 33:9  
**perform** 41:19 96:11  
 150:18 159:7 181:11  
 182:1 281:21 288:2  
 301:18  
**performance** 33:16,19  
 34:2,11 35:9 36:11  
 38:5,10,18 48:22  
 61:12 64:5,6,11,13  
 68:1,8,19 70:11 71:7  
 71:15 74:8 78:7,19  
 81:5 82:11 85:15,17  
 86:9 87:2 89:3 122:15  
 122:16 127:19 141:9  
 293:18 320:10  
**performed** 158:8 198:5  
**period** 63:1,2 64:21  
 70:21,22 71:2 75:9  
 80:7 87:10 94:5  
 191:14 212:16 218:5  
 224:20 248:14 249:3  
**periodically** 74:14  
**permanent** 289:10  
**permissible** 293:10  
**permissive** 205:10  
**permit** 176:1  
**permits** 54:15  
**permitted** 249:3  
**person** 56:17 261:9  
 263:4 285:8 312:8  
**personal** 4:21 239:5  
 243:1 276:21 278:22  
**personally** 127:6 254:6  
**personnel** 271:3  
**perspective** 11:19 34:8  
 38:16 43:17 44:21  
 51:18 64:14 65:9  
 100:19 113:7 116:11  
 124:18 126:16 141:6  
 142:22 185:5 186:13  
 186:16 205:20 221:16  
 247:14 280:22 300:12  
 301:22  
**perspectives** 33:16  
 139:16 142:21 143:1  
**persuade** 241:3  
**persuaded** 312:12  
**petition** 101:11  
**Petroleum** 2:5  
**pharmaceutical** 191:4  
 191:7  
**Phelps** 1:19 28:5  
**phenomenon** 95:7  
 98:11 99:5 226:4  
**phrase** 278:19 279:10  
**pick** 27:22 42:16 102:14  
 104:15 120:2 121:2  
 185:8 192:22 229:9  
 279:14  
**picking** 32:2 120:21  
 121:10  
**picks** 219:12  
**picture** 161:8  
**piece** 101:4 157:6 168:5  
 183:3 204:6 314:9  
**pieces** 98:22 170:22  
**pigeonhole** 271:10  
**pile** 243:21  
**pilot** 92:8  
**place** 80:10 89:7 95:10  
 115:10 157:7 164:6  
 185:22 187:8 196:17  
 198:13 220:13 259:21  
 269:11 273:6 277:9  
 285:17,20,21 286:2  
 291:16 311:8 320:19  
**placed** 39:16 146:6  
**placement** 142:4,5  
**places** 147:1 157:19  
 192:20 249:6,14  
 270:21  
**plan** 30:10 31:19 38:3  
 84:3,6 285:17,19,21  
**planned** 16:13 190:20  
 190:21  
**plants** 134:6  
**plate** 47:14 313:16  
**platform** 110:6  
**play** 6:8 45:19 112:4  
 142:15 250:20,21,22  
 251:13 253:2 280:19  
 292:14 293:11 296:14  
 302:1 311:8,9  
**played** 23:22  
**players** 63:21 250:15  
 250:18,19  
**playing** 22:21 296:9  
**plays** 149:3

- pleasant** 292:8  
**please** 26:20 91:6 131:5  
 141:2 155:2 162:22  
 163:2 226:9 239:4  
 279:19 309:16  
**pleased** 10:14 27:6  
**pleasure** 23:11 27:4  
 207:8 292:4 297:21  
 312:16  
**plenty** 316:21  
**plethora** 33:20  
**plug** 131:1  
**poach** 283:22  
**point** 12:4,12,13 39:9  
 48:14 50:4 65:11  
 67:19 68:4 69:21 77:5  
 77:15 85:9 86:7 94:19  
 100:6 101:19 108:13  
 111:12 113:10 116:18  
 117:17 141:22 142:1  
 144:8 145:6,8 146:7  
 156:9 163:5,14,15  
 167:6,10 183:16  
 189:19 191:18 196:2  
 198:14,14,17 210:1  
 212:11 214:16 217:2  
 221:13 224:20 239:19  
 243:18 249:4 250:12  
 252:9 253:5,6 257:12  
 257:14 258:20 264:14  
 265:14 266:4 269:18  
 277:21 279:9 281:12  
 282:5 293:4,20 295:4  
 295:20 296:3,8  
 298:10 300:22 310:8  
**pointed** 66:7 75:2,4  
 76:19 100:11 153:19  
 189:19  
**pointing** 67:16 266:14  
**points** 42:20 81:14 96:1  
 96:3 102:17 124:14  
 209:12 214:10 215:18  
 224:19 232:4 295:3  
 303:10  
**police** 29:10  
**policemen** 148:18  
**policies** 142:17  
**policy** 4:13 27:5 118:22  
**policymakers** 95:14  
**pollution** 181:8  
**pondering** 314:12  
**pool** 28:14  
**pools** 212:8  
**poor** 90:9 246:5,7,7  
 304:13  
**poorest** 258:13  
**populate** 262:10  
**portfolio** 2:8 28:12
- 58:18  
**portion** 159:10 210:2  
**portions** 21:11,13,14  
**pose** 271:12  
**posed** 104:6 205:9  
**poses** 102:22  
**position** 11:1 170:7  
 225:3 288:22 293:7  
**positive** 21:9 167:6  
 258:2,15 309:3,12  
**possibility** 36:9 279:11  
**possible** 68:11 82:22  
 108:1 109:15 113:5,9  
 148:15 244:2 322:22  
**possibly** 174:4 193:7  
 252:11  
**post** 278:2,3,5 279:16  
**post-** 19:21  
**post-implementation**  
 20:14  
**post-SOX** 46:9 159:10  
**posts** 229:3  
**posture** 280:3  
**potential** 90:2 147:12  
 154:11 155:12 191:3  
 191:19 218:3 258:15  
 278:14 280:1 305:14  
 306:14,16  
**potentially** 79:13,21  
 80:1 81:19 89:4,20  
 98:14 185:2 216:10  
 252:21 261:12 271:15  
 271:19 282:17  
**power** 94:19 116:5  
**powerful** 95:4  
**practical** 65:15 167:8  
 189:22 195:7  
**practically** 188:10  
**practice** 28:5 79:14  
 85:8 174:1 176:1  
 204:7,18 213:20  
 225:19 237:17 268:18  
 319:19  
**practices** 76:2 131:10  
 158:18 192:1,1 215:2  
 225:14,21 236:9,15  
**practitioner** 65:15  
**pragmatic** 114:6 115:13  
**pre-Dodd-Frank** 45:17  
**pre-SOX** 45:17  
**preaching** 295:14  
**preceding** 75:9  
**predecessors** 292:5  
**predict** 316:7  
**predictive** 34:20 76:7  
 228:2  
**preface** 280:13  
**prefer** 100:19 169:8
- 277:16  
**preferred** 81:2 84:1  
**premise** 48:14  
**premiums** 21:2  
**prepare** 286:8 292:7  
**prepared** 8:19 11:21  
 12:17 22:6 91:12  
 128:21 129:1,4  
 168:15 212:19 284:13  
**preparers** 18:6 92:11  
**preparing** 9:19  
**prescribe** 61:11,18  
 227:15 228:15  
**presence** 14:15  
**present** 7:3 16:15 206:2  
 322:20  
**presentation** 6:6 38:9  
 50:16 52:3 57:12 61:4  
 62:14 69:7 84:10  
 90:16,17 91:1 136:5  
 137:6 146:21 152:12  
 207:11,22 210:2  
 212:13 229:21 268:12  
**presentations** 97:9  
**presented** 33:16 107:7  
 107:8 227:10 241:18  
 293:3  
**presenting** 207:20  
**presents** 93:3  
**President** 2:3,6  
**presiding** 1:11  
**pressure** 127:10 260:19  
 268:2  
**pressures** 191:6 267:20  
 268:10,11 269:17  
**presumably** 279:16  
**pretty** 42:20 125:2  
 144:17 146:16 162:12  
 244:14 300:22 301:13  
**prevalence** 90:14  
**prevent** 190:4 277:3,4  
**prevented** 277:10  
**prevents** 88:13  
**previous** 11:13 160:3  
**previously** 45:13  
**price** 42:6 78:6  
**prices** 34:21 66:3  
**pride** 306:22  
**primarily** 29:20 228:5  
**primary** 4:8 85:22  
**principal** 1:15 2:8 28:12  
 53:3 68:5 228:8,9  
**principle** 208:5 237:20  
**principles** 208:16,17  
 227:4  
**prior** 75:10 89:20 90:8  
 225:8  
**priorities** 8:5
- priority** 5:1 53:9 217:16  
 225:18 310:11  
**prisoner** 277:8  
**private** 2:3 30:16,19  
 48:15 59:13 137:8  
 153:9 156:1 176:10  
 177:1 262:2  
**privilege** 156:5,6 173:5  
 173:11,15,16,18,20  
 174:18 176:14,18  
 200:1 292:3 294:19  
 310:20  
**privileged** 173:7 176:14  
 293:7  
**pro-forma** 49:15  
**probably** 36:20 54:6  
 60:9 61:13 70:14  
 79:22 117:11 135:13  
 135:19 157:15 162:9  
 175:16 179:10 181:13  
 183:22 184:10 201:9  
 210:1 236:19 259:19  
 260:4 263:8 269:1  
 272:6 273:5 283:18  
 300:7 301:6 303:11  
 308:11 309:9 310:2  
 310:11 315:4  
**probing** 159:15  
**problem** 19:3 24:16  
 37:6 61:22 62:20 64:3  
 64:9 65:8,19 66:13,19  
 70:20 71:4,18 72:7,16  
 72:20 73:1 76:4,22  
 84:2 85:15 94:15 98:4  
 107:2,18 118:16  
 119:14,16,18,21  
 120:3 121:14 128:11  
 135:17,18 147:12  
 154:6 170:6 171:8  
 176:7 177:9,10  
 182:15 204:11 236:20  
 254:21 265:13 278:9  
 284:19 320:9  
**problematic** 112:10  
**problems** 36:14 42:9  
 67:3 73:16 122:7  
 169:21 195:1 198:6  
 220:10,17 235:5,7  
 236:5 237:8 265:10  
 299:1 310:5  
**procedure** 114:14  
**procedures** 89:6 96:9  
 96:11 158:7 181:10  
 181:11 182:1 191:19  
**proceeded** 207:9  
**process** 16:4 20:15  
 21:5,10 42:12 48:22  
 49:12,15 50:7 53:7

54:10 105:16 106:3  
 108:5 132:5,8 142:8  
 142:19 154:1 175:21  
 185:22 190:10 198:18  
 205:12 210:8,16  
 214:8 217:7 228:7  
 237:17 243:5 247:13  
 249:15 252:18,20  
 255:16,18 257:6  
 280:1 304:12  
**processes** 139:2 157:4  
 211:17 212:7 215:8  
 228:18 230:18 277:13  
 296:22  
**processing** 318:18  
**produced** 16:2 141:18  
**product** 13:10 43:1  
 50:20 321:11  
**production** 134:5  
**productive** 22:16  
**products** 191:7  
**profession** 30:5 56:20  
 91:19 167:14 184:6  
 187:13 217:9 223:13  
 265:9 269:3,3 280:3  
 289:14 292:13 294:1  
 295:17 306:7 310:7  
 318:12,13  
**professional** 2:21 7:17  
 11:6 32:15 45:14 48:5  
 48:12 52:4 53:20  
 175:22 213:14,17  
 214:2 225:9 271:12  
**professional's** 223:13  
**professionalism**  
 213:13  
**professionals** 263:20  
 269:13 279:15  
**profile** 42:1 148:10  
**profit** 110:10 272:14  
**profitability** 319:15  
**profitable** 195:17 308:4  
**profits** 253:15  
**profound** 101:7  
**program** 20:18,19 92:8  
 159:14 171:4,22  
 173:2 315:16  
**programming** 135:1  
**programs** 159:18,18  
 170:21  
**progress** 13:13 35:14  
 168:1 195:22 248:4  
 316:19,21  
**progressed** 167:11  
**prohibited** 236:15  
 272:20 273:6  
**project** 13:9 18:4 81:20  
 82:17 89:3 106:6

