NOTICE: This is an unofficial transcript of the Public Company Accounting Oversight Board's March 22, 2012 Public Meeting on Auditor Independence and Audit Firm Rotation.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION

PCAOB RULEMAKING DOCKET MATTER

NO. 37

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PUBLIC MEETING

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THURSDAY

MARCH 22, 2012

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The Public Meeting convened in the National Association of Home Builders Auditorium, 1201 15th Street, N.W., Washington, D.C. at 8:45 a.m., Jim Doty, PCAOB Chairman, presiding.

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LARRY HARRINGTON, Vice President of Internal Audit, Raytheon Company; Chairman of the North American Board,

Institute of Internal Auditors

THE HONORABLE RODERICK M. HILLS, Chairman, Hills Program on Governance at the Center for Strategic and International Studies; Partner, Hills, Stern & Morley; former Chairman, U.S. Securities and Exchange Commission

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CATHERINE P. LEGO, Chairman of the Audit Committee, SanDisk Corporation and Lam Research Corporation

ALEX J. MANDL, Chairman of the Audit Committee, Dell Inc.

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JACK PARSONS, independent financial consultant

ROBERT POZEN, Senior Lecturer, Harvard Business School and Senior Fellow, Brookings Institution

RICHARD ROEDEL, Chairman of the Audit Committee, Lorillard, Inc.

ROBERT E. SMITH, Vice President and Deputy General Counsel, NiSource Inc.; Chairman of the Policy Advisory Committee, Society of Corporate Secretaries and Governance Professionals

CHARLES WEINSTEIN, Chief Executive Officer, EisnerAmper LLP

ARNOLD WRIGHT, Joseph M. Golemme Research Chair, Northeastern University, College of Business Administration

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8:45 a.m.

CHAIRMAN DOTY: Ladies and gentlemen, it is 8:45 PCAOB time and we have 15 minutes before this panel is scheduled to begin. And I thought I would say two things. Welcome. We are very grateful for the attention that members of the audience and the panels gave us yesterday. We believe we had an outstanding day in which we heard a lot of wonderful and stimulating comments from a wide range of participants in the financial services and auditing industry with comments that were not unexpected to us and much of it was comment that we had heard in one form or another before, but we thought it was especially well presented yesterday and it was important to have on the public record.

Today, we are continuing with audit committees, with former Commission and accounting officers, and academic opinion. We will move right through these panels. And I thought I would introduce the first panel and we could get going and save a little time, have more time for questions.

Steve Harris has a brief statement. Do you want to make a brief statement?

MEMBER HARRIS: Well, very briefly, Chairman Hills, I was rereading your testimony before the Senate Banking Committee ten years ago this past month and I think it is fair to say that as Chairman of the SEC you were the father of the mandatory audit committee and I know that you were primarily responsible for Section 301 of the Sarbanes-Oxley Act which establishes independent audit committees. So I particularly look forward to your statement this morning and thank you for joining us and for all your help in the crafting of SOX and in your support of the PCAOB during our constitutional challenge. So I particularly wanted to welcome you and that was ten years ago that you testified before the Committee.

CHAIRMAN DOTY: Do any other Board members want to make a statement before we begin?

I should also add that we were benefitted, as we always are, by the presence of the Chief Accountant and the Deputy Chief Accountant of the SEC. Jim Kroeker and Brian Croteau spent a long day with us yesterday and it was a big help to us to have them here.

The first committee focuses on audit committees and as Steve just said the father of the independent audit committee.

Paul W. Chellgren is Chairman of the Audit Committee of PNC Financial Services Group. He is the operating partner with Snow Phipps Group LLC, Private Equity. He has served some of the giants in American industry. He's been the Chief Executive Officer of Ashland, a big specialty chemical company. He was involved with McKinsey & Company early in his career, became an operations analyst in the Department of Defense. He has served in senior executive positions with Boise Cascade, Universal Capital. He holds a degree from University College Oxford and he is adjunct professor at the College of Business at Northern Kentucky. So welcome. Welcome to you, Paul.

Chairman Hills. Chairman Roderick Hills is a partner of Hills, Stern & Morley, LLP. He is former Chairman of the United States Securities and Exchange Commission, but knowing him as I do, I think that of which he is the most proud is that he is the Chairman of the Hills Program on Governance at the Center for Strategic and International Studies. And he has a very active program in the Peoples Republic of China at this point and spends as much of his time as a distinguished Fellow of the Yale Law School of Organization and Management and a lecturer in the School of Law at Stanford and supporting any number of important initiatives abroad as he does with his law practice.

Catherine Lego. Cathy Lego is Chairman of the Audit Committee of SanDisk Corporation and Lam Research Corporation. She was the general partner of the Photonics Fund, LLP, a venture capital investment fund that she founded. She has received her CPA in connection with her work at Coopers & Lybrand earlier in her career. But she is one of the people on the audit committees who is always dissuaded from resigning the job of Chairman of the Audit Committee. And she is the person of great financial literacy and we're glad to have her here.

Alex Mandl. Alex Mandl is Chairman of the Audit Committee of a small Austin, Texas-based company called Dell. He's been the Chairman of the Board of Gemalto, a global leader in digital security, the president and CEO and a member of the Board of Gemplus. He served previously as chairman and CEO of Telegent, president and COO of AT&T,

chairman and CEO of Sea-Land Service. Alex is one of the true heavies in the area of audit committee governance and board service and we are grateful for him taking the time to do it. He also serves, by the way, on our Standing Advisory Group.

Rich Roedel, Chairman of the Audit Committee of, Lorillard. Thirty years in public accountancy and the auditing profession, retiring from BDO Seidman in 2000, having served in various capacities including as chairman and CEO. He is on the audit committee on BrightPoint, Sealy, Broadview Networks. He's chairman of the audit committees. He is member of the Board of Directors of the Association of Audit Committee Members, Inc., a not-for-profit organization and as with many of our panelists devotes a lot of his time to nonprofit and public interest, public service roles. So we welcome all of you. We thank you and invite your comments.

Paul, do you want to begin? And then we'll move down the panel.

MR. CHELLGREN: Thank you, Mr. Chairman. I appreciate the opportunity on behalf of the Audit Committee on the PNC Financial Services Group to participate in this panel and discuss our views on mandatory audit firm rotation.

I first state that we absolutely agree with the goal of improving audit quality, including making sure the auditors are independent, objective, and exhibit professional skepticism. I do not dispute the need for continued focus in this area, however, we strongly object to mandatory audit firm rotation as a way to achieve this goal.

We come to the conclusion for several reasons. We start with the absence of any compelling evidence that mandatory audit firm rotation is like to provide meaningful enhancement to our audit quality. On the contrary, we are concerned about the impact of the costs and added risks of mandatory rotation, including the very real risk to audit quality for a period of time following a change in external auditor magnified by making those changes on a regular recurring basis. We're also keenly aware of a wide range of practical difficulties with forcing public companies to change auditors every few years.

In our comment letters, we and others have put significant details around these costs, risks, and practical difficulties. Let me focus today on our first objection to mandatory rotation. Frankly, it usurps the role of the audit committee. We believe mandatory audit firm rotation undercuts the primacy of the role of the audit committee in supervising the relationship with the external auditor. One of the important reforms coming out of Sarbanes-Oxley was to put to the audit committee clearly and firmly in charge of the relationship with the issuer's audit firm. Under Sarbanes, the decision to change audit firms is the responsibility of the company's audit committee. In our case, that decision and our annual selection of our auditor is ratified by the entire board and our shareholders.

We believe this is the right approach and that the decision as to who should be in an issuer's audit firm should not be controlled arbitrarily through regulation. The audit committee is in the best position to understand the issuer and its needs and to evaluate which audit firm best meets those needs. It is also best situated to weigh the risks and benefits of changing an audit firm at any particular point in time. The committee should not be forced to select an audit firm that it views as being less well suited or qualified for the position solely based on a hypothetical concern that a different firm might be insufficiently skeptical.

My understanding is that audit committees, including ours particularly, have stepped up following Sarbanes and take this responsibility to provide oversight of the audit firm very seriously. Ironically, the lessening of leverage resulting from mandatory rotation can only weaken the committee's ability to exercise proper oversight during the rotation period.

In many cases, as a practical matter, due to other relationships, other factors, engagement size or the need for specialized expertness, there will not be more than perhaps even two or three firms capable of handling an assignment. At PNC, our audit committee regularly reviews and evaluates the performance of our audit firm. We do this every year and consciously decide to re-employ our audit firm every year.

Indeed, five years ago, during my tenure as committee chair, we changed audit firms and thus have a pretty good idea what it entails at a large, complex, financial services company such as ours to change external auditors.

Our committee made this decision after careful consideration of costs, risks, and anticipated benefits. Although the internal resources and effort necessary to support the transition were significant, we concluded that the change was, on balance, desirable at the time. Mandatory audit firm rotation would take the ability to weigh costs and benefits out of the hands of those best positioned to make that analysis and judgment. That is the company's engaged audit committee, appointed by the board, elected by the shareholders, the owners of the company working with company management. This flies directly in the face of the principle established so clearly and frankly so successfully under Sarbanes that the audit committee must be responsible for the relationship with an issuer's outside audit firm.

Thank you for inviting me to participate here today and to take the opportunity to share with you our views on mandatory audit firm rotation. And I look forward to the panel discussion.

CHAIRMAN DOTY: Thank you. Chairman Hills.

MR. HILLS: Paul has saved a couple minutes of my presentation, so you can have those for the question and answer period. I like, Paul, appreciate the chance to give you my views on the question of audit independence. They are views, as you might imagine shaped by, in my case, 43 years of experience, 20 times as corporate director, 12 times chairman of the audit committee, a whole lot of corporate train wrecks, a lot of accounting scandals. But in particular, my views are affected by the fact that we had 400 American companies, give or take, about 400, that admitted they bribed a foreign official back in 1976, '77.

To deal with the problem back then we adopted a new auditing standard which essentially said that auditors, if they see something suspicious on the financial records of a company, they've got to call it to the attention of somebody independent of that suspicion. And we are able to persuade the New York Stock Exchange at the time to say they would have independent audit committees, so there would be somebody to which the suspicion could be taken.

I think it's fair to say that was the first time the SEC took seriously the question of auditor independence, the first time that somebody said you guys are supposed to protect that independence. Twenty-five years later, Enron, Global Crossing, Waste Management gave us Sarbanes-Oxley which has some of the DNA of what was done back in the '70s at the SEC. In particular, as Paul said, put new responsibility on the outside audit committee.

Now you ask whether or not mandatory rotation will somehow further enhance the role of the audit committee and I think the answer is no. And there are a lot of reasons for it. My concern, apparently, just like Paul's is what it would do to the authority of the audit committee.

Let me quote from my written statement. To a consensus reached by 57 individuals, I think the chairman was actually present at that session, 57 who were highly qualified to deal with the issue, who understand the issue. Their consensus is simply if rotation of auditors was made mandatory much of the authority of audit committees over auditors would be forfeited.

The better way to protect the independence of the auditors is to enhance the independence of the audit committee members. Let me quote from a report on corporate governance of the Committee for Economic

Development. Referring to a paradox of corporate stewardship "is that despite the principle that directors represent shareholders in the selection and retention of management, historically, most directors have been selected by management."

Until management is removed from the selection of directors, audit committee members are going to be suspect. The independence of audit committee members are going to be suspect and often compromised. I have to say that over those 43 years and all those instances where it was clear that management should be disciplined for some reason or another, there was always one or two directors who refused to criticize the person who put them on the corporate board. I think it's well within the discretion of the Board and of the Commission to say quite plainly that the manner in which directors are selected for board membership is necessarily related to the question of whether the audit committee members have appropriate independence.

Rather than take away the discretion of the audit committee, more responsibility can be plainly placed on them. Our experience and the last few times I was audit committee chairman was, to say quite plainly, every exigent number of years the audit committee will go through a routine to determine whether or not the auditor should be retained and the audit committee was required to express why they did or did not retain the audit committee. There are some other reasons for that. But it seems to me it should be self evident that an audit committee that has the responsibility to make that evaluation is going to have far more impact upon audit independence than one that has no discretion with respect to the retention of the audit committee.

Mandatory rotation would make salesmanship the single most important quality an audit committee partner. Think of the chaos that mandatory rotation would cause, 7-year rotation, 14 percent of all clients would have to be kicked out every year and to maintain the integrity of the firm you'd have to get 14 percent in. You can just imagine the swaps that would occur. Who are you losing this year? What is our chance of getting him? You have non-audit fees. You're losing an audit partner. How long is it going to take the audit partner to try to figure out a way to get the assignment for non-audit fees?

Mr. Chairman, it just seems to me that, in short, for so many reasons we should not sacrifice the audit committee to the bureaucracy, if I may say, of mandatory rotation. Thank you.

CHAIRMAN DOTY: Thank you. Cathy Lego.

MS. LEGO: Thank you, Chairman, and thank you, Board, for having me here to participate as an audit committee chair. I have chaired audit committees of private, small companies in my capacity as a venture capitalist for 25 years. In the most recent time, I've been the audit chair of a number of public companies and the current two public companies are large multi-national corporations.

I appreciate a chance to also tell you our goal is the same. As the audit committee chair of a company, it is the integrity of the financials and the information that's provided to shareholders which is our number one objective is to ensure high quality, to ensure that we have hired and retained and evaluate the external auditors that are independent, are skeptical, and can provide the judgment on the other side of management's judgment on all of the items of revenue recognition and tax and the complexity of the financials to the point where unless you're extremely current on today's financial standards, you need these professionals to give you as an audit committee member guidance.

I do not believe that mandatory rotation will improve the audit quality or enhance the auditor independence. So I will provide you some reasons and then maybe some color of what we do and maybe how we can make the independence more independent and the skepticism more skeptical, but we as a team need to work together.

I don't believe shorter tenure by forcing rotation will help. I do believe their institutional knowledge runs deep in the audit teams, especially when decisions have been made as to joint venture accounting in revenue recognition, on how we will apply certain policies on inventory and reserve analysis. That we can't lose by bringing a new firm up.

Yes, we have brought new firms up and that first year takes more time. On the audit committee, it takes more time on behalf of the financial staff of the organizations.

I concern myself with that learning curve, but we go through it at least every five years on a single individual as the audit partner and that's seriously the opportunity for the audit committee chair to work with the audit partner to make sure he or she is well versed in how things are done and bring their new perspective to question whether that's the correct way to be doing what we're choosing to do.

I'm concerned about the costs increasing because as I've asked people, the bidding process is not one of no cost. The cost of supplying the audit committee chair with a quality bid could be 5 or 1,000 hours of a firm's time. That will be embedded in everyone's costs. If we're adding more rotation, we're going to see a lot more bidding and lot more time to bring the financial team into the bids as well as bringing up the new partners. So I'm concerned with more cost to companies where we already have significant costs in this area.

I want you to believe, although independence is based on relationships, that the relationship which may be 20 or 30 years between a firm and a company, the firm being the Big Four, the company being a technology company, is not static. Within that time, the audit committee changes its constitution and its members. The CFO in the Valley, Silicon Valley, CFOs change every five years, controllers change about that same. The audit committee team is rotated. So you really have three sets of people with eyes. Businesses don't have eyes. People have eyes. And as audit committee people come in with fresh views from their companies and this is why I'm a strong proponent of sitting CFOs being part of committees, you have new controllers from other corporations.

I do underscore rotating people

from your auditing firm into your company does add some independence risk, so there may be need for a time out so that they come in with a little skepticism that they don't know everything because they weren't there yesterday. So these eyes are new eyes. They do add skeptical views. Do they do add well, this is how we did it over here and question the judgments of management.

But fundamentally, I agree with what Paul and what Mr. Hill said. It is the job of the audit committee. Please don't take my job away. I made a commitment to the shareholders that I'm there on the behalf of the board. The audit committee is there on behalf of the board to oversee the integrity of the financials. We are there to appoint, to compensate, to look over the qualifications, review the independence, and perform an evaluation of the firms. We do that periodically. We may need to add a little more rigor around the timing of that, but we do do it.

In one of my companies, when a partner came up for rotation, we spent quite a bit of time without going out to bid for another Big Four, to review the new person coming in, the quality of the work being performed by the Big Four auditor, the independence of that auditor and whether or not they could best serve that firm. We made the decision to stay with the firm, but we went through a process that took a significant amount of time.

The audit committees have really stepped up their game in the last ten years from merely attending quarterly meetings to review the financials and discuss the judgment items with the outside auditors. The number of meetings we have is enhanced by quarterly meetings with internal audit, quarterly meetings with internal compliance, reviews of auditors, references of partners, interviewing new partners of rotation. The amount of time it takes to be an audit committee chair, an audit committee member is increased significantly.

The risks, if you keep adding more and more time and responsibility, as we now see, we won't have people take the job. And the quality people have other things to do as well. So I don't want to lose sitting CFOs as members because the time committee is now increasing. I sit on round tables with other audit committee chairs at Ernst & Young, KPMG, Deloitte. They sponsor these round tables to give us an opportunity as audit committee chairs to talk about what's on our mind, what are the issues. We have a chance to dialogue about what's happening in audit practice.

What I would like to see is and encourage the PCAOB to dialogue with us, what's on your mind? If pricing policies is the issue, you're going to discuss this year, let us scope it in. Let us set the scope at a higher bar. Let us view what you have before the audit takes place, before your review takes place. Work with us.

I really believe that we can form a stronger team and I appreciate the opportunity to be here today and look forward to your questions and hopefully can provide some insight. Thank you.

CHAIRMAN DOTY: Thank you. Alex Mandl.

MR. MANDL: Thank you, Mr. Chairman. Thanks for having me. In listening to my panel colleagues on my left here, my prepared notes really echo almost all the points you just heard. And I'm not going to bore you with that. So instead, I think I'll just hit on a couple of topics that I think is particularly relevant and hopefully we'll bring you a big of a Dell perspective to what we're talking about here.

One of the advantages of being around for a while is that you have seen, there's this whole topic that's evolved over many years and I have been part of audit committees in one form or another for more than three decades. And so with it, I have a bit of a perspective as to how things have evolved.

The first point I want to make which echoes a little bit what a couple of my colleagues have touched on here a minute ago is the role of the audit committee. When I think back 25 years ago, and how the audit committee functioned at that point and what its purpose was, and how it had -- what sort of authorities and diligence it had, it was very, very different than what we have seen the last ten years since SOX came into place. And the difference is just basically accountability, diligence, really having specific accountabilities that just weren't there 25 years ago.

So the point is the audit committee today has -- and there's always room for improvement -- but the audit committees today do have real accountabilities, real responsibilities, and take their job very, very seriously. I'm not saying 25 years ago people didn't take that job seriously, but there's a different degree of sincerity, of commitment, of homework, of gathering the right resources and I guess the point is and it was made before, don't change that. I mean taking that away from what has evolved to be a really solid resource in the overall governance process I think would be a mistake and mandatory rotation would, I think, take some of that way. So that's one point I wanted to make.

The second point I was going to touch on relates to the institutional knowledge topic. I've been with Dell now for a long time. I won't tell you exactly how many years, but I'll tell the revenue of Dell when I joined was $3 billion and it's roughly $65 billion this year in that range.

(Laughter.)

CHAIRMAN DOTY: That is not a Reg FD violation.

(Laughter.)

MR. MANDL: That's what the analysts say. Yes, thank you.

(Laughter.)

And the point is that it's a complex business. It is all over the world and operates in 80 different countries, in some difficult countries, and our auditors have developed skills in those places, in Malaysia, in Bratislava, in other parts of the world where those resources are not naturally there. And so if you -- that's sort of institutional global perspective and knowledge understanding of the business to sort of swap that out every few years I think would add risk to the audit and would complicate the audit and I don't think would improve the quality of the audit.

So the institutional knowledge that gets developed over time by virtue of a firm being closely involved with many people over a longer period of time is something we need to respect and something we need to appreciate in the context of assessing the quality of the work that gets done.

So I would just urge us again in the context of mandatory rotation don't underestimate the importance of the enhancement of quality of audits by virtue of this institutional knowledge that has been developed over time. Thanks.

CHAIRMAN DOTY: Thank you. Rich Roedel

MR. ROEDEL: First of all, thank you for the opportunity to present Lorillard's view on auditor independence and audit firm rotation. The Chairman mentioned my background, but I'd like to spend just a moment mentioning it again because I think it will put into context the remarks that I'll make over the course of the next few minutes.

I spent the first 30 years, three

decades, at BDO and most of those years was as an auditor. I left the firm in 2000, then its chairman and CEO. And for the last 12 years I've been in the board business. I've served on nine public company boards. I've served on nine audit committees. I chaired seven of those committees and presently I sit on six public company boards and I chair four audit committees. I'm also the lead independent director for Lorillard.

At the risk of being obvious, the subject of audit quality and auditor independence are obviously important to me in the work that I do and obviously important to the investors that I serve.

In Lorillard's comment letter, we addressed the importance of maintaining healthy professional skepticism and independence in our view of how the existing environment which we believe supports those objectives can be approved.

One thing we mentioned as the

people to my left have as well, we don't believe that the benefits of mandatory rotation when viewed in context of the risk to audit quality is a very good idea. Auditor independence and audit quality have improved significantly since the implementation of the requirements of Sarbanes-Oxley. I would add to that that the efforts of the PCAOB, the audit firms, and audit committees, have all contributed significantly to creating an environment where as Alex said, I think we're a lot better off today than we were many years ago.

Specifically, two principles in the Act have been paramount, I believe, in improving audit quality. First, the required rotation of key members of the engagement team and second, charging the audit committee, comprised entirely of independent directors, with the responsibility to engage auditors, to oversee their work, and to review their performance.

With the remaining time I have, I'd like to comment on the continuing role audit committees can play in creating an environment that is conducive to audit excellence and an environment that demands professional skepticism and independence.

Audit committees will continue to play a critical role in improving audit quality provided they are experienced, knowledgeable and engaged. They're independent in how they are perceived and as importantly how they behave. Have the required resources and employ the best of breed processes. Develop the requisite relationship with the independent auditors, executive management, financial management, and internal auditors, a relationship that is both transparent and highly communicative. And help set the tone at the top that is conducive to assuring the highest standards of financial reporting, one where the needs of investors are never compromised.

