NOTICE: This is an unofficial transcript of the portions of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on October 13, 2010 that relate to the final rule, A Firm's System of Quality Control and Other Amendments to PCAOB Standards, Rules, and Forms. The other topics discussed during the October 13 meeting are not included in this transcript excerpt.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

SAG MEETING

National Association of Home Builders

1201 15th Street, Northwest

Washington, D.C.

October 13, 2010

9:34 a.m.

PARTICIPANTS

Moderators:

MARTIN BAUMANN

Participants:

BELLA RIVSHIN	DAMON SILVERS
JENNIFER RAND	DOUG ANDERSON
JIM COX	GAYLEN HANSON
NERI BUKSPAN	STEVEN RAFFERTY
JAMES SCHNURR	IAN DINGWALL
JEFF MAHONEY	DAN GOELZER
JOHN WHITE	PETER PROESTAKES
CHARLEY NIEMEIER	WAYNE CARNALL
GAIL HANSON	JENNIFER RAND
SAMUEL RANZILLA	ARNOLD SCHILDER
MARGARET FORAND	KURT SCHACHT
ANTHONY KENDALL	DENNIS BERESFORD
BILL GRADISON	PAUL SOBEL
ARCH ARCHAMBAULT	KEITH WILSON
BOB DACY	KEVIN REILLY

PARTICIPANTS CONTINUED

BARBARA ROPER	BRIAN CROTEAU
DOUG CARMICHAEL	LYNN TURNER
GARY KABURECK	KURT SCHACT
WAYNE KOLINS	STEVE HARRIS
MARY HARTMAN MORRIS	HELEN MUNTER
SHARON FIERSTEIN	GREG SCATES
PAUL BIJOU	

P R O C E E D I N G S

[9:34 a.m.]

MR. BAUMANN: Okay, it seems like things are now fully in order, so if we can begin this meeting of the Standing Advisory Group, that would be great.

I'm Marty Baumann, Chief Auditor and Director of Professional Standards at the PCAOB and I'd like to welcome everybody here today to the start of our two-day meeting. Hopefully -- we have a lively agenda, and we look forward to some outstanding input from the members of the SAG, as usual.

This meeting, like all SAG meetings, is being webcast, so I'd also like to welcome those who are listening in. I'd also like to welcome Peggy Forand who is not here, but will be participating by teleconference, and I'd also like to welcome everybody else in the room, observing the observing the meeting.

Before we begin the meeting, I thought that I'd just spend a few minutes going through the

agenda for the next day and a half just to give you a flavor of what we'll be doing. So, if you can just take a quick look at the agenda. In a moment or two, I'll turn the microphone over to our Acting Chairman Dan Goelzer, who will give you an update on a variety of PCAOB matters. After that, I'll lead a discussion updating you on PCAOB standards-setting activities, including activities over the 12 months, including an update in terms of previous SAG discussions and where we are with respect to those items today, and then finally, a discussion of the items that are on our standard-setting agenda. That's going to be about an hour and a half set aside for that.

One thing I will mention, during that session please raise your tent cards at any time throughout that session to make a point about any of the items I'm discussing or any other points you'd like to make, rather than holding questions to the end. I'd like to make that discussion as interactive as possible.

First thing this afternoon, we're going

[Break]

MR. BAUMANN: Well, the next subject and final subject for the day on our agenda deals with designing and implementing a system of quality control. As I mentioned this morning, the Board has quality control standards and other standards that we adopted from the SEC practice section as part of our quality control interim standards as well.

You heard Helen say in her comments that the findings that are in the 4010 report do provide some evidence of needs to improve quality control systems within the firms. While additional root cause analysis is necessary, there’s certainly leads you to that conclusion to a certain degree.

Also, the other recurring deficiencies that we see in inspection reports raise some questions about quality controls as well.

So as firms that continue to work and improve their quality controls, we’re looking at our existing quality control standards, and considering in what ways they could be improved to further enable improvements overall in quality controls, which are very important to the practice.

So we have a discussion today that we have the briefing paper that was sent out to the SAG members and a discussion that will be led by Greg Scates and Brian Degano. So with that, Greg?

MR. SCATES: Thanks, Marty. The purpose of our final discussion today is to get your views on topics relating to the design and implementation of systems of a quality control for the accounting firms.

As Marty mentioned this morning, we anticipate issuing a concept release on quality controls in the second quarter of 2011. Before we get started, I’d like to first briefly review our agenda. We’re going to start with a background discussion of the development of the quality control standards that were adopted by the Board, followed by an overview of the Board’s quality control standards that we have today. And that will be followed by the -- a discussion of the PCAOB’s evaluations of the firms’ systems of quality control.

And after that, we plan to have a brief session, a Q and A session at that moment. And then, following that Q and A session, then that will -- then we’ll go into our discussion topics that we outlined in the briefing paper.

And now, I’d like to turn over to the first item, the development of the quality control standards. Doug Carmichael, the PCAOB’s first Chief Auditor, will provide some remarks about the development of the quality control standards. Doug?

MR. CARMICHAEL: Thank you, Greg. The -- there’s been an interplay throughout the development of the quality control standards between those standards and peer review or in the PCAOB's structure inspections.

The process really began in August of 1972 when there was an activist Chief Accountant at the SEC named Sandy Burton. And as a result of a settlement of a two-way proceeding against a firm generally known as Laventhal and Horowath (phonetic), there was an agreement that they would have a peer review of their practice.

And at the time, there were no standards for doing that kind of review or the criteria that would be used for it. And that naturally raised the question of the need for quality control standards.

Sandy Burton thought that there should be a panel review. And people at the AICPA and particularly the -- under the influence of the firms were pushing for a firm on firm review. And that discussion continued for some time.

In between the beginning and the end of that discussion, a very important factor came along. And that was the equity funding fraud. Equity funding became known to the public. The inklings came out in March of 1973. And by April of 1973, it was clear that there was a huge fraud. And it's hard, given the number that we've experienced since that time to get some sense of what it was like, but the accounting profession clearly believed that the public fallout from that fraud had severely eroded confidence in the accounting profession. And when there were Congressional hearings, the Moss-Metcalf (phonetic) hearings, Congressman Moss described it as a great scandal that had shaken the country. And that was probably not too much of an exaggeration.

The SEC, through its chairman Brad Cook (phonetic), summoned all the people involved. And Equity Funding was an insurance company and a broker-dealer. So it had insurance regulation, broker-dealer regulation. It was a public company. It was audited by different firms, but the major problem was that a relatively large firm had acquired a very small firm that was the equity funding auditor, and really hadn't changed the audit team. And in some people's estimation, they're not supervised. The audit, in that sense, properly.

So by the time the Laventhal and Horowath (phonetic) review was agreed on, which was October 1973, it was agreed that the AICPA would appoint a panel to do the review. And, again, it pointed to the need for quality control standards, the criteria to use in doing that kind of review.

So the Auditing Standards Board did have a project underway. And it was initially titled Project on Supervision. And these events made it clear that were really two broad aspects of supervision. One was the supervision during an individual audit. And the other was the supervision by a firm of its audits.

So a task force was appointed. The task force chairman was Tom Holton (phonetic). He was a partner at what was then called Peat Marwick, now KPMG. And he had been a past chairman of the Auditing Standards Committee. And in addition to his competence, was appointed to the task because of his can do attitude. He had a way of just getting things done.

So he got the quality control standards done. There were nine elements of quality control then. We have fewer today, but that’s mainly just a consolidation of some of the nine. The AICPA proceeded to try to put together a voluntary peer review program. There were a lot of disputes about that. Peat Marwick volunteered to have the first peer review and believed that a firm on firm review was appropriate. And they engaged Lloyd Haskins and Sells to do the review.

Then there was a dispute about whether it -- the results of a peer review could be made public. Under the voluntary quality review program, some firms were concerned that a firm that successfully passed a review would be viewed as a better, higher quality firm that one that hadn’t passed. And so, there was objection to making the results public.

There was a special committee formed. And all of the quality control standards were there. It wasn’t until 1977, as indicated on the slide, that the AICPA proposed and developed a division for firms with an SEC practice section and a small company practice section that had a requirement for a peer review.

Up through that time, the quality control standards had been issued by the Auditing Standards Committee. A separate peer review committee was set up that was in charge of developing the quality control standards for a firm and the standards for how you do it did a peer review.

And ultimately, their first standard, the statement on standards of quality control, well, number one, was issued in November of 1979, superseding SAS Number 4 and a brief statement on auditing standards was put in the authoritative standards, which we still have today, that pointed out that if a firm should develop its quality control standards.

So that's a brief history. Stepping back from that, the things that I want to observe are that at least in the initial development through where we are today, the primary focus in developing the quality control standards was to provide criteria that would inspire user confidence. In other words, the viewpoint was more the confidence would -- that would inspired in the investment public by knowing that there were quality control standards and that there was some mechanism for firms adhering to them had been more important than developing -- than helping firms to develop the standards.