118:5,20 121:16  
 122:2,9,13 128:10  
 148:1,3 173:22  
 180:10 217:16 309:8  
 309:12 310:10  
**projects** 17:18 19:10,20  
 26:12 120:18  
**proliferation** 39:10 65:6  
**prominence** 142:2  
**promote** 91:13  
**promoting** 319:17  
**promotional** 215:11  
**prompted** 7:21  
**promulgate** 229:16  
 245:18  
**promulgated** 50:22  
**promulgating** 76:3  
**pronounced** 273:16  
**proper** 10:7 99:18  
 112:4,6 259:21  
 280:20  
**properly** 190:20,21  
 314:22  
**property** 110:21,22  
 111:4 112:15,16  
 113:1  
**proportion** 191:5  
**proposal** 17:1,11,16,19  
 50:18 52:12 56:11  
 230:21  
**proposals** 157:16  
 162:19 220:7  
**propose** 39:13 91:21  
 290:1,1  
**proposed** 37:22 51:14  
 84:13 218:3 231:3  
**proposing** 37:17 49:13  
 49:13,18 56:20 210:8  
**proposition** 213:7  
**proscribe** 61:18  
**prospect** 279:20  
**prospective** 249:11,15  
**protect** 57:1 150:13  
 208:14 277:17 278:16  
 318:22  
**protecting** 91:22 152:2  
 174:18  
**protection** 10:17 11:3  
 93:6 120:19 122:4  
 176:22  
**protects** 176:22  
**prove** 87:4 135:22  
**proven** 120:14  
**provide** 6:15 8:2 12:15  
 13:6 38:19 39:5,7  
 49:17,17,20 50:5,14  
 62:17 64:15 68:1,15  
 68:18 69:3,16,19 70:1

74:2 85:19 86:1 87:7  
 88:18 104:10 107:6  
 108:10 113:14 145:10  
 211:18 212:6,8 215:1  
 217:5 228:17 229:17  
 247:22 258:17 262:5  
 292:19 297:22 311:1  
**provided** 11:18 13:9  
 35:16,18,21 39:14  
 65:16 69:6 82:1,3  
 97:2 113:16 155:8  
 212:13 229:19 276:5  
 285:9  
**providers** 96:19 269:10  
 313:8  
**provides** 4:7 49:9 58:21  
 73:19 154:22 208:10  
 212:14 266:16  
**providing** 39:2 64:1  
 69:20 86:5 88:10  
 107:19 264:15 299:20  
**provisions** 170:21  
 179:9  
**proxies** 72:21 73:2  
**proxy** 71:16,16  
**public** 1:1,20 2:1 5:8  
 6:16 14:10,14 18:19  
 20:13 27:5 28:20,22  
 44:11 48:18,20 49:3  
 51:18 54:14 58:18,21  
 63:5 110:2 116:20  
 141:19 153:4 154:19  
 169:6,15 171:19  
 175:19 176:5,6  
 179:10 184:12,14  
 199:15 202:13,13  
 210:9 214:19 215:6  
 221:9 222:1 230:18  
 238:8,18 241:22  
 242:4 262:1,13  
 267:22 268:15 275:20  
 276:3 280:18 281:18  
 283:1 295:8 317:18  
 317:20,22  
**publication** 49:1 211:20  
 229:12  
**publicize** 216:19  
**publicly** 118:16,19  
 281:20  
**publish** 214:20  
**published** 51:13 52:2  
 74:15 142:12 212:15  
 214:7 222:3 224:22  
 250:9  
**publishes** 223:10  
**pull** 118:1  
**pullback** 13:1  
**pulled** 170:13

**pulls** 178:22  
**pump** 179:15  
**punchline** 80:15 90:20  
**pure** 43:16  
**purpose** 48:1 179:15  
 230:14 267:14  
**purposes** 19:17 51:2  
 167:8  
**pursue** 11:8  
**pushbacks** 88:21  
**put** 33:1 43:2 58:4  
 102:6 109:10 121:5  
 121:11 125:9,17  
 130:22 135:12 146:2  
 147:12 165:17 167:2  
 187:8 200:19 203:9  
 205:16 223:14,15,20  
 224:10 233:22 239:15  
 243:21 244:6 257:20  
 257:21 258:5 259:5  
 264:12 265:11 266:3  
 266:10 270:17 273:1  
 273:2,8 276:19 283:4  
 285:17,20 287:10  
 305:9 306:10 307:5  
 321:18  
**puts** 38:14 160:9  
**putting** 43:1 46:19  
 84:18 146:17 179:19  
 179:20 223:19 244:9  
 260:21 265:19 275:2  
**puzzle** 98:22  
**PwC** 236:14  
**pyramid** 259:6,7 262:18

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**Q**


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**qualifying** 210:8  
**qualitative** 78:13 161:1  
 163:7 164:9  
**quantitative** 229:2  
**quarter** 94:21 122:18  
 206:16  
**quarterly** 90:6,8 98:17  
 99:5 100:16 114:11  
**question** 36:1 44:21  
 66:11 86:9 97:16,20  
 98:2,7 101:5 102:1,18  
 102:20 103:2,4,10,18  
 103:20,21 104:7  
 109:15 121:10 126:13  
 126:13 128:16 132:1  
 132:4,20,22 154:13  
 155:10 156:5 165:19  
 172:6 180:5,13  
 182:21 186:19,22  
 187:4 188:6,11 190:8  
 190:14,16 192:17  
 193:4 202:17,18

204:22 221:12 238:19  
246:16,20 250:7  
257:17 258:19 261:18  
267:19 275:7 278:12  
279:12 285:15 286:8  
291:7 313:2,19 321:8  
**questioning** 132:3  
**questions** 24:13 59:11  
67:16 90:22 103:1  
146:9 152:11 156:17  
159:2 162:20 165:1  
190:10 225:18 226:1  
238:22,22 243:14  
268:4  
**quick** 55:7 163:4 208:1  
**quicker** 26:9 116:6  
**quickly** 25:21 26:17  
91:8 122:4 264:14  
298:17  
**quite** 23:11 27:19,21  
34:7 47:5 50:10 101:7  
101:16,17 108:21  
109:10 112:1 121:3  
126:3 136:3,13  
168:20 192:15 201:9  
218:15 239:12 251:9  
268:2 275:3  
**quote/unquote** 153:11

## R

**R** 2:11  
**R&D** 133:19  
**rabbit** 148:4  
**raise** 51:11 97:9 160:14  
162:5 225:18 226:1  
268:4 303:10 317:20  
**raised** 16:4 162:6  
214:17 225:10 259:17  
269:18 270:3 317:18  
321:8,13,16  
**raises** 90:21 176:12  
236:6  
**range** 186:4  
**rapidly** 17:11 177:17  
**rarely** 76:6  
**rate** 30:9 117:18 123:10  
123:14 213:2 220:2,3  
220:6 221:15 290:22  
**rate's** 117:19  
**rated** 258:13  
**rates** 50:9 77:21 212:22  
213:6 232:20 243:10  
**ratification** 217:7 239:9  
241:12  
**ratifying** 103:16,16  
**rating** 74:11,14,18,19  
241:22 242:4,7 252:6  
252:7,7 281:7,19

**ratings** 74:21 241:20  
242:5  
**ratio** 128:5  
**rational** 312:1  
**rationalized** 154:14  
**re-advance** 209:14  
**re-proposing** 210:9  
**reach** 118:12  
**reached** 47:7 118:19  
**reaches** 198:11  
**reaching** 137:17 256:3  
**react** 57:22 90:1  
**reacting** 98:12,16  
**reaction** 36:5 100:3  
275:4  
**reactions** 127:2  
**read** 56:17,18 95:14  
116:19 117:7 118:9  
131:18 250:14  
**readable** 57:1 153:2  
**reading** 46:22 100:9  
271:7 289:6  
**reads** 96:7  
**ready** 308:22  
**reaffirm** 231:21  
**real** 46:8 71:4 80:1  
102:21,21 112:17  
116:4 117:21 122:2  
128:17 195:11 221:15  
228:19 252:4 290:8  
**real-life** 187:6  
**realignment** 280:2  
**realistic** 40:20 117:11  
280:6 314:1  
**realistically** 126:20  
260:20  
**reality** 304:1  
**realization** 273:2  
**realize** 86:4 129:6  
230:20  
**realm** 103:4 307:8  
**reappoint** 257:18  
**reappointed** 251:21  
**reason** 70:19 73:1  
85:22 117:14 179:2  
200:12,13 212:20  
215:22 216:1 228:10  
283:18 294:13 320:3  
**reasonable** 12:15 88:10  
192:10 202:7  
**reasonably** 154:10  
269:5  
**reasoned** 172:16  
**reasons** 74:17 164:14  
241:1  
**recall** 77:9 171:7  
179:12 189:20 198:9  
**recap** 224:18 227:13

**receivables** 315:21  
**received** 16:3 73:8  
197:21  
**reception** 235:1  
**recognition** 84:21 85:6  
309:21,22  
**recognize** 8:4 13:21  
23:21 33:11 59:21  
71:21 150:1 157:11  
176:7 180:4 207:13  
280:15 316:14  
**recognizing** 82:10  
180:3 271:11  
**recommend** 52:12 53:9  
53:11,13 69:15 81:3  
90:4 251:20  
**recommendation** 61:20  
62:7 68:6 69:9 81:3  
81:15 106:4 161:19  
178:4 201:7 216:16  
224:21 229:15 251:22  
283:5 286:13 287:7  
289:1  
**recommendations** 7:4  
42:11,17 43:6 46:15  
46:19 52:9 53:2 61:9  
61:10 68:5 70:10  
89:16 102:10 146:5  
147:18 148:7 156:12  
156:14 159:3 162:7  
178:4 180:9 187:8  
206:9 209:13,18  
227:4,6,11 229:7,19  
231:22 274:7 286:9  
286:18 288:16 292:16  
292:20 302:5  
**recommended** 50:21  
211:11 274:6 285:17  
**recommending** 87:20  
**reconciled** 39:14  
**reconciliation** 38:9  
39:7 68:18 69:8 86:16  
87:12 90:5,8 107:10  
112:4 115:6 117:13  
121:5 255:15  
**reconciliations** 39:6  
65:2,3 87:8 88:4 89:9  
123:4  
**reconfiguration** 280:2  
**reconstruct** 14:18  
**reconvene** 206:16  
**record** 14:18 22:17  
29:15 97:14 124:1  
145:18 160:15 206:18  
286:15,20,22 288:13  
292:11 311:2 323:6  
**recorded** 191:17  
**recording** 154:6

**recovered** 209:13  
**recruitment** 271:3  
**recurring** 79:20  
**red** 121:7 211:9  
**reduce** 277:17  
**reduction** 129:21  
219:21 220:1 221:12  
**refer** 110:6  
**reference** 94:9 153:1  
190:14  
**referring** 151:12 178:20  
271:8  
**reflect** 4:14 34:1 41:12  
59:22 62:2 64:12  
121:8 151:16 256:2  
311:12  
**reflective** 37:14,15  
141:11  
**reflects** 127:14 141:8,9  
246:7  
**Reform** 153:9  
**reforms** 29:4  
**Reg** 77:16 87:22  
**regard** 10:22 11:16 25:4  
26:11 41:9,17 180:22  
182:1 192:13 218:20  
227:22 304:18  
**regarding** 14:13 17:1  
18:15 48:21 102:10  
142:21 150:16 270:7  
**regardless** 155:16  
**regime** 137:13 193:19  
217:3 276:10  
**regimen** 50:3 213:22  
**regimes** 20:22  
**register** 134:11  
**registered** 21:8,21  
**registrant** 289:11  
**registrants** 93:2 96:4  
97:3 289:8  
**registrants'** 96:21  
**regular** 56:5 123:8  
**regularly** 212:22  
**regulate** 9:12 208:6  
297:13 313:4  
**regulated** 6:21 318:6  
**regulating** 292:19  
313:5  
**regulation** 157:10  
270:7 293:14  
**regulations** 3:8,10 6:11  
18:22 24:22 40:4  
150:7 152:17 153:17  
179:9,14 180:15,21  
181:12 229:16  
**regulator** 66:22 136:8,8  
136:9 188:18,18  
194:11 221:4 240:12