Many constructive ideas were raised by respondents to enhance audit firm and audit committee communication. We believe they should be explored.

One remaining point. Since the passage of the Act, the PCAOB has issued numerous standards to guide auditors and promote independence and professional skepticism. And additional standards are scheduled to be released in 2012. We are certain that these will help make a difference.

We are confident a committed regulatory agency, a dedicated audit profession, and an engaged and relevant audit committees will continue to promote professional skepticism and independence and in the process continue to improve audit quality.

In closing, we applaud the efforts of the PCAOB and the audit firms to continue to improve the quality of financial audits for the benefit of our investors. Thank you again for the opportunity to present the views of Lorillard's audit committee.

CHAIRMAN DOTY: Thank you all. It's been my practice in the meeting to call on my colleagues on the Board first, but I want to make an exception here because there's one overhanging question that comes out of all of your comments, I think.

What if there's been no review by an audit committee after 15 years? I took away from the panel a kind of consensus, a very healthy one that we have heard reflected many times and that is we shouldn't take out of the hands of the audit committee the ability to do its job, to review the auditors and to evaluate them. And you all come from audit committees in which you've said that you do this periodically, annually, in the case of PNC.

Are you concerned or does it remain an issue as to whether independence should be in the terms of the audit committee and in terms of the reevaluation, should be assessed by us in a review, retain, and explain format. We heard a lot about this yesterday. In other words, would you be of the view that audit committees should disclose how often they review. If they don't review in say 15 years, that somehow this Board should make a judgment, a presumption, a rebuttable presumption about the independence of the auditors and require them to review. And if not reviewed, and if retained, and not explained by the audit committee, then we would have a more questionable set of facts.

How do the panelists react to that? Chairman Hills, would you start us and then we'll take it around?

MR. HILLS: I think that in simple terms an audit committee that does not do exactly what you suggested, constitutes a material weakness in the internal controls of the company. It's something that is actionable. Frankly, the auditor should be responsible for checking it. It is -- I don't see it as anything different from anything else you send your auditors for. The auditors have material weaknesses in the way they do the books, you say something about it, and ask them to fix it.

I'm not an expert. Mr. Ferguson will have to tell me whether you have the legal capacity to do this and I don't see any reason in the world why you can't cite a company, cite a board, audit committee, for failure to do what clearly should be done, because I think it is a material weakness.

I've been trying for 37 years to get somebody to say well, while he or she is still chairman of the SEC, that is a material weakness not to have a qualified independent audit committee that does its job. But I do think it's well within your responsibility. I don't think you have to wait 15 years. I think you can do it every year.

CHAIRMAN DOTY: Any other panelists have strong views on review, retain, and explain or what happens if an audit committee doesn't for 15 years, should we be concerned about the independence?

Cathy?

MS. LEGO: You know, in every annual proxy, the audit committee makes a statement that it does review, evaluate, and look at the independence of the audit firm. So asking them how they do that is a valid question or they shouldn't make the statement in the proxy.

CHAIRMAN DOTY: Should we be concerned as a Board to understand that thoroughly, how they do it?

MS. LEGO: I don't know if you need all the detail, but I think you need an assurance that it's being done.

MR. CHELLGREN: Cathy made, I thought, a good point. This is not a static situation. There are at least three sets of interpersonal dynamics that work here, changes within company management, CEO, CFO, controller, senior accounting personnel, number one. Number two, changes in the board and the audit committee composition. And three, with mandatory engagement partner rotation, changes in the external auditor staffing as well. So those dynamics are going on on a regular recurring basis.

CHAIRMAN DOTY: So there might be good explanatory matter you'd like to know about.

Rich?

MR. ROEDEL: Yes, I would just add, I think it's incumbent on audit committees to take their ownership of the relationship with the independent auditors quite seriously, right? That's really what we're talking about, how to exercise those ownership rights and obligations and one of the things that is paramount in that is to annually review the performance of the independent auditors.

And in the committees that I chair, we go through a very rigorous process of evaluating performance. We get input from executive management, financial management, people in the field who have touched that relationship, internal auditors, the audit committee, obviously, anybody who has the general counsel, anybody who has specific knowledge about how our external auditor performs. We evaluate that. We track results year over year.

And we sit down just like auditors do with management. We sit down and we review the results of that, figuring out where we can all do better in executing against our objectives.

In specific answer to your question, maybe the place for the audit committee to tell its investors what it has done is in the audit committee report that finds its way into a proxy. So maybe as part of our communication the audit committee's communication with investors is a place for us to say what we've done in context of exercising those ownership rights and obligations.

CHAIRMAN DOTY: Your favorable comments on our outstanding proposals, by the way, for communication with auditors is much appreciated. We take note.

Alex?

MR. MANDL: Yes, I think the annual review that's been described here, I think is absolutely critical and appropriate and called for and is needed and at least the companies that I'm familiar with I think would take that very seriously.

The additional comment I would make, however, is beyond that annual review that should go on at the audit committee and ensure that the audit function, the external audit function is being performed the right way, there should also be another level of question or concern and that is some kind of event, a merger of the company, or an accounting, a serious accounting problem, or some extraordinary event whereby that would trigger an even more comprehensive analysis and review of the audit committee to assess whether or not the current provider of those services is still appropriate.

CHAIRMAN DOTY: It may happen for these other reasons.

MR. MANDL: That's right. So I mean the only point is that annual reviews are critical and paramount for the audit committee to perform in this regard, but on top of that if there is some other major circumstance or event that should trigger an even more comprehensive assessment and review and diligence around who is providing the services.

MR. ROEDEL: One other point, Mr. Chairman, it also, this annual review I think is important because it also underscores what we're talking about here. And that is that the audit committee owns that relationship. And for us to exercise those rights and obligations and annual review of the firm's performance is paramount because it underscores where the relationship exists between audit committee and auditor and not financial management and auditor.

CHAIRMAN DOTY: Lewis, you've been taking notes. Do you want to jump in?

MEMBER FERGUSON: I would just like to ask the question because it seems to me that underlying what all of you have said is an assumption that audit committees, in fact, perform the things we've talked about here with a high level of skill.

And certainly, one of the things that I've observed both in this position and in many, many, many years of private law practice is that in the thousands of U.S. public companies, the skill levels of audit committees varies widely. There are many audit committees that simply have neither the skills nor perform the diligence that's necessary to do the kinds of things that you do which I applaud. I mean I think certainly the structure is in place to provide adequate oversight if it's done. So how do we deal with that?

Part of the reason we're considering these things is that you know is because we have seen significant failures by audit committees to perform the kinds of oversight you all are talking about. So how do we deal with that? What is your suggestion for that?

MR. HILLS: The audit committee charter should be a subject of examination by the Board, just like the way in which an audit firm does it audit, the audit committee charter tells an audit committee what it's supposed to do.

I think a good audit committee charter says that every five years, give or take, six years, four years, seven years, they must go through a procedure to test the efficacy of the auditors and the independence of the auditors.

I don't see any reason in the world why the Board should not be looking into the capacity of the audit committee and the routine that goes into it as it looks into the capacity of the auditors. The two go together. You have to have an effective independent audit committee to have an effective set of internal controls.

MR. ROEDEL: A couple of things in response. First of all, I think that the responsibility of that in large part lies with the investors to make sure that the board is properly constituted and, in particular, that the members on the board who serve on the audit committee are appropriately knowledgeable and skilled.

You mentioned, Mr. Ferguson, the structure to do all of this exists at the moment. Audit committees, if they're knowledgeable, if they're experienced, if they are truly independent, if they're engaged, if they take their job seriously, if they have the right skills and experience resident on that committee, can really do an effective job in managing and therefore mitigating the issues that concern all of us here today and that is making sure that there's an environment where there is healthy skepticism and undying independence.

And so I think the structure exists. Audit committees, I think Alex mentioned it before, audit committees are so different today. The first 30 years of my career, as I've mentioned twice already, was on the other side of this issue. I saw audit committees. I saw how they were constructed. I saw what they did, and sometimes I saw what they didn't do. The audit committees that I'm associated with, the people that I know who are in positions similar to mine, suggest that there has been a huge, a huge amount of change in the quality of those audit committees and, importantly, how they execute their fiduciary responsibilities.

MS. LEGO: The board of directors, really, appoints the committee to oversee the audit. Annually, the board has to conduct evaluations, and in the situation of my two public boards, the board evaluates the audit committee on how it performs its duty on behalf of the shareholders. So part of it is in there.

What I caution is a check box, do you have the skills, because I've been many individuals have the skills and not the time. You can see the skills and not the independence. You can see the skills and not the skepticism. It's how it's all applied.

I think it's important really in the role of the chair to assure that the constitution of his or her committee is of people who can bring the skepticism, can bring the talent, so that it's not one financial expert's view. So I just don't want it to be do you have these people that can do this. The board should be looking at it do we have the people who are doing this. Thank you.

MR. MANDL: I think Catherine said it well, at the risk of being slightly repetitive, it is the board, but more specifically, it's either the chairman of the board or the lead director working with the nomination governance committee, if that's not the same person which sometimes it is and sometimes it isn't, to assure that, quote, the right people are on the audit committee.

But to Catherine's point, there's a necessary second step. And that's the annual evaluation process that if performed with some independent resource from the outside usually, that really assesses how are these committees performing including the audit committee. I think the combination of those two factors I think can address your point. There's always room for improvement, and I'm not disagreeing with you that there are some audit committees that clearly probably are not at the peak level. But if you have that kind of process in place and provide assurance that that process is working, I think that's a way to address your question.

MR. HILLS: I had a small thought. Audit committees now are required to have a charter. They're required to look at the charter from time to time. Audit committees ought to be judged as to whether they've complied with their charter by the audit firm, and all the boards I've sat on for the last -- up until a few years ago, we had in our charter that the audit committee once a year, auditors once a year say they find that the audit committee has complied with the terms of their charter.

CHAIRMAN DOTY: Steven.

MEMBER HARRIS: Chairman Hills,

I'd love to get a progress report from you ten years later because they said you were the father of the mandatory audit committee and the independent audit committee. But as I say, I was rereading your testimony and you asked ten years ago what is wrong. And you indicated "it is becoming increasingly clear that the accounting profession is not able consistently to resist management pressures to permit misleading or incomplete financial statements."

You went on, "audit committees of too many boards are not exercising the authority given to them or the responsibility expected of them. The audit today has become a commodity. The CEOs see no added value in it. The accounting firms compete for it on the basis of cost, not on the basis of quality."

You went on, "audit committees should be protecting" -- I'm sorry, you went on "board members are too often chosen by the

CEO who also decides who will sit on the audit committee and who will chair it."

And you indicate finally, "the profession is ignoring the plain language of its own opinions which traditionally state in our opinion the financial statements prepared by management fairly present in all material respects the financial position of the company. In fact, today, the opinion only means we have found no material violation of an applicable regulation."

So ten years later, how much progress have we made in each of these areas, and what progress remains to be made in these areas?

MR. HILLS: I think there is a lot. I think if you ask an engagement partner of an auditing firm today who do you work for, they'll say we work for the audit committee. And the audit committee does provide protection. I should say it differently. An audit committee can provide that protection and often does.

But I think it's kind of elementary law here. You need to have a structure that causes an examination that creates an independence. And I repeat again, I think it has to be in the charter, and I think that the auditors have to be responsible for making sure that the charter is complied with, and I think the Board here should make sure that the system is working.

And I have to say again that I think so long as management plays the predominant role in selecting candidates for a board, you will never get the degree of independence you need. I want to make it clear that I don't think you should willy-nilly put people on the board that the management doesn't like. I think that you want harmonious boards as much as you can, but the issue is who selects the candidates for the board. And that should be done by independent directors with help from independent sources.

I think if you put that ritual in place, the process we hope we began ten years ago will continue to grow. It's over a period of time.

CHAIRMAN DOTY: Jay?

MEMBER HANSON: I want to thank you all for coming in and thank you all for submitting your letters. We got an outstanding number of letters which exceeded out expectations, and we don't always say that about the responses from audit committees. We were overwhelmed here and many times in the past we've maybe been underwhelmed. So this is really good. I appreciate that.

Many of the panelists yesterday just flat out don't agree with the positions that you have. I wish we could have a face-to-face debate between those panelists and you. I think it would be instructive for all of us, but since we don't have that format -- you stand at the ready -- that's good to know.

Just kind of piecing together some of the things that Lew said and Steve questioned, we got the consistency across to all audit committees that Lew asked about, but nobody quite used these words. But the underlying theme that came out from everybody that supported the mandatory rotation were things like well, audit committees really don't represent the interest of investors. They're just puppets to management. And audit committees really aren't doing their job with diligence and really aren't equipped to do their job. And you just naturally have a bias to stay with the status quo. And that seems to be the underlying theme.

So, one, I'm trying to get your blood pressure to react to that a little bit, but, two, I've got a very specific question. If you could -- well, many times the report that gets included in the proxy kind of looks like boilerplate, and you kind of question what was behind it, and when things are going well, everybody is happy. That's one thing. But could you provide some examples of situations where you had to kind of call an auditor to task over their objectivity or skepticism or independence and you were kind of on the bubble about are we going to get there or not and maybe some of the real color behind how you discharge your responsibilities. That's my real question.

MR. MANDL: Let me start. I think as to your first point around the auditors are really just beholden to management and -- the audit committee, rather, is beholden to management and all that, I mean if you go back historically, 20 years ago, I think that usually was the case. Or often was the case, I don't want to say always was the case. But certainly there's many examples and I've seen some personally when I was on certain boards way back then where that was more likely to be the case.

The main point I think that's come

across this morning, I think, on this table is that that has really dramatically changed. And you know it's not management, it's not the CEO that appoints the audit team or the chairman of the audit committee. It is the governance committee working with the full board to make sure the right people are on these committees, especially the audit committee.

And so I think the benefit of what happened -- of SOX and how this has evolved over the last ten years has been dramatic, maybe to overstate it, but not really. The fact is audit committee members, these are not full-time jobs. But they are jobs that demand a lot of time and, again, putting it into a historical perspective, I would say candidly if the job was X, you know, 25 years ago, it is 4 or 5X today. And I don't think I'm overstating that. So there's a dramatic increase in terms of the time, the attention, diligence required to make all this happen.

And your second question to what extent do you struggle with complications in an audit committee, you do. I mean that's a factor of how you deal with those issues. You have private sessions with the auditors to dig deeper and to get maybe their more unvarnished point of view on things, and that's usually an important process that's ongoing. So there are certainly issues that need to be addressed, but the process is set up in such a way today that that can work and can function in the right way.

MR. ROEDEL: A couple of things. Mr. Harris recited what Rod said a decade ago, and having just been in the board business back then having coming off 30 years as an auditor, I could attest to many of those.

But I would argue that the world has changed a great deal in the last 10 or 12 years since the implementation of the Sarbanes-Oxley Act which was an extraordinarily important piece of legislation, I believe. I've seen it in operation for over a decade now. And as the world has changed, so has the audit committees.

Audit committees are far more effective today. They do bring best of breed practices to the process, the committees that certainly I've been associated with are fiercely independent and objective. And we require that same level of independence and objectivity on the part of our independent auditors.

So the question is how do you make that work? Mr. Ferguson said before, and I agree, that the structure is well in place today for audit committees to be highly effective and to make a difference in the areas that we're speaking of today. And I think that there are several things that contributed to that. But first and foremost it's the development of the relationship between the audit committee and okay, it's chairmen, but the audit committee in general and the independent auditor. There's got to be a high level of frequent and transparent communication between the audit committee and the independent auditor fostered by reviewing objectives and audit plan and reviewing performance at the end of the year and approving, negotiating and approving audit fees. But there has to be this high level of communication so that the auditor knows what is of concern to the audit committee and the audit committee understands what's of concern to the auditor. Those communications are taking place routinely through the year, and if they're transparent, then a lot of what we're discussing here today is mitigated by that process.

MR. CHELLGREN: Thank you. You made what was clearly an effort to create some debate in terms of this provocative comment that you heard yesterday. I was not present during that, but I would be interested and if you will, the experience and judgment of the individuals making those comments and how current they are in terms of today's situation. Because as many of my colleagues have observed, the situation has changed quite dramatically over a relatively short period of time.

There are approximately 7,000 public companies in America, I think, plus or minus a bit. And clearly there is a spectrum of performance by boards, by various committees, by audit committees. The group here on this panel is, if you will, at a sharp edge. We're the ones on the point as chairs of audit committees, of companies that clearly take their responsibilities very seriously.

To some extent, also to the point that Commissioner Ferguson made, that there are more general criticisms or comments of boards generally. I think my observation, I haven't been on nearly as many public boards as some of my colleagues here, but I've been on six. In some ways the audit committees today are the most robust committee of all the committees on the board for a lot of reasons. And Sarbanes-Oxley was a big part of it. The requirements for audit committee financial experts, the requirements for financial literacy on all members of the audit committee, the roles of the external auditors, the increased robustness of internal audit in almost all of our firms.

So the world has changed, and if anything, it's changed more dramatically with audit committees on boards with boards generally, but especially with audit committees on board. So I think you need to look at the situation on a today's basis rather than perhaps a historic basis and certainly the people on this board and the opinions expressed I think have reflected leading edge, best practices kind of activities.

MR. HILLS: I hope I didn't leave

the impression that I thought things were just fine.

(Laughter.)

MEMBER HARRIS: I think I get the general gist that the panel thinks that things are just fine and for whatever reason all over the world, not in the United States, but in Europe, throughout the world, regulators are finding issues with respect to independence, objectivity and professional skepticism. There are lots and lots of different recommendations that are being made for improvement, whether any of them make a hoot's bit of sense, you know, that's what we're here analyzing.

And I think yesterday we heard a large number of various viewpoints and various suggestions that were brought to bear in terms of things that the profession might want to think about doing on their own or that we at the PCAOB ought to think about doing, but I do get the impression from this panel that virtually the status quo is fine. And as everybody in the -- not everybody, but the leaders of the profession and investors all would tell us, the status quo is not an option. There ought to be change.

And so I guess what I would ask of the five of you is what are some of the changes that you would recommend, with a degree of specificity. And then let me just get back as, Ms. Lego, I think the Board has committed to following up with you, well, not with you but with audit committees, the NACD, and if you could indicate to us some of the things that you would like the Board to be doing with respect to our outreach to audit committees. I think that is a priority of the chairman and the Board.

But if you could respond to the comments that Jay teed up and I'm following up, what specific changes are you recommending except for enforcement of charter provisions with respect to audit committees, and how can we move the process forward a little bit?

And also, let me just add one final question. An awful lot of the concerns that investors have brought to our attention, we're hearing can be handled by an independent audit committee. The audit report is a primary consideration of the Board, and we've got a standard out there. But what should be the role, as well, of the auditor, not only to the independent audit committee and to management, but directly to investors?

MR. HILLS: What you have here I think fairly said is not that we're all complacent. I think the point is we presented to you the model idea of how an audit committee should work and how it often works. And how do you get it to the standard that you seek.

I said yes there's a couple of reasons. But if you have read that testimony of ten years ago, one part said that the audit had become a commodity with no intrinsic value. I think Sarbanes-Oxley largely fixed that. I think the external audit has become more of a management tool today.

The other part of the testimony said the financial statement is obsolete. It requires a precision that doesn't exist. The chairman has heard me say more often than he wants to from The Economist magazine many years ago about the brittle illusion of accounting exactitude which tends to collapse in periods of economic strain.

The notion that the audit committee is looking at numbers and the notion that the auditors are saying these numbers are correct is at the heart of the mischief we have. Most of the numbers on a financial statement are forged out of the assumptions and -- estimates made by management and looked at by the auditors. It's not clear to me at all that a whole lot of audit committees sit down with the auditors and say what were the alternatives available to management in creating that financial statement? What was the range of alternatives? What was the range of discretion?

Even the most honorable of management has enormous discretion in the numbers they put up there. And bringing in the audit committee into the room of the auditor to say okay, of these alternatives management has picked fair ones is an area that's almost left untouched. And bringing the auditors into an audit report to say exactly what they've done in this respect, it seems to me important, and particularly important for the auditors to say that they have examined these alternatives with the audit committee and what they've done is attest to the fact that the process used to get these numbers was fair and the audit committee examined that process. That's a realm that should be more used that's not used, but I think when you heard from everybody here that you have several mechanisms at the PCAOB to move the standard up to the kind of standard that I think all of us here share.

So I think you have the tools. How exactly you want to use them is a matter of time. But I think you have the tools to create the system that we all want.

MR. ROEDEL: Mr. Harris, to echo I guess a little bit of what Rod said, I don't think any of us are here to tell you that it's Utopia in the audit committee business. On the other hand, as I responded to Mr. Ferguson before, I do think that there is a structure in place that if it works well and should that you have a mechanism to address and mitigate some of the issues that we're all very concerned about. Professional skepticism, independence is really at the heart of audit quality. And I think everybody, audit firms, PCAOB, SEC, and certainly the audit committee appreciates that.

I do think though that there is

certainly room for improvement and there is certainly room for communicating what audit committees do to ensure that, communicating through the proxy, to our investors, from the committee to the board. And I would think that the PCAOB in its inspection process and the audit firms through its audit certainly have the ability to weigh in on whether audit committees are doing an effective job.

My understanding was that -- and I'll ask a question of the chairman, my understanding was that the inspection process did ask the question about effectiveness of audit committees. I've been called once to explain what we do and maybe what we don't do, but only once during the process. So I think that that's another way for the PCAOB to gain an understanding of whether this structure, which we've all argued can and should work to promote skepticism and independence is, in fact, working. And I think the auditors in the conduct of their audit ought to be asking that same question as well because the conduct of an audit committee is paramount to doing their job right.

MS. LEGO: Along those lines, I haven't had direct contact with the PCAOB and they have conducted reviews. Concretely, I would appreciate discussion with PCAOB prior to the review. There are things I would love another set of eyes to look at, specifically the judgment items, the reserves on inventory, the cutoffs, the reserves on reserves for accounts receivables, contractual negotiations, on multiple elements.