In other words, firms didn't necessarily believe that they needed help in figuring out what the quality control measures would be. The development of standards, coupled with a peer review was designed to inspire investor confidence.

I was also struck by the fact that the whole process got started, and we really pushed by regulatory and disciplinary pressure. In other words, there wasn't so much internally generated as pushed from those outside factors. Those are the significant things.

I -- the other thing I noticed about the standards was that from the very beginning, they had a degree of scalability built into them, since they necessarily pertain to firms of dramatically different size and reach. And that that certainly is one of the problems in developing quality control standards, as maintaining that scalability, because it's obviously the -- an area where the cliché of one size does not fit all certainly applies.

MR. BIJOU: Thank you, Doug. I appreciate those remarks as we get started this afternoon for this final discussion.

I'd now like to turn our discussion over to Brian Degano, Associate Chief Auditor, who's going to give an overview of our quality control standards. Brian?

MR. SCATES: As you can see on the slide, our current quality control standards include QC-20, QC-30, and QC-40. And there's also certain requirements from the SEC practice section that Doug had mentioned, that have also been adopted by the Board.

And we'd like to give a brief overview of each of those standards. Next slide.

QC section 20 provides most of the overall guidance on designing and implementing a system of quality control. It defines a system of qualitative control. It outlines the elements of quality control and provides guidance on the administration of a quality control system.

QC-20 defines a system of quality control. As a process to provide a firm with reasonable assurance that its personnel comply with applicable professional standards and the firm standards of quality.

A firm system of quality control, according to QC 20, encompasses the firm's organization structure and the policies adopted and procedures established to provide reasonable assurance of complying with professional standards.

And as Doug had mentioned, the standards are very much written to be scalable for all different sizes of firms. And QC-20 notes that the nature, extent, and formality of a firm's quality control policies and procedures should be appropriately comprehensive and suitably designed in relation to factors such as the firm’s size, the number of its offices, the degree of authority allowed its personnel and its offices, the knowledge and experience of its personnel, and the nature and complexity of the firm’s practice.

QC-20 also notes that a system of quality control should provide a firm with reasonable assurance that the segments of the firm’s engagements that are performed by its foreign offices, or by its domestic or foreign affiliates are performed in accordance with professional standards.

And as shown as this on the slide, QC-20 requires that five specific elements be encompassed in a firm’s system of quality control and its policies and procedures.

The first element is independence, integrity, and objectivity. And firms need to establish policies and procedures to obtain reasonable assurance that its personnel maintain independence, and perform all professional responsibilities with integrity, and objectivity.

Another element required by QC-20 is personnel management. And a firm needs to have quality control policies and procedures that provide the firm with reasonable assurance that the people that the firm hires possess the appropriate characteristics to enable them to perform competently. The firm assigns work to people having the degree of technical training and proficiency required in the circumstances. Partners and staff participate in general and industry specific continuing professional education and other professional development activities to enable them to fulfill their responsibilities assigned to them, and to satisfy applicable continuing professional education requirements. And that the personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities that they will be called on to assume.

Another element that's required to be in a system of quality control is quality control policies and procedures regarding the acceptance and continuance of client relationships and engagements. And a firm is required to establish policies and procedures for deciding whether to accept or continue a client relationship, and whether to perform a specific engagement for that client. And those policies and procedures need to provide reasonable assurance that the firm undertakes only those engagements that the firm can reasonably expect to be completed with professional competence and that the firm appropriately considers the risks associated with providing professional services in particular circumstances.

Another element required by QC-20 is engagement performance. And a firm needs to establish quality control policies and procedures to provide the firm with reasonable assurance that the work performed by engagement personnel meets applicable professional standards, regulatory requirements, and the firm's standards of quality. Those policies and procedures encompass all phases of the design and execution of the audit engagement and include planning, performing, supervising, reviewing, documenting, and communicating the results of each audit engagement.

Those policies and procedures also need -- also should include policies and procedures to provide reasonable assurance that the firm's partners and staff refer to authoritative literature or other sources and consult on a timely basis with individuals who have the appropriate levels of knowledge, competence, judgment and authority.

The last element that QC-20 requires firms to include in their systems of quality control is monitoring procedures. And a firm needs to establish policies and procedures to provide the firm with reasonable assurance that the policies and procedures established by the firm for each of the other elements of quality control have been suitably designed and are being effectively applied.

Monitoring involves an ongoing consideration and evaluation of the relevance and adequacy of the firm's policies and procedures, the appropriateness of the firm's guidance, and practice alerts, effectiveness of professional development activities, and the compliance with the firm's policies and procedures by its personnel.

And we'll talk a little bit more about monitoring when we get into QC-30, which gives more advice on monitoring.

QC-20 also describes how these elements are interrelated. It notes through examples that maintaining integrity, objectivity, and independence requires a continuing assessment of client relationships. It also notes that quality control policies and procedures regarding personnel management, such as hiring and advancement, and assignment of the firm's personnel to engagements can impact policies and procedures developed to address the element of engagement performance.

QC-20 also gives guidance on the administration of a system of quality control, and notes that to provide reasonable assurance of the firm's quality control system, achieves its objectives, appropriate consideration needs to be given to the assignment of quality control responsibilities within the firm, the means by which quality control policies and procedures have been communicated, and the extent to which the policies and procedures and the compliance with those policies and procedures need to be documented. Next slide?

QC Section 30 provides additional guidance to firms on how to implement the monitoring element of a quality control system. And it notes that monitoring procedures taken as a whole need to enable the firm to obtain reasonable assurance that its system of quality control is effective.

The firm's monitoring procedures could include, for example, the analysis and assessment of items such as new professional pronouncements, the results of its independence policies and procedures, a review of continuing professional education and other development activities undertaken by firm personnel, and decisions related to acceptance and continuance of client relationships and engagements.

The firm's monitoring procedures may also include internal inspection procedures. A firm's internal inspection procedures should evaluate the adequacy of a firm's quality control policies and procedures, a firm's -- a firm personnel's understanding of those policies and procedures, and the extent of the firm's compliance with its own quality control policies and procedures.

The extent of inspection procedures depends in part on the existence and effectiveness of other monitoring procedures. Factors to be considered include, among other things, the nature, complexity, and diversity of the risks associated with the firm's practice and the results of recent practice reviews and previous inspection procedures.

The adequacy of and compliance with a firm's system of quality control can be evaluated by performing such inspection procedures as reviewing engagement working papers, reports, and client’s financial statements, summarizing findings from inspection procedures, and considering the root causes of findings that indicate improvements are needed, and determining corrective actions that need to be taken, or improvements that need to be made with specific engagements reviewed or the firm’s quality control policies and procedures.

QC-30 also recognizes that in small firms with a limited number of management level individuals monitor and procedures may need to be performed by some of the same individuals who are responsible for the compliance with the firm’s quality control policies and procedures, and provide some guidance on this matter.

QC-40 provides additional guidance on the element of personnel management in relation to engagement partners. And it notes that a firm’s quality control policies and procedures should be designed to provide reasonable assurance that an audit engagement partner possesses the appropriate competencies in light of their significant responsibilities in planning and performing an audit.

QC-40 defines competencies as the knowledge, skills, and abilities that enable an engagement partner to be qualified to perform an audit engagement. And QC-40 also notes that a firm’s expected to identify those competencies that are necessary in the individual circumstances.

And as noted on the slide, QC-40 includes several examples of competencies that firm's quality control policies and procedures should address. So for example, an engagement partner should possess an understanding of the firm's quality control systems and the code of professional conduct. An engagement partner possess an understanding of how to perform an audit, including performance, supervision and reporting aspects of an audit engagement. The engagement partner should have technical proficiency, a familiarity with the industry in which they're working. Their skills should also include professional judgment and an understanding of information technology systems that may be used by the firm under audit.

And with that, I'll turn it back over to Greg for the remainder of the discussion.

MR. SCATES: Okay. Thank you, Brian. The last item with -- in addition to QC sections 20, 30 and 40, the Board also adopted as part of its interim quality control standards certainly membership requirements from the SEC practice section. Those were outlined on the fly. There are actually six. And I'll talk about the sixth one in just a minute, but let's briefly go over those first five requirements from the SEC practice section.

Also, I might mention that as Marty noted this morning in the standard setting, look at the standard setting agenda, those -- these SEC PS requirements are applicable to only those firms that were members of the SEC practice section as of April of 2003.

The first bullet there, it has to do with the firm personnel. It requires that all professionals in the firm residing in the U.S. participate in a minimum number of continuing and professional education hours. It’s at least 20 hours every year, and at least 120 every three years.

This is so much similar to some of the requirements there on the state boards of accountancy. And the state boards in this country oftentimes have more stringent requirements.

The second one has to do with a -- requires the firms to communicate through a written statement to all professional personnel the broad principles that influence the firm’s quality control and out bearing policies and procedures on matters related to the recommendation and approval of accounting principles, present and potential client relationships, and the types of services provided, and inform professional firm personnel periodically that principles is mandatory.

There’s an illustrative statement, written statement, as a part of the Appendix 2, this particular requirement.