250:16,17 275:4  
 288:1 302:17 314:17  
**regulators** 6:21 21:19  
 52:3 67:20 68:6,14  
 75:17 86:14 89:1  
 90:12 92:4,12 95:8,15  
 95:19 136:4,17 137:1  
 145:10 153:12 209:1  
 218:19 219:4 241:5  
 254:2 283:4 297:8  
**regulatory** 11:6 28:7,8  
 48:8,16 139:22  
 198:11 241:3 242:16  
 302:16  
**rein** 185:19  
**REIT** 113:6  
**reiterate** 31:8 81:22  
 98:1 99:14 104:4  
 229:14 305:3  
**reiterated** 247:9 303:4  
**REITs** 112:17,21 113:1  
 113:4 116:14  
**relate** 51:6 164:7 211:5  
 212:8 228:6 268:11  
**related** 41:20 44:10  
 89:18 90:13 146:10  
 155:3 250:2 279:9  
 303:7 306:12  
**relates** 20:8 30:22  
 99:13 124:20 185:18  
 237:1 244:4 305:14  
 305:15 306:9,9  
**relating** 7:16 49:21  
 158:19  
**relation** 109:1 139:5  
 296:10 304:13  
**relations** 22:7  
**relationship** 5:14 76:10  
**relative** 89:11 139:4  
 182:13  
**relatively** 31:22  
**release** 14:14 15:20,21  
 17:8 51:14,16 54:2,5  
 89:20,22 100:4 131:7  
 131:11,13 218:3  
 230:21 233:22 234:6  
 234:7,21  
**released** 31:1 100:2  
 114:9  
**releases** 35:19 39:12  
 89:14,19,19 90:2,6,8  
 90:10,14 98:12,17  
 99:5 100:16 114:8  
**relevance** 34:19 65:12  
 65:21 76:7 99:11  
 209:15 318:14,21  
**relevancy** 56:6 57:2  
 92:1 97:5 132:3

289:13  
**relevant** 29:13 45:18  
 72:10 81:4 82:8,11  
 83:8 89:2 98:8 103:19  
 132:2 164:22 186:14  
 210:18 227:12  
**reliability** 228:12  
**reliable** 9:22 29:13  
 111:22  
**reliably** 266:7  
**reliance** 96:17  
**relies** 37:3,4 316:2  
**relook** 184:1  
**reluctant** 190:9  
**rely** 72:7,12 239:19  
 300:13 302:10  
**relying** 302:9  
**remain** 50:10 89:17  
**remaining** 280:8  
**remains** 78:12 186:22  
 224:22  
**remark** 231:6 278:22  
**remarks** 3:17 8:10,19  
 11:22 13:3 16:10  
**remedy** 254:16 257:9  
**remember** 99:22 100:9  
 127:1 145:1 205:4  
 210:7 248:13 249:22  
 264:8 297:7  
**remembered** 103:11  
**reminded** 112:13  
 301:15  
**reminder** 215:18  
 216:13 217:12  
**reminding** 288:17  
**reminds** 300:17  
**remiss** 9:13 58:9 243:5  
**remit** 37:19 68:12 86:10  
**removed** 186:2  
**repeat** 11:10 113:22  
 123:21 229:21 312:7  
**repeating** 228:11  
**replace** 81:5  
**Repo** 199:3  
**report** 3:4,7,11 11:18  
 20:13 30:6 32:19,21  
 41:6 42:9 50:6,20  
 52:2 54:7,13,13 71:7  
 81:13 83:6,16 94:9  
 100:4 118:6,6,12  
 123:3 131:16 135:12  
 150:3 151:19,21  
 152:3 154:19 160:4,5  
 160:7 168:19,20,21  
 168:22 169:3,4,5,9,14  
 169:21 175:17 176:12  
 176:17 179:21 183:12  
 188:10,17,19 194:10

194:16 199:20 200:3  
 203:14,17,22 214:7  
 215:4 216:15 220:11  
 222:6 223:21,22  
 224:10 228:15 235:17  
 237:22 244:19,19  
 245:6,14 251:20  
 265:2,20 266:11  
 293:18 309:2 316:19  
 319:3,4  
**reportable** 188:1  
 194:14,18  
**reported** 35:4 76:12  
 94:9 151:10 199:17  
 217:17  
**reporting** 4:20 5:6 7:7  
 9:22 11:14 14:1,14  
 15:8 16:20 19:6,7  
 25:21 26:4 28:21  
 43:11 58:5 59:21 60:5  
 63:18 77:6 84:8 86:9  
 88:9,19 91:11 92:3,5  
 92:9,10,19 94:5 95:7  
 95:22 96:15 101:8,13  
 101:15,18 102:1,15  
 103:1,6 108:22  
 109:13 114:22 115:1  
 115:8 118:5,8 142:2,3  
 142:5,18,20 144:5  
 154:20 156:21 159:22  
 160:2 162:14 164:20  
 172:18 181:18 184:18  
 188:22 193:2 204:2  
 204:10 215:12,14  
 220:19 230:15 252:3  
 252:4 254:3 296:10  
 317:7 321:13 322:5  
**reports** 54:2,5,7 117:8  
 131:18 174:17 175:3  
 176:21 179:20 185:21  
 186:3 188:22 194:13  
 212:15 214:20 215:10  
 221:7,9 229:13 230:5  
 232:8,17 233:11  
 235:7 247:5  
**repository** 210:22  
**representation** 197:9  
**representations** 229:2  
**representatives** 4:9  
**representing** 30:18  
 108:8 138:4  
**represents** 16:1 91:19  
 255:19  
**repurchases** 94:21  
**reputation** 42:6 149:21  
 154:13 155:13 189:16  
 276:9  
**request** 234:1

**require** 36:11 43:15  
 52:13 53:12 62:14  
 63:10 64:4 66:14 67:8  
 68:16 73:4 75:21 78:6  
 87:7,22 120:20  
 136:13 152:3 174:17  
 178:4 230:15 245:19  
 255:10 256:18  
**required** 4:10 83:14  
 150:17 158:6 196:22  
 197:2 238:4 255:3  
 281:19 286:13 287:8  
 300:5  
**requirement** 11:17  
 77:16 179:7 194:12  
 197:4 200:11 204:10  
 205:9 255:4 289:10  
 318:3 320:1  
**requirements** 38:8,9  
 45:3 85:6 86:17 87:12  
 87:13 107:11 115:8  
 115:10 153:10,15  
 154:17 158:2 178:20  
 179:13 181:5 189:18  
 200:8 204:9 215:15  
 253:1 295:9 299:22  
 320:18  
**requires** 11:3 15:2  
 115:2 168:19 188:4  
 266:22  
**requiring** 84:19 88:3,12  
 90:4 162:11 181:22  
 216:19  
**research** 18:3,4,17  
 19:10,12,16 20:20  
 21:4 24:8,10 33:20  
 34:17,18 35:1,1 36:6  
 65:14,15 70:8 75:5  
 76:6,14 82:17 100:2,2  
 135:12 147:12 172:7  
 173:22 248:13 272:18  
**researched** 82:21  
**researcher** 100:10  
**researching** 18:14  
**resembles** 137:11  
**reserve** 42:5 75:2,5,16  
 226:16  
**reserves** 149:21  
**resign** 204:1  
**resist** 266:14  
**resistance** 314:3  
**resolution** 285:18  
**resolve** 159:8 193:16  
 193:16  
**resolved** 172:20 188:12  
 194:9,19  
**resolves** 67:3  
**resonated** 305:6

**resounding** 124:9  
**resource** 49:22 305:19  
**resources** 120:17  
 159:20 211:14 212:2  
 212:4 215:2 227:16  
 253:16 272:13 314:2  
**respect** 10:14 34:8,22  
 35:12 36:14 37:16  
 39:9 47:1 52:15,20  
 56:9 57:5 59:9 64:2  
 65:8 68:17 69:6,10  
 70:3 84:4 87:13  
 105:18 108:11 133:6  
 143:22 149:8 156:4  
 165:5,21 201:20  
 210:13 211:2,4 214:4  
 219:1 230:11 266:1  
 270:2,19,22 271:18  
 273:12 280:10 286:6  
 292:12 298:2,10  
 322:4  
**respected** 224:7  
**respectful** 57:21  
**respectfully** 104:19  
**respective** 6:1 10:16  
 125:17 281:4  
**respects** 47:3  
**respond** 133:8 156:16  
 182:2 238:20 261:18  
**responding** 187:22  
 197:18  
**response** 44:7 167:9  
 176:2,4 177:6 193:10  
 193:12 202:10 219:12  
 290:15  
**responses** 238:22  
**responsibilities** 17:12  
 25:1 103:13 114:11  
 139:4,13 179:6 241:5  
 253:1 256:4  
**responsibility** 15:19  
 17:2 24:19 41:16 58:3  
 103:19 114:10 150:15  
 158:8 166:14 185:13  
 187:5,6 251:5 295:16  
 314:20  
**responsible** 59:19 60:7  
 114:8 130:7 161:17  
 297:17  
**rest** 56:1 57:5 81:7  
 83:18 165:20,21  
 208:21 292:6 305:3  
 312:18  
**restatement** 257:7  
**restatements** 53:15  
 230:2 248:10 250:2  
**restrict** 80:17  
**restriction** 222:2

**restructuring** 78:17  
 80:6 248:12,15  
**result** 5:16 36:13 71:21  
 73:14 74:3 181:16,17  
 218:13 246:12,14  
 260:19  
**resulting** 141:19  
**results** 5:11 20:14 50:6  
 53:7,13 121:8,9  
 191:16 194:14 212:15  
 213:21 215:7 227:10  
 230:16 232:11,14  
 233:3,5 236:3 267:6  
 294:4  
**resumed** 97:14 145:18  
 206:18  
**retail** 111:5 134:7  
**retailers** 134:9  
**retired** 2:4 29:19 32:8  
**Retirement** 1:20 2:2  
**return** 218:14 293:15  
 318:1,4  
**returns** 60:17 189:2  
**revenue** 72:22 78:5,8  
 84:21 171:10 249:5,8  
 250:3,3 271:1 273:22  
 309:21,21 310:4  
**revenues** 77:11 191:8  
 272:4,10  
**reversal** 249:8  
**revert** 293:3  
**review** 19:22,22 20:4,14  
 20:19,21 42:12 44:9  
 45:2 82:14 114:10  
 190:21 211:17 212:14  
 222:1 227:2 230:16  
 256:9 259:2 321:17  
**reviewing** 83:12  
**reviews** 114:11  
**revise** 294:11  
**revised** 311:12  
**revision** 257:7  
**revisit** 51:21 208:20  
 222:2 231:12 290:9  
**revisiting** 52:21  
**Revolutionary** 300:6  
**revolved** 133:18  
**reward** 34:2 62:3 64:13  
 72:8  
**rewarding** 263:14  
**rewrote** 237:5  
**rich** 141:21  
**Richard** 166:19 285:4  
**ridiculous** 172:14  
**rightly** 93:8 102:12  
 103:10  
**rights** 240:2  
**ringing** 312:9

**rise** 191:16  
**risen** 12:9  
**risk** 19:15,17 29:20  
 30:13 52:6 80:22 90:3  
 102:5,12 114:14  
 117:20 118:2 136:1  
 149:21 155:14 158:7  
 174:5 178:5,19  
 183:18,18,20,21  
 188:14 189:9,14,15  
 189:15 191:7 192:10  
 219:12,13,16 230:6  
 252:4 262:6,7 274:7  
 282:17 283:9 291:19  
 295:17 319:1,7  
**risk-based** 190:22  
 191:20  
**riskiest** 290:17  
**risks** 163:21 191:16  
 320:6  
**risky** 291:1,4,13,16  
 320:15  
**road** 149:20  
**roadmap** 83:2,11  
**Robert** 2:6 28:17  
 130:21 288:7 289:1  
**robust** 11:2  
**rock** 284:16  
**rocket** 272:15  
**role** 6:8 7:17 10:2 17:3  
 18:15 24:1,14 26:2,7  
 29:7,14 40:22 56:8  
 60:6 64:1 95:16 101:9  
 102:17 103:8 112:3  
 142:15 148:16,17  
 149:3 151:21 171:2  
 217:8 250:11,15,20  
 250:21 251:5,13  
 253:3,3 257:16 288:2  
 292:14 293:11 295:15  
 295:21 297:17 302:1  
 314:22 316:10  
**roll** 317:20  
**room** 50:7,13 51:9  
 110:6 124:21 139:17  
 175:14 213:8 217:22  
 237:1 241:16 243:2  
 271:17 302:12  
**root** 290:21  
**rooting** 11:3  
**rope** 167:4  
**rotate** 311:21  
**rotation** 243:4 283:6  
**rotational** 281:5  
**roundtable** 101:12  
**roundtables** 63:6  
**row** 109:6 289:21  
**rubber** 210:16