I would love to be able to say well, while you're in there, take a look at this because that's part of what our role is. I don't think every audit committee works at the level it could work. I don't -- from my meetings with roundtables, there are a lot of people who don't know what to do. They're poorly trained for their role. I think the PCAOB could, with the NACD, come up with what are best practices, assure people who are new to the role, there are people new to audit committee participation who don't know how to conduct an internal review, who have never done forensic analysis, who don't know really what they should do with FCPA, how to assure that. They don't know what to do with the IT department within organization and how to test it and what to do with many elements because they've never seen it.

So where Stanford has its Director College and the Stanford Law School has its Director College and the NACD does, it's almost as if I would just encourage you to perform a half day of let me tell you what you need to do. By the way, do you meet one on one with the auditors before the numbers are released? Do you meet with them in private session? Do you meet with all of the individuals below the controller and CFO who are in charge of the reserves, the judgment items? So if there's an issue, they can come to you. That's your responsibility.

I think you need to help the new people understand that if they're not being trained by the other people in their audit committee, they actually get trained by somebody so that all the shareholders will benefit by that. Thank you.

CHAIRMAN DOTY: That is very interesting and helpful.

Alex, I want to give Chief Accountant Kroeker a chance to weigh in on this and Jeannette also has been on the sidelines.

Go Jim.

MR. KROEKER: I certainly didn't want to get in front of Board Member Franzel, but I just had a follow up as to whether or not and we heard a little bit yesterday that information might not be readily available or enough information might not be available for audit committees in making an assessment about retention of auditors including information about the PCAOB's inspection findings. And so just the perspective of audit committee members of whether you're getting enough information in making those assessments.

MR. ROEDEL: The simple answer is yes. We are. We ask for that information routinely during the conduct of our annual review of our audit firm's performance.

MR. KROEKER: Are you able to get Part 2, for example, of the PCAOB's findings? We heard that, for example, some firms will summarize that. If I was asked to summarize my performance I might focus on the positive. Might not be the same nature of language, for example, an independent overseer might have.

MR. ROEDEL: There is one firm in particular, and I won't mention them, that we deal with where Part 2 this year was of -- was of great discussion, I'll leave it at that. But in answer to your question, we've not had an issue, and most of that is to your point is in a summary provided by the firms. But Part

2 is something that we pay a bunch of attention to.

CHAIRMAN DOTY: Jeanette Franzel has been waiting patiently. This is an hour and a half session, so you've got the floor.

MEMBER FRANZEL: Thank you, Mr. Chairman. I think yesterday we heard, and we're hearing from you all that there's been tremendous progress with audit committee performance, in general, since the Sarbanes-Oxley Act. But we also heard yesterday that there's inconsistency of the strength of audit committee performance and how audit committees do their jobs. We're hearing from you today that the structures are in place so that audit committees that want to do a good job can do a good job. And we're hearing from you all that you're all doing a great job.

I guess what I would like to ask each of you is what are the specific actions that PCAOB or SEC or others could take to help ensure consistent strong performance of audit committees out there, to do some of the best practices in terms of the annual review of the audit firm's performance, the oversight of the audit firm's independence, et cetera, how do we get that in place across the board?

MR. ROEDEL: I will try. Again, for the third or fourth time, I think you're absolutely right. The structure does exist. And how effective audit committees are really leans on a lot of things. First and foremost, it has a lot to do about who comprises that committee, how well they're balanced functionally, how much industry experience they bring to the table, what kind of financial knowledge that they have. There's no substitute for financial experts on an audit committee. And I'm not just talking about people who have backgrounds like mine, but people who have come up through the finance parts of organizations. They bring a very different skill set and a very different perspective, so a committee that is well balanced is absolutely critical, well balanced and knowledgeable and certainly engaged.

So your question is how -- what can the PCAOB do to support that? Well, I think several things. One, as I said before, you have at your disposal the inspection process. So on the companies that you inspect, I would think that one of the things that you'll be looking at is how, from your perspective, how well the audit committee is fulfilling its fiduciary responsibility, how are they comprised, and what resources do they have in place to make sure that they're executing efficiently and effectively.

Second, I go back to the audit report contained in the proxy. It may be the place that audit committees are obligated to tell more than they're telling at the moment, not only about their relationship with the outside auditors and how they effect those responsibilities, but two, how they execute their responsibilities and what processes they employ in that context. So I think some of what you need to know can come from the audit committees themselves, both through your process and through communication of audit committees to the investor in the proxy.

MR. CHELLGREN: I would endorse and maybe expand on the points just made. From an audit committee's point of view, what the PCAOB does is really detached. It seems to me that you people could be more proactive, if you will, in communicating with audit committees, helping us understand how you're evaluating our external auditors, number one.

Number two, clearly audit committees need ongoing training, continuing education, professional standards, if you will, along the lines that has been discussed earlier. We made a suggestion that within the external auditor, there could be in addition to mandatory rotation of engagement partner, there could be some mandatory rotation of the consenting review partners, for example, as another more mechanical kind of thing to help ensure independence and skepticism and professional changes.

You know, the role of an audit committee is a complex one, and it clearly can vary quite dramatically, given the size of the organization and the industry in which they're functioning. I think obviously our relationship for the external auditor is one of, if not our major responsibility, but we have lots of other responsibilities as well, be they working with internal auditors, be they working with professional financial management, be they working with in our case with regulators.

Chairman Hill made the statement that he wasn't sure we really get involved in more granular analysis of certain accounts. I know in our business and when you're in a regulated business you know we have a $160 billion loan portfolio and a $60 billion securities portfolio. At every meeting we review provisions, allowances, charge offs, in our loan portfolio and valuation issues in Level 2, Level 3, and our securities portfolio. I mean that's the fundamental assets of the organization. We really try to look at that on a reasonably granular kind of a basis.

So you've got to focus on where your risks are, where your exposures are, and where your challenges are. But those are a couple of observations, both in terms of the improvements, and PCAOB can help audit committees in performing their role, but also the responsibilities we take, or good audit committees take, regarding the role of our external auditors, plus frankly, our internal auditors and our professional financial management, plus other stakeholders.

MR. HILLS: To be simple about it, I think you need to have a charter that is precise about what audit committees should do, and you have to have a way of judging whether the charter is being complied with. I think that's the weapon that the PCAOB has and I'll say it again. I think that until we change the way in which members are selected for board membership, you're not going to have the degree of independence you need for the objective you're seeking.

MS. LEGO: I heard yesterday that everyone believes they're above average. So to deal with that I think people have to know what above average really is. And if you don't put in front of audit committees what the best are doing and hold them accountable for doing what they say they're doing through an analysis of the charter on a quarter basis, people do think they're doing a good job. They just don't know that other people are doing a better job. So communication from the PCAOB in a this is what we see out there, guys. This is what we find. So help us not find it.

We'll always see some human error

out there. The complexity is just growing every year. I worry personally that the tax situation is such that we have a second set of auditors looking at tax, and I'm not a tax expert. Do I have to get a tax expert on the audit committee to feel comfortable?

So all these questions come up, but I think we have to all ask ourselves, what are the best, the people who are really doing a great job doing and how can we do our job better? And you have that insight. You are the eyes there. So help us by showing us. And then we can do better jobs. Thank you.

MR. MANDL: I just wanted to take a minute and come back to Mr. Harris's point earlier which was that this panel seems to be saying everything is rosy and everything is okay. And I don't want to speak for the panel, but at least my strong sense is that the main point is a lot of progress has taken place in the last ten years, and I think we should feel good about that and no doubt about that, but it's progress. And it does not suggest that all is perfect, that every audit committee performs at a peak level, that everything is hunky dory or words to that effect.

On the contrary, I think there are a number of ongoing opportunities to further refine the skills, further refine the process, further refine the framework around which this whole function can be performed even at a higher level than what it is today. And I think your role in that, I think should be and could be very, very significant. So I just wanted to, at least speaking for myself, correct the notion or at least address the notion that everything is great, then we don't need to think about this.

CHAIRMAN DOTY: I know the Chief Auditor Martin Baumann has a question.

MR. BAUMANN: Thank you, Mr. Chairman. I, too, would like to thank all of the panelists for the great insights that you've shared with us today.

I'd like to just take a question in a slightly different direction, and, Mr. Chellgren, you have some experience particularly in this area because you changed -- your company changed auditors in 2007, I believe.

We heard yesterday from some CFOs, controllers of some very large companies, words like -- and these are actually quotes, being concerned about changing auditors, "effectiveness of the audit is lowest in the early years." Another quote was, "requisite knowledge cannot be built over a few years." As real concerns about higher audit risk in the early years after rotation even in a voluntary environment they were talking about. And of course, your rotation was in a voluntary environment.

Your letter to us, and thanks for the letter, but among other things the letter says "we're concerned that it is likely that rotation will result in more errors and less effective audits in the early years of an engagement due to the learning curve of the new auditor." So you expressed the same concern.

So I'm interested in your comments or the views of anybody else on the panel. So those concerns come across loud and clear. I'm not going to ask you whether you had more errors and a less effective audit. That would be an inappropriate question.

(Laughter.)

And taking aside your concern that you also expressed that there's maybe in your particular geographical area there aren't the right resources and let's just assume other firms could put in the right resources and would commit that they'd bring in an engagement partner from a very large bank and manager, et cetera.

But going back to that concern you expressed and others have expressed that even in a voluntary environment, what did your audit committee do and your auditor do to mitigate that significant risk we've heard about that there could be less effective audits in the early years after a rotation. And even if we're in a voluntary rotation environment which we are today, as the Chief Auditor and head of standard setting of the PCAOB, do we need to set additional auditing standards or additional requirements in the early years of an audit because of these increased risks that so many expressed yesterday and you expressed in your letter.

So I'm interested in your comments and those of others. Thanks.

MR. CHELLGREN: A very valid and important question and one we wrestled with in terms of our audit committee and the entire board in the 2006 time frame when we were making the decision to put our audit out for tender.

The reasons that triggered the

decision were -- came from a couple directions. Number one, the engagement partner with our previous firm was rotating off the job. So there was a natural change at the most senior level in the engagement leadership that was, in fact, going to occur, number one.

Number two, the previous firm nominated a few potential lead engagement partners. We interviewed them. We felt they were coming from much smaller, less complex institutions than we were at the time.

Our number three point is our strategy was to grow dramatically to become a larger, more complex, more national institution and that has, in fact, occurred. Since 2006, we've almost tripled in size in terms of total assets and deposits and branches and so forth and so on.

So we've implemented the strategy that the board collectively had embarked upon. So frankly, we wanted an organization that could help us move to the kind of level we wanted to be as an organization. We also found, frankly, our list of potential candidates to use was relatively short. We had some issues with one of the other Big Four firms. Frankly, in the banking business, one of the other Big Four firms, we were their lead bank and we were their recommended bank for their partners and their partners' lines of credit, and we and they decided that they didn't want to make all those changes nor necessarily did we, so therefore we were left with two potential candidates.

We conducted an interview process and an RFP kind of process. Made a decision. But the key in terms of making the decision was the experience at large, at much larger, more complex institutions, and it's a matter of public record, we went with PricewaterhouseCoopers and the thing that finally won the day was the engagement partner they recommended had just rotated off the J.P.

Morgan Chase account, and the other partner who was going to actually be physically relocating to Pittsburgh, and Pittsburgh is not New York City, had just been made partner on the Bank of America account. And we thought they were bringing a level of expertness and sophistication, plus other people who were being assigned to the job, and we met all those and we interviewed them, that that met our strategy and was a proper thing to do, and we were willing to live with the risks and costs at the time.

Frankly, I think because of the quality of the people that were assigned to our job, there was a lot of effort, extra effort particularly in 2007, and to some extent that's dropped in '08, '09, '10. But we felt the benefits of this new relationship would outweigh the costs of the change, but we had to make a change in that sense so a change was, in fact, going to be occurring with the job, with the leadership of the engagement.

MR. BAUMANN: Just to follow up,
the risk that some were expressing yesterday or you expressed about less effective audits due to the learning curve in the early years you feel can be mitigated depending upon the appropriate engagement team from another firm coming in and taking over.

MR. CHELLGREN: The key was the team of people.

MR. BAUMANN: So as long as the right people come in and the audit committee interviews the right people and they're comfortable that the engagement team is appropriate, that risk is mitigated in your view --

MR. CHELLGREN: And the commitment of the external auditor to staff the job with the number and quality of people that seem to be appropriate to get the job done.

MS. LEGO: Maybe I just can add that you do have a risk at the staff level. The work papers are new. They don't know the process. They don't know the people. So the time commitment is much larger, and the risk of something not getting revealed or questioned because there's a lot of new people could just be one issue. The other issue is the staff people are spending more time bringing these people, doing the flow charts again, doing the work papers again, and they don't have their eye on the ball at the company during that period of time. So I think that adds a bit of a risk.

CHAIRMAN DOTY: We began this panel a bit early. We have a little bit of time here, but if we broke, if we took a break at 20 past, we could stay on schedule. It is 10:12 PCAOB time. Why don't we see if Board members have any other questions for about five -- an additional five minutes or eight minutes of questions.

Jay?

MEMBER HANSON: One question and I'll start with an observation that many have observed that the A in our name, the Public Company Accounting Oversight Board is kind of a misnomer because we regulate auditors, we don't regulate accountants. And what's interesting is in your comments you've made about the discussions that you've had with your auditors it's generally about accounting matters.

Yesterday, we heard the leaders of the firms talk about some of the challenges they have and that they've spent so many resources on the complex accounting matters, and they all publish their big books on the different new accounting standards, but they maybe not put the same resources into the auditing of what's behind the complex transactions.

So my question for you, and you don't need to all answer this, just maybe a couple of observations, in your discussions with your auditors, how much time do you spend talking about what they do to audit the complex transactions and the reserves and the fair value of the financial instruments and the leveling of the financial instruments versus the accounting and disclosure? And has it changed over time at all?

MR. ROEDEL: We spend a fair amount of time looking at both of those issues, both the accounting and the auditing. So as far as the auditing is concerned, we spend a fair amount of time looking at the audit plan for the coming year. We talk about that in a fair amount of detail and then not only before the audit begins, but after the audit ends.

And then all during the year, each and every year, we take the most critical portions of our accounting, those that require the most -- the exercise of the most judgment, and we talk about that collectively. We talk about that from the internal perspective, about the choices of accounting policies, about controls over the accounting for those areas. We talk about what we can do from an internal control perspective to make sure that our controls are right and then in that same room, in that same discussion are our external auditors are talking about what they do to make sure that financial management has gotten it right.

So we spend a fair amount of time not just talking about the most important accounting and how we make sure that is done well and fairly represented in our financial statements, but how we make sure that the controls around all of that are appropriate and how we audit to those controls.

MR. HILLS: I think the key issue is to make certain you know what the alternatives are. The auditor's job is to tell you what the accounting alternatives are. If the auditors say this is the accounting principle and management says it is, it's very hard for most of us, even though we consider ourselves experts to judge that. But it's to make sure we understand the alternatives.

MEMBER HARRIS: Well, Mr. Mandl, you did indicate right up front that there was room for improvement so I want to note that. You said that, right? In your initial comments. And I think all of the panelists have offered us options and recommendations for improvement, so I very much appreciate the recommendations of each of you.

CHAIRMAN DOTY: I think this has been the longest panel of this two-day meeting. It has certainly been one of the most illuminating and informative. I think when the record is out, it may go down as the most important panel in terms of what it contributes to the actual process activities and effectiveness of the Public Company Accounting Oversight Board. So you've done a good day's work. Thank you all.

Let's take a ten-minute break. We'll get back here and get started with three of the SEC and accounting world's rock stars at 10:30. Big panel coming up. Thank you.

(Whereupon the above-entitled matter went off the record at 10:17 a.m. and resumed at 10:29 a.m.)

CHAIRMAN DOTY: In breaking from the last panel, I described the panel that would be taking the roster now as consisting of rock stars of the SEC. They all three share common characteristics.

They have devoted substantial parts of distinguished careers to public service. They've all served in the SEC. They have all gone on from the SEC to stellar careers in the financial services and related industries.

David Becker, Partner of Cleary Gottleib Stein & Hamilton, LLP, former General Counsel, Senior Policy Director of the United States Securities and Exchange Commission. He has the distinction of having served two chairman in two different stints in that office and having distinguished himself as being one of the great sources of wisdom for the Commissioners and the staff.

He was a Supreme Court clerk for the Associated Justice Stanley Reed. And he also was a law clerk to Judge Harold Leventhal of the Court of Appeals. David is known by his colleagues and close friends, many of them here present, as being one of the great legal minds in the securities regulatory area.

He is there at the table with Don Nicolaisen. Don Nicolaisen is Chairman of the Audit Committee of Morgan Stanley, Verizon. He was the former Chief Accountant of the United States Securities and Exchange Commission. He has served on numerous boards. He has led financial services practices. And he is on the Board of Advisors of the University of Southern California's Leventhal School of Accounting.

He serves in a variety of advisory capacities to other Fortune 25 companies, and there is no major financial service institution I think in the world that hasn't wanted Don Nicolaisen's advice both when he was the Chief Accountant and later and otherwise.

Bob Pozen, Senior Lecturer, Harvard Business School, Senior Fellow, Brookings Institution, Chairman of MSF Investment Management, Vice Chairman formerly of Fidelity Investments and President of Fidelity Management and Research Company, Associate General Counsel of the United States Securities and Exchange Commission.

But when asked by me what he thought was the most important achievement, he said he's the author of the standard text on mutual fund regulation in the mutual fund industry. Those of us who know him well look forward to receiving his Wall Street Journal op-eds on a regular basis. And we have all -- not one of us has failed to be benefitted immensely by having his advice and having access to his brilliant mind.

So we have three of the most brilliant minds certainly to come out of the SEC and three of the rock stars. Gentlemen, I would like for Mr. Becker to begin.

MR. BECKER: Thank you, Chairman Doty. I appreciate the Board's kind invitation to participate in this roundtable. I congratulate the Board on its approach to independence and other matters during Chairman Doty's chairmanship.

This approach is bold, showing an eagerness to take on important issues. Even more impressive, the Board is showing itself to be thoughtful with full understanding of the complexities of the issues and the multiplicity of views. I'm very optimistic about the outcome of these processes.

The views I express today are mine alone. They may or may not coincide with the views of others. Experience suggests they rarely do. But they are not intended to reflect the views of any persons with whom I'm associated or have ever been associated or any of my former or current clients.

The first point is that a key to any potential rule-making in this area is the information before the Board. The Board's Concept Release makes clear that the Board is troubled by the results of its inspections. And knowing the Board as I do, I take very seriously the mere fact that you're concerned.

But the Board's description of its inspections' results is somewhat circumspect. A more extensive description of your findings would enable the public better to evaluate possible regulatory responses.

The second point is that unlike most of the existing independence rules, a requirement for firm rotation would not address relatively narrow circumstances that are thought to raise significant risk of auditor bias. For the most part, the existing independence rules prohibit the auditor from having relationships with the audit client that in the opinion of regulators are likely to breed a pro-management bias in the auditor and, as a result of the bias, a loss of professional skepticism.

To take a simple example, the independence rules prohibit an auditor from borrowing from his audit client for fear that an auditor would have some reluctance to offend the client who has the power to call the loan.

The case for audit firm rotation is much less closely drawn. It starts with the assumption that all auditors are subject to economic leverage from their clients because the clients pay the bills and have the power to retain or replace them. This is plainly true and very significant.

What the proposal -- or what the proposal under discussion seeks to do is to lessen that leverage by limiting what an auditor stands to lose if management were to contrive to get her replaced. Cost aside, I would think that it is much harder to demonstrate the utility of this approach than one that is more narrowly drawn to problematic relationships.

I'm skeptical about the ability of any legal regime to affect the inner and often unconscious workings of an auditor's mind by calibrating the degree of economic reward that the auditor has at risk. I'm even more skeptical about the utility of doing so by focusing on the number of years an audit firm may be engaged. In essence, the rationale for a rotation requirement from an economic standpoint is to reduce the present value at any particular time, the present value of the economic benefit the auditor might receive over the life of any engagement and has accordingly in some sense at risk.

I'm not sure how the Board or any regulator or any group of five lawyers and auditors can sense how much isn't too much at risk to preserve an unbiased and objective mind. But even if the Board could sensibly draw that line, I can't see how it could be done on the basis of years as opposed to some other measurement, like dollars, as to what's at risk.

I don't know how one can differentiate, both as an economic matter and as to its effect on otherwise unbiased minds, between the long engagement that has a large present value and the short engagement that has an equally large economic present value. Indeed, one would think that notwithstanding the economic equivalence the auditor might probably feel because of the imminence of a benefit that he has more at stake in the latter situation.

The third point I want to make is that independence is not the same as professional skepticism. Independence is an absence of bias. The absence of bias is distinct from the presence of other necessary attributes for professional competence. Bias in favor of or against client management is, if it's significant enough, disables the auditor from acting with professional skepticism.

But it's not the only factor that may give rise to a lack skepticism. Among other things, insufficient professional skepticism may arise from the lack of talent, lack of training, a firm culture that doesn't promote skepticism, laziness, excessive trusting disposition, a predilection against taking measures that -- doing things that a client may be reluctant to pay for or experience suggesting that management is truthful and confident.

So lack of skepticism doesn't mean necessarily a lack of independence. And the same way that the absence of bias doesn't guarantee independence. To put it somewhat crudely, an independent dope is still a dope.

It's important for the Board to be able to articulate the dangers it sees fully and to draw the connection between the dangers it sees and the remedy that it is proposing. And that's why this is not merely a pedantic distinction, but I think something that the Board should take into account in deciding what to do.

Final point. I think the Concept Release does a very good job of pointing out some of the benefits that can be obtained by audit firm rotation. I don't think it's a matter of independence. I think it's a matter of seeing things new and knowing that someone is going to reconsider what you consider.

Whether that's worth it strikes me as an intensely situational calculus. This is something that audit committees should do. The Board ought to think about the means it has at its disposal, and the Commission has, to encourage that.

