NOTICE: This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Investor Advisory Group meeting on October 16, 2013 that relates to the standard-setting project, and related subject matter, discussed at PCAOB Docket 041: Firm and Engagement Metrics. The other topics discussed during the October 16, 2013 meeting are not included in this transcript excerpt. The Public Company Accounting Oversight Board does not certify the accuracy of this unofficial transcript, which may contain typographical or other errors or omissions. An archive of the webcast of the entire meeting can be found on the Public Company Accounting Oversight Board's website at https://pcaobus.org/news-events/events/event-details/pcaob-investor-advisory-group-meeting_758.

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

+ + + + +

INVESTOR ADVISORY GROUP

+ + + + +

MEETING

+ + + + +

WEDNESDAY
OCTOBER 16, 2013

+ + + + +

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

PRESENT

STEVE HARRIS, PCAOB Board Member, Chairman
BRANDON BECKER, TIAA-CREF
ROBERT T. BUETTNER, Newbrook Capital Advisors
MERCER E. BULLARD, University of Mississippi, Plancorp, LLC, and Fund Democracy, Inc.
CURTIS L. BUSER, The Carlyle Group
T. GRANT CALLERY, FINRA
JOSEPH V. CARCELLO, University of Tennessee
NORMAN J. HARRISON, FTI Consulting, Inc.
MICHAEL J. HEAD, TD AMERITRADE Holding Company
PETER H. NACHTWEY, Legg Mason, Inc.
BARBARA L. ROPER, Consumer Federation of America
LAWRENCE M. SHOVER, Solutions Funds Group
DAMON A. SILVERS, AFL-CIO
ANNE SIMPSON, California Public Employees' Retirement System (CalPERS)

TONY SONDHI, A.C. Sondhi & Associates, LLC
JUDGE STANLEY SPORKIN, U.S. District Court (Retired)
ROBERT M. TAROLA, Right Advisory, LLC
LYNN E. TURNER, Managing Director, LitiNomics and former SEC Chief Accountant
GARY G. WALSH, Luther King Capital Management
ANN L. YERGER, Council of Institutional Investors

ALSO PRESENT
JIM DOTY, Chairman, PCAOB
LEW FERGUSON, Board Member, PCAOB
JEANETTE FRANZEL, Board Member, PCAOB
JAY HANSON, Board Member, PCAOB
MARTY BAUMANN, Chief Auditor and Director of Professional Standards, PCAOB
BRIAN CROTEAU, Securities and Exchange Commission
GREG JONAS, Director, Office of Research and Analysis, PCAOB
HELEN MUNTER, Director, Division of Registration and Inspections, PCAOB
SANTINA ROCCA, Deputy Director, Division of Registration and Inspections PCAOB

T-A-B-L-E O-F C-O-N-T-E-N-T-S

PAGE

T-A-B-L-E O-F C-O-N-T-E-N-T-S
(continued)

T-A-B-L-E O-F C-O-N-T-E-N-T-S
(continued)

And now let me recognize the working group leaders. Tony Sondhi will provide a brief overview of his working group on audit quality indicators. His working group members are Michael Head, Norman Harrison, Lynn Turner and Damon Silvers.

Grant Callery, Grant, who is new to the IAG, very graciously agreed to serve as the lead of the audit firm governance and incentives working group. We very much appreciate that, Grant. And his working group members consist of Brandon Becker, Curt Buser, Joe Carcello and Lawrence Shover.

And Ann Yerger is the lead on the auditor interaction with audit committees working group. And her group includes Mercer Bullard, Howard Morris, who as I say regrets that he is unable to be here due to an illness and we wish him speedy recovery, Pete Nachtwey, Bob Tarola and Barbara Roper.

So with that, Tony, why don't you start off and then Grant and Ann for five minutes each on the overviews and then we'll get right into the program. Thank you.

MEMBER SONDHI: Thank you. Okay and, Steve, you said it's a five-minute overview?

Okay, very good.

Fundamentally our group has worked on these indicators and we've decided that, in essence, what we recommend is that you prescribe a set of audit quality indicators that would measure the quality of the audit, the actual audit, the output, the results that you get, help establish the accountability for that audit quality.

And these indicators ought to be forward-looking and have a significant amount of information and predictive content, because that's what we need.

In essence, we need to find audit quality indicators that'll help us understand how well the audit was performed, assign responsibility and accountability for that audit.

The working group also believes, again, that the current focus seems to be on audit firm quality and the audit process, rather than audit quality itself.

And we believe that investors are most concerned about the reliability and the credibility of the audit and we're interested in understanding how those audits, what those audits tell us about the companies that we are currently invested in and/or companies that we're interested in.