**Rubicon** 175:19  
**rubric** 138:16  
**rule** 4:21,22 14:7 15:18  
 45:4 80:12 190:3  
 283:6  
**rule-setting** 15:14  
**ruled** 235:11  
**rulemaking** 13:8  
**rules** 66:15 80:21  
 175:22,22 189:5  
 193:10 194:13 197:6  
 202:10 226:1 230:4  
 236:13 237:6 251:10  
 251:17  
**rules-based** 110:3  
**run** 12:12 27:10 31:21  
 34:22 62:2 256:21  
 269:22  
**running** 36:20 107:20  
 134:6 186:13 262:22  
 277:22 313:2  
**runs** 60:3 138:16  
 295:17  
**rushes** 118:2,3

---

**S**


---

**S-K** 77:16  
**S&L** 187:2  
**S&P** 130:10  
**safe** 158:15  
**SAG** 51:17 217:20  
 218:1,8 245:17  
**sails** 218:13  
**sales** 134:10,10 191:5,7  
**San** 27:8  
**Sarbanes-Oxley** 80:12  
 87:21 158:2 187:2  
 205:22 211:10 215:20  
 259:15 272:20  
**SASB** 83:7 105:3,3  
 133:2,3 136:21  
 138:14  
**SASB-type** 105:15  
 134:12,13  
**sat** 262:17 263:9  
**satisfaction** 54:12  
 194:9  
**satisfactory** 177:6  
**satisfied** 78:8  
**save** 226:17 275:6  
 285:9  
**savior** 299:6  
**saw** 24:11 84:6 117:12  
 138:1 171:19 220:15  
**saying** 100:7 101:18  
 114:13 143:16 145:8  
 160:13 167:15 173:1  
 183:22 195:20 198:6



199:8 204:12 221:14  
 242:19 260:8 265:21  
 280:13 289:19 297:6  
 297:20 298:14 299:7  
 299:9 301:19 309:15  
**says** 75:6 121:7 122:10  
 143:20 144:10 169:17  
 175:17 196:3 199:17  
 221:21 222:17 238:12  
 244:20 295:14  
**Scandinavia** 283:22  
**scary** 262:14  
**scenario** 170:4 184:17  
 265:5  
**scene** 242:3,6  
**schedule** 33:6 262:5  
**schedules** 262:16  
**scheme** 220:21  
**school** 263:10 282:15  
**Schumpeter** 277:12  
**scientist** 272:15  
**scope** 105:10 132:12  
 154:18 160:4 163:10  
 192:18,22 268:14  
 271:13  
**scoped** 192:10  
**scores** 263:9  
**scrambling** 102:2  
**screening** 139:9  
**scrutiny** 83:18  
**se** 190:13  
**search** 17:6 266:15,16  
**seat** 145:20 285:8  
**sec** 2:7 10:15 11:7  
 13:19 16:1 18:18  
 22:12 28:10 31:1,3  
 32:22 35:12 42:22  
 56:21 67:11 77:15  
 78:10 81:19 87:21  
 92:3,8,15,18 93:16  
 95:1,11 97:3 101:11  
 106:6 115:7,19,21  
 119:16 120:19 124:19  
 131:2 152:20 162:11  
 172:7 175:22 236:16  
 252:21 254:19,20  
 255:7,21 286:7  
 289:10 300:5 304:21  
 305:20 311:13 316:3  
 316:10,10  
**SEC's** 10:19 23:6 56:10  
 95:20  
**second** 61:20 109:6  
 157:5 159:22 190:7  
 233:4 246:16 248:20  
 282:10 286:19 288:3  
 303:16 304:5 307:3  
 307:11 313:19

**seconded** 288:4  
**Secondly** 142:7  
**Section** 45:3 80:13  
 153:5,8 203:2 204:4  
**sector** 48:15 59:14  
 110:22 111:1,4,5,11  
 130:8 273:16 283:1  
**sectors** 273:17,18  
**securities** 2:13,16,17  
 15:13 45:3 151:11  
 153:6,9 158:19  
 256:10  
**security** 95:19  
**seeing** 54:20 77:10  
 79:6 220:10 269:12  
 308:7  
**seeking** 9:10 98:4  
 192:8  
**seen** 36:6 78:12 123:2,9  
 135:4 140:15 163:12  
 166:12 169:9 174:1  
 185:4 202:6,8 212:12  
 214:15 226:5,11  
 233:10 235:6,8,10  
 261:4 268:22 269:1  
**segment** 84:8 91:10  
 114:22 115:1,7  
**Seidler** 259:16  
**select** 7:1 38:18 233:4  
**selected** 38:11 69:16  
 86:21 87:9,14 179:9  
 281:4 311:17  
**selecting** 19:17 316:5  
**selection** 217:7  
**selective** 77:6 80:11,22  
 129:21  
**selectively** 80:17 81:13  
**self-** 177:19  
**self-regulating** 62:12  
**self-regulation** 62:9  
 243:8  
**self-regulators** 62:11  
**sell** 239:21  
**selling** 144:16  
**semiconductor** 119:9  
 122:16 133:14,15  
 134:1  
**senate** 205:21  
**Senators** 44:6  
**send** 267:11  
**senior** 260:14  
**sense** 10:10 37:7 51:22  
 52:10 61:18 62:4 63:4  
 63:5 71:16 72:1 95:14  
 103:14 105:12,14  
 108:3 112:14,21  
 117:22 126:4 178:9  
 229:4 249:18 316:2

**sensible** 111:20  
**sensitive** 270:1  
**sent** 169:4 199:7  
**sentence** 122:10  
 149:12 180:19  
**separate** 93:1 115:8  
 203:17 223:21 278:11  
**separated** 311:16  
**separating** 143:5  
**September** 198:21  
**serious** 65:10 67:9  
 122:3 194:7 257:16  
 268:4  
**seriously** 103:13  
 115:22 135:16 160:16  
 298:8 321:14,15  
**serve** 10:2 50:2 89:8  
 211:9 264:3 305:18  
 306:20  
**served** 144:22  
**service** 269:10 278:21  
 301:5 307:18 313:8  
**services** 48:5,11  
 253:21,22 270:16  
 271:12 272:8,21  
 273:6 275:19 276:5  
 311:17  
**servicing** 100:1 122:3  
**session** 6:5 55:13  
 145:20 146:4 205:15  
 206:9,19 262:3  
 269:22 274:8 282:4  
 290:14  
**sessions** 303:13  
**set** 11:20 43:3 52:18  
 58:21 94:14 105:19  
 105:20 107:3 124:18  
 130:11 138:12 153:2  
 185:22 215:13 219:20  
 227:15 229:16 231:11  
 237:4 271:14,14  
 275:19 289:11 305:8  
**sets** 69:1  
**setter** 66:22 110:18  
**setters** 74:6 209:2  
**setting** 133:5,7 147:15  
 216:4 217:14 218:19  
 302:18  
**settle** 202:1  
**settled** 22:18 65:20  
**seven** 7:6 55:18  
**severity** 243:19,22  
**shades** 149:22  
**shake** 166:15  
**share** 94:21 109:22  
 141:19 232:1 239:7  
 239:13,16 241:3  
**shared** 10:17

**shareholder** 51:2 188:9  
 240:2  
**shareholders** 13:6  
 49:14 210:13 217:6  
 229:6 240:14 251:12  
 314:16  
**shareowners** 103:11  
**sharing** 18:17 22:14  
 106:13  
**sheet** 93:18 101:20  
 155:12  
**shield** 204:19  
**shift** 95:11 101:6  
**shifting** 185:2  
**shocking** 243:16  
**shoes** 309:5  
**shoot** 122:1  
**shopping** 111:5  
**shops** 270:15 279:16  
 282:7  
**short** 66:3 97:17 204:7  
 242:11  
**short-** 128:16  
**short-or** 100:12  
**short-term** 36:5 97:18  
 98:10,20 99:4,5,9  
 104:7 122:8 126:14  
 126:21 127:2,7 128:1  
 128:8  
**shorter-term** 98:11  
**shoulds** 45:22 290:9  
**shout** 292:6 321:21  
 322:16  
**shout-out** 223:20  
 224:14  
**Shover** 1:21 28:13,13  
 289:18  
**show** 33:21 34:18 50:7  
 78:18 123:15 224:13  
**showed** 35:3 75:5  
 100:2 118:11  
**shown** 144:6 224:5  
**shows** 36:6 76:14 94:20  
 172:7 220:15 262:5  
 264:5 277:7 292:11  
**shut** 321:1  
**sickbed** 317:4  
**side** 25:10 64:8 79:6,7  
 103:9 162:6 262:8  
 278:2 295:3  
**sidebar** 283:3  
**sided** 79:5  
**sides** 242:8 278:5  
**sign** 101:6 254:12  
**signatories** 101:11  
**significance** 140:14  
 303:7  
**significant** 48:18 63:21

72:16 76:18 83:22  
 89:17 91:4 174:20  
 189:4 217:5 251:9  
**significantly** 10:17  
 72:12 77:1,12 78:19  
 133:11 232:21 233:6  
 298:8  
**signs** 49:21  
**silently** 287:12  
**silver** 109:17  
**similar** 198:8 220:16  
 296:16,17 297:2  
 307:22  
**similarity** 162:13  
**simple** 15:8 64:4 116:4  
 169:6 228:10  
**simplistic** 97:19  
**simply** 36:15 67:7  
 125:3 159:16 170:18  
 215:11 231:21 245:4  
 248:2 278:20  
**Simpson** 2:1 29:1,2  
 49:5 101:1,2 239:3  
 276:17,18,21 279:2  
 287:10,17,20 288:4  
 288:11,14,20 312:7  
 312:21  
**Simultaneous** 165:16  
 201:22 287:1  
**Singapore** 220:17  
 221:11 238:13  
**single** 12:5 109:19  
 110:14 111:10 136:7  
 136:10,16 169:15  
 205:20 316:9  
**singular** 143:11  
**singularity** 141:13,14  
**sins** 202:21  
**sit** 30:9 185:18 280:15  
**sitting** 23:12 110:16  
 193:7 287:12  
**situation** 155:15 162:4  
 180:5 181:8 184:5  
 186:18,19 191:9  
 194:6 195:3 196:4  
 204:17 226:6,20  
 258:10 285:14 286:1  
 307:22  
**situations** 148:10,11  
 149:17 155:8,20  
 163:13 181:4 211:12  
**six** 21:12 73:10 75:6  
 119:10 122:14,15  
 219:6 233:21 234:3  
 238:12 248:14,16  
 249:2  
**size** 248:20 273:22  
 284:20

**skeptical** 10:3  
**skepticism** 7:17 12:18  
 213:14,17 214:2  
**skills** 253:16 282:19  
 314:21  
**skip** 241:16  
**sleepless** 274:13  
**sleepy** 241:9  
**slew** 131:11  
**slicing** 232:18  
**slide** 43:2 79:1 89:5  
 91:6 136:5 160:3,20  
 180:14 233:19 235:13  
 235:20 237:7,9  
**slides** 33:13 78:21 91:2  
 119:15 153:3 156:15  
 157:17 168:4 232:11  
 259:1 272:4  
**slight** 76:17  
**slightly** 142:1  
**slim** 161:22  
**slippage** 54:3  
**slippery** 67:6 157:11  
**slog** 43:12 46:21  
 308:14  
**slope** 67:7 157:12  
**slower** 116:7  
**slowly** 319:15  
**smack** 274:10  
**small** 122:19 130:9  
**smaller** 21:15 103:21  
 297:7  
**smallest** 273:22  
**Smart** 2:2 30:15,15  
 124:13,17 185:11,12  
 243:13,14 306:18  
**smartest** 272:10  
**so-called** 56:14 95:12  
 109:17  
**social** 86:4 295:12  
**society** 15:15  
**softball** 97:16  
**software** 78:1 127:16  
 197:20  
**sole** 267:14  
**solution** 106:18 119:19  
 175:9 280:14 298:22  
**solutions** 1:16,22  
 180:12 306:14  
**solve** 90:12 122:7  
 128:10 135:17 186:17  
 194:1 282:16 320:9  
**solved** 260:11  
**solves** 195:1  
**somebody** 113:5  
 161:12 188:9 267:11  
 286:21  
**someones** 308:3