Now after I've said finally I have one last point. The Chief Accountant was kind enough in his gracious way to point out an error in my written statement and I would like to correct it. I said I was concerned about lack of consultation at the Commission.

The Chief Accountant pointed out to me that for different reasons I had not been involved in this process for the last three years. And that he and his staff have done all they can to increase transparency in consultation. I take him at his word and I correct the error and apologize for it.

CHAIRMAN DOTY: Is the apology accepted?

MR. KROEKER: Absolutely.

CHAIRMAN DOTY: Yes. Don Nicolaisen.

MR. NICOLAISEN: Good morning and thank you very much for the privilege of being able to address the Board. I'm very much interested in the topic of audit quality. And I think anyone who knows me and knows that I've been interested and concerned and involved in ways to improve quality for a very long period of time.

I'm delighted that you're addressing some of these tough questions. This one is not new. It's been around as long as I've been in the profession. And it's appropriate, I think, for the Board to reconsider and study it and reach its own informed decisions.

I have to say I was deeply struck in reading the Concept Release by the wording that inspection results suggest that audit partners and managers have a bias towards accepting management's perspective, which from stems from a firm culture that allows or tolerates audit approaches that do not consistently emphasize the need for appropriate level of critical analysis.

That, to me, is just unbelievable and incomprehensible that in today's environment that someone would rely -- that an auditor would not audit. That they would rely on the representations of management without doing any testing.

If, in fact, that were the case and that came to an audit committee, I would also be very amazed if the audit committee accepted that. I can't imagine a basis upon which you would say, "Oh, that's fine. Stop. You talked to management. That's good enough." That doesn't seem to fit a model of auditing.

My concern is with the findings that are represented. It sounds to me like there's a fundamental issue in the auditors' perspective of what their role is. Or there is a bias towards not being confrontational or wanting to avoid dealing with the tough issues or whatever it might be that has, I think, little to do with the question of mandatory rotation.

As far as the concept of requiring all firms or some firms to rotate audits outside of the judgment of the audit committee, it seems to me that that's a very blunt instrument. That essentially throws out the good to deal with what are perceived to be bad situations, situations where auditors are not independent. And it may well result in unintended consequences, including a firm that has a good auditor, that has a challenging environment, being replaced by one of those firms whose culture you've described in the Concept Release as lacking.

There's no question that it makes it difficult for audit committees to find, in many instances, the right firm for replacement. You're well aware of, and they've all been discussed, all of the reasons why that's complex. But generally speaking, in very large organizations that are global with hundreds of audit staff involved, it's hard to imagine that it would be fortuitous enough that another firm at an appointed point in time, without being pre-identified, would have the necessary resources with the appropriate training in the right locations to be able to simply plug in and replace an audit firm.

I'm worried about what the implications would be, especially if, let's say, a term of fixed year, five years, ten years, 15 years, whatever you choose to think about, were imposed. I would be concerned at the front end with the hand-off. I would be concerned that if the period were too short that the firm may not invest appropriately in the resources that are necessary to do a quality audit.

Instead they might address it as this is viewed as a commodity, approach it as a commodity, and put in place sufficient resources to satisfy in form the requirements that exist and to be able to complete a checklist.

Midway through, if the firm starts to lose some of its talented people, I would be concerned whether they would be replaced. I'd be concerned whether if technology changes and new ways of auditing are introduced, whether there would be an investment appetite by a firm to put that in place to make that work. At the end, I'd be concerned that staff partners in the firm would be looking for the next client to serve and would be fixated more on that, or possibly equally on that, as they are on the audit itself.

In any event, I think there are reasons why, if the Board should decide to proceed, that you should do so with care, cautiously and think about managing the other implications that can occur. I do think that the Board is right in many of its projects in dealing with audit quality.

I really like the idea of the audit partners signing the opinion. I like the idea of better training. I think that stronger enforcement actions, where you find situations where an auditor is not appropriately performing an audit, that that's perfectly doable. In extreme situations you may even choose to put a monitor in over the firm to make sure that they do the things that you've required them to do.

And I would also welcome dialogue between audit committees and the Board in order to make sure that we understand what your thinking is. I mean, the ideal world is if you saw a situation where you thought that the firm is not independent and it's serving a company that there would be a vehicle in which dialogue could occur with that audit committee.

I think there are other ways to strengthen audit quality. And I would keep the focus on are we really improving audit quality. Thank you.

CHAIRMAN DOTY: Thank you.

Mr. Pozen.

MR. POZEN: Thank you this opportunity and I have a lot of sympathy with the Board. Yesterday it seemed like you heard a lot of people who were saying that the auditors were too beholden to management.

Today, in the first panel at least, you got a very different point of view. It's like that movie Rashamon where you're watching the same movie, but it's like two totally different perspectives.

But I think there is a way to reconcile these and it all has to do with the definition of the client. And to me the key is that the client of the auditor needs to shift from management to the audit committee. And what I heard the last panel say, which I happen to agree with, if the Board acts in a way to undermine the independent audit committee as the client then that will be unfortunate.

But I believe that there is a way to have a modified version of rotation that will reinforce the independence of the auditor and their relationship to the audit committee, the independent audit committee, as their client.

And I've outlined it in my statement, but basically it says that there should be a requirement for the audit committee to put out an RFP, a request for proposal, periodically for auditors. But, and this is important, that the existing auditor is allowed to bid and can be chosen by the audit committee if the members of the audit committee believe that that's the best from their point of view in terms of the financials of the company.

I'd like to say that there are at least three things that I think are really advantageous about the proposal. The first is that I think we would all agree that since SOX the role of the audit committee has been enhanced. I sit on two audit committees and I can vouch for the fact that it's dramatically different now than it was before.

But you do have, and my statistic shows, 58 percent of all auditors who were appointed 11 years or more ago, meaning before

SOX. So these people may not feel themselves as accountable to the audit committee. And they probably were appointed by management. So we want to shift that. And the very RFP process would shift that.

Second of all, I do think it would keep auditors on their toes, and all the benefits that you heard yesterday were auditors would feel that someone might come in and question their work, the next auditor. You would have that. Of course, it might not happen, but it's the risk that it could happen that might make the incentives go in a way that I think people yesterday were talking about.

And, third of all, it's been my experience, and I have run RFPs when I was at Fidelity, when I was running that board process, that it does have some real benefits. The auditors, even if they're chosen again, pay a lot more attention. You do get better focus, better quality and, quite frankly, you get lower fees. So that seems like a good thing.

Now I can think of at least three different objections here. And let me see if I can deal with them. The first is how often. Now I actually have a very precise idea here, though people may disagree. And that's to have the RFP every 14 years. And that's based on the notion that we want the existing firm to go through three partner rotations and, if there's a change, for it to happen on the 15th year.

Now some people might say that's too long. But I believe that a lot of the things that are said, and I'm sure Don would agree, is that there is expertise that's built up. If we're going to have a new firm, they have to have the incentive and they have to have the time to get up to speed. We really don't want to have auditors changed every five years. In these global companies, it's just much too frequently.

Now if you say to me it shouldn't be 14, it should be 12. I'm not going to get into a disagreement. But you've got to give people time to get up to speed. And this is important. You want to have new firms coming in, at least, maybe one of the fifth or sixth firms. And they need to feel it's worth it for them to bid and have a 15 year engagement.

And, of course, if you only have it once every 14 years, the process itself does have some cost. And so you're not going to have to incur that every five years.

Second question people will say, and I think they've said a number of times in a lot of these conferences, there aren't enough firms that are bidding. And that's because a lot of companies, such as the ones I'm involved with, would hire some of the other big four to do consulting work or to do non-audit work.

But I believe that's a solvable problem. It's a solvable problem. First of all, I think you have very good bidding process if you have the existing auditor in two firms. And, second of all, I think PCAOB would have to come out with some rule that says even though you had done non-audit services in the last year, that's okay because now you're in a different role.

And obviously if you took over the audit you would no longer be able to do the non-audit. But there would be some sort of transitional rule that would deal with that question.

A third question that I think a number of people have raised is does this put the auditor, the external auditor, in the position where they're sort of like always selling themselves? They're always promoting themselves to the client because they want to keep the business.

So my answer is, if the auditor is selling the firm and how good they are and what a good job they are to the audit committee, that's a good thing, because we want that audit committee to feel that these auditors are really helping them hold management accountable. And everyone on an audit committee knows that there's limit to what you can know on an audit committee. And you really need the help of the external auditors. And you want them to feel really that they're accountable to you and that they're going to do a really good job for you.

So I don't think this is -- again, we go back to this issue of the client. Who is the client? And what I want, and this is totally consistent with what the prior panel said, is I want the client to be the independent audit committee and I want them to have the auditor, who is really working hard to please them, to get them what they need, the independent audit committee. And then I am sympathetic with the points that are made about whether or not this is cost-benefit.

So we eliminate those problems

because we now are not saying you have to have mandatory rotation. So we haven't taken the job away from the audit committee. It's there. And they can make the evaluation whether or not it's worth it on a cost-benefit basis.

But we should all realize that if we do this, probably I would assume in over 80 percent of the times, the existing auditor will be chosen. And that's okay. It's okay in my view because then they will have heightened sensitivity to who they're serving, which is the independent audit committee, and they will do I think a better job. They will be more focused. They may give lower fees.

And occasionally there will be a new audit firm. And maybe if we're really lucky we'll get a big five instead of a big four. And somebody else will break into the ranks here. Thank you very much.

CHAIRMAN DOTY: Thank you all, Jeanette Franzel.

MEMBER FRANZEL: So I don't mean to put any of the panelists on the spot or do anything controversial here, but I would like to ask the other panelists your reactions to Mr. Pozen's proposal and then also your thoughts on PCAOB communications with audit committees.

Mr. Becker, you mentioned that this is a very situational thing, deciding whether there needs to be a fresh set of eyes, and PCAOB has information or may have information in certain cases. So not only what do you all think of the RFP proposal, but what do you think about a situation where PCAOB is going to the auditors and/or the audit committees and saying, "We see a situation that calls for a need for a fresh set of eyes?"

MR. BECKER: I'm all for it. I think it's a fine idea. I think it's probably something that would -- there may be some legal issues with it, but I haven't thought very hard about it, and there may be ways to get from here to there. I don't think -- I mean, the Board doesn't have direct authority over audit committees. Whether you could get there through requirements for auditors, I suspect you could.

In terms of communication, and this is a little bit heterodoxical, but I think that the Board needs to realize that much of what it does, particularly because it has a defined regulated community, is an exercise in communication. It is mostly verbal communication. There is some nonverbal communication consisting of one smack or another for misbehavior.

But even the rules that the Board has are media for expressing values, expressing the Board's view, backed with some coercive power as to what folks ought to do. I think regulatory bodies including the Board, including the SEC, tend to underestimate the values of their communicative processes, all of which is a fancy way of saying, I think it's great. I think you ought to be talking to audit committees. You ought to tell them what you're seeing, what you're concerned about and what you think they ought to do. And you'll learn in the process.

MR. NICOLAISEN: Yes, I would agree with that also. I think that if there were to be some communication with audit committees that that would be extremely helpful.

We don't know what you know about a firm. And so it's very difficult for us, even in a tending process, to be highly confident that we would be picking the firm that has absolutely all the best resources and has the attributes of quality auditing that you would expect and that we would expect, but that we're unable to view from our perspective. So I think that would be a real plus.

As far as periodic tendering of

the audit, I don't see any problem with that to do it. It's hard to pick the period. I think Bob is right, that is he has a view of three turnovers of an engagement partner and that's one way of thinking of it. You may also find that that turnover occurs when you're also introducing a new CEO and a new CFO and making other changes in the organization that would cause you to not want to also change auditors at that same time.

So I think with some degree of flexibility that's a workable situation. It is difficult. I've gone through this and it is difficult, and I'm sure you've heard it elsewhere, to find the firm that is able to step in and to have really a competitive bidding situation for the largest companies.

And, in part, it's because perhaps one or more firms are doing other work that would disqualify them as independent. Or one of the firms audits a subsidiary on behalf of another investor where you have a joint venture operation and both parties want their own auditors looking at things. So you wouldn't -- you can't in those situations just replace in kind with that firm.

And then there are firms that are great firms but may not have experience in your industry and not sure that you want to be the test case of enabling them to develop the experience.

MEMBER FRANZEL: Mr. Pozen, your thoughts on communication between PCAOB and audit committees.

MR. POZEN: Let me just address this. I do think you can have decent RFP even if you have only existing firm and one firm. In fact, I've been in that situation. I think Don's points are well taken about having some flexibility on the time period and joint ventures. I hadn't thought about it. It's a good point.

In terms of disclosure vis … vis -- I agree with both Don and David. As a member of the audit committee, you sort of feel like you get a very -- I don't know -- summary would be actually too broad a word. You get this slice of what happened. You know your auditor comes and tells you, "Well, the PCAOB, I can't really tell you what happened, but it wasn't so bad."

"Was there any problem?"

"Well." It's all very vague.

And so I think we want to protect the confidentiality of audit firms. But it seems to be that there's got to be a better way to convey to these audit committees what is important to them. They have a legitimate interest in knowing if the firm really had a major problem. The only way we can find out is if there is a lawsuit two years later. It seems like maybe not such a good way to find out.

I would encourage the Board to try to figure out some sort of communication vehicle that would give audit committees more specific information and would yet not violate the rights of other people. And I think every audit committee would really welcome that.

CHAIRMAN DOTY: Before I recognize Jay Hanson, I want you to confirm that you and I have not coordinated these comments in any way.

Jay.

MEMBER HANSON: Let me start with an observation. And then I have a couple specific questions for Mr. Pozen.

Yesterday we had Valarie Sheppard, the comptroller for Proctor & Gamble, come and talk a little bit about her organization and her written comment letter from Proctor & Gamble. There was a discussion that the audit team has over 900 professionals in 75 countries around the world.

And I'm just having a hard time wrapping my head around the tendering process when a firm would credibly have to effectively figure out in those 75 countries do they have the right resources, do they have any independence issues and effectively what would it take for multiple firms to be ready to say, "Yes, I can do this around the world," and whether that effort could be expended in a different way to get to the same objectives. I just maybe pose that as an observation.

But a couple of questions for Mr. Pozen. One is the companies that you're a member of the audit committee on, Medtronic and Nielsen, whether you have a mandatory tending process in place at those companies right now? And, if not, maybe why not?

But then a second question, you've mentioned a benefit of the tendering process of reduced fees. And I'm having a little hard time reconciling that with the idea that auditors are under a lot of pressure already with fee issues. And we're giving them a lot of pressure to do more because they're not complying with the standards as they are written today and the world is getting more and more complex. So just curious as to your thoughts about the reconciling of the audit quality concept with reduction in fees.

MR. POZEN: As to the first question, neither Medtronic nor Nielsen is in a tendering mode. I'm a member of the audit committee. At Fidelity, I was President. So I guess the difference is I had more say in how things are done.

Both companies, in my view, have very good partner auditors who are doing an excellent job. So I don't think there's any pressure on those. Whether that would be true after -- I've been on one of those boards for five or six years and the other for one or two years -- whether that would be true in 15 years -- and I should be clear. As David would say, I'm not representing either company here. I'm representing myself.

As to the question of fees, I think every audit committee is engaged in sort of hand-to-hand combat with their auditors on fees. I'm sure Don is, too. And that involves a lot of things, scope, how much will be done by internal auditors, what do we actually mean by risk based things. As firms go overseas more, you know, how will that be done?

I don't think I've seen real huge changes in audit fees. But generally when you have a competitor in there, it just leads to people taking a look at their fees. It gives you some sort of benchmark.

I don't think this is any different than what I'm analogizing it to. If a mutual fund complex bids out its custodian business, yes, bank custodians are under pressure now. And they'll reduce fees. But if you have a competitive bidding, they figure out different ways to do it. Maybe it's more automation. Maybe it's more internal controls. Various other things.

I don't think that there's any audit committee that I know of that's saying, "We want to bring down audit fees by 50 percent or 30 percent," because we all know that that would be a big problem in terms of functionality.

But I do think there is this issue now, we're in a low inflationary environment, it's really the question of are your fees going to go up by four or five percent? Are they going to stay the same? Are they going to go down by one or two percent? That's the range of the discussion.

I don't want you to think that my proposal contemplates this huge change in audit fees. I think most audit committees would be pretty happy if audit fees just stayed at the current rate of inflation, they would think that that's pretty good given the environment.

MEMBER HANSON: I don't know if either Mr. Nicolaisen or Mr. Becker want to comment on either one of those things.

MR. NICOLAISEN: Just I don't

think fees ought to be the driver of thinking about a change in audit firms. I would say from my experience having been in a number of different seats, including that of auditor for a lot of years, the last thing that you'd want to have is the audit from hell where nobody within an office wants to work on that engagement because it's such a tight fee structure or it's so politicized or so difficult to be involved.

And I think that audit committees, at least the ones that I'm familiar with, fees are not the -- the level of fees is not the primary concern. The primary concern is does the level of communication between the auditor and the audit committee satisfy us? Are we getting the information that we need? Do we feel that we have competent team, that the team is really testing, challenging, doing auditing, verifying, checking to make sure that what is purported to be the case is actually the case?

Those are the criteria that we talk about day in and day out. Fees, once a year you do go through the exercise, or if there's some expansion or change in scope, you do talk about it.

MR. BECKER: I would add two things to your first point. The first is it is not unheard of at all among very large companies to make sure that they basically pick an audit firm and say, "Even though this isn't our auditor, we're going to make sure that we're independent from them and they're independent from us. So we're not going to answer to any of these business relations because just in case you never know what happens."

We might have acquisition, something dreadful may happen with our auditor, and we don't want to be in the position where there's no one independent from us.

And in terms of the incentive for

audit firms to go through the trouble to determine whether they can bid, I guess I think if the economic incentives are sufficient, they'll do it. If they're not, they won't. And one of the things you learn from a tender is that you've got only one qualified audit firm who's prepared to do your audit. So I think requiring or encouraging an audit committee to exercise its business judgment periodically on rotation, I don't see those downsides to it.

MR. POZEN: I would think -- I may be speculating here, but given the size of the audit engagement with Proctor & Gamble, if somebody said this 15 year audit engagement of Proctor & Gamble is now going to go up on an RFP, I think there would be at least one other firm that would -- it's a big engagement. It's very prestigious. It helps a firm develop expertise in this area. I would shocked if there wasn't another -- at least one other firm that thought it was in its interest to go through the process.

And I think that, picking up on something David said, is sometimes very large firms decide to sort of have a second, maybe you call it almost a back-up auditor, you know, like they'll have either through a joint venture or through a smaller deal or a side thing. So they'll get some experience with that.

And so that's the sort of thing that can come out. Even if you don't get chosen as Proctor & Gamble main auditor, there is other work that they have, not non-audit work, but audit work, whether it's joint venture work or whether it's some subsidiary they have where they have a minority interest or something like that.

So it's like a way to have a little bit of a tryout. And as David said, if you really do get in a jam, you do have a second violinist there. You're not only have the first violinist.

CHAIRMAN DOTY: Lewis Ferguson.

MEMBER FERGUSON: I'd like to ask you to comment on what I'll call the fresh look problem. And I think we're very aware of the fact that mandatory rotation is radical surgery and that if we do anything in this area, if we can do it minimally invasively it probably would be better.

But where I see the fresh look coming from, and I think one of our concerns about long audit tenure, in some cases some of the largest companies in America the audit tenure over 100 years, for example, is that inevitably over that period of time methodologies get developed. There's a certain kind of orthodoxy in thinking that develops, I suspect perhaps an identification with the client. And those probably are related to skepticism. Orthodoxy is generally the enemy of skepticism.

So are there things that can be done short of mandatory rotation that will give the kind of fresh view of an audit and of the kinds of things the auditor is doing that I think we all would find useful? I think in all of our human experience bringing a fresh set of eyes to something is a useful thing to do.

We've had a couple of suggestions. I just want to ask you about them. One of our commentators suggested that perhaps a useful thing to do would be periodically to require companies or have companies, in order if they want to keep the tenure of their auditor, to bring in another audit firm to do an intensive look at a particular area. And it could be revenue recognition, some of this. So you get a second view of what's going on in your company. And have to do that periodically, and not the same area again and again, but where the audit is looked at that way.

A second suggestion was that after a certain period of time if you're going to continue the tenure of your auditor you need, perhaps in accordance with guidance either from the SEC or the PCAOB, to have the audit committee go through a specific set of steps to evaluate what the auditor is doing, the quality of what they're doing, and actually to justify to the shareholders in a public way, why they're electing to continue the tenure of the auditor.

But the general question is this sort of fresh look question: (a) Do we need that? And (b) how can we get that short of auditor rotation?

MR. BECKER: Let me give you my own bias, which is the same as yours, that fresh looks are generally a good idea because thinking gets ossified. It's just as simple as that. It's true at regulatory agencies. It's true, as far as I'm concerned, in just about all organizations.

And then there is the sort of fear factor that someone else is going to look at something. My own view is I suspect that will cause people to behave differently. Whether it will cause them to behave better, I don't know. I think that the freshness of it is important.

I'm not -- I mean, it strikes me the first suggestion is another version of peer review, which I think has historically not been fully successful. So I'd be a little skeptical about that.

I see promise in the second suggestion. I also think that it may well be -- I mean, there was a hint in the Concept Release about some variability, possible variability, in the inspection program with respect to different types of things in different types of firms. And it may well be that after every X years, in addition to whatever category the firm falls into for inspections, that you have a particularly intensive inspection that focuses on particular things.

With respect to if you're

inspecting a firm on a yearly cycle or whatever it is, you say, "All right. We're going to spend -- generally, we spend a representative sampling or something like that. We're going to spend 40 percent or 50 percent of our time on any audit relationship that is over X years old." That might be a way to do it, too.

MR. POZEN: I agree with David. The first suggestion, I'd have to think through it, but it does have some peer review overtones that we'd really want to think about.