Many of us who've served on or advised audit committees have found that audit committee members are also most interested in the quality of the auditor's work for their company, in essence, rather than the actions that their audit firms have taken that relate to audit quality, but in general rather than specifically with respect to the output of the audit itself.

The final point I'd like to make in the introduction is that we think we need a focus on output-based indicators or results-based indicators of audit quality and we're going to propose a few of those in our principal discussions. Thank you.

CHAIRMAN HARRIS: Thank you very much, Tony, and I did look at the slides late last night and I think you've done an excellent job and we look forward to the presentation.

Grant, you want to give us a brief overview?

MEMBER CALLERY: Sure. The topic that our group was looking at was governance of incentives and what we've put together is a group of slides that raise a number of questions I think.

And so I look forward to the discussion today and very much look forward to the input from this group and thank you very much, again, for all of the efforts.

MR. JONAS: Greg Jonas, PCAOB.

MEMBER FRANZEL: Jeanette Franzel, PCAOB.

CHAIRMAN HARRIS: And Steve Harris, PCAOB.

And now starting with Audit Quality Indicators, as early as 2010 this Advisory Group suggested the Board develop audit quality indicators.

Later, in our 2012 meeting, the working group on audit firm practice and transparency recommended the issuance of a concept release on AQIs, initiating a project to identify audit quality measures with a longer term goal of tracking such measures over time is one of the priorities of the Board. The PCAOB Office of Research and Analysis has been leading this effort

And as you will hear from Greg Jonas, the Director of the ORA, during our first presentation today, the staff of ORA has been working hard to identify certain key audit quality indicators.

And as part of the effort, ORA has reached out to the Board's various advisory groups, including the IAG.

I've asked Greg to start off the discussion with a very brief overview and then we'll turn it over to Tony.

But, Greg, congratulations on a terrific start, a terrific effort on an extraordinarily difficult subject matter and we appreciate your opening it up.

MR. JONAS: Great, Steve. Thanks. Good morning, everyone.

Among the challenges to audit quality is the curious circumstance that the customer of the audit, the investor and the buyer of the audit, the audit committee really has limited visibility today into the underlying quality of the audit work.

Now, to be sure, they understand when things go wrong, restatements, missed fraud, last-minute problems, and so forth.

But the absence of a problem, of course, doesn't necessarily indicate a high-quality audit.

As we've thought about it, we view the audit very much like an iceberg where the customer and the buyer really see only the tip and there's very little visibility into the largest part of the iceberg, which is the part that's underwater.

And so at its heart, we fashioned the AQI project as trying to give visibility to that part of the audit that is underwater.

And with the sunshine on that section, we think there are four broad beneficiaries of the information.

First, for investors we think the insight can give them knowledge, better knowledge of risk in the companies that they invest. We also think it can help inform their proxy voting.

For audit committees we think that insight can help them understand the right questions to ask the auditor and that will inform their hiring decision and their compensation decision of the auditors.

Firms we think can benefit from this by being able to compare their firm with others, to ask themselves the right questions, to know where to invest, where are the problems and what to do about them and ultimately to be rewarded for a job well done.

And for regulators, too, there's help. It can help us understand where there is risk. It can help us understand the system of quality control and it can help focus the regulatory endeavor.

So we've been on this. Brian mentioned this project has been named a strategic priority, a short-term strategic priority, and we've been at it since last December.

And we fashioned our first milestone to be a concept release that we hope to issue at around this year-end.

We envision that the concept release will have three broad sections. One would be background purpose of the project. The second would be about quality indicators. We fashion a portfolio of metrics, quantitative measures, informing audit quality. And the third section would be to discuss possible uses of these indicators.

We do not intend this document to be declarative at this point, but rather to in a structured way tee up important issues and seek public comment on those issues.

Let me hum a couple bars first about the indicators. What we have in mind is a balanced portfolio, kind of a scorecard of measures that give insight into quality.

We do not envision that this is benchmarking. We do not believe that these indicators will answer questions, but rather they will focus people on the right questions.

We envision the metrics to be balanced in the sense that some will relate to people, some will relate to process and some will relate to results, the output of the audit.

To date, we have embarked on a fairly extensive research effort, trying to read all that has gone before us about quality indicators and there is a fair amount.

We have fashioned a definition of quality. We have developed a framework for thinking about quality and we've surfaced roughly about 70 different measures that we think are candidates for metrics.

We've discussed these candidates with many thought leaders, including our advisory groups, with the SEC and others.

And we have been in the process for the past few months, really since May, of trying to screen the list of 70 down to something more manageable that we think would be the most promising indicators, maybe in the range of 25 to 30 that we would put forth in the concept release.