**someplace** 219:22  
**somewhat** 89:15  
 185:16 243:16 299:17  
**Sondhi** 2:3,3 27:10,10  
 33:12,14 61:6 83:21  
 99:20,22 106:21  
 112:12 143:11,14  
 247:8 297:19  
**soon** 20:13 22:5 152:11  
 249:20  
**sooner** 89:22 248:1  
**sophisticated** 184:13  
**sorry** 70:18 123:19  
 130:4 141:1 151:1  
 278:22 287:2,7  
**sort** 35:20 43:1,4 46:1  
 71:12,13 77:21 85:18  
 86:21 90:15 99:5  
 101:15 104:4,6,7,10  
 104:15,16,20,21  
 105:6,12 108:2,3  
 125:3,7 138:13,14,16  
 139:3,9,11,12 140:2,4  
 140:8,8,12 160:9  
 186:2,4 194:11  
 243:19,20 244:5  
 253:18 276:22 277:6  
 281:11,14,15 296:16  
 296:17 297:5 300:18  
 301:10,13 302:2,16  
 304:7 307:13 308:6  
 317:15  
**Sorter** 100:11  
**sorts** 184:18  
**sound** 116:4 310:18  
**sounding** 224:9  
**sounds** 164:1  
**source** 96:19  
**sources** 102:4  
**South** 27:14,21 54:21  
 108:20 109:21 180:5  
 184:5,17 185:4 188:1  
 189:6,12 194:4 226:5  
 226:11,22 253:8  
 274:14,19 276:13  
 279:21 282:9,14  
 295:6 296:5,18 308:1  
**SOX** 45:17,19 48:3  
**space** 111:5,7,7 251:4  
 252:21  
**spaces** 251:1  
**sparingly** 222:18  
**speak** 4:16 23:14 33:7  
 40:10 58:13 160:15  
 276:21  
**speaking** 26:21 40:5  
 58:13,14 62:22 79:19  
 165:16 201:22 287:1

**speaks** 237:9 321:11  
**special** 312:11  
**specialist** 172:1,2  
**specialists** 17:17,21  
**specialize** 299:4  
**specific** 46:18 48:19  
 59:13 67:16 75:22  
 83:14 87:1 103:4  
 110:22 118:10 146:4  
 157:16 170:20 182:22  
 184:6 189:16 206:8  
 209:18 214:8 228:20  
 229:19 230:7 237:13  
 237:22 238:14 246:9  
 251:15 252:6 267:14  
 267:15 282:14 302:2  
**specifically** 6:16 24:14  
 44:10 52:8 124:2,20  
 211:5 250:15 282:9  
**spectrum** 111:10  
**speed** 291:14 303:18  
**spend** 50:16 52:21  
 108:8 123:16 227:2  
 260:15 295:1  
**spending** 264:7,9 269:5  
**spends** 134:22  
**spent** 32:7 94:21  
 107:12 145:2 166:1  
 230:6 260:10 261:5,8  
 274:12  
**spillover** 21:9,9  
**spirit** 314:10  
**splits** 110:5  
**spoke** 31:17 184:8  
 232:3 282:21  
**spoken** 136:7  
**sponsoring** 13:22  
**Sporkin** 2:4 254:11,12  
 255:20 256:13 257:1  
 315:13,15  
**spreading** 17:13  
**springs** 247:2  
**square** 134:10  
**squishy** 157:20  
**stability** 102:9 318:1  
**staff** 2:19 4:12,15 5:2  
 9:14 11:11,12 13:7  
 15:1 16:8 31:22 40:8  
 40:9 42:12,22 43:8  
 44:9,17 46:5 62:3  
 106:15 157:14 203:7  
 203:8 208:22 216:21  
 251:15 259:5,16,16  
 262:9 291:13 292:7  
 312:17  
**staff's** 213:10  
**staffed** 291:9  
**staffing** 53:20 267:20

- 268:5  
**stage** 155:16  
**stake** 97:5  
**stamp** 210:16  
**stand** 320:14 322:17  
**standard** 4:20 20:1,5  
41:10,14 42:15 45:11  
45:14,20,21,22 46:9  
52:12 78:5 84:21,22  
84:22 89:9 92:9 93:13  
115:22 124:18 144:9  
147:15 153:7 154:4  
154:11 161:20 166:5  
167:12,13,16 168:11  
170:14 176:21,22  
177:10,15,22 180:18  
180:21 181:22 196:4  
200:7 201:10 204:9  
209:2 216:4 218:18  
249:6 250:3 252:12  
255:4,5 256:22  
266:22 296:11 302:18  
309:11,22 310:13  
**standard-** 66:21 74:5  
**standard-setter** 107:2  
107:15 108:2 109:16  
111:8  
**standard-setters** 34:9  
35:10 36:10 37:18  
38:7 47:1 62:21 63:1  
63:8,19 67:21,22 68:6  
68:12,14 74:1,1 85:19  
86:11,13 108:16  
112:3 136:4 145:10  
**standard-setting** 15:14  
16:18 18:11 25:5 26:9  
26:12 44:8 48:8 108:5  
110:18 118:21 137:8  
137:12,20 143:6  
**standardization** 64:16  
105:2,8  
**standardize** 92:5  
**standardized** 81:16  
125:3  
**standards** 1:18 2:21  
7:13 10:4 11:6 18:4,5  
18:12 20:4 27:18  
32:15 40:21 41:9  
42:12,14 43:3,5 44:9  
44:13 45:5 46:4,13  
53:11 60:5 63:2 83:1  
85:5,10,22 95:18  
96:14 118:21 119:5  
138:15 141:16 143:5  
147:3 148:22 150:2,6  
151:18 152:21 153:16  
154:2,22 155:6  
158:13 161:16 165:3  
165:6,8,12,20 166:3,6  
166:7,10 167:7,8,21  
168:6,13,14 170:12  
170:14,18 174:22  
179:8 192:14 196:8  
196:13 200:10 203:12  
213:19 228:15 254:13  
254:15,21 255:1,8,10  
255:11 256:10,18,20  
256:22 257:8 276:9  
296:15 302:10,19  
311:11  
**standing** 51:7  
**standpoint** 148:1  
291:18  
**stands** 70:16  
**STANLEY** 2:4  
**staples** 273:17  
**start** 26:22 61:7 78:2  
97:15 102:15,20  
106:15,16 118:1  
120:3 136:15 153:8  
163:2 207:6 231:11  
232:18 233:14 240:14  
247:21 248:5 249:1  
252:22 254:2 265:7  
266:3 267:7 280:1  
286:6 289:18 297:19  
302:18,20 303:5  
317:14  
**started** 4:3 31:4 99:22  
106:16 110:1 116:14  
203:21 222:9 235:16  
263:9 294:6,14  
300:18 315:19 317:11  
**starting** 48:14 108:6  
191:18 221:13 236:14  
262:6 266:4 269:14  
311:20,21  
**starts** 246:19  
**state** 25:14 30:10  
152:16 198:7,9  
239:15 300:5  
**stated** 81:3 244:19  
271:8  
**statement** 11:19 12:17  
14:13 53:16 90:7  
93:13 95:13 96:1,12  
121:15 122:5,10,11  
131:21 144:20 153:4  
154:14 155:6 157:2  
163:15 181:19 190:20  
257:6 311:15  
**statements** 6:7 8:14  
10:3 18:1 25:18 36:12  
39:15 41:21 55:15  
56:9 57:6 62:15 64:7  
73:3,13 80:18 81:7,8  
81:11 83:18 89:10  
91:12,16,20 92:14  
93:9,17 96:2 97:6  
149:8 150:21 153:12  
154:5 158:10 183:3  
183:11,19 255:14  
257:4 284:7,12  
285:22 286:14 287:9  
289:12 293:6 299:20  
306:9 310:7 311:2,5,5  
313:8 316:3  
**States** 5:8 242:13 243:3  
304:12  
**static** 59:22  
**statistic** 266:2  
**statistical** 272:18  
**statistics** 57:8 258:12  
259:2  
**status** 293:13 307:14  
**statute** 54:14 237:18  
281:19 282:2 293:14  
**statutes** 80:10  
**statutory** 43:4 176:22  
295:10  
**stay** 37:4 72:13 91:8  
108:15 145:11 226:14  
289:3  
**staying** 306:3  
**stealing** 161:12  
**steals** 149:15  
**step** 25:14 49:7 103:7  
109:8 129:14 138:9  
238:18 265:6 280:1  
289:14 308:3  
**steps** 41:18 115:16  
150:17 159:7 208:15  
215:7 228:16 297:15  
302:15,21 305:18  
**Steve** 8:16 9:6 11:22  
14:6 23:10 24:3,3  
27:5 28:3 33:14 39:18  
47:10 55:8,16,17 61:6  
91:8 97:7 98:7 99:20  
106:2 112:12 126:12  
130:22 132:19 137:17  
143:14 177:21 180:7  
190:7 197:15 207:7  
209:19 260:5 267:18  
275:7 279:8 280:12  
283:13 288:15 291:22  
297:19 301:4 305:3  
306:19 308:12 310:19  
312:11 317:3  
**Steven** 1:11,14  
**stewardship** 29:7  
103:19 104:13 139:4  
240:1  
**stick** 127:19 260:4  
319:21  
**stifle** 103:6 111:13  
113:13  
**stock** 36:22 37:3 42:6  
72:2,8 76:20 80:3  
99:6 188:20 194:12  
194:20 251:10,17  
**stocks** 32:2 130:8  
**stone** 195:22  
**stop** 16:10 152:6  
270:15 312:5  
**stopping** 242:11  
**stores** 113:2  
**story** 290:11  
**straightforward** 65:3  
84:17  
**strategic** 320:21  
**strategies** 272:3  
**strategy** 270:5  
**street** 1:10 34:17 35:1  
65:15 76:6 117:9  
**strengthen** 42:11,11  
190:5 251:5 252:22  
**strengthened** 41:15  
44:14  
**strengthening** 151:17  
189:18  
**stress** 29:5 267:2  
**strictly** 148:5  
**strike** 195:19  
**strikes** 105:11 259:20  
**stringent** 46:5  
**strong** 4:21 41:15 48:20  
89:14 150:13 157:7  
187:18 239:21 282:15  
**stronger** 239:10 253:3  
**strongly** 5:4 102:14  
151:3 199:20 208:12  
210:20 214:11 229:10  
230:13 231:9 303:5  
**struck** 143:15 248:8  
249:4 259:20 295:6  
313:14  
**structural** 54:17  
**structure** 259:7 268:20  
268:21 289:5 296:1  
314:14,16,17 317:11  
318:6,8  
**structured** 56:10 91:16  
95:1 250:4 298:19  
299:5  
**structures** 164:6,15,16  
296:6  
**struggle** 157:15  
**stuck** 240:22 315:5  
**studies** 33:20  
**study** 35:2 76:8 248:13  
**studying** 136:16 147:14

**stuff** 45:1 114:12  
 116:17 134:11 135:12  
 164:2 167:4 171:9  
 199:21 223:19 265:8  
 282:17  
**stumble** 183:8  
**subgroup** 233:21  
**subgroups** 7:3  
**subject** 20:11 21:1  
 109:1 124:4 132:5  
 138:2 206:20 211:16  
 213:18 230:16  
**subjected** 91:18 93:9  
 96:9 114:14 132:16  
**subjectivity** 7:16 201:7  
**subjects** 108:22 290:2  
 320:18  
**submission** 189:1  
**submit** 73:22 104:19  
**submitted** 93:2  
**subpoenaed** 177:1  
**subscription** 144:17  
**subsequent** 7:21  
**substantial** 13:6 18:8  
 210:5  
**substantially** 160:1  
**substantive** 85:5  
**substitute** 215:13  
**subtotal** 84:18,19  
**subtracted** 116:21  
**succeed** 292:21  
**success** 133:10 161:22  
 260:12 322:15  
**successful** 133:10  
 310:12  
**succinctly** 125:18  
**sue** 239:22  
**sufficiency** 212:9  
**sufficient** 205:7 231:16  
 248:3 256:13  
**sufficiently** 154:10  
**suggest** 38:7 104:8  
 193:15 290:2  
**suggested** 105:2  
**suggesting** 68:13  
 136:15,22 174:13  
 196:11 205:5,12  
 240:7,8 302:22  
**suggestion** 86:13  
 111:18 237:12 286:12  
 293:2 302:14  
**suggestions** 286:9  
 290:6  
**suggests** 48:14 84:2  
 100:7 240:3  
**summaries** 212:14,19  
**summarize** 33:12  
 152:19 153:3 209:11