The third requirement has to do with a notification to the commission when there’s -- when the firm has resigned. When the member of a firm has been the auditor for an SEC registrant, and the -- and has resigned or declined to stand for re-election, or has been dismissed, then the firm must report that fact that the client audit relationship has ceased in writing to the SEC -- to the former SEC client also with a copy of the latter going to the Office of the Chief Accountant at the SEC.

On the fourth bullet, for these member firms that are associated with international firms or international associations of firms then that firm is to certain policies and procedures are to be adopted by the international organization or individual for an associated firm that are consistent with the objectives. And these objectives are set out. And Colony referred to --

OPERATOR: We're sorry, your conference is ending now. Please hang up.

MALE SPEAKER: Does that mean I'm supposed to quit?

MALE SPEAKER: You're stuck. Keep going.

MR. SCATES: These objectives are set forth in what we commonly refer to as Appendix K. The Appendix K includes the following review requirements, as well as internal inspection procedures, as well as other matters. We discussed the Appendix K in our SAG meeting in October of 2007.

The last item, the fifth bullet there, requires firms to ensure that the member firm has policies and procedures in place to comply with the applicable -- all applicable independence requirements.

As I mentioned earlier, there was a sixth requirement. And that was a requirement where we were commonly referred to as Appendix E, requiring the concurring -- a concurring review requirement.

That requirement was superseded by Auditing Standard Number 7, entitled Engagement Quality Review. That was adopted by the Board in July of 2009, and approved by the SEC in December of 2009, and is now applicable to all registered firms.

That concludes our remarks and overview on the quality control standards. And now I'd like to turn our discussion over to Walt Miles, a Deputy Director in Inspections, who will provide an overview of the PCAOB evaluations of firm's systems of quality control. Walt?

MR. MILES: Okay. Thanks, Greg. I'll just spend a few minutes to talk about it at a fairly high level, our inspection processes related to the quality control -- systems of quality control with the firms.

I think we'll have some time at the end of this, a fair amount of time that people can ask more specific questions if you have. But in general, our process, you know, as I think Doug mentioned and Brian mentioned, that, you know, the quality control standards are scalable by necessity. Obviously, a small firm is very different than a larger firm. And the standards set out a variety of things to consider when designing a system of quality controls.

And in the same sense, our inspection processes vary, depending on the type of firm that we're looking at, of course.

We've listed on this slide various -- what we think of as functional areas of quality control. I think Doug also mentioned that, you know, there's been over time, there's been the elements of quality control have kind of changed. There's various ways you can group the consider -- the things that you need to consider and the areas that you need to look at.

For us, we think of these as kind of the traditional functional areas that we look at. And we design inspection procedures at each inspection to address each of these various areas.

Also, I think it's no surprise anybody here, but what I -- you know, you talk about how we go about assessing the system of quality controls, and where we get the information that we use to evaluate a firm's quality of control system.

The bulk of our evidence and the bulk of our information about the operation of the controller comes from looking at engagement performance. That's when we look at each of the individual audits that are performed and evaluate the extent to which they comply with standards.

So what we find there, you know, similar to what was in the 4010 that was talked about earlier, is we find a range of practice and that we find a number of instances in firms where there's not compliance with standards that causes us to believe that the -- in some cases, they're so significant, that they can support the opinion on an individual engagement.

So the issues are identified there. And those are -- and the quality control standards set out that a firm, of course, has to have a sufficient system of quality controls and provide a reasonable assurance that they're personnel comply with the standards.

So these engagements specific issues, to the extent that they're pervasive, are indicative of a potential problems or defects and a system of quality controls.

But of course, the difficulty you have there is that it's not real clear in many cases what it is about the system of quality controls is defective. You know that there's instances of -- there's problematic audits, but it's not exactly clear what control process is defective. And that gets back to the discussion, I think, that's come up a number of times a day about the root cause analysis and trying to figure out why are things occurring and what is it a firm needs to change about their system of quality controls to address this?

I'll come back to talk a little bit more about root cause analysis and some of the things that we're looking -- you know, some of the efforts that we undertake at the largest firms particularly to look at the monitoring of audit quality and the response to audit quality issues.

But so in addition to the engagement performance issues that we identify, we perform specific tests of the outputs of the control system. And that, I think has been, you know, traditionally, that's where our focus had been is looking at, you know, identifying when controls fail, look at the output, and did something that -- something occur that you would expect control process to have identified.

Increasingly, though, when we -- particularly in largest firms, we're spending more time looking at the design and operation of the controls themselves and looking the extent to which the controls are designed in a comprehensive way, that there's a reasonable expectation that they would be effective.

Not just testing for the output of the things of -- that may have gotten through the controls, but looking much more closely at the controls themselves.

And this is a fairly comprehensive process at the large firms. We are increasingly dedicating more inspection resources to this area. We have -- at the largest firms, we have teams of inspectors that focus on this pretty much throughout the year and perform various testing.

And we've kind of renamed more recently our processes in this area. We call it the, you know, it's the -- looking at the significant management and monitoring process of the firms as kind of the FMM process to kind of identify that aspect of what we're doing.

Am I supposed to point this at something? No, okay, all right. So a little more detail about our -- kind of our process, the inspection process. In the largest firms, you know, there -- what we do is obviously, each year, we find things that we believe are defects in a firm system of equality controls. And those things have to be followed up on. And so, we design specific inspection procedures to look at those areas and to evaluate the extent to which firms have taken remedial actions and the specific issues that we've identified.

But of course, you know, kind of stepping back a minute, you know, the largest firms, of course, there's -- it's a pretty comprehensive system of management processes and controls that are interrelated in ways that it's in any one inspection cycle, it's not possible for us to fully evaluate all of the control processes at the detail that we might like to. But what we try to do is to follow up on the issues that we've identified in the past, test those, understand the extent to which remediation has occurred. We understand the extent to which changes have occurred and significant processes and follow up on loads, understand the loads.

And then increasingly, in more recent years, we perform what we call horizontal inspection activities. And so in those cases, what we'll do is we'll take specific areas of the quality control process. We'll develop more detailed scoping documents, think about what we want to look at in more detail.

And we look at the same issues and the same processes at a number of firms at the same time. There's a number of benefits to that, I think some of which are probably relatively obvious, but it gives us an understanding of the industry and not just one firm. It lets us understand the range of practice and to think about the implications of that range of practice. And then, it helps us determine, you know, what it is that's defective in individual firms and what needs to be done and called out in our reporting process.

So I think -- I thought maybe what I would do is spend a little more time in one specific area. Obviously, of the functional quality control areas that I talked about earlier, there's lots of different things that we do in different areas, but one of the things that we've spent an increasing amount of time on in recent years is kind of the comprehensive processes that the firm's monitoring processes for monitoring and responding to audit quality. You know, I think, traditionally, people think of the internal inspection program. That's the, you know, the key process that a firm uses to understand the deficiencies that exist in a practice. And that's, you know, that's certainly a key process and a key element of a control process, but there's a, you know, there's a wider variety of things, I think, that need to be considered in a firm.

There's the internal inspection process is looking at engagements and reviewing those on a -- on some kind of a cycle to understand issues, but there's also other things in a firm that are indicative of audit quality deficiencies. There's restatements. There's litigation. There's PCAOB findings, peer review findings. There's a bunch of different things that indicative or that may be indicative of problems with quality in a firm.

And so, our inspection processes, you know, look to see the extent of which a firm -- you know, we look at the individual processes. So we look at the internal inspection program itself. And increasingly, we spent more time, you know, in addition to doing some testing of engagements that internal inspections have looked at, to see whether we agree with the findings that the internal inspectors found, and see if there's issues that they didn't identify.

We also looked to see, you know, the design of the inspection program itself, looked to see, you know, if, you know, how are they staffed? How is an internal inspection program staffed? Does it have appropriate dedication of resources at senior levels? Do they spend enough time on audits when they're looking at them? Is the scope of what they're looking at, is it sufficient? You know, doing internal inspections is not as if that isn't something that we don't have a little experience with ourselves. We're in the same business. We've learned over time that to really understand complex issues in some of the biggest audits, it takes a fair amount of time and dedication of resources to fully deal with the more complex issues. So we look at the extent to which the firm's programs allow for that, and deal with those issues.

So we look at the individual processes, like the internal inspection program. We look at the firm's processes. What do they do around restatements to understand the extent of audit deficiencies? Are the processes, you know, primarily focused at understanding accounting issues in a restatement and dealing with the accounting issue? Or are they also focused in understanding what auditing issue occurred as well to -- that didn't detect the accounting issue and the -- in the first instance.

So then we looked to see, you know, where the processes the firms have, are these -- are each of these processes in a silo'd nature? Or are there process that the firm to pool all those together and think about the extent to which those deficiencies are more -- might be more indicative of pervasive issues that are not just isolated in individual engagement performance, but are indicative of problems with the system of quality controls.

And then, look -- once there's an understanding of the issues, then we get focused on the extent to which the firms have processes for understanding root causes.