The third section of the document deals with uses. Again, we don't intend to be declarative but rather to tee up in a structured way the many questions we have about possible uses.

Let me give you some examples. Should engagement teams discuss with audit committees engagement-level metrics? Should they also discuss firm-level metrics?

Should firms themselves publish publicly in their reports on audit quality quantitative metrics of audit quality and what insight they get from those metrics and what they're doing about weaknesses?

Should regulators publish insight about the metrics, comparing one firm to another, offering observations for the good of audit quality?

Should these programs be voluntary or should they be mandatory? How might we phase in such a program of audit quality indicators over time?

Scope, should all public companies be subject to these metrics or should we exclude certain company audits? Are all firms in or should we exclude certain firms?

And we'll ask questions, I suspect, about benefits and costs of an audit quality indicator program.

As others have mentioned, I too deeply appreciate on behalf of the staff the help that you have given us. Tony and his task force have been terrific and we've had the benefit of one-on-one conversations with each of the task force members.

But, of course, we haven't had the benefit of the full group discussion and the great dynamics that come from that.

So it's an excellent time for this group to weigh in to influence our thinking. You already have, and I know today's discussion will do so again and we eagerly await the conversation. Thank you, Steve.

CHAIRMAN HARRIS: Tony, now let me turn it over to you and I'm not sure we've got our tech system working but hopefully we can flip to the slides, you know, as you go through them.

MEMBER SONDHI: Yes, I think we can manage that. Thank you very much, Steve, and thank you, Greg, as well for that introduction.

Let me begin with just a very simple comment on the fact that I have been helped greatly by members of my group and also by Matt Waldron of the CFA Institute.

He's given me access to a great deal of information. I'm going to report on one of the surveys that he's provided that they conducted last year.

And in addition to that, I've had conversations with several other people, members of the IASB, some accounting firms, and I've tried to gather as much information as I could to bring in to inform this discussion and some of these issues that I'm going to present.

But I must say that despite all their help, there will be some shortcomings and those are mine, so just keep that. I promised Norman that I would mention this so that the -- no, I'm just --

But I do appreciate everyone's help and particularly George Wilfert and Greg, spent a great deal of time with them so the PCAOB staff has been very, very helpful.

So let me go back and begin with the executive summary that I had just briefly mentioned earlier.

In essence, as I said earlier, we believe that these audit quality indicators ought to be designed to measure the quality of the audit itself.

We need to be able to develop indicators that help us understand and also establish the accountability for that audit quality.

But probably most important, these audit quality indicators need to have these two characteristics, that is they should be forward-looking and at the same time also have information of predictive content because, as we're going to show you, investors and the audit committee, of course, need information about the audit quality more than anything else.

So investors are concerned about the reliability and the credibility of the audits and I think that's what the audit quality indicators ought to emphasize.

Another thing that I mentioned earlier is that those of us who served on or advised audit committees have found that committee members are mostly interested in the quality of the auditor's work for their company.

So it's a very specific interest and that's why, again, I emphasize that we're interested in output-based or results-based audit quality indicators.

The objectives of this project we think should be the development of indicators that help you measure audit quality.

In effect, the objective would be to provide the investors with timely information that they can use to understand the credibility of the audits.

That information would also help investors in their annual voting on auditors and retention and appointment of the auditors.

The audit committees would benefit from the publication of timely information on audit quality because that'll help them with respect to the specific oversight responsibilities that they have, as well as the selection of audit firms.

So overall, what we're looking for is information about risks that are identified. It would be helpful to get that information from the results of the PCAOB inspections and what's been discussed in those PCAOB reports as well.

With respect to the data collection, dissemination and the publication of that information, we believe that audit firms should be required to provide the regulator, the PCAOB, with that data on the audit quality indicators.

One of the things that I think is interesting with respect to these audit quality indicators and their collection and dissemination is that although the quantitative information is likely to be most helpful, I do believe there are places where some qualitative information would be helpful as well.

And the data that is collected and then disseminated by the audit firms ought to be subject to review, verification and comment by the PCAOB.

Greg had pointed out that there's a question as to whether that ought to be analyzed by regulators and that's something that I think we ought to explore during our discussions.

What we're talking about here, in essence, is that it should be collected and disseminated by the audit firms and it should be subject to review and verification by the PCAOB.

With respect to the audit quality indicators themselves, what we have decided here is to present three categories.

Some indicators we believe ought to be collected, analyzed and disseminated at the engagement level.

There's another category that we believe makes sense at the firm level, but there also indicators that we think should be collected at both, so just to sort of give you a broad view and perspective on the types of indicators that we're going to talk about.