**summary** 8:3 67:11  
 96:15 155:5  
**summer** 218:1  
**supervision** 17:4  
**supervisor** 217:8  
**supplementary** 63:11  
**supplied** 222:17  
**supplier** 79:10  
**supplies** 149:15  
**supply** 149:15  
**support** 4:21 28:7,8  
 29:4 32:20 121:12  
 215:2 245:12 246:11  
 266:1 302:9 309:1  
 314:17 323:1  
**supported** 52:18 245:8  
**supportive** 82:16 309:6  
 323:2  
**supposed** 54:13  
**Supreme** 173:13,19  
 175:10  
**surprised** 93:10 170:9  
 232:16  
**surprises** 155:13  
**surprising** 84:5 243:16  
 272:6  
**surrounding** 82:19  
 118:22  
**survey** 227:10  
**survey-taking** 142:8  
**surveys** 140:13  
**suspect** 34:22 284:19  
**suspected** 151:19,21  
**Sustainability** 83:1  
**sustainable** 109:12  
 110:9,10  
**sweeping** 20:7  
**Swiss** 222:10,12 223:5  
**switched** 313:13  
**sympathetic** 240:8  
**sync** 234:21  
**system** 2:2 17:15 91:18  
 91:21 95:9 97:3  
 221:20 238:3 243:10  
 258:18 259:21 265:16  
 275:16 277:4 281:5  
**systemic** 54:17  
**systemically** 278:19  
**systems** 62:12 95:13

---

**T**

---

**T** 1:15  
**table** 5:19 26:18 57:10  
 60:21 132:1 163:2  
 204:12 205:16,18  
 243:6 260:1 286:5  
 292:1 304:20 307:5  
**tables** 212:18

**tackle** 150:2  
**tackled** 148:2  
**tactical** 302:14  
**tactics** 302:7  
**tag** 93:21,22 94:3,11  
**tagged** 94:2  
**tags** 96:12  
**tainted** 185:6  
**taken** 42:13 46:14  
 79:22 100:17 116:17  
 116:21 117:3 151:20  
 177:16 196:17 216:8  
 218:8 219:3 314:11  
 321:14,15  
**takes** 16:3 20:17 48:13  
 62:22 86:22 176:9  
 224:8 247:1 272:15  
 277:9  
**talent** 268:7,17  
**talented** 32:19 263:6  
 272:11,13 273:3  
**talk** 33:20 36:8 38:4  
 42:16 57:4 64:18 84:9  
 124:5,6 128:2,22  
 129:1,4 131:19 138:5  
 162:2 163:22 166:19  
 169:16 172:4,4 181:3  
 221:3 228:16 237:22  
 254:9 289:16 294:2  
 300:2 306:8  
**talked** 44:7 61:7 73:11  
 84:3 98:13 129:5  
 222:13 232:6,14  
 258:20 290:2,3 304:5  
 309:20  
**talking** 34:13 38:1  
 63:20 73:13 84:14,18  
 87:19 100:5 105:21  
 112:15,22 114:9  
 132:11 143:18 164:21  
 172:2 236:21 239:12  
 241:19 247:4 267:7  
 282:12  
**talks** 250:15  
**tampered** 181:5  
**tangibles** 101:21  
**targeted** 124:2  
**Tarola** 2:6 28:17,17  
 45:7 55:14,16,21 91:5  
 130:21,22 131:5,6  
 152:13 182:2,4  
 196:14 254:11 257:15  
 279:1 288:9,12,15  
 289:3  
**Tarola's** 196:3  
**task** 73:12 108:7 118:13  
 155:5 180:8 302:22  
 303:1

**tasked** 60:2  
**taskforce** 73:8 102:10  
 144:15  
**tax** 171:10 188:20 189:1  
 189:2 284:9  
**taxes** 36:18 70:17  
 158:20  
**TD Ameritrade** 29:19  
**team** 32:19 33:2,17  
 53:21 66:4 147:3  
 178:3 179:22 184:21  
 205:17 230:8 247:10  
 270:1 305:4,9 306:10  
**teams** 113:12 129:22  
 130:17  
**tech** 310:5  
**technical** 126:21 128:9  
 190:9 230:10 261:9  
**techniques** 22:15 174:6  
**technology** 18:15 26:3  
 37:5 57:4 72:13,13  
 91:10,15 92:2,18,20  
 94:20 281:15  
**telecommunications**  
 130:8  
**tell** 35:7 37:8 38:13  
 68:16 71:10 72:17  
 73:18 77:20 100:20  
 122:17,18 126:6  
 131:6 137:2,3,4 170:1  
 172:13 173:11 179:18  
 187:21 197:12 200:18  
 226:13 236:11 248:9  
 248:17 267:10 284:13  
 317:19 320:8,10,15  
**telling** 108:10 110:18  
 131:15 157:21 197:8  
 212:21  
**tells** 62:1 71:6  
**ten** 74:17 130:18  
 165:22 204:12 220:9  
 259:4 294:2  
**ten-page** 210:2  
**tend** 74:11  
**tender** 275:2  
**tendering** 277:18  
**tenets** 10:19  
**tension** 12:12 55:4  
 270:4 272:2  
**tent** 123:19 197:16  
 201:16 238:21 257:12  
**tents** 207:18  
**term** 66:3 104:10  
 126:14 128:17 178:21  
 179:2  
**terminology** 114:19  
**terms** 24:1,8 41:16 57:4  
 105:16 124:8 133:2

133:20 134:5,22  
 149:3 165:9 166:10  
 167:7 177:14 178:10  
 180:22 185:19 190:15  
 191:8,22 201:7 206:2  
 207:2 228:16 230:20  
 243:21 260:2,2  
 270:15 273:21 274:7  
 284:5 286:16 288:15  
 302:14 307:14 321:9  
**terrific** 165:2 211:22  
**terrifically** 259:11  
**test** 30:7 83:15 93:16  
 179:8 198:18 206:1  
**tested** 123:3 198:16  
**testifying** 27:1  
**testing** 160:5 178:7  
 179:13,17,18 181:5  
 198:5 199:2  
**Texas** 1:19 29:18 129:7  
**text** 14:8  
**thanking** 301:4,4 317:5  
 321:4  
**thanks** 23:10 24:3 31:9  
 47:12 78:22 87:16  
 98:7 103:21 128:19  
 130:22 147:17 152:13  
 152:19 177:21 180:8  
 310:13,19 312:6,11  
 314:7 315:12  
**theme** 133:1 208:4  
 313:2  
**themes** 56:4  
**themselves** 260:8  
**theology** 174:21  
**theoretical** 93:11  
**theory** 204:18  
**they'd** 118:19 132:21  
 173:19  
**things** 11:3 31:3,20  
 40:11 41:3,13 42:21  
 45:18 46:7,12 53:21  
 57:17 58:16 67:17  
 72:1 84:5 109:5  
 110:13 113:12 129:5  
 129:9,17 138:10,13  
 142:16 143:15 146:17  
 146:22 149:22 151:6  
 157:1,4,6,14 158:16  
 158:18,22 159:15  
 160:18 161:7 162:2  
 162:17 169:20 175:2  
 184:16,18 195:13  
 201:5 203:13,13,20  
 216:20 220:18 221:9  
 234:19 236:12 240:16  
 240:21 243:11 246:22  
 247:18 248:10 250:6

250:8,9 262:4 267:13  
 276:1 278:8 285:16  
 293:22 294:21 295:12  
 296:7,12,12 298:16  
 303:19 306:11 311:19  
 314:10,13 316:20,21  
 320:22  
**thinkers** 320:22  
**thinks** 66:10  
**thinly** 284:8,21  
**third** 62:7 142:14 217:2  
 225:5 229:10 248:21  
**third-party** 175:6  
**Thornton** 283:21  
**Thorntons** 282:13  
**thought** 43:21 55:19  
 103:3 105:1 109:4,9  
 111:12 124:9 139:8  
 159:9 165:10 181:14  
 237:6 241:2 250:10  
 252:8 258:10 282:15  
 286:17 290:14 300:6  
 301:14 307:4,7 315:3  
 317:12 318:7,16  
 320:17  
**thoughtful** 51:13  
 192:15 218:4 231:4  
**thoughtfully** 190:1  
**thoughts** 157:17 163:1  
 232:1 278:13 308:6  
 315:14 316:13  
**thread** 85:9  
**threat** 271:11  
**threatens** 270:11  
**three** 28:21 38:19 68:22  
 69:1,17 70:1 73:10  
 75:10 81:14 84:22  
 85:5,7 87:9 88:12  
 109:17 116:13 156:19  
 170:22 174:3 199:15  
 206:16 224:11,13  
 232:20 233:5 264:1  
 267:13 269:9 270:8  
 271:21 274:9 280:8  
 283:17 295:3 303:10  
 310:14  
**three-way** 314:17  
**thresholds** 193:1  
**tier** 213:5 233:5 265:16  
 265:16 282:10  
**tight** 15:5  
**tightly** 23:19  
**timeframe** 219:22  
**timeline** 15:5  
**timeliness** 89:19  
**timely** 41:7 42:10 54:5  
 60:18 62:22 149:10  
 151:10 310:12

**times** 29:4 35:20 65:2  
 75:7,11 77:6 128:3  
 157:18 184:8 185:16  
 250:13 295:4 311:9  
**timing** 33:10  
**title** 196:20  
**titled** 74:16  
**titles** 262:8  
**today** 4:12 5:3 13:14,18  
 24:9,12 25:6,16 26:16  
 27:3 29:15 36:8 38:7  
 39:10 40:6 41:12,15  
 42:10 46:19 51:20  
 52:3,21 53:2 56:13  
 58:2 59:9 60:12 63:17  
 76:20 91:20 92:17  
 98:14 117:21 126:22  
 128:6,18 142:20  
 164:21 184:9 202:5  
 207:9,16 208:5,15  
 209:8,16 214:11  
 217:22 218:11 225:7  
 226:4,20 227:12  
 230:20 231:15 236:21  
 250:13 263:18 265:21  
 289:4,19 290:3 292:1  
 293:3 295:4 303:16  
 304:7 307:5 317:4  
 320:17 321:16  
**today's** 5:22 11:9 25:2  
 97:19 117:21 313:15  
**toggle** 207:21  
**told** 121:17 182:16  
 193:5 197:2,11,13,22  
 199:14,18 244:8  
 267:9  
**tomorrow** 27:1 263:15  
**ton** 123:5  
**tone** 178:8,11,13 237:4  
 305:6,9  
**Tony** 2:3 27:10 33:11  
 39:22 61:3 78:22 79:2  
 79:18 83:19 87:16,19  
 91:5 97:16 101:3  
 104:2 106:20 112:11  
 117:6 121:14 124:12  
 137:22 140:22 141:3  
 143:8,13 209:9 247:7  
 297:18 309:20  
**tool** 50:15 95:4  
**tools** 85:18 292:20  
**top** 119:10 121:7 125:9  
 125:17 134:4 178:8  
 178:11,14 198:2,14  
 233:21 235:5 237:3  
 262:5,6 263:10  
 264:13 305:7 310:11  
**top-notch** 135:5

**Tope** 322:19  
**topic** 6:13 25:18 40:7  
 47:22 52:22 56:7  
 141:4 147:5 150:2  
 208:17,21 209:3,6,20  
 210:4 213:17 214:8  
 214:16 217:11,19,21  
 218:14 225:7 268:12  
 287:12 289:4 294:2  
 303:4 306:12  
**topical** 14:4  
**topics** 3:3 7:2,7,21 9:21  
 24:9 25:15 26:5 33:8  
 58:15 162:8 277:1  
 297:1,2 305:14 306:8  
 313:15,18  
**total** 273:14  
**totally** 161:4 323:3  
**touch** 89:13 159:3  
**touched** 79:3,18 160:17  
 224:19 225:6  
**touchy-feely** 164:2  
**tough** 31:12 43:12  
 46:21 207:8 308:14  
**traceable** 39:7  
**traces** 50:17 215:20  
**track** 23:3 25:11 38:21  
 71:6 211:11 215:4,15  
 294:8  
**tracking** 49:2 211:20  
 230:2 232:13  
**trading** 158:19  
**traditionally** 163:10  
**trail** 160:11 218:10  
**train** 309:22  
**trained** 259:13 269:9  
**training** 215:1 228:18  
 260:18 261:13 268:7  
 269:11  
**transaction** 59:8 78:6  
**transactions** 81:10  
 155:4 199:4  
**transformation** 95:6  
**transforming** 101:17  
**transition** 301:11  
**translate** 135:2  
**transparency** 5:7 7:8  
 7:11,19 14:1 17:8  
 48:21 56:5 71:3 206:2  
 229:12 232:5,7,17  
 233:9,17 253:6,10  
 254:3 261:2 265:9  
 281:1 296:3,5 298:5  
 302:10,20 321:12  
 322:4  
**transparent** 69:5  
**transparently** 69:12  
**transpired** 41:13 186:4