The second suggestion, I guess if you're really going to go to the trouble, let's say, every ten years to go through an elaborate process of justifying why you're keeping on your current auditor, I guess I would rather see a tendering because you're going to have to do almost as much work, but it's going to be a bit artificial. I'm sure within no time you'll have boilerplate answers that everyone will copy from everybody else's statements. That's the way this thing tends to go.

It just strikes me as a little artificial. That is, if you really want people to justify it, it's just a lot easier for the audit committee to have somebody else to compare it to. It's a very hard just to look at this in the abstract, whether you're justifying, you know, but relative to what? It's not easy to figure out relative to what.

I guess between those two suggestions, the idea of an elaborate justification versus a tendering, I would prefer a tendering.

MEMBER FERGUSON: I wasn't suggesting one or the other. I was just suggesting that those are two things we have heard about that none of you had mentioned here, so I wanted your views on them.

MR. POZEN: Yes. Though I don't think, Lew, I don't think you'd want to do both, would you?

MEMBER FERGUSON: No, no. I'm not sure you want to do any of them.

MR. POZEN: That's a fair point. But I was just viewing it as sort of -- I thought you were asking for a bit of a comparative analysis. But maybe I was wrong.

MEMBER FERGUSON: Not necessarily, no.

MR. POZEN: Okay.

MR. NICOLAISEN: I think everybody supports the idea of a fresh look. I think that's part of what SOX had intended by mandatory rotation of lead partner and others that are involved in an audit. And I think you do get that. Having sat on audit committees where there's been a change in engagement partners, there is a change in attitude and view and approach.

And you see, despite it being the same firm, that there are personality differences. There are experience differences. There are things that a new person brings to the table, not the least of which is they'd rather not be associated with somebody else's problem. So if they're there, they want to identify issues that relate and deal with them as quickly as they possibly can.

I think the idea of bringing in others to look at specific areas, or to do what's more broad, I think as you've described it, a peer review, but really looking at review of an individual company's circumstances. You want to avoid the risk of giving the appearance that you're doing an opinion shopping by bringing in another audit firm to essentially provide great ideas of how to do different accounting. And you'd want to make sure that whatever you did really is focused on improving the quality and addressing the issues that an audit committee would be concerned about.

CHAIRMAN DOTY: Steven. We're

going to run over.

MEMBER HARRIS: An awful lot of the focus the past two days has been on the discussion of mandatory rotation. But I believe the primary focus of these meetings is to discuss ways to improve independence, objectivity and professional skepticism. And mandatory rotation is one of many options.

But, Mr. Becker, you appropriately make the distinction that words do matter and the words independence, objectivity and professional skepticism have different meanings. I think you pointed out that independence is the absence of bias. Professional skepticism relates to the lack of talent and training.

And I was wondering if the three of you have specific recommendations in terms of, absent mandatory rotation, how you would increase independence, in terms of how you would define it, and how you would increase objectivity, and how you would increase professional skepticism. And I'm not sure whether there were recommendations under each of those categories. But because words do matter and you drew the distinction, I'm wondering whether or not there are options in each of those three areas.

MR. BECKER: I tend to think, in circumstances in which there is a lack of professional skepticism, people tend to move too quickly to the lack of independence as the cause. And I say that particularly in the context of people are auditing their client.

I don't care of it's the audit committee who speaks for the client or management. And that may make a huge difference, but it's still a professional client relationship, and one in which, among other things, clients are concerned about whether the fees are too high.

Having had the experience for a couple years recently of being with the SEC where we were audited by the GAO, I've got to tell you that's a very different set of dynamics. Very interesting sort of laboratory experiment for me.

I think it would be very useful, it's what I started with, to tease out what it is that you're actually finding in your inspections. What are the -- I mean, I know what it's like to look at someone else's judgment and to roll my eyes and to say, "How could they possibly have thought that?"

I think it would be useful to learn more about those situations. What are the common threads? And from that get a more informed view of what the more promising lines of attack would be.

MR. NICOLAISEN: I think it's hard to disagree with David's observations. I would say I would look for ways to reinforce what the role of the auditor is with great clarity. And it is: good auditors are skeptics; good auditors are critical; good auditors are a pain; they ask the kinds of questions that you really know are right at the heart of what the company does, or its operations, or its strategy or its plans for the future, and so on.

So good auditors, the ideal place I think is within the inspection process, is that rewarded. Does it come across that firms appropriately reward the people who are critical, who are skeptical, who do ask the tough questions? And if you question that, I think I would look towards the other actions that the Board can take to ensure that that's not a repetitive occurrence.

MR. POZEN: I do have a specific idea because I believe that the most difficult problem for any audit committee is to know what they don't know as Donald Rumsfeld said, or some variant of that. It's all the things that you don't know that come to sometimes get you in the end.

And so the way -- and David knows and I'm sure Lew knows more about this -- most auditors would say that if there is a significant disagreement where they actually disagree with management, then they have to bring it to the audit committee. But really as an audit committee member, I'm interesting in knowing where were the areas of debate, not where they ultimately disagree. But I want to know where they had a big debate and then they came out and they might have resolved it.

And that's the sort of question that we need to get out there, is what are the things that we're not hearing? And I'm sure Don does this. Every good audit committee member when you're in the private session with the external auditor, the first question you ask them is "What are all the things that you didn't talk about at the meeting" and trying to get that out.

But that is the biggest issue. Because if you look at something like Lehman and Repo 105, the audit committee didn't know that that was happening recurrently. So they never had a change to say "Is this right or is this wrong?" And apparently the auditor agreed with management. You can argue whatever you want on technicalities, but they did agree.

So I say to the extent that you can sort of get the questioning beyond that actual disagreement to areas of debate; where were there areas of debate? That would be very helpful in terms of improving the audit process.

CHAIRMAN DOTY: This panel did not disappoint. It was put together with a lot of thought that we were getting three of the best minds in the country to think hard with us and articulate what we ought to be thinking about. And I think that's what you heard from Board.

We are deeply grateful for your having given us things to think about, given us a gentle nudge away from simple solutions, and even given us some very specific ideas about where in fact we could focus our efforts productively.

And that's all in the record. It's a great record. And in doing that you've made another real contribution to a distinguished public service career. Thank you all.

We'll go to the next panel. The next panel are money managers. Some of us are going to walk around for a moment or two.

(Whereupon, a short recess was taken.)

CHAIRMAN DOTY: We have a quorum. I think I may have said before this brief break, that we want to hear from money managers. These are actually portfolio analysts. We're now hearing from the people who get the information, who use the information, and who are in a position to tell us what we want to see in the information, what the audited report is.

It also will prove definitively that there are some things that are more important than lunch to the PCAOB, that this kind of intelligence is more important than lunch.

We have an outstanding panel. Jack Ciesielski is the President of R.G. Associates, Inc., but he is also the publisher of the Analyst Accounting Observer. He spent seven years as a security analyst with Legg Mason. He has had a career with Coopers and Lybrand, internal auditor for Black and Decker.

He serves in a very distinguished capacity and company. He is a member of the Financial Accounting Standards Advisory Council, FASAC. That's the advisory council, the advisory body that consults with FASB, the Financial Accounting Standards Board. He has been on the AICPA's SEC Regulations Committee. He has served as a member of their Accounting Standards Executive Committee.

He entered a five-year term this last year as a member of the FASB's Emerging

Issues Task Force. So Jack is a real guru in this area and someone who, fortunately for the PCAOB, has always been available to share his perceptions about what auditors need.

We're pleased to have for the first time Ms. Mia Martinez, who is Deputy Director of the Black Economic Council, Latino Business of Greater Los Angeles, and the National Asian American Coalition. Mia is one of the people who traveled a great distance to get here, and we're grateful for that.

She is the D.C. Deputy Chief of the Black Economic Council and the Latino Business Chamber of Greater Los Angeles and the National Asian American Coalition. And she heads the Regulatory and Congressional Liaison Office here; the minority, consumer, and small business efforts before the Federal Reserve, the OCC, the FDIC, the Treasury, the FTC, the Department of Justice's Antitrust Division, and the FCC. In fact, she was appointed by the FCC to the Consumer Advisory

Committee in June. And they have been active in a number of issues in which they have taken a lead role on small business loans and the lack of responsible home origination loans available for minority communities, diversity among Fortune 500 corporations, antitrust issues, and CRA and community investment issues.

So, although she is around the corner in her D.C. office, she has a wide scope of activities. And she will be talking to us about what she thinks the audit issues that we have been talking about raise.

Mary Hartman Morris, Investment Officer for Global Equity, California Public Employees' Retirement System, CalPERS. Mary Hartman has been a mainstay of some of our outreach efforts to garner information from the investor and the analyst community. Mary Hartman has served with distinction on our advisory committees.

She has been at CalPERS for more

than 15 years. She has over 25 years experience as an auditor, accountant, and financial analyst. So we have got here -- and she also serves with technical and accounting expertise on International Corporate Governance Network and a number of other of the important outreach organizations that follow this area.

So we have three people here whose focus is on getting right information right and getting it timely and using it. So we're happy to have you. Thank you all.

Jack, do you want to start us off?

MR. CIESIELSKI: Thanks, Jim.

I would like to thank the Board for the opportunity to present my views on the matter of auditor rotation. I believe the PCAOB is acting in the best interests of investors by challenging the status quo and searching for ways to improve the objectivity of auditors, which ultimately should improve the audit process and overall financial reporting quality.

Well-intentioned as it is, however, I don't believe that required auditor rotation addresses the root cause of objectivity problems within the audit profession. The root cause is that auditors' interests are aligned with management and not aligned with the interests of shareholders of necessity.

Simply changing the auditors every few years only treats the symptom of the problem, and not the cause. There is no guarantee that a new auditor will do a better job than a previous auditor, and it is very possible that newly installed auditors might not be effective in the early part of their stint.

Rather than encouraging skepticism and increasing financial reporting quality, auditor rotation might actually work counter to investor interests. I recommend that the Board should try to align the interests of auditors and shareholders in more fundamental ways than through auditor rotation.

Auditors' interests are currently aligned with management's because of the client-payer model. Nominally, shareholders approve the hiring of an auditor based on the audit committee's recommendation. That's the extent of their involvement.

The audit fee is paid by the company. The auditor is examining the work of those who pay him or her. The auditor is in the awkward position of retaining independence and objectivity while depending on management for acquiring knowledge of the auditee firm without trying to alienate the managers.

This doesn't necessarily foster an auditor attitude of working for investors, and it encourages auditors to extend their relationships with clients as long as they can or until it becomes clear that their own interests may be harmed by continuing to serve an unacceptably risky client.

Note that the root cause of the objectivity problem is the client-payer relationship. This fosters a long-term financial interest in the client that can impair objectivity, and gets in the way of working on behalf of investors.

Staying for the long run can have benefits, too. The auditor's experience and working knowledge of a client should increase over time. This is an investor benefit only, however, if the auditor is working strictly from their point of view, which brings me to another reason for a misalignment of auditors' interests with investors' interests. The auditors aren't retained by a single party of investors. The composition of investor ownership changes by the minute. And that may be the long term.

It may be difficult to expect auditors to feel allegiance to a shifting, faceless group of investors who only seem to act as a cohesive bunch only when there's a legal threat. Again, that's not a situation that will engender strong auditor-investor relations.

What needs to be done is to change the model for auditor payment so that all the right parties to the audit process have the proper incentives and penalties so their behavior will benefit investors.

To improve the objectivity of the auditing profession, there needs to be a more sweeping solution than mere auditor rotation. I believe this can be accomplished by introducing the insurance industry into the investor relationship with the auditor and issuer.

Consider a model where financial statement issuers would purchase financial statement insurance that covers investors against the losses resulting from financial reporting misrepresentations.

You could think of it as a guarantee by the insurance company that the financial statements are fit for use by investors. If you will, they could be providing warranty of merchantability of use of the financial statements by investors.

By transacting with the insurance company, the issuing firm would have a direct interest in the quality of the reporting process. The more confidence the insurer can place in the financial reporting process of the insured, the lower the premiums that would be needed to be charged the issuer.

There would be a tension between the issuer and the insurer that plays out in the price of the premiums which, incidentally, should be publicly disclosed, along with the amount of coverage.

The insurer wants to minimize losses so as to preserve profitability of the financial statement insurance product and will charge what it needs to obtain comfort that it won't lose. The issuer will want to make its reporting as clean as possible in order to prove to the insurer that it deserves the lowest possible premium.

This is a transparent, market-driven mechanism that rewards virtuous reporting, and the insurer effectively stands in the shoes of the investors. Insurer has the same interest as the investor and is the interface between the company and the auditor.

Insurers already are willing to provide insurance against risk of loss from events over which they have no control whatsoever. In offering financial statement insurance, they would be insuring events where they could actually exert influence on the outcome of events.

The insurer would gain comfort about the reliability and suitability of the financial statements because they would be the ones to hire and pay auditors to act as their agents. Auditors wouldn't have to worry about favor with an auditee firm's managers to insure a flow of future revenues. They would be more incentivized to provide a high degree of audit assurance to the insurance company that hired them.

The insurer, not the auditee, would be the source of the auditor's future revenues. So acting in the insurer's interests, and the investors' interests, would also be good for the auditor.

The issuing firm being audited would be highly motivated to work with the auditors because their premiums for financial statement insurance would be directly affected by their cooperation with the auditors.

The proposed model provides further incentives for auditors to perform high-quality audits. It would be likely that one auditing firm would be retained by one insurer for many audits.

A sub-par audit causing the insurer to pay unacceptably high claims could damage the auditing firm relationship with the insurer and cause a loss of revenues far beyond those stemming from one sub-par audit.

Contrast that to the current consequences of a substandard audit. Scattered investors are rounded up by the legal profession into a class of litigants and take the auditor to court, which is an inefficient process.

If the court finds for the plaintiffs, the auditor faces economic penalties related to that single audit. The auditor may lose reputational capital, but the auditor doesn't generally lose other audit clients because of the failure of one audit. Facing the threat of losing revenue for many audits as a consequence for doing a poor job on one engagement would be a far more powerful auditor motivation than legal consequences.

In short, the proposed insurance model would provide proper incentives and penalties for all parties to report more effectively for the benefit of investors. While I commend the Board for taking a big step in considering auditor rotation, I strongly encourage the Board to think bigger and give serious consideration to the more sweeping reform potential of the insurance model.

I believe the Board will find that investors would be interested in this model if it was given more attention. For example, it is my understanding that the CFA Institute also supports exploration of the insurance model as an alternative to the client-payer system.

That concludes my remarks. And I would be happy to take any questions.

CHAIRMAN DOTY: Thank you.

Ms. Martinez?

MS. MARTINEZ: Good morning. The Black Economic Council, the Latino Business Chamber of Greater Los Angeles, and the National Asian American Coalition, thank Chairman Doty and the PCAOB for the opportunity to be on the panel and commend them for their efforts on behalf of consumers. We also wish to thank you for welcoming a consumer perspective on the matter.

These comments are on behalf of black, Latino, and Asian American consumer and business groups that have actively participated in a broad range of regulatory actions before the Federal Reserve, Treasury, the FDIC, the OCC, the Department of Justice, the FTC, and even the FCC.

Main Street, at least as much as Wall Street, is adversely affected by the present lack of independent CPA audits. This is, in part, due to the lack of competition, even among Big Four firms.

For example, only two CPA firms effectively bid for audits of the major financial institutions. Similarly, only two appear to effectively bid for audits of utilities, and only two effectively bid for high tech firm audits.

Our analysis was submitted to the

Department of Justice, the FTC, the PCAOB, the Federal Reserve, the FDIC, Treasury and the OCC. And it demonstrates this concentration.

Monopolies are per se dangerous for the well-being of even the strongest economic system in the world, but they are far more dangerous given the existence of audit duopolies in three key industries by auditors who have been chastised by the PCAOB in the recent past for lack of independent audits, for failing to use Generally Accepted Accounting Principles, and for unduly cozy relationships with management.

To the best of our knowledge, an estimated 95 percent of Fortune 500 corporations are audited by the Big Four, all of whom have been chastised by the PCAOB.

A Wall Street Journal article of March 20th states, "The Big Four firm audits 97.5 percent of the total market value of U.S. companies." It also states that "KPMG, and Ernst and Young audited more than 70 percent of commercial banks' market capital."

However, independent of the quasi monopolistic practices of the Big Four and the duopolies in major industries essential to our nation's economic survival, we strongly support two key matters raised by the PCAOB for this roundtable.

Firstly, we support rotation for CPA firms. We recommend, particularly for Fortune 1,000 corporations, that rotation be every 6 years, rather than the present average of approximately 25 years.

Secondly, we strongly support the barring of any audit contract where the auditor is also paid for other services, such as management services. As previously identified by the PCAOB, this creates a far too cozy relationship between the auditor and management.

For example, Monday's American Banker demonstrates our concerns regarding the entire financial industry, where 5 of the 14 servicers subject to the Federal Reserve/OCC consent order in mortgage fraud has as their chief adviser for management services Big Four CPA firms.

Our three groups are particularly pleased that we are joined on this panel by an extraordinary public interest pension fund: CalPERS. Joined by CalPERS and other government pension funds, we believe that the reforms raised by the PCAOB can be quickly achieved. That is, CalPERS is in a position to recommend, for the thousands of corporations in which it holds stocks, a vote of no confidence to management, and management's positions, on a broad range of issues unless management agrees to rotation of auditors every six years and the separation of audit functions from management and service functions.

We offer examples of the adverse impact of the present system of long-time auditors who have failed to protect the public, but similar examples abound across the nation. For example, Sempra Energy is seeking a $2.4 billion rate increase to be paid by consumers based in large measure on the accounting services of its long-time prime auditor for 50 years: Deloitte and Touche.

Similarly, all banks subject to the regulatory stress tests or seen to be too big to fail are audited by the Big Four CPA firms, such as Deloitte and Touche, and PricewaterhouseCoopers, who have been heavily criticized by the PCAOB for shoddy financial practices.

Further, some of the Big Four firms have been allowed by the very federal regulatory bodies who have criticized the foreclosure practices of the banks they audit to be the judge and jury for the Federal Reserve/OCC consent order against the 14 largest servicers for malpractice and fraud against homeowners in distress.

And, as to the importance of this

proceeding, please note that the Federal Reserve is now closely examining the appropriateness of the Chinese government's largest bank, Industrial and Commercial Bank of China, acquiring FDIC-insured bank is the Bank of East Asia. Their auditors are Ernst and Young and KPMG.

We have examined ten of the largest financial institutions that were involved in financial fraud that have been bailed out and/or failed and were audited by the Big Four firms. Ameriquest, Bear Stearns, Merrill Lynch, and Washington Mutual were audited by Deloitte. Countrywide, New Century Financial, and Wachovia were audited by KPMG. IndyMac and Lehman Brothers were audited by Ernst and Young. And AIG was audited by PricewaterhouseCoopers.

The two changes that the PCAOB is considering and that we support in our testimony could enable at least 25 large CPA firms to effectively compete for business;

therefore, eliminating the quasi monopolistic power of the Big Four.

And if other reforms are put into place by other government bodies, up to 100 firms could effectively compete to audit most Fortune 500 and Fortune 1,000 corporations. One suggested government reform would be for the federal government to refuse to allow its $500 billion in contracts to be awarded to any corporation that has been audited by the CPA firm whose accounting practices have been criticized by the PCAOB.

This type of competition is not pie in the sky. Consider the legal profession, where there are at least 100 firms that effectively compete.

Lastly, since diversity is not part of this proceeding, we will not comment in it except to suggest that the PCAOB read our written statement. We also wish to inform the Board that our groups are committed to work with the PCAOB on this issue.

Thank you.

CHAIRMAN DOTY: Thank you.

Ms. Morris?

MS. MORRIS: Thank you.

Chairman Doty, Board Members Ferguson, Franzel, Hanson, Harris, distinguished panel members, and guests, my name is Mary Hartman Morris. I'm an investment officer with the California Public Employees' Retirement System, CalPERS. I would like to thank you for the opportunity to provide an institutional investor's perspective, a share owner's perspective, an asset owner.

I would like to thank you for the discussion on the ways to enhance auditor independence, objectivity, and professional skepticism through mandatory rotation or term limits for audit firms.

One point I would like to make sure that we know is that corporate governance now at CalPERS is across all of our asset classes because although before we used to report to global equity, now we feel it needs to be elevated because these are really important issues.

CalPERS is the largest public pension fund in the United States with approximately $238 billion in global assets in more than 9,000 public companies worldwide within 47 markets. CalPERS invests assets on behalf of 1.6 million public workers, retirees, and their family beneficiaries.

As a long-term and social investor, CalPERS believes the role of the auditing profession is critical to the integrity, efficiency, and confidence of the capital markets. The financial interests of CalPERS beneficiaries are most effectively served in an environment where investors can justifiably rely upon financing, reporting to evaluate the risk, and rewards.

The primary objective of an external auditor should be to provide consumers with an independent opinion. I have four points that I would like to emphasize from an investor's perspective this morning. Number one, audit committees should promote the rotation of auditors to ensure a fresh perspective and review of the financial reporting framework.

CalPERS recently adopted an internal board governance policy that requires our risk and audit committee to engage in a competitive bidding process every five years to select or retain the external auditor.

Number two, CalPERS's global principles of accountable corporate governance recommends that audit committees annually assess the independence of the external auditor and require written disclosures demonstrating this independence. I think we have heard this quite a bit over the morning and as of yesterday.

Number three, the need for professional skepticism and objectivity in an audit cannot be overemphasized.

Number four, the public company audit market is quite concentrated. And we also heard that from Mia. Our principal support that audit committees should endorse is expanding the pool of auditors for the annual audit. We currently only have Jenny Macias to help improve market competition and minimize the concentration of audit from which to engage audit services.

Let's talk about fresh perspective, rotation of the auditor. There's a fundamental and inherent conflict of interest in an audit client paying the auditor, although we must be reminded that it is share owners' capital that pays for an external audit through the contracting process of the audit committee.

CalPERS' global principles state the audit committees should promote the rotation of auditor to ensure a fresh perspective and review of the financial reporting framework. So I'm emphasizing that.