Now, finally, with respect to these indicators, we recommend one other aspect and that is the audit quality indicators should be stratified, and the question then becomes what kind of stratification makes the most sense.

And I think this is a function of the type of audit client, it's a function of the type of audit quality indicator.

Some audit quality indicators may be best stratified in terms of the size of the client. Others we may need information about the business that the client is involved in or different businesses.

So we've discussed stratification measures such as SIC class, the codes or something similar.

I want to be very clear. I don't think there's a single answer with respect to stratification. In fact, I strongly believe that it's important to have good understanding and apply them judiciously to different types of indicators.

But I do believe that stratification is going to be critical because otherwise it's very difficult to understand.

For example, you know, take a very simple case. What I want to know about an audit of a company the size of Citigroup or JPMorgan is a little different from the bank down the street that has two branches or maybe three.

But that's a very simple argument but that also does express the nature of the stratification that I do believe we need, okay?

Now what I'd like to do is to spend a little bit of time talking about some very specific indicators.

Sort of an overarching comment that I'd like to make is please take these suggestions and recommendations as an approach to looking at and developing indicators.

These are not, in any sense, final. This is, as

Steve and Greg have both pointed out, a fairly complex undertaking and it is our first stab at it so please keep in mind that these are suggestions. They're what we've been thinking about.

We think they're important, very critical, and yet we certainly agree and would accept that they do have to be evaluated carefully and may require various levels of discussion and modification over time.

So I'm going to begin with the specific engagement level indicators. It's important, I believe, to understand how the time is spent on an audit, so the partner and manager hours relative to the hours charged by the rest of the engagement team, the identification of key risk areas in an audit and how much time was spent on those.

Another set of indicators relates to the inspection, whether that particular audit has been inspected by the PCAOB in the most recent year, what types of deficiencies were identified and a description of the types of those deficiencies, the amount of time that's spent by the audit partners and the staff and firms that are not subject to inspection and this, I think, is a critical element in understanding the audit and the output of the audit itself.

A few others, and here what I believe we're looking for is the amount of time that is spent by people outside the immediate audit team.

So one of the indicators looks at the amount of time, the audit hours outsourced to either another firm or to an affiliate in a foreign country, whether there was any consultation with the national technical office and, if so, on what issues.

So we're looking, in other words, for what kinds of other information, other help you've used.

And then ultimately, third one in this case is the name of the lead engagement partner which would allow us to assess whether they have participated in other audits which were inspected and where credibility was an issue.

So that would clarify the types of audits and provide us with some more information on those.

So let's move now to some audit firm-level indicators. The policy and measurement and management of audit quality indicators ought to be public. That's just a general comment with respect to the audit indicators.

And this I believe is an expression from the firm itself that's collecting and disseminating that information and this aspect, of course, would also be different and the regulators would give us their perspective on it.

With respect to the audit firm-level indicators compensation policy, the executive partners for the audit partners on the engagement and the audit staff, what we believe is important to understand with respect to compensation levels is how those are linked to audit quality, including the specific triggers measured and used in linking that audit quality to compensation levels.

The average billing hours and responsibility of audit partners, also the average chargeable hours of partners, managers and the audit staff. So we're looking for some detailed information with respect to both the compensation and how they're spending time on the audit itself.

Another set of indicators at the firm level would look at specific audit engagements and provide information on the number of audit engagements for which an independent review occurred. And of those where an independent review occurred, we would like to see information about the number and the aggregate estimated fees of non-audit engagements which the firm declined to accept.

Information about the identification of affiliates not subject to an inspection by the PCAOB and identification of affiliates who do not provide audit documentation to the U.S. affiliate in compliance with SOX. And we can look at that at different levels, different types of compliance and so on, but the idea is to get a sense of who participated in the audit and to what extent they're subject to regulation.

This set of indicators -- let me begin actually with the last three and then I'll come back to the first two. The billable fees or hours by major industry groups, and this is something that'll allow us to understand what type of expertise the audit firm has. Portion of the audits that are assessed as being high-risk audits and how they're spending the revenues on the audit staff.

We've also proposed two indicators that are effectively output-based, and those are the number of restatements and the number of material weaknesses reported by a major industry group.

As you can see, we brought in at different places certain kinds of stratifications, so we do make certain recommendations, but please keep my earlier point in mind that it is important to understand and to be clear about what kinds of stratification is needed and where.

We're also interested in understanding the resources that the audit firms are spending on audit tools and audit technology. We need to understand the number of pending SEC and PCAOB enforcement actions with respect to the firms, the average salary for new hires on the audit staff, the number of first-year audit engagements where the prior auditor resigned or there was disagreement that was reported with respect to the prior auditors.