And I think this is an area that we've, you know, it -- we've increasingly focused on it the last couple years. And not only are we as the PCAOB do we need to understand better the root causes of the things that we identify, but it's a critical element of the firm's quality control processes, that they themselves undertake sufficient efforts to understand the root causes.

And that's, I think you know, that area in particular, there's a lot of, you know, probably debate or question about how best to perform root cause analysis. The extent of resources that should be dedicated to that, and how to go about doing it.

The one thing that I don't think there's any debate about, though, is that it's very difficult to do. And it's not easy to figure out what is the root cause. And in some cases, it may not be possible on an individual engagement to really know with any level of certainty what the root cause is.

But I think we also all agree, too, that the probability of success of a remedial action is enhanced significantly to the extent that you have some understanding about why it occurred.

And in many cases, you know, what you have to do, what a system of quality control will need to do is it needs to make informed judgments about why those things occurred, and then take remedial actions that are responsive to that.

Of course, the other important part is once you look at it -- how the firms deal with these issues, just look at the extent to which they've -- once they've kind of understood the issues, and why they might have occurred, to look at the linkage to the corrective action. You know, is it -- is there a systematic process for ensuring that the corrective action that is taken is -- the people that understand best why the issued occurred, are looking at the remedial action, and saying, yeah, that is dealing with the issue, and why we think it occurred, not just that the remedial action that's being undertaken is in the neighborhood, I guess, or somewhat related to the issue. But making an evaluation and ensuring that there is a linkage to what the corrective action to the cause of the issue.

And then, finally, the last thing in that area that I'll mention is the importance of kind of a follow-up monitoring procedures. Once you know you have an issue, and you believe that the issue is somewhat pervasive, and you've taken remedial action, it's important in a healthy quality control process to design additional procedures, detect procedures to determine whether the actions you took were effective or not.

And so, we look to the extent to which firms have developed, you know, either through the internal inspection process, or through other control processes, to follow-up on the issue to determine, you know make a conclusion about whether the remedial actions were appropriate.

I think with that, I'll turn it back to you, Greg.

MR. SCATES: I'd now like to open the floor up for any questions or comments on our -- this background session on our standards and on the PCAOB evaluation process of the firm's quality controls. Gaylen Hansen?

MR. HANSEN: Thank you and thanks for that great presentation. That's great background, some of which I wasn't familiar with.

Let me just say a couple things about peer review and state boards, since that was mentioned. Peer review is now required in almost every state, I think, except for one. And mandatory peer review is required in the vast majority of those states.

And one of the things that I think is critical to state boards and to NASBA (phonetic), in particular, is having some sort of regulatory oversight. So there's a lot of effort that has gone on in this area in the last few years.

We really don't even actually mention it as peer review anymore. We call it compliance assurance. And so, I think this is an area that we're really working on at state boards to try to improve.

And the significance of mandatory peer review in a small firm world was there were actually firms that would intentioinally not belong to the AICPA to professional membership organizations such as state societies, so that they could avoid having to go through a peer review process. And I can understand that majority of those are not involved in -- with auditing of public companies. Regardless, there were probably a few of those hints. They got around this requirement with the PCAOB and the SEC, because they were not a member of the SEC practice section back at the time that the interim standards were adopted.

As far as the QC standards, and I've gone through the current AICPA Standard Number 7 that came into effect about a year ago, I think it's a pretty good starting point for discussion of this subject.

My only issue with it is its strength is also its weakness. And that's it's sort of an open source document and scalable. And it has all of these different elements, but there’s not a lot of mandatory to it, like you have to have an inspection or there has to be so many hours of CPE.

And surprisingly enough, I mean, an auditor, it can be involved in a -- the audit of a public company, but be taking tax courses in CPE. So you know, it seems to me that the flexibility of this needs to be looked at as far as inspection, CPE. And independence, something as simple as independence audit now, I understand that’s required on the larger firms that are auditing more than 500 clients, but it seems to me that every firm should be going through an independence audit with their partners and -- at a minimum, their audit partners and managers every single year.

So those are -- there’s some of the things that I think would be relevance, governance, and tone it to top and so on, and compensation, and promotion of individuals. I think that it should be more than just a focus on scalability. I believe that there should be some mandatory elements.

MR. SCATES: Thank you, Gaylen, for those remarks. Wayne Kolins?

MR. KOLINS: It seems that the inspection staff would be privy to a wealth of information about practices at the firms from a quality control aspect. Has the Board staff given consideration to issuing kind of a 4010 report on best practices that other firms could look at to shore up their own quality controls to the extent necessary in the circumstances?

MR. MILES: I'll guess I'll respond and any other members of the -- the board members can respond if they'd like. I mean, I think there's been some discussion about that, that there is a fair amount of information that we're collecting over time to understand how firms quality control systems work.

And we certainly use that in our -- that understanding in -- as a background in our evaluation of individual firms. And you know, when we're discussing with firms about the deficiencies that we've observed that informs our basis for those deficiencies, and so, I guess -- what I would say, and others could respond, I think that there's a possibility it just hasn't happened yet.

MR. CARMICHAEL: I might chime in just a little bit in connection with our formulation of a concept release on quality controls, which we mentioned we plan for the second quarter of next year, in addition to getting input from the SAG and this discussion today, obviously, we're doing a lot of other work, spending time with inspections about what they're seeing in quality control systems, where they're working, where they're not working, etcetera to quality of the root cause, and the effectiveness of root cause analysis at firms and so on and so forth.

I think that should lead us to concepts and discussion in the concept release, which would be asking questions of others about would you think this would be an appropriate way to go forward with respect to potentially enhancing the quality control systems? And I think the basis for some of those thoughts would be best practices, if you will, that we'd observe or discuss together.

So if we didn't do that, otherwise, I think that we come out to a large degree in a concept release.

MR. SCATES: Kevin Reilly?

MR. REILLY: Greg, I was just reading through the paper. I was troubled by and confused by one statement. So let me just read it to you on the top of page 5. "The PCAOB has pressed firms to take more significant steps to address what may be deeply rooted management and cultural impediments to audit quality." So that's a very troublesome statement. I don't personally believe it's operative relative to the profession. But holy smokes, if you believe that, I'm not so sure putting together 10,000 pages worth of quality control guidance is going to address this type of issue. So I would just appreciate some clarification on that statement?

MR. MILES: I'm not -- Greg will probably want to respond to something. I mean, I can talk from an inspections perspective, I guess, as kind of respond to that issue. What exactly is not in the paper, Greg may want to elaborate on that.

But I mean, I think the thing is that there -- there are instances, individual engagement instances where I think it's when you look at the root cause and try to determine why things happened, you might get to a range of conclusions, some of which could be very troubling, just like you mentioned.

Now to the extent to which that's a pervasive issue in a firm or in an industry, and if that is the issue that has be addressed, obviously, addressing that issue is a very significant thing, and probably the most significant thing that you can deal with in a firm.

I don't think, you know, I don't know what was meant exactly in the paper, but I don't think that statement in the paper is meant to imply that we believe that that is the issues in firms in general, and that that is -- or that that is the primary issues that firms are dealing with. But Greg, you may want to say something or Marty?

MR. SCATES: Yeah, Kevin, that line is actually from the 2009 annual report as it's footnoted. It's not meant to be indicative of the profession as a whole. It's a line that just talks about how the board has tried to go out and do inspections and some of the things that it's been doing. It's not directed to the profession as a whole at all. It's just saying that, you know, in response to successful inspections, it's for individual firms that might have needed extra work. So it's not meant to cast a shadow on everybody.

MR. REILLY: I got to tell you, it definitely casts a shadow. I don't mean to sound defensive, but that type of statement is really dangerous. And to the extent that it's out there in the paper. And if it's not what you specifically thought it was going to mean, I can only tell you as a reader, I took a look at that and said, holy smokes, folks, if this is your view, I think we're talking about the wrong issue. This is not going to be a quality control issue. This is a much broader issue facing the profession.

And Ron, I hear you, but that's not the language that was in the 2009 annual report at least as I tried to connect the dots.

MR. SCATES: All right, thank you, Kevin. We'll -- Barbara Roper?

MS. ROPER: Yeah, I mean, I actually had exactly the opposite response to that language, because it seems to me that it reflects a realization on the part of the board that not every problem can be addressed just by a new standard, that there's a range, I mean, that certainly there should be a range of remedies. It's very difficult for me sitting in this position to know what part of this problem we solved through standards, what part of this problem we solved through sort of tougher remediation requirements, what part of this problem we solved through enforcement actions.

But the report suggests to me that there’s a role for all three of those. And I assume that the Board is engaged in all three of those activities.

And you know, an acknowledgement there, in some cases, the problem is not just a problem with the standard, but a problem with more deep seeded, cultural impediments in the firms to getting this stuff right, I think, is actually a healthy view for the Board to keep as part of its broad spectrum of analysis of issues at the firms.