As a member, -- CalPERS is a member of the Investor Advisory Group -- we urge the PCAOB to consider firm rotation in the context of lessons learned from the financial crisis. I think there's a lot of information that was discussed, of course, with the financial institutions.

As the group indicated, the purpose in audit is to provide confidence to investors that an independent set of eyes has looked at the numbers reported by management and objectively, without bias, determined that they can indeed be relied upon.

If investors' confidence in this process is diminished or lost, the benefit of the audit and its costs may be questioned. Absent and fully embracing the notion of rotation, CalPERS believes that audit committees should use a robust bidding and competitive bidding process to select or retain the external auditor on a periodic basis.

Importantly -- and I think both individuals had mentioned -- non-audit services should be discussed with the topic of auditor independence and considered by the audit committee when annually evaluating the auditor and during the competitive bidding process.

Independence: those charged with governance of a company, including the audit committees, should annually assess the independence of the external auditor.

Again, our principles recommend that audit committees require the external auditor to provide written disclosures of the following on an annual basis; and I think it is really important that the audit committee really go through and determine the relationship: All relationships between the registered public accounting firm or any affiliates of their firm and potential audit clients or persons in a financial reporting oversight role that may have a bearing on independence; the potential effects of those relationships on the independence in both appearance and fact of the public registered public accounting firm; the substance of the registered accounting firm's discussions with the audit committee; skepticism and objectivity.

The need for professional skepticism in an audit cannot be overemphasized. Both the IAASB, of course, and the PCAOB standards emphasize the need for professional skepticism.

CalPERS' view is auditor skepticism is a fundamental characteristic exhibited by auditors to individually and collectively through their firms. And we believe it should be the bedrock of the professionalism.

We believe the application of an appropriate degree of professional skepticism is a crucial skill for auditors. Unless auditors are prepared to challenge management's assertions, they will not act as a deterrent to fraud or be able to confirm, with confidence, that a company's financial statements are fairly stated in all material aspects.

In the aftermath of the 2008-2009 global financial crisis, the recent PCAOB inspections reports in various jurisdictions have noticed areas such as fair value, related party transaction, going concerns assessments, and failure to actually obtain sufficient competent audit evidence. Where regulators and oversight bodies believe that auditors should have more clearly demonstrated professional skepticism.

We believe that staffing requirements along with training are attributes that may impact a level of auditor skepticism exhibited during an audit.

Clearly understanding a client's business operation is crucial to performing a high-quality audit. However, over-familiarity could lead to an erosion of skepticism and improper reliance on assumptions and clients' representations. It may be valuable to request that audit partners and audit staff document how they demonstrate and apply the skepticism.

In the interest of time, I won't go into audit firm concentration. I think others have talked about it. But we'll include this information in our written statement.

In closing, as Chairman Doty stated in issuance of this Concept Release on auditor independence and audit firm rotation, -- I think we found this very insightful -- the fact that inspections cannot always link a specific failure to an absence of objectivity in the auditor's mindset does not establish that the auditor was unaffected by the pressures and incentives inherent in the system.

To the contrary, experience teaches that those pressures and incentives are powerful and pervasive. The public is aware of those pressures and incentives. They may well have eroded public confidence in audits. And I think they have. This is why it is important to consider ways better to protect auditor independence.

Thank you, Chairman Doty and other Board members. CalPERS applauds your efforts and challenges the PCAOB to continue its hard work in restoring investor confidence in helping the market work better.

And I look forward to the opportunity to respond to any questions. Thank you.

CHAIRMAN DOTY: Thank you.

Steven? Steve Harris?

MEMBER HARRIS: I would like to take one minute and maybe go off script here because other panelists did yesterday, other participants.

Ms. Martinez, you raised the issue of diversity. Could you just spend 30 seconds in terms of what your concerns are with respect to diversity?

MS. MARTINEZ: Sure. So basically our organizations, we have looked into the diversity of Fortune 500 corporations, and we know that the accounting or the audit industry is a predominantly white male industry. So when it comes to diversity, we wanted to explore also how other firms can -- there are a lot of good firms out there and how we can also tap into these resources.

MEMBER FRANZEL: I also have a follow-up. Go ahead, though.

I want to just take that one step further, Ms. Martinez. You mentioned concerns about concentration. What ideas do your organizations have, the organizations that you represent, for how diversity can be expanded in the profession? And part of that is, how can concentration maybe be lessened?

MS. MARTINEZ: Well, one of the recommendations that we had was to, for example, have the other federal agencies put even more importance on PCAOB findings and PCAOB recommendations. Like, for example, we mentioned earlier like the federal agencies, instead of just giving their $500 billion in contracts to all these larger corporations to explore also and to critically explore the findings of the PCAOB as to the audits. And, you know, this way we can invite more -- it would invite more competition among other firms as well.

MEMBER HARRIS: I'd like to ask a question of Ms. Morris. And, first of all, thank you for your participation, both the SAG and the Investor Advisory Group.

Recognizing the retirement systems at CalPERS are different from traditional issuers, we have heard over the past day and a half how costly and how disruptive audit rotation would be. How costly and disruptive has it been for you? And why did you decide to go five years?

MS. MORRIS: From our perspective, it has enhanced the integrity of financial reporting. I don't think that we believed that there was that additional cost involved. So we don't see that the need, the ability to rotate the auditor is more important than the additional cost. But I don't think we necessarily have experienced that additional cost.

MEMBER HANSON: I have got three distinct questions for each of you. And I will start with Jack. And I'll tell you the question. Then I'll circle back.

So, Jack, one of the things that you had cited was your proposal that insurance companies would write a contract that guarantees that the financial statements are fit for use by investors. And I would like to hear your thoughts on how that differs from that the financial statements are fairly stated in accordance with GAAP. So think about that one.

Ms. Martinez, a question I'll come back to you on is your observation that the Big Four firms all have significant findings of audit failures by us. That's true. And, in fact, the top seven firms do. And there are only seven firms that have global networks that are connected by common quality controls systems around the globe.

So yesterday we heard from Valarie Sheppard, the comptroller at Proctor and Gamble. And she provided some data about their audit around the world, that they have over 900 individuals in audit firms in 75 different countries. And so if you say, "Let's take the top seven off the table," I would like to hear your thoughts on how Proctor and Gamble would get an audit done.

And then, Ms. Morris, just a broader question for you about how CalPERS, and how you personally feel about the job that audit committees are doing today. That's a softball question. I'll throw it to you first.

MS. MORRIS: Thank you for the softball question. I think that our perspective and our principles for support and as we go in and engage -- because we have our corporate engagement, because CalPERS is mainly an index investor, however, we are bringing more inside and realizing that active ownership is very important to our beneficiaries.

I think that we view the audit committee as a fiduciary. You know, it is their responsibility to share owners, to identify and work with investors and provide that transparency. However, I don't know necessarily that we feel that they have done the excellent job. I think if we had to grade our audit committees, I think that there are some questions.

And I think that when we go out and engage companies, we do, we ask to speak with the audit committee chair. And I think that we are looking at other options about how to get that message across and the importance of that.

So I appreciate the question. So thank you.

MS. MARTINEZ: For diversifying and tapping into the smaller firms: we actually in our written statements had contrasted this with the legal profession, for example, where you have about the top 100 firms competing, and you have smaller legal firms with about 300, for example, attorneys, who are competing with those who are even higher-ranked in terms of prestige with those with about 5,000 or 7,000 employees.

So this is something that we would really like to encourage as well in the audit industry, that you truly explore the potential of all these companies.

MR. CIESIELSKI: What would useabilty or merchantability or reliability of financial statements mean in the insurance model? What's in the auditor's report? Not any deviation from GAAP. What's in the financial statements represents the economic reality; if they have X dollars of cash on the balance sheet, X dollars exists.

MEMBER HANSON: Jack and I served on the AIT for many years. And economic reality and what's in the financial statement are sometimes very different things.

MR. CIESIELSKI: Yes. Well, economic reality as described by GAAP. That's what I'm getting at, not something different, not --

MEMBER HANSON: You would still have a GAAP based --

MR. CIESIELSKI: Yes.

MEMBER HANSON: If the financial statement was in accordance with GAAP, the insurance company would not have a payoff to make, even if the business failed or even if the --

MR. CIESIELSKI: Basically the insurer is backing up the findings of the auditor. If they are happy that the auditor has done the job in accordance with GAAP and GAAS, they're willing to put themselves out for the amount of loss that they have insured. So basically it is making sure that the auditor is doing what GAAP and GAAS require of the financial statements, which, by the way, I think is pretty useable for investors when it is done right.

If you think back to when financial statements weren't reliable -- okay? -- that's kind of the opposite of what I mean. Okay? It's easier to illustrate by what went wrong than what went right.

MEMBER FERGUSON: I have both a comment and a question. Mr. Ciesielski, I think your idea of an insurance scheme is an interesting one, but it strikes me as being way beyond the statutory mandate and the powers of this Board and probably beyond the powers of the Securities and Exchange Commission. It seems to me if we want that, you probably would be having this discussion on Capitol Hill because it strikes me to take changes to the statutory structure.

But, having said that, my question is, one of the things we heard yesterday was, and heard today as well, that a problem with mandatory auditor rotation is that it would, in fact, undermine the independence and the power of the audit committee and that one of the great changes that Sarbanes-Oxley did in the last ten years was to give audit committees more power, that if we had a mechanical rule that you had to basically rotate auditors however many years it was, that, in fact, the independent decision of the audit committee to look at this and make their own decisions about this would be undermined. If they were happy, for example, with the audit report, the auditor was doing a terrific job, that wouldn't matter. They would still have to rotate.

I guess I would like your views, all the views of all three of you, on what you think about that, whether mandatory rotation would, in fact, undermine the power of the audit committee, which I think we all want to make sure to keep strong.

MR. CIESIELSKI: Okay. First of all, in reaction to your comment about the scope of the insurance model being outside of the PCAOB's mandate, I agree it is outside of what you are legally required or allowed to do right now.

At the same time, I can't think of any body that exists in Washington that is better positioned to tee-up such an issue. If you really want to get out of the rut with auditor rotation, which I think you are going to find yourself in, what's the right number of years? What's the right number of firms? If we need more firms, how do we make more firms? I think you have to think something a little bit more sweeping than just let's reinvent some of the old rules.

I think that the issue with the insurance model if it were able to be implemented is that I think mandatory auditor rotation would not be the kind of issue that it is now. I think that the longer -- I think it would accent the benefits that you have from a long relationship with a client and auditee, I should say, because the client would be the insurance company because the auditor would be more responsive to somebody that could actually have an impact on their future.

So I would still stick with the insurance model as being the solution for auditor rotation, not auditor rotation itself.

So Mia?

MS. MARTINEZ: So for auditor rotation, we go back again to our comparison with other industries, such as the medical and legal industries, where we have more competition. And we don't think that it's the answer, of course.

But, then, we also would like to agree with -- I think that was Mr. Bowsher yesterday when he mentioned that, you know, it's a great idea, but, of course, there is still much more that has to be done outside of it.

MS. MORRIS: I think CalPERS definitely supports the fiduciary responsibility of the audit committee. I think they have a responsibility to us as share owners. I think, actually, rotation actually strengthens the opportunities for audit committees to vet, discuss, understand the independence of the auditor. I don't see that it would be -- I think it is more of a building block and not necessarily a weakness to do that.

CHAIRMAN DOTY: I have a few questions, but we have plenty of time. So I want to give the chance to other Board members, who may not have gotten through. Jeanette, did you have some more?

MEMBER FRANZEL: Yes. A question for Ms. Morris. You site CalPERS global principles of accountable corporate governance, and the recommendations that you make for audit committees, to oversee the independence of auditors, And it appears that those were just approved. Could you explain how those principles are being used by companies and audit committees?

MS. MORRIS: CalPERS owns 9,000 companies worldwide. And our principles are used as the building blocks voting every single one of those securities that we own.

We also have corporate engagement, right? And so in identifying activism, we look and talked to audit committees and asked them about their responsibilities.

And so we use our principles as our building block, our guidelines, and in voting our proxies, in identifying our ownership and also in identifying the companies that we want to own as a shareholder.

MEMBER FRANZEL: And are you finding that companies and audit committees are being responsive?

MS. MORRIS: I think that is still in the works. We are trying to figure that one out still.

You know, I really do believe the engagement process is important. And I think being CalPERS, of course, we have the opportunity to be able to do that and talk to audit committees. I think that being on the SAG, being on the Investors Advisory Group, working through International Corporate Governance Network, the Council of Institutional Investors, I think collectively investors are being heard. And I think audit committees are stepping back and realizing that they do have that fiduciary responsibility to their owners.

CHAIRMAN DOTY: I am going to follow the Hanson model and try to get three questions and degree of difficulty here.

The first one, Jack, you can think about. I'll give you a while to think about it. And that is, have you done any research or what do you know about the research regarding the depth and the ability of the market to cover major audits?

I have, of course, not read in depth in this area. What we do in this role is read a lot of things quickly. But my impression is from reading that some people have looked at the depth of the market, have concluded that there is not enough insurance in the market. So that would be in my mind an issue. Whether there is enough depth in the large market to undertake even the engagements of one major firm would be a question.

The second would be my own experience as a lawyer is that once you get insurance companies involved in settling a dispute, you have just bought yourself major litigation. And have you thought about the fact that the audit may be the last stop? The auditor and the independent auditor may be where things do come to rest ultimately and that by adding an insurance company, you have moved on or deferred the very difficult cause and the very difficult issues about whether or not the auditor has done a good audit. Get some time to think about that.

The next most difficult question is for Ms. Martinez. We have heard a lot about the audit committees. And you have just heard some comment about Board members here on that.

I have the impression that one of the most important changes in corporate America since Sarbanes-Oxley has been diversity in the board room and diversity on the audit committee.

I would be interested in your comments on that because while we recognized that diversity in the audit profession is a goal for the audit firms as well as the rest of us in society and while our scholarship program, which -- we have now instituted a scholarship program which encourages universities taking our scholarships to consider the award of our scholarship to groups of people who have been historically under-represented in the audit profession.

So we're trying to do our bit, but it would seem to me that one of the most important things that your society could do and your efforts could be directed towards is monitoring and putting out some concrete information on how progress is being made in diversity in the board room and diversity on the audit committee because in my own experience, some of the best audit committees and board members I have seen have come to the Board in that role. That has really positively I think affected positively and constructively the cause of diversity in our commercial life. So I'll leave you to think about whether you can do something to help us on that.

One of the messages that we are getting from this colloquium in this public meeting is we need to do more as Public Company Accounting Oversight Board to deal more directly with boards and audit committees.

So if we are doing that, it would be interesting to us to know where diversity is succeeding and where progress needs to be made.

I saved the softball for Ann -- rather for Mary Hartman. Ann wrote a letter to us on this proposal and reminded us that in March of last year, you urged us to consider firm rotation in the context of lessons learned from the financial crisis. You then go on to say that you are noting the effect that the issue of mandatory rotation is currently being addressed abroad.

And, of course, since you wrote this letter, other countries in Europe and elsewhere have simply adopted mandatory rotation, usually on a six-year model but not necessarily, but you conclude by saying you believe it is essential that the PCAOB collaborates with non-U.S. regulators and standard setters on this matter.

We know for a fact that many auditors regard the patchwork that is emerging in different patterns of mandatory rotation, different conditions, different time periods and different regimes across the world -- India is now taking it up. The Netherlands just did it.

We know that that patchwork is a concern to audit firms that are having to deal with an emerging international global financial system.

We are also as a Board told that we are wasting resources and that we shouldn't be engaged in considering auditor independence in the context of firm rotation at all. There are people we will hear from later today who have said, "You never should have taken the subject up. And you should certainly drop it now" because 99 percent of your comment letters are against mandatory firm rotation.

My question to you is whether it is essential -- this is a leading question. That's why I said it was softball. But isn't it essential if we are going to influence or affect what other audit regimes do by way of mandatory firm rotation and they're doing it that we have our own views about what is bad or good about different ways of going about managing the tenure issue?

We heard from the panel before you a number of very interesting issues, very interesting proposals and ideas on how to manage the tenure issue. Yesterday Arthur Levitt said we should simply feel better about an audit arrangement that is reexamined at least once every 25 years. And it goes 25 years, and it's unexamined. We just don't feel as good about that.

We don't have any means of engaging, I think, independent auditor regulators or even professionally designated audit regulators in other regimes who are designated by the profession if we don't have any information on mandatory firm rotation, if we haven't had the comments of CalPERS.

You have come out in favor of a six-year term. You say that works for CalPERS. We heard today from PNC that they evaluate it every year but they don't necessarily change. And we heard from Rob Pozen, who has run one of the largest investment firms in the world.

I would suppose that they found rotation a very interesting concept to use. But he thinks it ought to be really just a reevaluation of tenure at the end of 14 years. He's in favor of simply reevaluating tenure at the end of 14 years at the audit committee level and making a decision. And if you retain the existing audit firm, which he thinks may well happen, you explain it.

Now, that is a lot of context to throw at you, but I would like your comments on how the Board is going to constructively engage with and influence a discussion that is going on around the world on audit rotation if we don't have a Concept Release out and if we don't have a project to hear from people like yourselves on the pros and cons of audit rotation and the different ways of managing what might be called the tenure issue.

One must simply say the tenure issue doesn't exist or we don't recognize it. Would you answer my leading question?

MS. MORRIS: Thank you, Chairman Doty. And you can ask me hardball questions, too. I would appreciate that. Thank you.

I think that from a global perspective and ownership -- and the reason why we say that -- I mean, we do agree. I mean, the PCAOB has to form a viewpoint on this. And I think that it is important, but we are a global owner. And the world has become more global. And there is no stopping that.

So I think it is really important whether you're talking about global auditing standards -- I think whether we are talking about global auditing standards.

So I think if I heard you correctly -- and please correct me if I am wrong -- how will this Board engage and influence around the world unless they have developed their own concept? And I urge you and agree with you that you have to develop and become a strong player in that viewpoint?

I think that, you know, from our perspective, audit committees play a really crucial role. And I think that although that is outside of your scope right now, I think it is important that investors through our international networks, whether it be the

Council of Institutional Investors, charter financial analyst, you know, whatever it may be that continues this dialogue, continue working together and understanding, you know, where are the pitfalls. And where are the strengths that we can all build upon.

I think that, you know, we say it does provide a different perspective. And, you know, we're not taking away from the audit committee. Either we are strengthening the audit committee's role with rotation, with a tenure.

Our dialogue with others -- I was just in London. I flew in from London. We were talking to members from all kinds of different institutional investors around the world about this topic. And there are lots different ideas. So do you go with tenure after six and then you can have a second term? But if you have a second term, then you go with four years only or do you go with six years and six years. And then you must mandatorily rotate the auditor. You know, I don't believe that we have a perspective on saying that this is the right key. We don't have that evidence.

But I think that it is important to continue that dialogue around the world, but I do believe that rotation actually only strengthens the audit committee and their perspective and their ability to be able to say, you know, "We need to look at this. We need to look at your independence." And we want to ensure that skepticism and that the bottom line: integrity of financial reporting, integrity to those investors who utilize your financial statements to make those decisions. So thank you.

MS. MARTINEZ: Thank you for your question on diversity. We have -- actually, we have already actually expressed our concerns to Chairman Shapiro in a meeting about a year or so ago. So basically our three organizations, we like to follow a

California model where diversity should be part of our DNAs.

So our suggestion is to start by gathering data and to ask the question as to how diversified is your board, where are your numbers.

And, secondly, the model that I would like to follow is that in California, for example, Governor Brown had recognized the importance of diversity. And in his first years, 23 percent of his judicial appointees were blacks, 20 percent were Latino, 14 percent Asian American. So today the California Supreme Court looks like the State of California and an increasing part of America.

So for the seven Supreme Court justices, four of them are women. And so the goal of our three organizations is that for the Big Four firms, other CPA firms to reflect the diversity, to reflect those they serve and who they protect in terms of diversity, one model that we have also represented to other federal regulatory bodies is that which is being used in California before the California Public Utilities Commission. It's the GO-156 provision, where they collect diversity data from the companies who they oversee. So this way it is out in the open. So we have seen very positive responses from the telecommunications companies, for example. They have increased their numbers throughout the years.

So this is one example of a model that could be applied for both, you know, the regulatory bodies as well as to the companies that they oversee.

MS. MORRIS: Before you start, could I just add something to that? I know that question wasn't directed to CalPERS, but I think it's really important that we point out CalPERS' perspective.

We have an initiative. We call it the Diverse Directed Database and/or Data

Source, however you want to. And I think it is really important that as share owners, we do look at that.

And it's not necessarily just about ethnicity and race and age and all of that, but it is also about the skill sets of boards.

And so you asked me, I think it was asked by a couple of different members, are audit committees doing their jobs? And I think, really, it surrounds about the building blocks of the expertise and the skill sets.

So, you know, diversity can mean a lot of different things, but from our perspective, it does mean diversity of skill sets. And so one of our initiatives with CalSTRS as well as lots of other institutional investors as a part of that is to identify where boards need to build out those skill sets. And audit committees are definitely included in that.

So thank you.

MR. CIESIELSKI: Back to the insurance model. I know that you have to read a lot of things quickly, but I think one paper that would be very worthwhile to spend time with is the Ronen paper by Joshua Ronen of NYU, as referenced in the Concept Release, which has an excellent outline of how the insurance model could work, should work.

And obviously I had to leave a lot of details out to keep it to five minutes, but there is a lot more in there that I think covers some of the questions that you have.

Your question was, have I done any work to find out if there is enough insurance in the world to cover all the losses? I have not.

CHAIRMAN DOTY: I didn't mean you personally, but has it --

MR. CIESIELSKI: I haven't seen anything along those lines, but it all depends on how you are going to define a loss.

As Ronen describes in his paper,

the insurers would do preliminary work, describe the amount of -- you know, they would employ auditors to do preliminary work, find out what kind of risks might be involved, how much they would be willing to charge for how much coverage. It wouldn't be unlimited. They would be writing policies with limits on coverage.