Certain additional indicators, remember I pointed out that we have three categories and this is our third category where we'd like information on both the engagement level and the firm level. The average number of hours of professional education for partners, managers and staff assigned to the audit. Please keep in mind that this is information that we think will help us better understand the type of the quality that the audit firm brings to the audit, the kind of expertise that they bring to the audit.

We are, however, we do understand, we're clear about the fact that, you know, just the hours or the dollars spent aren't going to give us very good information. So this is something that we need to think carefully about as to how to develop and design these indicators so they can actually tell us what type of expertise is being developed and what expertise they have.

Information about turnover in staffing at partner, manager and staff levels. That turnover is very critical because it helps us understand, again, the type of expertise that comes in and what's happening to the staff levels there. The average years of experience of the audit partner and personnel staff assigned to the audits, experience on the specific engagement, experience in the industry and overall audit experience. We think one of the most critical things in audits is to understand what type of industry and business expertise the auditors bring to their audits. Any violations of the PCAOB auditor independence rules. Okay.

Now, I'd like to step away from the audit quality indicators and tell you a little bit about one of the surveys that the CFA Institute conducted last year in September 2012. The CFA Institute, as you know, is the one that administers the Chartered Financial Analyst designation, and I can provide you with a lot of information about where they are. They're represented all over the world.

They surveyed 498 members of their financial reporting survey pool, so these are people who are really well-informed that expressed an interest in these issues. The response rate was 21 percent and the margin of error is 8.5 percent at the 95 percent confidence level. The objective the CFA Institute had in mind in conducting this survey was to provide feedback to the International Forum of Independent Audit Regulators for use in the deliberations and proposed changes to the audit process.

I'm going to use these in this discussion to illustrate investor preferences with respect to expanded transparency in audit regulation as well as the independent audit report. For those of you who are interested, the entire survey and the questions, et cetera, are available at the CFA Institute website.

Let's focus on four of the questions that were asked in this survey. The first question concerned the quality of the audit, and the question was to what extent do you agree or disagree that regulatory oversight and enforcement of the independent audit improves the quality of the audit?

Now here, 72 percent of the respondents agreed that regulatory oversight and enforcement improves audit quality. What's interesting is the divergence of views around the world. The Asia-Pacific members, 47 percent of them strongly agreed with this contention, 40 percent in Europe and Middle East and Africa and then 34 percent in America. But you can see that you got a fairly significant number of respondents who feel that oversight and enforcement are critical to improving audit quality.

The next question that the CFA Institute asked was with respect to current regulatory oversight and enforcement. The question was to what extent do you agree or disagree that current regulatory oversight and enforcement of the independent audit is effective? Now, I at least found the results here somewhat mixed. Take a look at it and you'll see what I mean. Thirty-seven percent neither agreed nor disagreed. Thirty percent agreed that current regulation and oversight are effective.

Now, I don't know. It, you know, depends on what you do with the neither agree nor disagree contingent here, but interestingly what I found was that the EMEA, 47 percent of those respondents and one third of the respondents in the Americas do not believe that the current regime is effective.

(Off microphone discussion)

MEMBER SONDHI: I'm not sure. I don't think they're inconsistent. I think the first one is telling us that people believe that regulatory oversight and enforcement would help. What the second one is talking about is the current regimes that we have around the world, what they believe in about those.

But as I said, and I think that's partly, you know, the reason why I assume you're asking is, interestingly enough, that only 18 percent of the APAC members disagree with that. Lynn, did you --

MEMBER TURNER: No. In response to Jim's question --

MEMBER SONDHI: Yes, please.

MEMBER TURNER: I think the first set of questions say do you think regulatory oversight's important? Yes. And the second set of questions is do you think it's getting the job done? And there was interesting views on both, yes.

MEMBER SONDHI: And it's interesting to see the differences across the three groups that are represented as well. The third question --

MEMBER SIMPSON: Can I make a comment on that, Tony?

MEMBER SONDHI: Please.

MEMBER SIMPSON: I'm sorry, because I think this is a really interesting point and it rather backs up what Greg said at the very beginning. And I speak in all humility as one of those wretched investors who have a strong opinion that regulation is a terrific idea and then become rather hazy when asked, well, what's really going on and do you understand what's going on? So I think this really sets the stage for a message for the investor community, that we need to be better informed and we really need to back up our regulators.

So, you know, more on that later when we get to the general discussion about what we could be and should be doing. It's a little bit, you know, like sitting around wanting the world to work more effectively but not stepping up to do the work that's needed. So I think, you know, the investor community, we need to look to our own record here. It's not inconsistent. I think it probably says more about the investor community than the regulatory community.