MR. GOELZER: Maybe I should just say I’m not sure, Kevin, I understand want your problem with the statement is. I think it is an accurate statement of findings in the QC part, the non-public part of certain inspection reports. I think this has already been said. It’s -- that’s not meant to be a statement about every firm that we’ve inspected or a pervasive statement about firm quality controls, but I just -- it’s an accurate statement about certain situations that we’ve looked at, where we feel there are deeply rooted management and cultural impediments to audit quality. So I don’t find anything misleading about that statement.

MR. REILLY: And Dan, you know, again, forgive me. It’s just my confusion that in the context of reading the paper, I thought it was taking a look at profession issues across the board, not specific to what you're findings might have been with one particular inspection.

MR. GOELZER: Well, I think it applies to more than one, but it's not meant to be a broad statement necessarily about firms everywhere, but there certainly are, I would say, important significant situations where that's -- we've made that finding and we've applied that kind of pressure.

MR. SCATES: Lynn Turner?

MR. TURNER: I can certainly understand why the PCAOB would be making that statement and given some circumstances that have popped up in recent years. In one year, we had the Japanese regulators shut down a firm, an entire firm in Japan. We've had serious problems raised with respect to a firm in India. And a year ago, we had the regulators raid the offices of a firm in Hong Kong over issues of integrity.

So it's certainly outside the U.S., it's certainly consistent with what we've actually seen occurring, and probably raises the issue of, you know, are the quality control systems, what they need to be. And perhaps it's more serious than just quality control to the point that Kevin is making.

As I look through the paper, and the questions you raised in the paper, I think it does cause you to go back and rethink this whole issue of quality control and how we've thought about it in the profession ever since the first systems were put in place in the early ‘70s as Doug described.

I think more recently, we have what has been happening with compliance to improve controls in the 40 ad companies, and how the SEC has approached that with respect to compliance inspections and compliance reports, and establishing accountability for those systems.

And now we certainly have with respect to the credit rating agencies a new system going in there, both of which have some superior components to them, that we don’t have in the auditing profession, especially with the notion of a Chief Compliance Officer, who has to oversee the entire compliance program, and who has to report up through an independent source to the top, and a governance mechanism established over that. And what will be, in essence, a public, or is a public compliance inspection report.

And I think that’s something that certainly needs to be considered here in the context of quality control. I think they’re -- when you look at the components of quality control, a piece that I think is lacking there is a specific item that gets into the issue of how do you establish accountability and responsibility for this and bring that forward in the context of transparency?

I know when the ISO rules originally went in for manufacturing people, everyone went in and adopted those rules, and put systems in place. But what we found in manufacturing companies was that people put a lot of emphasis on process. And everyone had processes.

But the defect rate never went down. And so, I think you have to look to more than processes. You have to look at the actual outcome of the process, and see if it's actually getting the defect rate down to what it, you know, what it's supposed to be.

And hopefully here, we have an -- you know, we'll never get to zero defect rate on audits, but I would certainly hope that that's our goal and objective even though we might not change it. But I do think we have to look well beyond just process here. And we have to start looking at not only how they've been designed, but is the design not only -- and are we testing not only what it is, but are we testing what it should be. Especially as the markets and economic conditions change, are we changing that system? And that includes in the international process as we become more global and international and the international audits become a much more important piece, do we have the right systems? Do we have accountability? Do we have someone in essence at the top of these big firms as well as the smaller firms that are ultimately responsible in that -- for that quality control system, not only here, but wherever that audit reaches around the globe.

And that's not only for the Big 4. That's a serious question for these affiliates of some of the smaller firms, where they're kind of a consortium of groups. And you may have McGladry here or you may have an affiliate some place else, but in that case, who is really responsible? And who can the PCAOB really hold accountable?

If there's someone to be held accountable because the system isn't working, who do you point to? And unfortunately, we've seen the firms where everyone points the finger at one another. And it's not me. And I think that has to be considered in this context of quality control as well.

MR. SCATES: Thank you, Lynn. Bill Gradison?

MR. GRADISON: I'd like to comment on the question of cultural factors. And what I want to offer is purely personal observation and truly just an hypothesis.

But it is based upon reading maybe 1,000 inspection reports over the last eight years, thinking about it. I think there is a cultural problem in many instances, which goes to the question of what does it mean to be a professional? I think that many professionals are accustomed by the time they become a partner of a law firm, or get their medical degree, or get their -- become partner of a big -- a very large accounting firm, to feel that they have the experience and the know how to operate with a high degree of independence, and truly don't expect to have people looking over their shoulder.

I worked for a law firm. I don’t remember anybody in the front office taking a look at the things I was sending out to clients. Typical physician, they’re seeing more of that now, but I think that in the small group, physicians at least, that they’re accustomed to that kind of review at all.

What I don’t know is whether there’s any -- first, whether it has anything to do with what I’m suggesting, because if there is, there -- we might detect some difference between newer partners and those who have been around for a while, because the newer ones are coming into a regulatory environment that’s been around for eight years.

Now whereas others may have grown up in a period when there was less centralization of oversight within the firm itself, forget us, within the firm itself.

I think at times, that in terms of best practice, and again, just my observation, that the firms that seem to be doing the best, and they’re not all equal, that seem to me to be doing the best in terms of quality controls are the ones that have a significantly higher degree of centralization in these areas than others. I can’t prove that, but I wouldn’t quickly dismiss the possibility that cultural factors were of significance.

MR. SCATES: Thank you, Bill. Jeff Mahoney?

MR. MAHONEY: Thank you. I just note there’s maybe somewhat similar language in the audit inspection unit report of the U.K. professional recite board. And their July 21st report under audit quality major firms, they state notwithstanding the quality of firms policies and procedures, the number of audits assessed is requiring significant improvement at major firms is too high. Firms are therefore not always consistently applying their policies and procedures on all aspects of individual audits.

It goes on to say policies and procedures, however, can only go so far in supporting, encouraging desirable behaviors to delivery audit quality. While firms are willing to change to these, and to provide additional training to staff, such actions will be insufficient without effective behavioral change, which is more difficult to achieve.

So it seems like maybe some of that language is somewhat analogous to the language you have in your paper.

MR. BAUMANN: I think it is, Jeff. And I think it's a good point. And I appreciate that input. We had a meeting just about a month or so ago here. And that meeting was discuss communications with audit committees. And there was a very strong sentiment of the audit committee members, who were at that meeting, that one of the most important factors driving behavior in the organizations of which they were audit committee chairs in many cases was the culture of that organization.

And equally important, and maybe even more important comment they made was the tone at the top was maybe one of the most important things that they felt was necessary to understand if they were going to understand the controls within the organization. I think that goes to this point as well. Understanding the culture of firms is very important, and what drives that culture, whether it's driven towards audit quality, driven towards profitability, whatever the major factors are in the culture, I think, are critical. And they vary from firm to firm, but that culture can affect audit quality.

I also have a question almost for you, Walt. And that is audit committee members said that they were able to observe the tone at the top and communicate to the CEO and others about the tone. And that was critical. They asked the external auditors about the tone at the top. And they felt that was one of the important communications that they got from the external auditors, so they could assess tone at the top to ensure that the organization was behaving correctly, and setting the right course.

How -- as you look at firms, where does top management of the firms hear about the tone at the top? They don't have the equivalent of an audit committee necessarily or a board that's looking at that, or hearing from external auditors. Are we the only ones who are communicating about the tone at the top to an organization? Or do the firms themselves have other ways to assess their own tone at the top, since everybody, I think, feels that's so important in other types of organizations, and probably in accounting firms as well.

MR. MILES: That's a good question, Marty. I guess the way I respond in a couple of ways, I guess. One, I think assessing tone at the top is a difficult effort for anyone to do. And so, I think, you know, we look at it in a variety of ways that we get information about the tone at the top. And it's a lot of the things that have been mentioned here. And Lynn mentioned some of them. Accountability and the kind of information that firms themselves, the way they structure themselves to get information about quality incidence, and the execution of engagements to the right people within the firm and the way that they respond to those, and the extent to which they've implemented a proactive, what I think of as a proactive management and control infrastructure, and get the right information to the right people within the firm to understand not only engagement performance, but to understand the culture within the firm, and how people are acting.

So I think the firm's own processes themselves to a variety of -- in a variety of ways, they have designed information flows to get that information to the right people. And they've set up management structures. They don't have the same governance structure that you would in a -- in say a listed entity or something like that, but they have some of those kind of things.

I think it varies, though. And I think it varies -- another thing that was mentioned by someone earlier, you know, Bill, I think, discussed it, but the extent to which firms operate in a distributed fashion on which they've allocated responsibility and accountability at a -- in a more granular way, I'm not so sure that those firms necessarily have as good a processes about understanding the culture that exists, and the extent to which it's not -- an extent to which the culture is consistent even.

And so, I'm not sure if that answers your question, but I think there's a variety of ways that we ourselves in inspections, we look at tone at the top from a number of different ways. Like I said, the actual performance of engagements, the extent to which how firms respond, the issues when they've identified them to the extent to which firms have, you know, treat their control infrastructure as what I would call, you know, something more than a compliance exercise. It's a proactive process to understand when things are occurring, and understand when the culture might be shifting or changing inappropriately, and incentives might be getting out of line. But it varies between the firms.