And when there is allegation of unfit for usability by investors who claim to be harmed, an arbitrator who would be suitable for both sides would be selected, which would decide the merits of the case, decide whether or not the insurer has to pay.

So there is a lot more of a mechanism that has been thought out by some people that are way smarter than me, but like I said, you have to take a little bit of time to spend with the paper. And I think it is really a worthwhile idea to investigate and do what you can with it.

CHAIRMAN DOTY: That is helpful.

I would ask my colleagues on the Board, should we let these nice people go?

MEMBER HARRIS: Well, I just wanted to thank Ms. Martinez. We have outreached to you with respect to people who actually know something about auditing and accounting in terms of either our investor advisory group or our standing advisory group.

We appreciate the name. At least I do. I haven't forwarded it to Board members yet, but we are committed to diversifying internally our own organizations as well. So thank you very much.

CHAIRMAN DOTY: The three of you have helped us, and we appreciate you doing this immensely. It has been a delightful session. We will see you again soon. Thank you.

We will reconvene. We have a dynamite panel beginning at 1:30, and we will begin it then promptly.

(Whereupon the above-entitled

matter went off the record at
12:36 p.m. and resumed at 1:30
p.m.)

CHAIRMAN DOTY: Ladies and gentlemen, it is 12:30 PCAOB time, and we are welcoming a panel of diverse experts in financial analysis. And this is a panel where we will hear from people who have had to make tough business decisions, and will tell us what they think the value of the audit is, what they need, and how it may be affected by the Auditor Independence issues we're discussing.

Larry Harrington is the Vice President of Internal Audit at the Raytheon Company, Chairman of the North American Board of the Institute of Internal Auditors. Larry has had a long and distinguished career in this capacity, and spent most of his career in finance and internal audit, an area of great interest to us.

He's been with Aetna, he's been

with several global Fortune 500 companies, including Staples, LTV. He's a member of the Institute of Internal Auditors, as I've said, and past President of their Boston Chapter. We're grateful for having Larry here. He has a perspective that is going to be invaluable to us.

Jack Parsons, Independent Financial Consultant. He was the Chief Operating Officer and Chief Financial Officer of AIM Technologies, an early stage direct marketing database company specializing in in-venue loyalty programs operated for professional and collegiate sports teams. CFO and Vice President of Macromedia, the Learning Company. He had a 16-year career with Coopers & Lybrand, and received the Professional Accounting Fellowship in the Office of the Chief Accountant to the United States Securities and Exchange Commission, so he's one of Mr. Kroeker's star pupils and products. And he has the kind of information and background that we're going to find useful going forward in this discussion.

David Hirschmann is the President and CEO of the Center for Capital Markets Competitiveness. He's here because his colleague, Tom Quaadman, has had a death in the family, and I appreciate David's flexibility in being here. And I know I met with David and Tom in my first week in this job, and it was very helpful. So, we're glad you're here, David.

Robert Smith, Bob Smith is the Vice President and Deputy General Counsel of NiSource located in Merriville, Indiana. And it's a Fortune 500 energy holding company. Subsidiaries engaged in natural gas transmission storage and distribution.

Bob is the second energy giant executive that we have had in this colloquium, in this series and that's an important area for us to hear from. He's a member of the Board of the Society of Corporate Secretaries and Governance Professionals, and takes an active part in a number of those -- in that society's activities.

He's been in the legal departments of two other Fortune 500 companies, Progress Energy and Merit Corporation, so we've got a good spread. And with that, I'd like to turn it over to Larry to begin. Thank you.

MR. HARRINGTON: Thank you on behalf of the Institute of Internal Auditors. I thank you for having us here.

The Institute of Internal Auditors represents 173,000 internal auditors from 165 countries, including 63,000 internal auditors in the United States; the eyes, the global voice, the acknowledged leader, the principal educator, and the recognized authority of the internal audit profession, and we maintain the international standards for the professional practice of internal auditing.

Internal auditors, external auditors, management, and boards work together as cornerstones of effective corporate governance. Internal and external auditors have interlocking goals, and internal auditors work closely with external auditors to bring a systematic disciplined approach to evaluating the effectiveness of internal controls over financial reporting and related disclosure controls.

As a result, independence, objectivity, and quality are critical to us. We agree with your Release Paper on a number of issues, particularly the impact that the PCAOB has had along with other reforms relative to auditor quality and auditor independence.

We support additional efforts to further increase the quality of and the confidence in financial statements. However, we believe the costs and the unintended negative consequences of mandatory rotation outweigh the benefits, and therefore we oppose the concept. Further, we believe the proposed requirement could damage the quality of financial statements by mandating a one size fits all approach to auditor selection.

We base our position on the following points. First, we sought the opinions of leading internal audit practitioners around the United States, the majority of whom disagree with audit firm rotation because of the loss of company-specific knowledge, the steep learning curves involved for new auditors, significant work disruptions, increased costs, and the risk of decrease in audit quality.

Number two, mandatory rotation of lead and reviewing audit partners, prohibitions on the provision of most non-auditing services by the external auditing firm, requirements for the audit committee to pre-approve all audit and non-audit services not otherwise prohibited, and other initiatives to improve audit quality have had a substantial impact. Also, the availability of qualified alternative firms for auditor rotation is limited and/or non-existent in some markets.

Three, no other group is in a better position to oversee the work of the external audit firm on a continuing basis or judge the appropriateness of changing firms than the audit committees themselves.

Given the growing financial expertise and improved oversight structures developed by American audit committees, it seems unfortunate that their role in auditor selection and approval could be replaced right now with a one-size fits all mandatory rotation.

Four, auditors need significant knowledge and understanding of a company to effectively deal with the complex accounting and auditing issues. Just as the audit of certain industries requires significant industry experience, the audit of highly complex organizations is improved by a strong knowledge of the organization under audit.

Changes to auditors and audit firms should be made only with careful consideration of a number of different factors related to audit quality rather than according to an arbitrary rotation schedule.

And, five, financial statement auditing and its oversight by audit committees are undergoing a major period of transformation. Because our processes and systems are in a flux, it might be impossible to evaluate the true impact of a change to a mandatory audit firm rotation at this time.

To this end, the IIA believes the following alternatives should be considered to mandatory audit firm rotation. Introduction of a mandatory change of auditors in very limited circumstances such as a financial statement fraud; requiring increased disclosure about the audit committee's role in overseeing the quality of the audit, including its periodic evaluation of auditor independence;

implementing a system whereby audit committees could request from the PCAOB to perform an enhanced inspection of their company's audit while reporting those results both to the company and to its auditors.

We believe that it should be the responsibility of each audit committee to review their audit firm's performance annually and recommend changes if they deem those necessary. The organization's internal audit function supports the audit committee in this assessment.

In the quest to improve audit quality, we need to strengthen coordination between internal and external auditors, to leverage the knowledge, the skills, the experience, and the expertise of internal audit. This enhanced coordination can lead to deeper understanding of company risk and controls.

The Institute of Internal Auditors would be honored to assist the PCAOB in this or in any upcoming initiatives. Thank you very much.

CHAIRMAN DOTY: Thank you. Jack Parsons.

MR. PARSONS: Thank you for the opportunity to participate in this panel and to discuss the Board's Concept Release on Auditor Independence and Auditor Firm Rotation.

During my career I've been an audit partner with one of the major firms, a professional accounting fellow at the SEC, CFO of several public companies, an executive with two startup entities, financial consultant, and an investor. As a result, I've been in the role of auditor, regulator, preparer and user of financial statements. Currently an independent financial consultant with a focus on corporate governance and risk management.

Recently, I had the opportunity to sit in on a standing advisory group meeting where the current Board initiatives were discussed, and I've been actively following the various Board initiatives.

First, let me commend the Board for taking up the many important issues on its docket. Many of these issues have been discussed over a long period of time; yet still remain unresolved. I'm sure we would all agree that auditor independence, objectivity, and professional skepticism are essential to audit quality, financial reporting, and the effective functioning of the capital markets.

We also know that the investor community is looking for more from the auditor and that some changes appear necessary. One potential change involves the issue posed by the Board in this release regarding whether audit quality would be improved by requiring auditor rotation; and if so, how such a requirement should be implemented.

This proposed solution seems to be the result of various audit issues identified by the Board during its inspections over the past nine years or so where it appeared to the Board that the auditors hadn't evidenced the appropriate level of objectivity and skepticism in performing their procedures. However, as I noted in my comment letter on this topic dated December 14th, 2011, the Board stated in the release that it has found no correlation between auditor tenure and the number of comments in its inspection reports.

And my own personal view is that while major longstanding clients are likely to be given priority service and assigned the firm's best people, I don't believe that the partners assigned to these accounts are compromising their skepticism or objectivity because of that longstanding relationship.

I firmly believe that the CPA profession is comprised of individuals with the highest integrity who perform their work in a very ethical, dedicated, and uncompromising manner, so it's not clear to me that mandatory rotation would solve the perceived issue here. However, I am concerned that we've seen far too many instances where companies have failed without any advance warning from the auditor, which has caused some level of erosion in public confidence in the role of the auditor. And, to me, it's the confidence that the investor community has with the audit process that this issue is all about.

If there's a perceived lack of independence when the same audit firm has been issuing audit opinions on a registrant for an extended period of time, then I believe we should take action and do something about that.

Now, keep in mind that the tenure of the company auditor relationship is not something that's disclosed to shareholders in the normal course, but it will definitely get highlighted if something goes wrong. And if that tenure is longstanding, the reaction from others will no doubt be that independence was impaired, whether true or not.

So, the question in my mind becomes what should we do to address the perception problem? Mandatory rotation is certainly one alternative, but after giving considerable thought to this proposed solution, I'm not convinced it's the best solution to solve the perception issue; particularly given the cost and disruption that it would cause.

I'm just not comfortable with a rule that requires companies to change auditors at the end of some arbitrary period as I firmly believe the company and its audit committee should be the parties making the decision regarding auditor selection and retention based on their informed evaluation of all relevant factors. Plus, I don't see this as a burning topic for investors, nor am I convinced they'd be willing to spend the money and incur the disruption that making these regular changes in auditors would involve.

I would suggest that there are other topics that are more relevant and more deserving of significant change. However, I do believe investor confidence can be improved in this area with a fairly simple fix that includes enhanced communication with shareholders.

My recommendation is instead of requiring mandatory auditor rotation, the Board should work with the SEC to impose a requirement that a company puts its audit out to bid after some defined period, say 10 or 15 years, and require that the audit committee communicate the details of this process and the basis for its final decision to the company shareholders in its proxy statement and possibly in its Form 10-K. That way there's an expectation that the company will be making periodic changes in its audit firm, but if it decides to retain the existing firm it will need to provide the reasons for that decision in written communication to shareholders. And as part of this communication it should be required to disclose how long the audit firm has been its auditors. As a result, shareholders will have this additional information on auditor tenure when they vote on the auditor appointment each year.

Another solution proposed by assignments for the company to engage the auditor under a multi-year commitment rather than the current annual commitment. Some believe this would increase auditor objectivity and skepticism because the auditor would be protected for some defined period from being dismissed for taking tough positions.

I think it would be worth hearing comments or views on the pros and cons of this solution. My view is that this approach has some merit, particularly when combined with the requirement to put the audit out for bid after some defined period.

In conclusion, my view is that some action should be taken at this time to address this issue rather than defer it again to a later date, but I don't support mandatory auditor rotation. My recommendation again is that the Board work with the SEC to implement a mandatory bid process after some defined period with enhanced shareholder communication. I believe that approach highlights the issue with shareholders, and evidences that the audit committee is considering auditor tenure when it makes its evaluation and recommendation regarding auditor appointments. I also believe that the extended engagement term approach is something the Board should pursue further.

That concludes my prepared remarks. Thanks again to the Board for allowing me to participate in this panel discussion, and I look forward to further discussion. Thank you.

CHAIRMAN DOTY: Thank you. David Hirschmann.

MR. HIRSCHMANN: Mr. Chairman, Members of the Board and staff, thank you very much for including us in this panel, and we commend you for holding two days of roundtable discussions that I'm sure has tested the stamina, but from the discussions it really has benefitted from a wide range of views on the subject. And I think it's a model to be followed elsewhere.

Effective financial reporting and internal controls is an important priority for the Chamber. In fact, it's really one of the reasons we started the Center for Capital Markets at the Chamber. We began to be concerned about the erosion of diverse and robust sources of capital for all types of businesses, and came to the conclusion that we needed to modernize regulations, strengthen regulation, and look at all the ways that capital is threatened. And one of them is to insure that investors have access to financial information that is an essential part of that.

So, from day one even though nobody would accuse that dealing with accounting and auditing issues would win us a prize on American Idol or some other popularity contest, we viewed it as fundamental and essential to driving the success of the American economy.

Businesses are also investors, and companies must mitigate risk and raise cash on a daily basis to pay bills on time. As active participants in the debt and equity markets, companies must also have access to reliable and relevant financial data to operate as investors in the marketplace.

So, while we disagree with mandatory firm rotation proposals, we even more strongly agree with the goal, which is insuring auditor independence and a continued focus on improving audit quality.

To strengthen financial reporting

the Chamber has communicated its views with a whole wide range of entities, obviously, the PCAOB, FASB, the International Accounting Standards Boards, the SEC, the Treasury, Congress, the European Union, the Financial Stability Board, G-20, just to name a few. And let me be clear about what we are for; providing the means to identify and resolve problems early through a financial reporting form, exploring the use of judgment frameworks for accounting and auditing decisions, and ensuring auditor independence are among the issues that we believe should be explored and addressed. In that regard, we would -- we have tried to be an active participant making specific suggestions.

Too often in the past, business views have been absent from discussions around accounting and auditing. We have sought to remedy that, as I've indicated, by engaging more actively. But we believe regulators also have a responsibility to strengthen their process by formalizing the way in which they get early input from business even before proposals are made.

Just to give you one recent example, when -- we believe the fair value accounting crisis of a couple of years ago was brought about in part because of the lack of communication between FASB at that time and the business community. Failing to understand the role the business community in financial reporting led to an absence of communication that deprived FASB from useful information and facts harming standard development.

Consequently, standards contained flaws and preventing financial reports to realistically measure economic activity rather than in some cases becoming a driver of economic activity.

Under the leadership of a financial accounting foundation, Chairman Jack Brennan and the current FASB Chair, Leslie Seidman, FASB has sought to make a concerted effort to reach out to all stakeholders including business. I believe this communication has been helpful and fruitful particularly now that the agenda at FASB is so full with the convergence process.

Are all of our concerns addressed? Absolutely not. Do we agree with all the standard proposals? Absolutely not. But having access to business input on a regular basis early on we think ultimately has benefitted that process. That is in part why we have recommended that the PCAOB consider establishing a business advisory group just as it has an investor advisory group.

Now, an issue like mandatory audit rotation you probably won't struggle to get business' view. I can tell you on our end we measure intensity, member interest by the inbound phone calls we get, phone calls we start receiving even before we solicit member views. And when this proposal came out, when the Concept Release came out we had an abundance of inbound phone calls, so we know that passions run deep. And as you saw in the comment period you received a lot of input, and will continue to receive input on this. But that's not the case with all issues that the Board will consider. So, we think having a business advisory group to formalize in addition to your outreach and the roundtables the way you receive input from business would be very helpful to the PCAOB, as well.

Too often regulators despite the best of intentions reach a conclusion about a solution before they clearly have defined the problem or explored the full range of options to deal with that problem. As a result the debate often ends up being more about how to modify the proposed solution rather than taking a step back to do a better job defining the problem and looking at full range of solutions.

We are hopeful that will not be the case with this proposal, and we hope that not only with this roundtable but the ones you've announced you're going to do later on that you will not just focus on the particular -- on mandatory audit firm rotation but really take a step back to look at defining the perception about the lack of quality of audits, where audit independence is, and to look at the full range of possible options to deal with problems that are identified.

At the Chamber, at least, we stand ready to work with you to address what we fundamentally agree are serious problems, but hope that the solutions won't be limited to the narrow field before us today.

Now, the reason you've heard from so many folks on mandatory firm rotation are solid. You've heard that over the last two days. We have included a long list of reasons in our comment letter, as well as in the full statement for the hearing today, so I'll just mention a couple.

Congress in debating Sarbanes-

Oxley explicitly declined to enact a provision to require mandatory audit firm rotation. The GAO has twice reviewed and rejected the need for mandatory firm rotation. A number of academic studies have demonstrated that mandatory firm rotation may harm companies through increased incidents of undetected fraud.

The PCAOB has failed to provide information through its inspections process that demonstrates a clear need for mandatory firm rotation, and the majority of investors commenting have also opposed mandatory firm rotation.

For these reasons, we believe that we have made the recommendation that PCAOB take a step back from this Concept Release, and focus on more clearly defining the problem it is seeking to solve, and invite all parties to the table to identify solutions that more directly address problems that are identified. Thank you very much.

CHAIRMAN DOTY: Thank you. Bob Smith.

MR. SMITH: Thank you, Mr. Chairman. In your introductory remarks you noted my position at NiSource, but I also wanted to quickly note that I'm here in my capacity as Chair of the Policy Advisory Committee of the Society of Corporate Secretaries and Governance Professionals, and that is a national organization that's focused on corporate governance.

The society was founded in 1946 and has over 3,000 members nationwide, and we serve through that representation more than 1,500 organizations. More than half of our members are from small and mid cap companies. So, I'm honored to participate in this roundtable, and really appreciate the robust process on information gathering that you've engaged in, and I'm thankful to be invited.

We've heard many viewpoints over the last day and a half from various organizations, and let me just start with we oppose the mandatory audit firm rotation rule. And we believe that it would not be beneficial to the audit quality, nor do we believe it would enhance auditor independence, skepticism, or objectivity.

Firstly, we believe that the exclusive authority to hire and retain an audit firm should remain with the company's independent audit committee. The audit committee remains tasked by Congress and the SEC with the responsibility of selecting a company's audit firm, and we believe that the audit committee is best able to judge is the audit firm is bringing the right level of technical competence, objectivity, and professional skepticism to its work.

It's our view that mandatory rotation would unnecessarily impinge on the audit committee's independent business judgment because it would take away this responsibility from a group of independent engaged persons who are charged with both legal and fiduciary duties to act in the best interest of the company, and also in the best interest of its shareholders. And it would replace this with an arbitrary one-size fits all requirement.

This would appear to be a step backwards into a rules-based approach rather than progressing into the principles-based independent analytical approach which we believe currently exists; although, with room for improvement.

In short, the significant body of corporate law dealing with director duties and the Stock Exchange rules requiring independence for audit committee members should not be rejected in favor of a general blanket requirement that would change auditors when those who are independent and charged by law to protect shareholders do not deem it appropriate.

Secondly, we believe that the

costs of mandatory rotation outweigh potential benefits from the blanket rule. The costs associated with mandatory audit firm rotation are considerable, and involve both direct and indirect expenses. And these indirect expenses are still very real.

By of example, one society member, a large global company that voluntarily rotated its audit firm within the past 10 years estimated that the time expended from the start of the request for proposal through retaining its new audit firm entailed approximately 100 hours of audit committee time, five to six hundred hours of senior management time, and between two to three thousand hours of finance, legal, tax, accounting, and internal audit employees' times. Additionally, approximately half of surveyed members indicated that they believe fees for audit and audit-related services would increase 20 percent or more in the initial years following an auditor change. In fact, in 2003 the GAO estimated that additional first-year audit-related costs would range from between 43 percent to 128 percent higher than the audit costs had there been no change.

Furthermore, we believe that the benefits of forced rotation would be minimal, and that rotation would likely have a negative effect on audit quality. Studies cited in the Concept Release from 1987, 1999, and 2010 revealed numerous audit failures involving companies that had recently changed auditors. Our members believe that short-tenured audit firms would result in a decrease in overall audit quality. In fact, more than 85 percent of our members surveyed were very concerned about the loss of the audit firm's institutional knowledge of the company and of the industry if required to switch auditors. And 70 percent of the responding members that had experienced an auditor change within the last 10 years indicated that they had noticed a change in the audit quality as a result of the new engagement.

We regard -- with regard to insuring professional skepticism we believe that the PCAOB's inspection and enforcement powers are currently sufficient to accomplish that purpose. Members have already noticed an increase in questioning and documentation requirements as a result of the PCAOB's levying of penalties and publicizing audit failures of the firms.

The public letters regarding audit failures are often reviewed by audit committees, and the audit firms are placed in an uncomfortable position of explaining themselves and their firm's reactions to the public citations. In this regard, we believe that the Board is in a unique position to use its authority to speak out on the need for auditor skepticism further heightening sensitivity to this topic.

Finally, we believe that mandatory

audit firm rotation would leave many public companies with few experienced and eligible audit firms. Many public companies in certain industries have very limited choices with respect to the audit firms with appropriate expertise. In fact, many can, as a practical matter, only use one or two firms. And I know there's been a lot of discussion about this over the day and a half.

Nearly 90 percent of member surveys concluded that its company's audit committees currently evaluate audit firms based on industry knowledge or international expertise, and considered these items very important in the selection of the audit firm. Requiring a company to choose a less qualified, less expertised firm seems significantly less than ideal from a governance perspective.

In conclusion, we urge the Board to resist implementing rules requiring mandatory firm rotation, and instead recognize the important legal and fiduciary duties entrusted to and indeed required for independent audit committees. Thank you very much.

CHAIRMAN DOTY: Thank you. I think it is a salient feature of the discussions we've had over recent days that there needs to be some attention to independence and skepticism that we should investigate the means we have at our disposal to do that short of imposing on corporate America, on audit firms a regimen that would require them to rotate their firms mechanically over six years, every ten years, every fifteen years, has come through very clear.

As I said last night, the thing that has characterized these discussions has been the constructive nature of the comments. And my practice has been to call on my colleagues here, but for a minute I first have to talk to David about a letter that came over the transom last night.

It's an unsigned letter. It says that the PCAOB is suffering from a disease, the same disease that afflicted FASB in the Fair Value Accounting, that our standards are not reflective of real world considerations, or that there's concern that our standards are not reflective. It questions whether any valuable resources, time and money, should be spent on this project. Should we actually be asking these questions.