MEMBER SONDHI: And I think you're right because over the years that we've conducted surveys and talked to analysts, we don't get very detailed and informed responses with respect to the audit report. But if you tell them what happens if we take it away --

MEMBER SIMPSON: Oh, yes.

MEMBER SONDHI: Yes and, you know, then there is an uproar. So you're right, there's no question that analysts need to be more informed.

But remember, you're also looking at, you know, some levels of technical expertise that's required in order to understand these. And we do have various types of analysts out there. There are some people who use accounting information and there are many, or some who don't, so that makes a difference as well and has an impact on some of these results in the surveys that we conduct.

MEMBER TURNER: Tony.

MEMBER SONDHI: Yes.

MEMBER TURNER: I wouldn't put the focus on investors and say that takes away from it at all. I think it reflects how these people who are using the financial statements actually perceive the process.

And that's what's important because what you're trying to build is trust and confidence here. And if they don't have trust in the regulator actually getting the job done, then that's, in essence, what they're telling you and then the regulator needs to take steps to address that shortcoming, either in reality or in perception. But clearly there's a perception there that is a serious issue.

MEMBER SONDHI: Right, thank you, yes. Please.

CHAIRMAN HARRIS: After the judge asks the question, maybe you can finish off the full presentation because there are a ton of issues here on this subject matter. So, Judge, go ahead and then everybody else --

JUDGE SPORKIN: Well, maybe this is the wrong time --

CHAIRMAN HARRIS: -- hold your peace until after, you know, after we're finished, but by all means.

JUDGE SPORKIN: Yes, I don't know whether it's the right time but I didn't see a whole lot in the planning of the audit as to a quality indicator. Is that in here?

Because I've found that with good plans, when you sit down and look at the company and determine what areas they're in and whatnot and how you're going to go about to do that audit, that I've found that's extremely important. Has that been looked at, the audit planning stage?

MEMBER SONDHI: Yes. We've actually, we've talked about that a great deal and we will come back to that as well. I certainly agree with you, no question, and the group itself in the discussions has made that very clear, that that's a -- the distinction that I'm trying to draw here is to bring our focus on to the outputs.

But I agree with you. That's part of the process. There's no question. And you're not going to have a good audit without that. But if you would bear with us, let me provide a little bit more information about the general report and then, as Steve suggested, we do have about 45 minutes for the discussion so we'll come back to that.

The third question that the survey asked had to do with the transparency of inspection reports, and we asked whether those need to be more transparent. The results here are clearer, 80 percent of the respondents called for increased transparency and the highest proportion of that is 88 percent of America's respondents, 73 percent in the APAC and 69 in Europe. And that, as I said, you know, that seems straightforward and clearly that's what, and you'd expect that.

And finally, the independent auditor's report, should risk factors associated with measurement uncertainties in the entity's financial statements be included in the independent auditor's report?

And here, respondents called for the disclosure by a three-to-one margin, all right, so they're looking for disclosure. What was also interesting in here is that 57 percent of the respondents wanted to limit the disclosure to significant risk factors, whereas 18 percent, which is a reasonable number, would prefer to have all risk factors disclosed. And, you know, you can think of that as information and how they're going to use it, but that's the idea here.

So to summarize the survey, certainly I think that the respondents agree that regulatory oversight and enforcement have a positive impact, but one in three don't believe that currently we're getting what we would like to get with respect to that.

And then finally, 75 percent of the respondents would like to see more disclosure of risk factors and 80 percent are calling for greater transparency. So that should, you know, give you a good sense of what people are looking for.

What I'd like to do now in the last few minutes that I have, is to focus on another set of indicators. I've talked a great deal about and I mentioned output-based indicators, but here's what I'd like to say about that. We strongly recommend that the PCAOB develop output-based indicators, the quality and the credibility of the audits.

Now, what we believe this calls for is the development of indicators that are credible early warning signals or forecasts of risks. The output-based indicators of predictive content, in essence they involve an assessment of the decisions that relate to recognition or timing and the measurement or the amount of a particular issue and those choices. And very often those choices are based on variable or uncertain data or soft data, as we often call it, and that type of soft data requires significant judgment and estimates that have to be combined with a really good comprehensive understanding of your own business.

One example is the use of discretionary accruals and I believe that Greg and his team have been thinking about this and I believe you've included this or an indicator based on discretionary accruals. Now the fundamental challenge, of course, with developing these types of indicators, informative, forward-looking indicators, is that many if not most of them are observed ex post. It's after the audit and the financial statements have been made public.