MR. BAUMANN: Well, I was agreeing with Barbara’s comment that she made earlier and Jeff’s reading of comment that came out of the U.K. that you can -- we can establish all the procedures we want, and as we think about our concept release and what we’re doing going forward. But clearly, the culture of the organization and the tone at the top are critical elements that will make the quality controls be effective or not in my view.

So the extent to which firms have the ability to assess those things themselves becomes critically important also.

Jim Schnurr?

MR. SCHNURR: Thanks, Marty. Just a couple of points I’d like to make. First of all, maybe to follow up on Kevin’s point. I mean, there’s other language in this paper that implies that the firms need to be motivated to promote audit quality, or to minimize incentives to not to promote audit quality.

And I take exception to that point for a number of reasons. First of all, at least in the U.S., the legal environment here causes me to go home every night and think about doing the right thing. I have a substantial amount of my net worth tied up in the firm, in the form of my capital, and my retirement, which I’m pretty close to.

So I don’t know a better motivation than essentially losing your financial wherewithal, to do the right thing. And the loss of a single client is not going to cause the firm to go out of business.

As a firm, we spend hundreds of millions of dollars a year with respect to investigations and lawsuits, etcetera. So, again, that pales comparison to just about any fee we get from a single client.

So I think in the context of looking at this issue, it’s important to put into context that an individual is motivated to do the right thing. And the fact that there are audit deficiencies in no way, I believe, you know, with few exceptions are it’s done intentionally.

We talked today about the number professional standards that require judgment. In terms of judgment, different people have different views. Not only with respect to the application of accounting principles, but also, with respect to the application of the auditing standards. I don’t think we always agree even within the firm as to what constitutes sufficient competent audit evidence.

So I think it’s important that we look at all of that in context. If you want to look at another factor that may impact audit quality, we ought to look at the reporting deadlines. Several years ago, the SEC accelerated the reporting deadlines. 60 days is not a lot of time to get an audit done with respect to some of the judgments and the estimates that need to be made. We talk about, you know, fair value. Well, if an audit form were require -- if had, you know, six months to do an audit, they could go out and do an independent calculation of fair value, get all the inputs, do the calculation independently.

We do not have six months to do that. And the capital markets will not tolerate that. So the context of what constitutes sufficient and competent audit evidence should take that into consideration.

So I just think it’s important that we keep this in perspective, as we look at the -- addressing, you know, audit standards as a motivator. Because I think there’s plenty of motivation right now.

MR. SCATES: Thank you, Jim, for those comments. Now Doug Anderson?

MR. ANDERSON: Thinking a little bit about culture, as an internal auditor, of course, like any auditor, independence and objectively is really critical. It think one of the differences internal and external audit is objectivity has a different context for an internal auditor, because any internal audit has got to recognize that if you do your job right, and really act with objectivity, you clearly could put your career at risk with that employer. And I don’t think any Chief Auditor or audit executive would take the job without recognizing that they clearly lose their jobs with that employer by doing the right thing if they maintain their objectivity.

So as I think about that role as an internal auditor, the concern of objectivity, the concern isn't so much that somebody just goes off reservation. One of my staff just purposely makes a wrong decision. The real risk is you get seduced into losing your perspective. And you get seduced into lose your objectivity and make a bad call and accept something you shouldn't.

And I've always felt that the largest projection against that is culture, making sure the firm and the organization's got the right culture that really prevents somebody from being seduced in that way to losing their objectivity, and just continually reinforcing the culture.

So as I think about how to do that in a public accounting firm, I was in one of those firms a long time ago, so I'm sure things have changed, but there are ways to assess it -- to assess culture and monitor culture closely to make sure that you don't have the ingredients that could cause people to make bad decisions. We do that as an issuer to comply with 404 and 302 and SOX. We have to assess the culture in our organizations and the tone in our organizations to be able to take -- to make the assertion that we have adequate internal controls over financial reporting. We do that through surveys. We do that through looking at individual pieces, connecting a lot of the dots, constantly driving to root cause analysis on issues we see to explicitly and formally assess the culture and organization.

And so, I would think that there would be an opportunity. Maybe the firms already do it, but to make sure that at a firm level, at an office level, at a partner level, there’s an explicit consideration of culture and tone that’s being set, and measure that, and watch it, and monitor that, as probably the best way to prevent loss of objectivity by the individuals.

MR. SCATES: Okay. Thanks, Doug. Arnold Schilder?

MR. SCHILDER: Thank you. I wanted strongly to support what Marty said about the tone at the top. I think it’s a very important point. And you have seen to recognize more and more over the years.

And the IASB discussed a couple of years ago. It’s still not on quality control. After serious debate, this was actually the first requirement in ISQC1, starting about leadership, responsibilities for quality within the firm. And the first line, that is, the firm shall establish policies and procedures designed to promote an internal culture, recognizing that quality is essential, etcetera.

Before coming to the other elements of quality that are fairly similar to what is in your paper, so I'm pleased, Marty, that you brought the point up. And I hope that it will come back, because that's all where it starts. And then continues the important role of the Chief Executive or the managing board, etcetera. So I think that's a very powerful starting point.

MR. SCATES: Okay, thank you, Arnold. Lynn Turner?

MR. TURNER: I'd like to come back and respond to something that Jim said about the audit partners doing the right thing. I used to have the view that people in the firms do do the right thing, but then we ran across a whole raft of these with Enron and Worldcom, Adelphia, Quest, Tyco. Everyone of the firms, Xerox, everyone of the firms had a rash of these. And the notion that litigation and the risk of litigation, which are real, I think they're very real and very significant would deter someone from succumbing to the pressures, if you will, of the job, and rationalizing away a bad answer, I think went by the wayside.

And I think -- I just don't buy the notion anymore that reputation alone, after living through that, and certainly what we went through in the last couple years as well, that reputation alone is the most important thing for people even in this great profession. And I think that quality controls are important. And I think people these days will and have done the right -- wrong thing unless there's some mechanism for making sure that what's happening is transparent, and that there's a high degree of accountability when people do the wrong thing or behave in a bad way.

So and I think that certainly applies to this profession, as well as to other professions.

One of the things is, this profession has an extremely important role. It's probably one of the most difficult jobs you could have, but it's also one of the most important, because if this profession doesn't get its job done right, our capital markets can't function. And tens of millions of people can suffer. And that's very important.

So I think the Board taken up this quality control project is great. I think you got to think out of the box on it. And I think you also have to think very globally on it, in light of where we are today with the world's overall economy, not only today, but where it's going to go. The international stuff is going to become much more important as more of our business does go offshore. And as the U.S. shrinks, as a percentage of the international global market, the stuff offshore is going to become more important, and how do you maintain those quality controls in light of that? So I do commend the board and the staff from moving forward, but the notion that reputation alone will keep people doing the right thing, I think that's a misnomer and a figment of someone's imagination these days.

MR. SCATES: Steve Rafferty?

MR. RAFFERTY: Thank you. I didn't realize until Lynn started there that I was going to agree with him on something, but I am.

[laughter]

I think you're on the right track here. I commend the effort to address a quality control system because you are finding things in the inspection process, and I think you have to step back from those findings and say am I finding these over and over again? Are they indications of systemic problems in the system of quality control that we need to do something about? So I think you're definitely on the right track.

But I think we have to be realistic that we can write standards, but standards have to be written at such a high level, that I would be willing to bet you that you could write any quality control standard that you want, and sitting here today, all of the big firms would meet that standard.

You have to drill into the details to determine what those controls and procedures really need to be in any firm, just like when we go through our inspection process internally, in our firm, we carefully evaluate the results, and have to step back and ask ourselves is this a one off problem or is this an indication of something in the system that needs to be fixed?

And I think the PCAOB has a real opportunity here in the remediation role that you play in the inspection process to drive some development of internal controls and procedures within the firms to truly improve audit quality and address some of these things that you keep seeing over and over again, whether that's a consultation process that's missing, or a review process that needs to be revised, or whatever it is within a system, I think you've got an opportunity to address that kind of thing.

So I would encourage you to do that, to evaluate those root causes and see what the remediation might -- ought to be. But in many cases, it will be a firm on firm decision.

I think setting some higher threshold than we have today will perhaps work well for some of the smallest firms, but certainly not the biggest.

And then, finally, I think, you know, with respect to the whole culture thing, I think my own observation is the better my controls, the more I drive integrity and culture and communicate integrity and culture within a firm. So I would encourage you to take advantage of the opportunity to drive culture by requiring controls and procedures be improved.

MR. SCATES: Barbara Roper?

MS. ROPER: Yeah, I wanted to agree with what Doug

Anderson said earlier. I had the experience recently of listening to Dalien Kane, who's a professor at Yale in the School of Management. He's a behavioral economist.

And he was talking about some of the insights, behavioral economics, and offers into actual response in various industries and with investors to conflicts of interest, among other things.