**trash** 220:4  
**travels** 94:12,12  
**treasury** 285:16  
**treat** 239:4 312:14  
**tree** 196:15  
**tremendous** 35:14  
 206:4 233:9  
**trend** 70:3 87:10  
**trends** 211:13  
**tri-part** 314:14,16  
**trial** 51:19 235:12  
**tricky** 157:13  
**tried** 45:19 200:14  
 233:1 321:6  
**trip** 27:21 202:2  
**tripartite** 10:19  
**trouble** 117:22 236:11  
 285:19  
**troubled** 264:19  
**troubling** 196:7 304:10  
**true** 48:15,16 49:11  
 122:20 128:4 172:7  
 236:2 318:8  
**truly** 13:18 51:10  
 242:13  
**trust** 91:13 93:4 119:22  
 120:4,13 123:18  
 318:14,21 319:8  
**trusted** 97:4 123:13  
**trusting** 120:3  
**trusts** 112:18  
**try** 8:21 43:21 91:7  
 119:18 138:15 201:4  
 226:17 266:9,10  
 298:15 301:8 306:14  
 316:1 322:6  
**trying** 12:21 32:18  
 77:11 107:13 119:20  
 145:2 183:16 185:12  
 219:20 221:11 223:11  
 264:17,22 278:7  
 311:8  
**TUESDAY** 1:7  
**turn** 6:10 8:9,13 14:5  
 23:9 40:2 47:8 50:1  
 55:15 83:19 123:16  
 124:11 134:10 137:22  
 152:8 156:11 176:10  
 195:21 209:1 218:20  
 231:19 255:20  
**turnaround** 28:18  
**turned** 171:12 255:21  
**Turner** 2:7 29:22,22  
 30:3,9 47:20 116:10  
 116:11 120:7,11  
 132:18,19 133:8  
 152:19 165:19 171:1  
 173:13 197:18 201:12

201:21 202:1 203:1  
 218:22 226:8,10  
 232:3 261:16,18,21  
 276:20 283:11 286:22  
 308:11  
**turning** 317:15  
**turns** 169:17  
**tweak** 231:12 294:11  
**twice** 248:20  
**two** 5:15 22:10 23:12  
 40:11 41:3 54:5,7,13  
 56:4 60:17 85:2  
 109:17 121:16 132:13  
 134:14 136:3 137:19  
 144:14 145:1,8  
 153:14 156:8 165:1  
 168:17 172:11 182:22  
 186:6 207:9 213:3  
 219:10 224:19 229:8  
 230:22 232:4 235:10  
 243:14 244:4 248:22  
 250:18,19 263:4  
 269:9 273:17 277:22  
 278:13 289:12,20  
 292:10 295:3 305:11  
 313:14 316:8  
**two-** 79:4  
**two-pronged** 70:6  
**type** 78:8,9 80:11  
 112:16 118:5 134:11  
 134:21 164:21 169:14  
 179:5 181:8,10 191:9  
 196:15 220:10,17  
 226:12 236:5 254:1  
 263:22 264:11 265:4  
 286:1 307:22  
**typed** 169:3  
**types** 58:11 62:5 66:20  
 67:5,7 68:1 76:2  
 85:10 99:12 139:7,9  
 155:1 159:14 160:8  
 191:13 215:10  
**typically** 262:20 284:7

---

**U**


---

**U.K** 166:21 220:8,14,19  
 221:6,10 238:2  
 239:10,11 296:18  
**U.S** 2:5 21:6,12 47:2  
 59:3 63:19 153:4  
 166:22 173:13,19  
 220:14 223:14 226:21  
 236:15 239:13,16,21  
 270:17 273:13,20  
 296:18 297:12  
**U.S.'s** 11:1  
**ultimate** 48:7,10 245:2  
**ultimately** 121:14,21  
 183:4,5 185:3 236:19  
 236:22 265:8 277:7  
**unanimous** 288:18,19  
 313:6,7  
**unaudited** 90:10  
**unbelievably** 58:22  
**uncertainties** 191:16  
**unclear** 66:22 85:13  
**unconvincing** 62:10  
**uncover** 155:7 180:15  
 195:18  
**underlines** 93:19  
**underlying** 208:5  
 261:12  
**Underneath** 93:21  
**underpinned** 19:11  
**understand** 15:9,9  
 36:19 45:13 70:5  
 77:14 85:21 90:11  
 128:13 136:12 144:9  
 148:16 159:14,19  
 161:9 167:19 173:2  
 185:13 240:15 253:12  
 253:13 254:17 257:13  
 263:5 277:14  
**understanding** 43:17  
 100:21 108:9 127:22  
 171:4 239:16 307:13  
**understate** 35:11  
**understatement** 14:12  
**understood** 263:3  
**undesirable** 89:21  
**undetected** 53:15  
**undone** 224:22  
**undoubtedly** 13:10  
 55:5  
**unfinished** 51:5 313:16  
 313:17 314:4  
**unfortunate** 59:10  
 285:13  
**unfortunately** 24:17  
 166:13 169:12 207:15  
**uniform** 62:17 215:13  
 302:8  
**uniformity** 22:21  
 215:14 302:12  
**unintended** 20:10  
**unique** 31:20 82:10  
 293:11 311:4  
**uniquely** 303:19  
**unit** 169:2  
**United** 5:8 242:13 243:3  
 304:12  
**Universities** 32:13  
**University** 1:19 29:18  
 100:1  
**unlimited** 212:4  
**unrealistic** 40:16

161:18  
**unsophisticated**  
 148:15  
**untenable** 182:14  
**unusual** 14:9 79:2  
 80:20 81:10 192:21  
**unwilling** 81:18  
**update** 7:7 45:16 87:22  
 290:9  
**updated** 41:11 150:7  
 153:18 167:22 227:6  
 311:12  
**updating** 150:12  
**urge** 52:17 54:1 214:12  
 218:11 228:4 231:9  
 294:5  
**urged** 227:14 230:13  
**urgency** 51:22 52:10  
**use** 17:21 18:14 19:11  
 22:22 26:2 33:18 34:6  
 36:3 39:1 40:15 56:16  
 61:21 62:5 64:12 66:5  
 69:1,22 71:6,7 72:21  
 73:5,21 74:11,17,19  
 74:20,21,22,22 80:6  
 80:22 92:18 95:8,22  
 96:4 98:21 107:3  
 111:3 122:5,10  
 124:22 127:3 134:19  
 141:21 144:10 168:2  
 196:16 197:22 221:8  
 224:9 266:12 287:5  
**useful** 18:1 20:16 34:7  
 46:15 86:1,7 88:17  
 100:8 109:4,5 180:11  
 224:1 232:19 238:4  
 247:6 261:5,8  
**user** 55:3 142:10  
**user's** 80:17  
**users** 11:19 18:1,6  
 74:11 76:11 96:1,7  
**uses** 70:8 75:2 178:22  
**usually** 119:12 215:3  
**utilities** 301:17 317:22  
**utility** 65:12 273:18  
 280:19 301:20 317:18  
 317:21  
**utilization** 133:20  
**utilize** 87:21

---

**V**


---

**valid** 53:2 111:12  
**validate** 320:14  
**validated** 62:8  
**validation** 132:16  
**validity** 65:11  
**valuable** 31:10 58:22  
 122:22 123:1 147:16

149:13 216:10 301:1  
**valuations** 59:7 117:10  
 117:17 121:13  
**value** 13:6 17:16,21  
 21:5 34:19 37:15  
 58:17 59:5 65:12,20  
 76:7,10 94:4 102:3  
 104:11,14 105:7  
 109:12 110:7,7,10  
 111:9,20 131:16  
 138:21 141:6 149:5  
 210:22 269:11 296:17  
 303:13,14 310:22  
 321:10  
**value-** 129:2  
**value-add** 131:5  
**valued** 164:5  
**variant** 20:6  
**variation** 133:1  
**variety** 7:15 28:6  
 208:12 210:17 293:12  
**various** 33:8 133:6,7  
 139:22 214:21 216:3  
 216:16 247:16 262:16  
 268:1  
**vary** 125:1  
**varying** 80:7  
**Vaughn** 323:2  
**Venice** 187:16  
**verification** 230:17  
**versus** 24:19 97:17,21  
 116:6 129:2 153:20  
 155:10 157:18 251:2  
 264:16 272:22 304:9  
**vetted** 124:4  
**vice** 30:16  
**view** 7:14 12:12,13  
 15:21 81:15 149:6  
 163:15 165:6 173:20  
 182:9 187:6 190:5  
 215:9 218:5 225:2  
 231:2 237:19 245:18  
 247:1 276:14 286:16  
 299:18 302:1  
**viewed** 98:10 273:16  
**viewing** 270:14  
**viewpoint** 148:5  
**views** 4:13,14 6:17 8:7  
 9:10 151:2 181:21  
 259:10 260:1 273:11  
 274:8  
**vigilant** 12:20,20,21  
**violated** 181:4 230:4  
**violation** 151:11  
**violations** 151:13 157:9  
 160:5 181:16  
**virtually** 58:10 114:2  
 124:6

**visibility** 290:18 291:5  
**vision** 92:17  
**vital** 13:17 96:22 227:12  
 288:1 292:13,14  
**vitality** 10:2  
**void** 308:3  
**volatility** 127:7  
**Volkswagen** 198:21  
**volume** 191:5  
**voluntarily** 214:20  
**voluntary** 215:10 254:5  
**vote** 30:1 224:2 234:13  
 235:15 239:14 240:4  
 290:12  
**voted** 241:12 288:6  
**voting** 103:13,15  
 234:13,14,15 239:18  
**vu** 310:9

---

**W**


---

**wait** 60:16 274:19  
 286:19  
**waiting** 120:19 254:22  
 310:1  
**walk** 152:15  
**walking** 113:2  
**Wall** 117:9  
**wallet** 23:16  
**Walsh** 2:8 28:11,11  
 128:20,21 130:4,6  
 290:14 291:12  
**wanted** 15:9,9,10,10,15  
 31:3 42:21 61:6 65:11  
 66:1 67:19 74:9 77:5  
 77:14 79:16 89:13  
 101:5 122:2 124:5,6  
 124:15 141:21 171:22  
 202:5 207:1 210:3  
 217:1 248:7 267:18  
 268:9 297:19 298:13  
**wanting** 25:11 173:11  
**wants** 64:15 148:8  
 181:2 246:13 281:5  
**warning** 49:21  
**Warren** 44:6  
**Washington** 1:11 23:12  
 23:13 28:4,19 171:8  
**wasn't** 15:6 62:20 129:4  
 198:7 205:20  
**watchdogs** 275:20  
**way** 7:1 12:15,19,22  
 17:6 24:17 34:1,2,12  
 56:12 62:2,3 63:12  
 64:12,13,17 66:10  
 67:10,22 68:1 74:13  
 75:18 76:1 77:12,14  
 77:20 85:16 86:4 87:5  
 87:11 94:7 102:2

106:8 109:14 110:4  
 111:16 113:6 114:17  
 115:13,13 119:2  
 136:6 139:22 145:9  
 145:13 158:3 168:22  
 170:22 172:16 175:17  
 195:8 197:7,9 200:6  
 201:12 202:7 204:5,5  
 215:17 216:5 219:6  
 222:7 224:18 240:1  
 242:6 248:19 249:3  
 249:22 250:4 262:18  
 263:6 268:7 278:17  
 281:6 283:2 286:15  
 290:11 292:5,10,17  
 293:2 294:12 300:10  
 312:1 315:6 322:6,9  
**ways** 46:3 67:18 101:17  
 109:18 162:13 211:19  
 272:9 277:16,17  
 291:6  
**weak** 194:2,2 240:2  
**weaker** 165:6,20  
**weaknesses** 53:17 54:8  
 178:12,13  
**wealth** 94:4  
**wearing** 139:18 302:16  
**weather** 16:16  
**weave** 306:11  
**weaving** 300:10 304:6  
**website** 17:7 134:4,5  
 220:15 229:22 266:16  
**week** 166:16  
**weeks** 84:7 144:14  
**weigh** 190:9 267:19  
**weighing** 44:11  
**welcome** 3:2 4:4 5:9  
 26:15 69:2 108:22  
**welcoming** 4:17  
**well-formulated** 218:4  
**well-functioning** 13:5  
**well-informed** 127:8  
**well-rooted** 22:14  
**Wells** 40:17 42:2 44:2  
 161:2 170:16 197:20  
 199:13 200:2,4  
**went** 44:15 52:22 97:13  
 114:21 121:16 124:4  
 145:17 203:2,7  
 206:17 218:10 219:20  
 234:6 279:17 284:21  
 285:3,5 296:7 310:7  
 323:5  
**weren't** 121:18 170:6  
 182:16 309:5  
**Wes** 2:16 5:9,16,17  
 12:20 13:11 14:22  
 30:4 31:2 47:16 58:2