So for example, the number and frequency of restatements, errors in going concern assessments, the impairments, issues with valuation, the adequacy of allowances or reserves for contingencies and the valuation allowance for deferred tax assets, for example, these are all observed, generally speaking, after the fact.

Now, we believe that an important characteristic of these types of forward-looking and informative indicators is their ability to forecast risks and problems. So I'll give you just a brief idea of what I am thinking about here. See, research shows that financial statement recognition, in other words the timing of impairments and also the amount of the impairment recognized with respect to long-lived tangible assets, like machinery equipment, for example, these are often preceded by LIFO inventory liquidations. In fact, research shows that sometimes LIFO inventory liquidation can be as much as a year or two years prior to the company acknowledging that that particular business isn't working.

If you look at bricks and mortar retailers, and I draw that distinction because Internet retailers are quite different in respect to this and you have to think about them differently, but for a long time analyses of financial distress on a very timely basis can be achieved by looking at trends in the operating cycle. How long does it take to sell your inventory? How many days does it take to collect your receivables? That's what we, the analytical world, we call that the operating cycle. If you subtract from that the amount of time the suppliers allow you to pay off for your purchases, that gives you a cash cycle.

And trends in these operating and cash cycles have been indicative of financial distress for as much as three years. And three years, as most of the investors would agree, is almost, you know, an eternity in the financial markets. So from that perspective, these are the kinds of measures that I think are very helpful or can be very helpful.

Similar analyses of deferred tax footnotes, valuation allowance for deferred tax assets, the way statements of cash flows present and provide information, these I think would yield significantly useful indicators.

The fundamental challenge, however, is in identifying appropriate risk measures in order to develop these types of output-based indicators.

All right, so that's my presentation, Steve.

CHAIRMAN HARRIS: Well, Tony, thank you very much. I think that's an excellent presentation. I think what I'd like to do is let you lead the discussion, or the general discussion, with respect to the questions and, Greg, you should feel free to join the fray as you see fit.

But I think there are a number of questions and, first of all, I'd like to open it up to the members to ask whatever questions, recognizing Security and Exchange Commission first, so Brian.

MR. CROTEAU: Well, thanks very much. I just wanted to go back to the point that you raised, I don't know if the slide has a number, but on transparency of inspection results.

And it's not surprising 80 percent of respondents called for increased transparency but, of course, that can mean a lot of different things. And the PCAOB certainly is looking at this relative to improving the content of inspection reports and this is on the agenda for today.

But is there any more detail relative to what that meant to the respondents in terms of the types of transparency that respondents were looking for?

MEMBER SONDHI: Before I answer that, though, let me just mention that, you know, all of my group, you're all welcome to respond to these. I've been doing all the --I've done the presentation, but please feel free because you've obviously contributed to this and you have your own views as well on this.

Brian, with respect to that specific question, you know, one of the problems or one of the sort of shortcomings of questionnaires is that you provide a certain amount of information. One of the things that we've done, that the CFA Institute has been doing lately, is for particularly difficult issues they provide a great deal of information beforehand.

For example, they recently conducted a survey on leases and they presented both the FASB and the IASB perspectives and provided information in those webcasts and slides and explained aspects and then asked questions, right?

But in this particular instance, I don't think we had that much detail and what you see, in a sense, is what you get. But I certainly agree that, you know, that could be one of those questions that we need about five or six different aspects of it probed and then we could get better information from our respondents on that.

CHAIRMAN HARRIS: Identify yourself for the person that's taking the transcript, if you would.

MEMBER HEAD: Mike Head, and I only have a population of one because I interacted with my company's audit committee on a regular basis and on multiple years of inspection reports.

And when they talked about in our dialogues in the meeting on transparency relative to the inspection reports, it really tied very closely to but what's it mean for our engagement? What's it mean about our team? What's it mean about -- and so we would go through exercises and we got to a point where we anticipated it.

After the first one, it was a fire drill but then it was more routine, is taking the other firms' inspection reports, comparing it to ours and then going through every question and saying if that was applicable to our industry and our company and, if so, having our auditors respond to how they were addressing it for our audit.

So, I think the audit quality indicators initiatives and what our audit committee saw as missing information to connect the dots was what about our engagement, our team and the quality of that relative to, because our audit didn't happen to be in the sample that was inspected, and that was the disconnect for them.

CHAIRMAN HARRIS: Tony, I'm going to let you lead the discussion but as the tent cards go up I think that Barbara's went up and then Peter's went up. But why don't you lead it and --

MEMBER SONDHI: Yes. Barbara.

MEMBER ROPER: Barbara Roper, Consumer Federation of America. Thanks for the presentation. I found it very useful.