And his basic point on conflicts was that no matter how concerned you are about the harm that conflicts cause, they're worse than you realize. And then, the other side of that, which isn't as directly relevant here is no matter how ineffective you think disclosures are in addressing those conflicts, they're less effective than you think they are.

And one of his points was that people have a way of getting comfortable in their own mind with what they do. And that people don't think they're doing the wrong thing a lot of the time when they do the wrong thing.

And so, you know, and I was also going to make the point that Lynn already made, which is that the PCAOB exists because the threat of litigation and concerns about reputation and all of those things that we have traditional tried to rely on didn't work to prevent a number of people getting comfortable with audits, that simply weren't reliable.

So I think there's a role for quality control standards as part of the solution to that. And enforcement is part of the solution and whatever.

On the culture issue, there's an example from the broker-dealer experience, the -- I'm showing my age here, in that it's a report from the early '90s, when Levitt was the Chairman of the SEC. And they did something they called the large firm report, where they went in. There was a reporter at "The Los Angeles Times" who had done a series of articles about the major brokerage firms hiring brokers with long records of sales abuse practices. And they were staying -- they were managing to stay in the business despite all of these rules that were supposed to be in place at firms for supervision, what not.

And so they went in and they did this series of special enforcement examinations at the nine largest firms. And they found one, they found a number of sales abuse practices within what were supposed to be the, you know, the leading firms. But beyond that, they found something in excess of 80 percent of the violations were at one firm.

Now that is a firm with a deep seated cultural problem that isn't going to be addressed through standards. And it, you know, exists in the -- and they ultimately ended up, if I -- they -- the SEC didn't name the firm, but if I'm right about what the firm was, and I'm like 99 percent certain that I am, they ended up paying the largest settlement ever in the history of the broker-dealer industry at that time for some of the sales abuses that they were engaged in.

So I just -- I do think you can't ignore this question of the role that culture plays in setting the conduct within a firm and try to get at that through whatever means you can.

MR. SCATES: Denny Beresford?

MR. BERESFORD: I'd like to say just a couple of words about culture also. Especially for the very largest firms, 150,000 or whatever people around the world, I think this is a very difficult thing to make sure that everybody's getting the same message.

And just to share a very recent experience I had, I participated in an academic list serve of about 700 people. Someone circulated a video that they'd found on a website. And it was one of the major firms had -- was announcing a new program. And they'd sent a video around all their people around the world, I guess it was, about five minutes or so, celebrating again a very exciting new program, and had people quoted from all over the world about this. And they went on and on about how exciting this was. And they were talking about their relationships with their clients. And it was all of the value we're going to be adding to our clients, based on this new program, value added, value added.

And then, a couple of references to the client doesn't really care how we get to the answer. It’s the final answer that they get that’s really most important to them. And I really didn’t react to it very well. And I just to this list serve, I sent a note back and said this sort of sounds like kind of back pre-Sarbanes Oxley. And there the firms go again a little bit. And I had just had finished in my class talking about the Anderson situation. And again, I shared that with this list serve.

A couple days later, I got a call from one of the partners from that particular accounting firm, saying that he was calling on behalf of the worldwide in America CEO of that firm, saying that they were very concerned about my concerns. First of all, they said that they were concerned about the -- my blog. I said well, I don’t have a blog, first of all. I had just -- I just had shared this with this list serve.

And they wanted me to know that their concern was -- or that their issue was obviously quality at all measures. I was absolutely their -- what they wanted to do. And I said I know that. Absolutely, I know that that’s what you want to do. And that’s the message you want to get across. All I’m telling you is that you sent this message out to 150,000 people or whatever it was, and what I heard when I’m thinking of is a staff accountant or a manager, whatever getting this thing was add value to all your clients. The client, once they get the final answer, they don't really care how much you got there -- how you got there. And that doesn't sort of strike me as quality is our most important thing.

He said, well, that's not what we intended. And I thought that was -- first of all, I thought they were going to put a hit on me after sending the thing out. And then, a couple of days later, I got a call from one of the two CEO's himself, reiterating that they're very concerned. And I just wanted to be sure that I'd gotten the message right, and wanted to inform you again.

So but -- and again, I said, look at, I said I'm not trying to start any trouble here. I'm just telling you that I think this is a very serious issue when you're trying to talk about a very important new program for the firm, but what are you -- what message are your people getting?

Now maybe the 160,000 people didn't get the same message that I got. And they weren't probably all of them weren't studying the Arthur Anderson situation at the same time that they were getting the message. So they probably weren't kind of sensitized in the same way that I was.

But I think that's a real challenge that the firms have is trying to get people to work together on these things. And I just think that as the firms frankly the larger firms and particularly start moving back into more and more of the consulting type practice, start broadening their practices again, start -- I'm not saying there they go again, but I think there is at least a little bit of a concern in the professional community that we are perhaps taking our eye off the ball just a little bit. We're looking to the PCAOB to make sure that that doesn't happen, and to the firms.

I -- as a former partner in public accounting, Jim, I still count on the firms to help pay my retirement, too. So I worry about these things.

But I just think that we all have to be very sensitized to these things, and worry about the messages that we're sending to all the people in the field.

MR. SCATES: Jim Schnurr?

MR. SCHNURR: First of all, I want -- I don't want to leave this group with the impression that I don't support quality control systems. I absolutely think they're essential. And to Denny's point, the bigger the organization, the more important they are, and the more robust they need to be.

Secondly, in terms of looking at the culture of the firm, tone at the top, I also agree with that point. I think ISQC-1 is very focused on that, including looking at the responsibility of senior management for the quality control systems.

I do think that one area, Marty, I think you brought it up earlier, you know, in terms of, you know, where does the quality control system report in the organization, where you don't have kind of an independent board of directors is probably a good area to look at. And I would note that a number of the U.K. firms have started to take or bring independent directors onto their boards. And I assume that's one of the reasons they've done it. So that could be, you know, a very fruitful area to look at. So thanks.

MR. SCATES: Mary Morris?

MS. MORRIS: Thanks, Greg. And Jim, I'm glad you brought that up, because that's what I was going to about. First of all, thank you from the investor's perspective, I think, Doug, you mentioned that, you know, ideally, quality control is supposed to help investors and the confidence that it builds. And I think that many of the comments was -- were very important as far as transparency.

So I think one of the things that I just want to make sure, and maybe bring it up again to the audit firms is, you know, in the U.K., they are looking at audit firm governance. And what is -- I think, you know, one of the things that we all think about is, and we talked about incentive pay, and compensation, so what are the drivers -- what do audit firms believe that success? And what are the key performance indicators? And so for us, for investors, it'd probably be nice to get some kind of, you know, what is that audit firm governance? What is that code?

And I think that many of the firms have said that, yes, they're going to start doing that across the board internationally.

So I think that might be helpful. And I would like for your, you know, you consider that, maybe an audit firm governance code.

MR. SCATES: Thank you, Mary. In the few minutes we have left, we'd -- do we have some more questions that we may have some more comments. The first couple of questions, some of these, I've heard comments on several of these as we've gone through the discussion this afternoon.

The first one put an integrated framework, similar to the coastal (phonetic) framework, would that better emphasize the need to design and implement a system of quality control that appropriately develops all necessary elements, integrates those elements of quality control into a complete system, and stresses an ongoing assessment, and remediation of deficiencies.

In addition, what a separate risk assessment process to identify, assess, and address relative risk to audit quality improve the design and implementation of systems of quality control.

You think about those, and also, we had a few a couple of -- additional questions. What changes to the board's quality control standards would better motivate the firms to use known audit deficiencies to identify and remediate defects in quality controls that allow the deficiencies to actually occur?

And are there lessons learned from other industries that could be useful at designing and implementing systems of quality control for accounting firms for example, the recent reforms instituted for the credit rating agencies.

So with those questions in mind, any other additional -- some additional comments, remarks? Doug Anderson?

MR. ANDERSON: I just want to make a quick comment on number 2 and the risk assessment process. I would think a QA process just like just about any other process, risk assessment's not a separate process, but it's fully integrated and understanding it. Throughout the design and the execution and the valuation and monitoring of a QA process, you have to consider the risk of the various pieces. So clearly, risk has to be there.

I took exception to the word separate. I don't think it's a separate process. It's an -- it's risk assessment has to be integrated throughout the QA process.

MR. SCATES: Thank you, Doug. Paul Sobel?

MR. SOBEL: In response to number 1, first of all, I always like pictures and even though I know it was a fairly cryptic drawing, I did like the kind of modified COSO cube that you had on the previous page.

The comment I had, which actually supports a little bit what Doug says, is that to me, and you can tell by the discussion that we've just had over the last hour, to me, the key is making sure there's sufficient guidance on that control environment slice of the cube or whatever framework you end up using.

An awful lot was developed for, you know, companies subject to the Sarbanes Oxley Act. You know, sometimes you get into 100 plus questions, which I think was overkill, but I do think it might be helpful to come up with some guidance or maybe even specific questions or criteria to be considered at the control environment level of a big accounting firm.

MR. SCATES: Thanks, Paul. That's very helpful.