58:12 61:1 124:1  
 136:12 141:1,2 143:8  
 255:9 256:17 284:3  
 286:10 289:9 308:22  
 310:3 321:5  
**Westin** 1:10  
**whatsoever** 200:2  
**wherewithal** 307:14  
**whilst** 278:7  
**whistle** 171:16  
**whistleblower** 159:10  
 159:14 171:3,4,11,13  
 171:22 172:11,22  
 173:2 174:11 177:14  
 186:2 199:4,5,7  
 205:19  
**whistleblower's** 185:20  
**whistleblowers** 46:8,9  
 159:11 171:9 185:19  
**whistleblowing** 170:21  
**who've** 140:14 267:21  
 292:2  
**wide** 111:10  
**widely** 93:5  
**wider** 185:3  
**wild** 299:21  
**willing** 106:5 195:11,12  
 304:20  
**willingness** 20:9  
 225:19  
**Willkie** 167:1  
**win** 132:14  
**win-win** 242:8  
**wind** 218:12  
**window** 66:10 240:10  
**wins** 304:1  
**wish** 8:10,14 57:18  
 77:17 224:11 270:8  
**wishing** 279:18  
**withdrawal** 205:2,3,7  
 205:10,10,11  
**withheld** 182:5  
**witnesses** 175:1  
**woke** 116:19  
**women** 140:6  
**wonder** 298:22  
**wonderful** 15:12 312:17  
 315:16 320:21  
**wondering** 165:4  
 180:13 181:2 195:5  
 259:6,10 271:4,16  
**word** 40:15 141:4 143:9  
 147:9 150:20 167:15  
 201:20 204:13 206:21  
 292:10  
**words** 37:13 38:12  
 69:21 71:14 75:12  
 149:12,20 150:17

155:13 174:12 188:8  
205:9 238:6 244:22  
267:7 287:5 292:11  
**wordsmiths** 287:4  
**work** 6:1 11:8 12:22  
14:21 15:18 16:8  
17:17 19:19 20:22  
22:8,10 26:14 29:2  
32:22 33:15 35:11  
43:1 44:18 51:21  
52:10,21 54:4 55:11  
55:12,14 56:1 58:2,4  
58:7 62:11 74:20 85:2  
86:14 101:4 102:19  
103:20 104:2 105:3  
119:6 145:4 146:2  
152:18 154:18 156:16  
164:10 166:11,21  
169:1 173:17 178:18  
181:14 185:9 192:2  
206:5,7,13 208:21  
212:5,10 214:13  
218:16 219:3 223:8  
223:17 224:22 225:9  
227:2,5,9 229:4  
231:17 237:6 242:3  
256:2 257:3 258:18  
262:19 264:3,13  
272:11 273:3 278:1  
279:12,15 282:6  
292:4,7,14 297:11  
302:17 304:3 306:13  
308:14,15,18 310:14  
312:14,16  
**worked** 9:6 19:14 32:17  
45:9 83:2,7 167:1  
204:6 270:2 305:12  
312:9  
**working** 3:3,4,7,11 6:1  
6:2 12:19 29:10 31:11  
32:8,10 33:7 40:9  
43:8,22 44:17 46:15  
47:11,21 48:13 50:5  
51:10 52:22 67:12  
78:2 82:15 84:11  
89:15 101:3 105:11  
106:11,11,17 108:19  
124:8 147:4 148:1  
150:8 156:15 157:14  
161:21 162:18,21,22  
165:5 166:3 171:5,5  
172:12 187:12 207:3  
209:9,10,11,18  
214:16 216:7 217:13  
222:10,11 227:3,14  
239:4 243:11 267:22  
295:21 297:21 302:6  
303:11 306:1 307:10

314:18  
**workload** 53:20 313:21  
314:5  
**workloads** 227:17  
**works** 5:12 22:9 57:4  
93:16 172:21 173:12  
**world** 21:6 41:12 42:14  
46:9 57:5 59:4 71:9  
77:11 92:4 95:5,8,15  
95:21 115:21 165:21  
165:22 236:3,4  
240:17 270:18 276:3  
278:20

**world's** 11:1  
**WorldCom** 191:9,12  
**worldview** 95:5  
**worried** 273:5  
**worries** 177:7  
**worrisome** 249:19  
**worry** 113:16 129:13  
**worse** 117:4,15,20  
232:21 233:6  
**worth** 241:13  
**worthwhile** 261:16  
294:22  
**worthy** 218:15  
**wouldn't** 43:13 129:8  
132:20 141:14 181:13  
285:9 298:20 312:3  
**wrap** 55:13 138:1 141:1  
282:4  
**wrapped** 142:7  
**wreck** 309:22  
**write** 145:1 201:10  
202:18  
**writing** 200:19  
**written** 29:3 40:21  
41:10 45:20 73:6  
74:16 160:7,15 167:9  
167:22 174:17 175:3  
175:8 176:12 188:3  
**wrong** 35:6 150:12  
160:20 190:4 200:16  
240:16,21 252:10,14  
252:14 257:5 296:7  
299:7 307:21  
**wrongdoing** 190:19  
**wrote** 182:2 305:6  
311:15  
**Wyden** 203:8

---

**X**


---

**X** 244:8 245:10  
**XBR** 95:16  
**XBRL** 56:14,15 92:5,20  
93:17 95:12 96:7,12  
96:20 299:5 311:6

---

**Y**


---

**Y** 245:10  
**yard** 274:11  
**year** 21:11 22:4,16,19  
23:5 33:17 38:22 44:8  
47:17 48:13 50:6  
51:16,17 61:8,9 63:14  
65:17,18 66:7,8 69:18  
70:7,18 75:2,4 76:16  
87:9 88:12,14,14  
109:6 122:19 147:13  
168:22 169:3 198:20  
209:9 211:8,11,12  
212:16,17 217:20  
218:7 219:6 227:6  
229:14 230:21 232:1  
248:14 249:3 263:1  
263:20,21,21 267:17  
290:4 292:4 300:20  
303:4,4 305:14  
307:10 308:7 314:3  
315:11  
**year's** 128:2 209:11,18  
**years** 5:4 7:6 12:6 16:2  
24:5,15 27:19 30:22  
32:9,18,21 33:19 34:4  
34:14 35:13 38:4,20  
50:11 52:1 55:18  
67:12 69:17 70:1 73:9  
73:12 74:15 75:10  
108:4 109:21 121:16  
126:5,5,6,22 127:20  
144:4,6 154:8 162:8  
165:22 171:7 186:22  
199:15 204:12 213:2  
213:4,5 214:6 220:9  
225:8,10 227:22  
230:22 232:12 234:11  
241:13 248:17 250:1  
254:22 257:19 260:6  
262:21 263:4 264:2  
268:3,13 269:9  
289:21 292:3 294:3,8  
305:11 308:15 310:5  
310:22 315:20 322:14  
**yellow** 43:4 46:4 160:1  
165:7 169:2 170:11  
194:21 198:17  
**yesterday** 4:19 11:15  
12:18 15:21 30:1 33:1  
117:12  
**yesterday's** 29:16 49:6  
218:13  
**York** 23:13 100:1  
166:17  
**you's** 312:8  
**Young** 166:22 173:14  
175:5,10

**younger** 269:13

---

**Z**


---

**Z** 245:10  
**zero** 221:18,18 262:20

---

**0**


---

**01** 116:17

---

**1**


---

**1:00** 145:16  
**1:07** 145:18  
**10** 33:7 279:14  
**10-K** 114:19 131:21  
132:8  
**10:00** 33:9  
**10:52** 97:14  
**100,000** 161:5  
**103** 199:3  
**105** 199:3  
**10A** 45:3 153:5,8  
156:19 175:21,21  
176:9 177:3 203:2  
204:4  
**11:00** 97:11  
**11:10** 97:14  
**1105** 89:7  
**12** 54:12 73:9,12  
**12:09** 145:18  
**120** 73:9  
**12b-20** 80:12  
**14** 180:14 196:3 219:5  
**140** 21:13  
**1400** 1:10  
**15** 73:12 97:10 109:21  
250:1  
**15-minute** 206:15  
**150** 3:8 21:15  
**16** 136:5  
**18** 108:4 128:3  
**180** 3:10  
**1970s** 101:15,20 167:9  
**1980** 100:6  
**1989** 41:10 150:11  
**1990's** 248:13  
**1995** 153:8  
**1996/2003** 158:1  
**1st** 221:22

---

**2**


---

**2** 117:19 246:17 267:6,8  
267:9  
**2:27** 206:18  
**2:44** 206:18  
**20** 12:6 21:19 109:21  
110:21 238:13 279:14  
**2001** 259:19  
**2002** 259:18



<b>2003</b> 41:11 150:12	<b>400</b> 21:14
<b>2003/2004</b> 258:5	<b>401</b> 80:13
<b>2007</b> 20:2 187:3 197:21	<b>42</b> 219:7,8,19 243:18
<b>2008</b> 50:20 187:3	265:21,22 290:15,21
222:10	<b>43</b> 243:18
<b>2011</b> 223:8	<b>45</b> 208:2
<b>2012</b> 212:16 213:19	<b>47</b> 31:19 219:7
217:14	<hr/>
<b>2013</b> 51:6 52:22 209:7	<b>5</b>
209:14 214:15 217:15	<b>5,000</b> 161:4
217:16,19 227:3,14	<b>5:12</b> 323:6
229:15,20 231:21	<b>50</b> 21:18 30:10 50:12
242:10 247:9	93:11 194:11 213:3
<b>2014</b> 198:4 218:1	<b>500</b> 129:8
<b>2015</b> 51:13 198:21	<b>54</b> 213:3
212:16,16 218:2	<hr/>
223:11	<b>6</b>
<b>2016</b> 78:2 113:11	<b>6</b> 152:18
<b>2017</b> 1:7	<b>6,000</b> 271:2
<b>2018</b> 17:22 219:22	<b>60</b> 21:20
<b>2019</b> 219:22	<b>606</b> 78:10
<b>2020</b> 219:22	<hr/>
<b>206</b> 3:12	<b>7</b>
<b>20s</b> 213:1	<b>7</b> 20:2 73:6 145:1
<b>22</b> 21:22	152:18
<b>239</b> 3:15	<b>70s</b> 167:22
<b>24</b> 1:7	<hr/>
<b>2405</b> 41:10 45:4 150:11	<b>8</b>
153:7 156:19 157:19	<b>8-K</b> 205:11
290:9	<b>8:59</b> 4:2
<b>25</b> 219:20 220:1 221:12	<b>80's</b> 310:6
221:13 234:5	<b>80-odd</b> 16:2
<b>270</b> 21:12	<b>80s</b> 116:15
<b>2701</b> 89:7	<b>85</b> 101:20,21 172:8
<b>28</b> 51:14 218:3 234:5	259:4 262:19
<hr/>	<hr/>
<b>3</b>	<b>9</b>
<b>3.2</b> 248:16,16	<b>9:00</b> 1:11
<b>30</b> 50:10 123:9,17	<b>90</b> 30:18 126:1
188:13 208:2 213:1	<b>90s</b> 205:4
220:2,3 221:15,19	<b>91</b> 117:13
<b>30,000</b> 299:18 301:6	<b>92</b> 118:4
<b>306</b> 3:17	<b>95</b> 122:5
<b>31</b> 220:10	<b>96</b> 118:7
<b>323</b> 3:19	<b>97</b> 3:6
<b>33</b> 3:3,4 137:13	<b>97.5</b> 273:14
<b>330</b> 29:9	<b>98</b> 116:17
<b>34</b> 126:22	<b>99.1</b> 273:18 312:1
<b>35,000</b> 301:6	<b>99.4</b> 273:19
<b>365</b> 263:1	
<b>37</b> 265:22	
<hr/>	
<b>4</b>	
<b>4</b> 3:2	
<b>4.5</b> 117:18	
<b>40</b> 22:19 123:10,17	
221:14 310:4	
<b>40,000</b> 279:14	

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: 10-24-17

Place: Washington, DC

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