You know, I come at this from sort of a certain approach, which is that I think we have a business model for auditors that's fundamentally inconsistent with their gatekeeper role. So we then spend a lot of time -- so when the client is paying the person who is supposed to be holding the management accountable, that creates a fundamental problem in the auditor's willingness to serve in that role effectively.

So we spent a lot of time on policies that are designed to create counter-incentives, and this strikes me as an important part of that effort. One of the problems we're dealing with here is that there is an incentive and even with the audit committee oversight of the audit, there is an incentive to under-invest in a quality audit, to have pressures on the fees and to have that be a factor that drives the conduct of the audit.

And to the degree that we can look at audit quality indicators that are designed to create a counterincentive to invest in a high-quality audit, I think that has the potential to be beneficial in the long run. And I think a lot of what you've gotten at here in these specific suggestions go toward that in terms of both looking at how the audit is staffed and the expertise and the area.

And I think it has a secondary benefit in the sense of holding audit committees accountable for who they hire and how they oversee that audit. So, I think you've done a good job in focusing on some key issues that are really important to that and I'm very supportive.

MEMBER SONDHI: Thank you, Barbara. Norman, did you want to respond?

MEMBER HARRISON: Yes. Barbara, thank you. I agree. I think you raise a very important concept and point and we certainly were mindful of that in our deliberations and in preparing our presentation remarks for today. And you've provided me an opening or a window to raise a similar issue that I think should inform the staff's and the Board's thinking as you get to the task of identifying specific indicators or categories of indicators and their relative value or worth.

I guess what I would suggest is, and perhaps appropriately given that we are the Investor Advisory Group, that as you consider specific candidates for input and process and output-based indicators, that you overlay an investment framework as well, because at the end of the day I think what we're doing here in the process of developing or proposing indicators is in one form or another measuring behavior, measuring behavior of individuals, measuring behavior of an enterprise.

And individuals is relatively straightforward. It's the technical competence and the quality and the integrity of the people conducting the audits and the results of their performance in prior years. But when it comes to measuring or assessing the behavior of an enterprise, I think one of the ways we have to do it is by looking at where and how they've chosen to spend or invest their resources. And I think that the audit quality indicator discussion and framework gives us an opportunity to look at that.

And as I look back at the discussion paper that was prepared for the SAG meeting in the spring and the exhibits which outline the framework and the considerations that underlie each of the potential indicators, it occurred to me that some of those fall more into the category of an expenditure as such, whereas others have more the quality of an actual investment associated with them.

And what I mean by that is, for example, if we measure the amount of money that a firm spends on training or on its promotional materials or publications, other current expenditures that are designed to talk about or characterize or reinforce its commitment to audit quality, I'm not sure what we get out of those, other than how much money they've spent. It's like looking at their grocery list for the ingredients they bought for the cake, but until we see the cake or the soufflé come out of the oven, I'm not sure what that's really told us.

Similarly, to jump to a balance-sheet analogy, there are intangibles that are, I think, incorporated into some of the indicators, for example tone at the top or some attempt to measure partner fortitude in standing up to a client where there may be a contentious issue.

Again, I'm not sure there is as much value in those as there is in what I think of as the third category, and that is places where the firm has in one or another made an actual investment. And, investment in the form of an opportunity cost, investment in the form of allocation of resources to non-fee-producing activities.

I think two good examples, and I'll be quick because I know that others want to speak, two good examples of that reflected in our presentation is that in some way I think the indicators that the Board proposes should try to capture and provide some insight into the independence process at the firms, the independence review process. To what extent, to what degree have they demonstrated a willingness to forsake revenue or to put revenue at risk in order to protect the integrity of their audit practice? And we had a good discussion around this at last year's meeting, discussion of the growth of the advisory businesses in the firms and some of the cultural issues that creates. I think that's relevant here as well.

And as a second example, again it's reflected in your discussion paper as well as in our presentation, the issue of the findings of audit quality review processes internally. I think the issue there is not only, you know, what are the findings and what can we learn from them, but if there is some way to capture the level of investment that the firms are making in their QPR processes.

Are they taking partners, high fee-producing partners out of rotation for a period to serve in that capacity? What is the nature of the follow-on work that's being done, the remediation work that's being done, the investment that's being made in running these issues to ground and being sure they're fixed? And that's not a current period issue. That's an issue that unfolds over time so that would be my thought and, Barbara, I appreciate the point. It's a very good one.

MEMBER SONDHI: Thank you, Norman. Lynn, did you want to respond to this or add?

MEMBER TURNER: I wanted to come back to Brian's question about the transparency and more specifically what are people saying about transparency?

In talking to people who are analysts inside these large funds, one of the things, and this goes back