MR. BAUMANN: I think that was the point of utilizing the COSO (phonetic) cube and framework here, the point you're making. And actually, Doug, the point you made as well that to some degree, one could look at the quality control standards as a listing of procedures, things to do.

Firms may have integrated them. And maybe they're not in the way which the firms are applying them.

But we did think that potentially a framework similar to the COSO (phonetic) environment, where it was all put together. And all of the pieces worked together, starting with the top one control environment, culture, tone at the top, then leading all the rest of them into an ongoing risk assessment throughout, as well performing all the other quality control steps that were there before.

Might have some benefits in how one looks at quality controls, if it was more of a framework approach.

So as we're thinking about things to explore, as someone said, out of the box, not sure if the COSO framework is out of the box completely, but applying that type of framework, which is used very well in industry as the evaluated, their controls, and the design of their controls potentially as a framework for firms to look at for evaluating their quality controls and the design of the quality controls might have some effect of -- might be effective.

MR. SCATES: Lynn Turner?

MR. TURNER: With respect to question 1, and the COSO notion, one thing that seems to be missing in COSO, and certainly, was missed during the financial crisis was the ability of a quality control system to pick up and react to changes, changes that are going on in the economy are or elsewhere.

And so, if you go that path, I think you got to build something into this quality control system that says is it actually searching for changes that may be impacting this? And if so, is it reacting and adjusting to that? So that's our number 1.

On number 4, again, I would think out of the box here, and I would certainly look at the compliance programs inside the 40 Act, the investment complexes. They have some very significant issues with respect to compliance and controls. I think some things that the SEC did in the first half of this last decade there, including with respect to establishment of a compliance officer, the reporting format, and what that compliance officer has to do to ensure that the inspection program is working is very good, and certainly worthwhile. And I happen to know that's what the Dodd Frank bill was modeled after when they did the credit rating stuff. And I think the credit rating stuff in the Dodd Frank bill is very good as well, including to Mary's point, the fact that it looks for this compliance officer to be independent, and reporting up through some accountable governance type mechanism, as well, and building all of that in is good.

The other thing I'd do is I'd reach out to a couple of firms like McKinsey and Boston Consulting Group who consult all the time on quality, certainly in the context of the ISO 9000 type stuff. And I think it'd be very helpful to get their perspective on quality and what makes for a good quality systems.

And I'd certainly -- you know, I'm sure they'd be willing to spend some time with you. So I'd reach out to them, because they an excellent job in that area.

MR. SCATES: Thanks, Lynn. Appreciate those comments as we move forward with our concept release. Bob Dacey?

MR. DACEY: Thanks. I just wanted to bring up the fact that in our government auditing standards, otherwise known as the Yellow Book, we do have a requirement for audit organizations to at least annually analyze and summarize all the deficiencies they've noted in terms of their monitoring processes, identify systemic issues that are causing them, and develop recommendations to address them on a broad scale, rather than on an individual audit.

So if you want to talk at any time, we'd be happy to share our experiences in that regard. Thanks.

MR. SCATES: Thanks, Bob. We'll plan on that. And Denny Beresford?

MR. BERESFORD: In thinking about both the last issue we discussed and this one, it kept coming back to me that if we had some sort of a framework for documenting audit judgments, that it would have addressed at least some of the issues that we face on these topics. So it seems to me that that might be something you should be thinking about.

If nothing else, I was struck by I think it was Walt's comment about the horizontal approach to looking at some of these issues. I know that several of the accounting firms have developed their own approach to documenting judgments about accounting estimates for example right now. And I think it would be helpful to capture that kind of information and perhaps have some sort of a best practices type of a pronouncement, included in as a separate item, or in some other broader list later on.

MR. SCATES: Thank you, Denny. And Neri Bukspan?

MR. BUKSPAN: A couple points. I think when we think about designing a system for quality, I think, first, you need to step back and say what is quality? So somebody needs to define what's a quality audit? What are the levers that are looking at audit? And then the second issue that I am a large proponent of, since I started to -- dealing with quality in my own organization is the notion of measurement.

Regardless of tone at the top that we all believe does exist, I think if you do have any -- even if you put the PCAOB organization totally aside, the larger the organization, the greater difficulty to understand how the tone reaches every corner of the organization.

So there's a notion of constant measurement, defining those levers, and getting some information and some data.

And when you think about data in the context of the accounting world, you can think about two types of data or data buckets, if you will.

One could be process indicators. Number of hours, number of training hours, that type of talent -- that you have a particular audit, the number of findings, or number of audit change -- audit changes and so forth.

And then you have a process -- a product quality. You know, how many of our products actually failed? And I think some of those indicators, going back to our earlier discussion, should not be always looked in isolation. There's some element to look at all these data elements.

And I do agree that at some point, it's important to understand who within the organization look at those data points, who considers them, and who takes action with respect to the indicators that are being observed by the organization itself?

So I do agree that in integrated framework is quite useful and important, but I think regardless of the framework what it is, the challenge is that currently is how do you deal with quality and what's quality? Some would say I recognize quality when I see it. It's quite interesting because we all speaking from a voice of experience.

But without having a framework to define what quality is, and also go to some questions that were inherently asked when this Board was first established is can we actually, not looking at quality as meeting similarly exceeding a particular yardstick and then where quality stops, is can you actually discern or differentiate among audit in some spirit of quality? Or you are trying to differentiate between an audit that is just okay, and an audit is a quality audit, even though both have not resulted necessarily in restatement.

So this could provide you an opportunity to actually penetrate this area that has been -- you know, many investors have been asked to get some more information. And actually, some of the discussion associated with more information in the dialogue with auditors and audit committee speaks directly to that.

MR. SCATES: Thank you, Neri. And a few remaining questions. If there's some additional comments, we've already touched on the cultures in the firms. Last two questions, what changes to the Board's quality control standards might be necessary in light of the potential changes to designing and implementing a system of quality control? Are there other challenges that should be considered? And the last one, what attributes are necessary for a firm culture to be conducive to audit quality? What requirements or other measure could the PCAOB propose to motivate firms to promote a firm culture that minimizes -- that do not promote audit quality?

We’ve touched on audit quality. Now we had several very good comments and remarks on the firm quality throughout this discussion, but I wanted to see if there’s any other tent cards, any other discussion or remarks in this particular area? And then we had one last question, what quality controls should be in place when using the work of a foreign affiliated firm? We spent a lot of time in that area. We have I know in other SAG discussions when we talked about Appendix K, as well as the adoption of IFRS. With -- any additional comments in this area?

MR. BAUMANN: The only comment I’ll make, Greg, is that the existing QC standards are -- don’t say a lot in this area. There’s QC 20.06. I think it’s basically one sentence or so, that indicates that a firm should have controls in place to ensure that the work of its affiliates comply with professional standards. And I think the essence of this question is this is an area we have to explore for many reasons, as part of this project and an area where the initial belief is that quality controls to be in place when using the work of affiliated firms probably needs significant attention.

MR. BAUMANN: The only

MR. SCATES: Gary Kaburek? I’m sorry.

MR. KABUREK: The -- Greg, to your question, it’s really I guess question 5 about the quality control standards, and maybe this is already buried some place in there. This preparer I'm not all that familiar with them, but under QC section 40 about competencies expected by the engagement partner, one wonders should you have a standard or a quality control procedure, whatever, out? The firm's policies with respect to admitting partners. I mean, seems to me is it starts there. I mean, it's the partners that are there are fine, but it's the partners, the future is what's going to sort of carry the firm's legacy going forward. What are they looking for in admitting partners?

I mean, I appreciate revenue generation as certainly a part of it, but there's a lot of other pieces as well. So, again, maybe it's already in there. And if it is, I'll retract or drop the statement, but it suggestion about what you might want to consider to look for.

MR. BAUMANN: Hopefully it's more than revenue generation.

MR. KABUREK: I said many other things. Hopefully, technical competence and having a backbone and stuff like that are more important.

MR. SCATES: Any other comments, remarks before we conclude for the day? Okay, I'll turn it back over to Marty.

MR. BAUMANN: Well, Walt, and Greg, and Brian, thanks for leading that discussion. I think the involvement of everybody around the table was clearly indicative of the fact that the SAG views quality controls to be very important, and views identification of needs or areas and ways to improve quality controls as being very important. So I think we got a lot of very good messages from all of you in terms of things we should be focusing on in this project, and taking that forward. So I appreciate, again, a very lively discussion, and input on what's to us, one of our more important projects going forward.

Well, thank you all for a very -- being with us today and being very, very involved and engaged in all of the discussion items that we had. These meetings are only good to the extent that you're very engaged and add a lot of comments. And you certainly did that today. And we appreciate that very much.

I think we're ready to wrap up for the day. We're -- we have a reception right across the street at the Madison beginning at 6:30, and look forward to seeing you all there, and then back here again tomorrow morning at 8:30 for the session, but continental breakfast beginning at 8:00 a.m. Thanks a lot and we'll see you at the reception shortly.

[Whereupon, at 5:17 p.m., the meeting was adjourned.]