I think, clearly, the Concept Release said that this is a recurrent issue that's arisen of independence through tenure, change through rotation, but we want to know if not a rule on tenure than what? So, we have been hearing for two days, and I think very constructively on what might be an alternative to a rigid rule on tenure.

But then it gets into what I think David -- these seem to me to be apparent factual inaccuracies. It says that we have a proposed auditor discussion and analysis. Now, I think our Concept Release on the ARM has not yet resulted in a proposal. I don't think we proposed auditor discussion and analysis. I think wouldn't you agree that we've asked about auditor discussion and analysis in the same way we've asked about tenure issues? And that's where you suggest, you say that the PCAOB has engaged in mission creep. The overriding impression I have had from the last two days is that the subjects of this colloquium and of this open meeting really are not mission creep. They're within the main line of what a lot of people, preparers, readers, other users want us to take up, including no small group of auditors.

And then because of these reasons you say we ask the PCAOB to withdraw the Concept Release. I mean, David, do you really mean that? Do you think we should withdraw a Concept Release that has occasioned 600 letters, the kind of intelligent discussion you've had over the last two days, our ability to consider doing what Jack Parsons says some actions, but not to defer action on these issues. Do you want to sign this letter now, or do you want to withdraw the letter?

Wouldn't you -- I mean, you were very reasonable and constructive in your presentation today, so I'm a little concerned that perhaps when the pen is taken up the Chamber of Commerce, and this is under the Chamber of Commerce's letterhead, the Chamber may not be exhibiting the same kind of balanced editorial thought that you have given to your overall presentation today.

Do you really mean these things? Are we engaged in mission creep? Are we suffering from a disease? Should we withdraw the Concept Release and not -- I thought I detected a sliver in your statements of confirmation we should go ahead and hold these colloquiums in other parts of the country we plan to do on what to do about independence and objectivity, and skepticism. Can I rest þ-

- can I go to sleep tonight thinking that the Chamber is okay with me holding these meetings? Is that -- or am I to take away the notion that whatever we do by way of redefining, reforming the audit reporting model, whatever we do is going to have some letter like this from the Chamber that says we've done too much. Can you give me a hint here where you're headed over there? You've got a big poster up that says "Jobs USA." Did Enron create jobs? Think about that now. I'll give you a chance to respond before I go to the panelists.

MR. HIRSCHMANN: Well, I certainly appreciate the response, and I appreciate the question. That is our formal statement for the record, and I tried to not read every word of it.

CHAIRMAN DOTY: But you stand by the record that we should withdraw this Concept Release, we should not expend resources on this question.

MR. HIRSCHMANN: What I said in the comments here verbally what we intend by that, so it is -- look, to the degree that the Board has seized on a particular solution --

CHAIRMAN DOTY: We didn't seize on a solution. We asked about a solution that has been seized on by commentors going back for 30 years as you heard from the first panel. This is a proposal that is being enacted in Europe and around the world. Do you think that we should not inform ourselves on the adverse consequences of mandatory rotation if we hope to shape and to express to our colleagues in other countries why they should not do it? Are we better advised to simply say we've not studied it. We've stopped our Concept Release because the Chamber wanted us to. Does that sound like good policy to you?

MR. HIRSCHMANN: Look, I don't -- what I think you -- what we recommend you do, respectfully, is that you take a step back from just looking at mandatory audit rotation.

CHAIRMAN DOTY: What do you think the last two days have been but a step back and an inquiry -- an elicitation of a lot of informed opinion about many solutions, some of which you heard today and which are very serious proposals to addressing objectivity, and other solutions we heard this morning about strengthening audit committees. Isn't that what we're supposed to do, think about what we do with audit committees?

MR. HIRSCHMANN: But if you take a step back you also begin to better define the specific problems that need to be solved. For example, I also heard --

CHAIRMAN DOTY: Excuse me. One of the problems has been the communications with audit committees. And we heard a lot today about the fact that we need to be more communicative with audit committees. I have back at the office a comment from your group which opposes our communications with audit committees. You don't like having standard having communications with audit committees.

You seem to be -- and, by the way, capital formation, you're very big on capital formation but we've got a Chinese issuer engaged in baby products manufacture that lost its auditor early this week. Do you think they should be coming in and competing for capital with Kimberly Clark and not be subject to our inspections?

MR. HIRSCHMANN: I'm happy to clarify what we're for. I don't want to engage in a debate over -- but I do think -- I think we are concerned to the degree that the PCAOB ends up being a regulator for audit committees, that that is beyond the scope of the PCAOB's mandate. And to the degree that þ-- so, we want you to talk to everybody, but we don't want you to become the regulator of the audit committee so that the audit committees have dual regulation.

CHAIRMAN DOTY: But do you want us not to talk to audit committees about what we learn in the inspections? Do you want to seal us off from audit committees so they don't have the benefit of what our findings mean?

MR. HIRSCHMANN: I think the PCAOB should work with the SEC and should find --

CHAIRMAN DOTY: I take that as an evasive answer, David.

MR. HIRSCHMANN: Look, I don't think --

CHAIRMAN DOTY: You also keep saying you stand by this letter, and you keep abandoning the articles of the letter, which are --

MR. HIRSCHMANN: What we said is -- you should -- if the focus of the Board is to find which form of mandatory audit rotation is the best form, then we urge you to take a step back that. We urge you to abandon that. If the focus is, instead, to really engage in a constructive discussion about how to strengthen auditor quality, strengthen auditor independence, then count us as full in partners, but let's define the problem we're trying to solve. I heard a lot of disagreement the last two days over even defining what an audit failure is.

CHAIRMAN DOTY: Oh, I don't think there's disagreement about that. I think what you heard was a disagreement about independence, what the state of mind or the state of activity that constitutes independence is. That is a difficult question to resolve, and it's not an easy one. But I do not know how many times we have to say to the Chamber a Concept Release is a Concept Release.

A Concept Release is for the purpose of eliciting views of the kind we have heard from your thoughtful colleagues on the panel. It does not constitute a proposal. We do have a proposal out, however, on communications with audit committees which you've opposed. But that communications with audit committees proposal standard has received endorsement from the audit firms in the course of the last 24 hours, it's had a lot of support from people who appeared on behalf companies who think we should enhance those communications.

I think -- if I may say so, I think we're glad you're here. I'm sorry to put you on the spot, but I think you ought to look at what you're writing. I think that you ought to give some attention to whether you mean that we should try to withdraw our Concept Release, we should not hold meetings around the country in other locations on issues of independence. And I think you should be careful about the use of the word "mission creep," and I think you shouldn't ascribe to organizations a disease unless you have something more defined in mind.

With that, I'm going to stop this little inquiry, but it is an excoriation but it's prompted by a written document, which I think you ought to go and re-read.

With that, I'm going to turn the microphone over to Jay Hanson for --

MR. HIRSCHMANN: Can I just respond, Mr. Chairman?

CHAIRMAN DOTY: Yes.

MR. HIRSCHMANN: Certainly, our intent here is not to cause offense. And one of our standard operating rules of the Chamber is always good manners and high integrity. But we do state our views clearly, and we are concerned that the Board has embarked on a path that will lead to one of several versions of auditor rotation without really taking -- stepping back and finding evidence. And what we offer is a constructive partnership with us and with others --

CHAIRMAN DOTY: We'll avoid that. We're going to avoid that. We're going to take you up on your partnership. Do you think it's good manners to send unsigned letters?

MR. HIRSCHMANN: It's testimony, it's not an unsigned letter.

CHAIRMAN DOTY: Okay. I'm going to pass the mic to my colleague, Jay Hanson.

MEMBER HANSON: I'll let you off the hook for a little bit here.

(Laughter.)

MEMBER HANSON: Mr. Smith, you commented in your statements a few minutes ago about the increase in first your costs of an audit, and your testimony and letter referred to members' estimates of 20 percent being consistent with what the GAO study from 2003 was.

Some of the panelists that have come before you in these two days have effectively said baloney, that it's not going to be that much, that it's way overblown, that their personal experiences have been that the audit costs really don't go up in the first year. In fact, in the competitive bidding process the costs tend to go down.

And I'm wondering if you've seen any data that your members have provided, or have any more insight about if there was an actual process that companies went through to come up with these estimates, or if it was essentially a pile-on to what the prior GAO study was. I'm trying to reconcile in my own mind the differing views between 20 percent is a lot, but so many people saying oh, it's not going to be that at all. And thoughts from any of the rest of you on that question, too.

MR. SMITH: Thank you. The data was based on a survey that was done that didn't reference the GAO study at all, so the responses that we got weren't prompted in any way by any presupposition that it would be up or down. So, the response that we received was -- I think should -- can be taken at its word. However, what's not there is documentation as to how anyone derived that information.

So, I think what we did see was that there was a subset of that group that had been in an audit rotation situation within the last 10 years, which was one of the questions that we asked, so presumably they would have concrete evidence as to what it would cost. And I alluded to the one firm that gave us the real concrete anecdotal evidence of what they saw the indirect costs being.

I don't know if that same firm -- I believe they did. They also included what their audit costs were but I don't remember offhand what it was, but I believe that it's probably a mixture of people stepping back saying we think that we would go through this process, and it would result in a -- and then some that had concrete information.

MEMBER HANSON: And just scope-wise for the 20 percent, do you think that directionally includes the incremental fee paid to the firm as well as the internal costs incurred, or is it just focused on the cost?

MR. SMITH: No, the question was separate, so that was what was anticipated from an overall audit fee increase. And my guess is that -- I mean, as I look at it I think it probably included some shadowing from -- you know, in the transition year which you would think would have to take place. And then you would also have digging into old issues to make sure that they're understood.

Certainly, some of that could be offset by economics gained in a newly bidded transaction, so I think there's -- you would see an economic tradeoff on the one side, but we do believe that the overall result would be an increase.

MEMBER HANSON: Okay. Comments from any of the rest of you are welcome, too.

MR. PARSONS: Let me just weigh in a bit on that. I think, Jay, that in the current environment I think what happens is that very few companies will change auditors and increase their audit fee. Right? I mean, they'll put it out to bid and they'll get a lesser fee and they'll decide to change.

I think if you ended up with a mandatory requirement, I think from an economic standpoint that dynamic might change a bit. I mean, under the current scenario a firm might be willing to discount its fees to get an audit engagement knowing that it's going to be in there for a while. If it knows it's not going to be in there for a while, then I think that economic dynamic might change a bit.

You know, the other thing is I think that the accounting firms -- I think getting in -- just a little bit anecdotal, but I think if you want to think about sort of objectivity and auditor skepticism, you know, the skeptic might say if you go in and reduce your fees from what the previous auditor was charging with the understanding that you're going to be in there for a while, maybe that's really the highest risk scenario for a situation where the auditor might be less skeptical or less objective, because he doesn't really want to deal with the hard issues the first year or the second year because he knows he's going to be in there for N number of years to recoup his fees, to get his fees up to where he needs them to be. Just a thought, just something to think about.

MR. HARRINGTON: The other thing I would add is when we surveyed our members, what they talked about is -- and as you can imagine as your folks go out to do audits, if you haven't been there before understanding who the client is, getting up to speed with the issues, understanding the issues can be very time consuming.

In addition to that, on the company side there's a lot of time being invested in providing new information, explaining things over again. There's a learning curve on both sides. And while you could argue that on the company side that's a fixed cost, it is a burden on the company to have to re-indoctrinate an entirely new audit team.

It can be disruptive when you

rotate the partner every five years, you bring a new person in, you bring in a fresh set of eyes, but the rest of that firm's team has been on the account for a while. They understand the company, they understand the issues. They're able to kind of indoctrinate that new partner, as well, and it's not as disruptive. And the things that you've done to rotate the partners and require some of the other things have been so helpful in improving the process.

Just to go back to what the Chairman said, I think that as we continue to dialogue between yourselves, management, audit committee, the firms themselves, as we better understand the root causes of the issues, as we apply Six Sigma techniques to why those particular failures existed; in your paper, you talk about the bias samples that you used, which is risk-based auditing, which is the way to do it. So, you go in looking for the highest risk areas, and you're looking for issues. So, theoretically you would find more than if you just did a random audit in general.

So, as we continue to dialogue, as the Chairman suggested, and we understand what are the root causes we can help audit committees be stronger, we can help audit committees ask different questions. The firms have obviously taken your criticism over the last few years very, very seriously, and they've worked very hard at addressing those issues. So, I commend you for the work you've done, and I think if we continue to work in the same positive spirit of giving the feedback, understanding what failed, working on fixing it. And then if people don't fix it, then to hold them accountable for that. And I think the marketplace will have some impact on that, as well.

MEMBER HANSON: Just one last comment, then I'll turn it over to my fellow Board Members. The word you chose of indoctrinate the partner into what's been done plays right into the hands of those that say that's why we need mandatory rotation because it's -- you need a completely fresh set of eyes.

MR. HARRINGTON: No, I would just say that if you come into a company brand new you don't know the company, you don't know the history, you don't know the issues, you don't know what kind of accounting systems they use, you don't know what kind of -- so, when I'm talking about that what I'm saying helping them understand what the company is all about, from the accounting systems, to the transactions, to the complexity. It takes a while to really understand all that.

CHAIRMAN DOTY: Jeanette, do you want to spread oil on the water here?

MEMBER FRANZEL: All right. Well, I had this line of questioning planned before the exchange, and I'm going to go there anyway. And I was actually going to take Mr.

Hirschmann's advice and step back a little bit, and take advantage of the business experience, the governance experience, and the internal audit experience on this panel. And I trust you're not going to accuse me of mission creep here. But I really want to talk about the role of internal audit. It's something we haven't explored over the last day and a half.

It seems to me that the internal auditors are in the middle of all of this. The internal auditors are monitoring the business operations and trends year round and identifying risks real time, assisting with the external auditors -- with the external audit, and having regular communications with the audit committees.

Are there some best practices out there that could really -- that the internal auditors could assist with in terms of communications and dealing with the external audit to really help improve the quality of financial reporting, get involved with some of these tough calls. What types of structures could be put in place to really tap into the potential and talents of the internal audit function?

MR. HARRINGTON: Well, I'll start with that. I'm glad that you acknowledge the value that internal auditors play because as I say, we are a cornerstone in this. We work very closely with the audit committee on a regular basis providing the audit committee direct input into the value of the external audit firm and how well it's going, and how objective they are and independent, as well as how we think everything else within the company is going, and how management is going.

A strong internal audit department has an ongoing relationship with the audit committee, so the Institute of Internal Auditors puts out a lot of material to help internal auditors and audit committees know how to relate to each other, documents such as questions that audit committees should be asking, providing in advance meetings when you -- often the chief audit executive will meet one-on-one with the audit committee chair before a meeting and talk about what's on the agenda, what are the topics, what are the kinds of questions you might want to ask, where might you want to probe? Where are the issues that you would want to focus on?

In addition to that, the internal audit department is working on a regular basis throughout the year in partnership with the public accounting firm in the sense that they get copies of all of our audit reports so that they see what internal audit is working on. When we do our own risk assessment we sit down and share with them that risk assessment, understand their risk assessment.

We're making sure that throughout the year there's a constant dialogue, and we're providing information to our members and to audit committees through the NACD and other relationships to make sure we're helping the audit committee ask the right questions.

MEMBER FRANZEL: How can this be operationalized I guess so that it works the way you just described, so that internal auditors are alerting the audit committee? Is this happening consistently in practice, or could more be done to really insure more consistent practice?

MR. HARRINGTON: There's obviously ways to improve it. Every audit committee is not of the same strength, they're not of the same maturity model. Every internal audit function is not -- we try to through the IIA, but we'd be happy to work with PCAOB and others to provide further guidance so that we can more consistently share those best practices, and as we indicate in our testimony, provide more dialogue between yourselves and the audit committees, so the audit committees are hearing directly from you, or directly from NACD those best practices that we're sharing.

We try very hard to be an advocate, but sometimes when you've got someone like yourself or the NACD advocating the same position as we do, it has a bigger impact.

MEMBER FRANZEL: And I'd be interested in hearing the views of any of the other panelists on this.

MR. SMITH: Yes. I'll just note, having been in board rooms and in audit committee meetings since 2000 or so, I've noticed a significant role and increase of the internal audit department and lead internal auditor. And I think that's been a very positive thing, so I've seen issues come up in those audit committee meetings that otherwise probably wouldn't have come up because of the direct reporting nature of the lead auditor. And I think that's been a positive development, and I think further developments like that can continue to help with good governance and with appropriate internal auditing and external audit reviews.

MR. HIRSCHMANN: I would just add that, obviously, in many cases internal auditors rely on the expertise of outside firms, and if there were mandatory audit firm rotation that would reduce the number of choices the companies would have in terms of the advice that the internal auditors can get from the marketplace, as well.

MR. PARSONS: Let me just add one comment. I think from an audit committee perspective, I think the work of the internal auditor is critical. I mean, it's a key part of the company's system of internal controls. I mean, the internal auditors go through -- there is more of an operational audit, systems, procedures, controls as opposed to an objective external financial statement focused audit that the external auditors do. But from an audit committee perspective I think you'd be crazy enough to spend a lot of time talking to the internal auditors as to what their finding from the company perspective.

But in terms of the audit itself, I mean I think, obviously, from an external auditor's perspective the internal auditors can play a role but only so much of a role. Right? I mean, I don't think you want the internal auditors playing too significant a role, and we've got standards around that. Right? So, it's important from an objectivity and skepticism standpoint that the external auditors do their thing, but I think the internal auditors play an invaluable role in helping to enhance the company's system internal control.

MR. SMITH: And one other comment, too. I don't know if you guys are familiar with the Caremark case back in 1995 or so, but as a result of that you saw compliance departments at companies really develop and begin to flourish, and the quality of the internal departments to address those types of compliance issues increased greatly. I think the same thing has happened with respect now to the internal audit departments as a result of Sarbanes-Oxley. You've seen the game really increase, the level of the playing field has really gotten better, and there's been a quality increase that's notable.

Mr. FERGUSON: Just one quick observation. I think virtually every panel member we've heard including members of this panel has applauded a mandatory partner rotation. And we've had people talk about how they think that mandatory engagement quality review partner rotation is good. Some companies mandate -- themselves mandate the rotation of senior staff members on the audit. We know from experience that staff members turn over a lot on audits.

So, why then is it so difficult to rotate the firm? If we're willing to rotate every -- essentially everybody who's on the audit team on a regular basis, why then does it seem such a leap to ask for the rotation of the firm itself?

MR. PARSONS: I guess I would comment and say when you rotate the firm you're rotating everybody at one time. In the scenario that you gave it could happen over a period of time, that there's some people rotating this year, there's some people next year, there's some people the year before. If you're rotating everybody at one time it becomes a real transitional period for the new firm as well as for the company that has to make sure that they spend the extra time making sure that the new auditors coming in understand the company, understand the systems, understand the operation.

MR. SMITH: Yes, and I'll add, I went through -- I was at a firm -- a company that had -- Andersen, at the time that Andersen went under, and I remember going through the transition which was very tumultuous because of the extreme nature of it, the quick nature of it. There wasn't a lot of planning so transition helps address this to some extent, but we spent so much time going through legacy issues and reinventing the wheel so to speak on issues that had already been documented and decided upon, but now you have a different firm that has a little different perspective on some of these legacy issues, that I think there's a big fear that when you're looking back so much and trying to re-document those things in the first few years of the audit term that things will drop through the cracks on a current basis that you really need to be focusing on because so much internal time, as I talked about in my opening remarks are spent on the orientation process and addressing all of those issues, that there's a fear that you'd lose the current view, as well.

MR. PARSONS: Let me just add one thing. I think it's a good question, it's a fair question. I think you could -- I think you've got enough change in auditors going on right now that it's pretty clear it can happen. It's not going to be the end of the world when you change auditors, and I guarantee you that in every engagement letter or a new engagement letter is the audit firm saying this is going to be a huge issue for you guys. We're never going to be able to get through it. We're never going to be able to get up to speed. It's going to cost you -- there's always a way, okay, here's how we're going to deal with all these issues. And there is a solution, and there's a way to do it.

But I think the issue is whether you want to mandate it. I mean, whether you want to mandate rotation. I mean, I think you could -- I think auditors can be rotated. I think -- we know it happens, it happens all the time. For me, it's just a question do we want to mandate it every N years, and that's where I come down saying, you know, I'm really not sure that's the right answer for a lot of other reasons, but to your question I think, you know, it -- we could get through it if we decided that was right thing. I just don't think it's the right thing.

MEMBER HARRIS: Just to get it on the record, Mr. Parsons, you recommended the importance of confidence, improving investor confidence in the audit, and you made a specific recommendation. I'm wondering whether the other panelists would have any specific recommendations in terms of how to improve investor confidence in the audit because we've got a number of suggestions over the past day and a half, and if any of the other three of you have a specific suggestion, I wish you'd give it to us.

MR. SMITH: Yes, I think it's a really tough issue. And that's, obviously, one that needs more focus and more attention specifically on that issue. And I think further roundtables would be good. But I liked one of the earlier panelist's suggestions of education and insuring that audit committee members know what their role is. And there's certainly probably a role that could be played by the Board, probably in conjunction with the SEC to insure that appropriate education is taking place. I don't know what that would like, and I'm not saying that that's a position that we espouse, but I think it's interesting to think about.

The other thing I note is -- I was reading through some of the other comment letters, and the NACD had some suggestions that were of interest, as well. And one of them was just insuring that the audit committee played more of a lead role in the engagement and the hiring, and the actual interviewing of the prospective auditors, so as they're coming on. So, I think that's also worthy of exploration.

MR. HARRINGTON: I would just add that there are not a lot of shareholder meetings that my members that I've talked to have said that shareholders are asking questions at the annual meeting to the Chairman of the Audit committee specifically about the audit, so I do think that confidence has improved since this body was established and the changes that were made, but I think there's more we can do from a communication standpoint.

Communication from audit committees to the investor community, and more communication from yourself to the investor community, helping people understand the things that you do and how well you do them, and the things that the audit committee is doing on a regular basis to understand the quality of the firm, the issues around the firm, inquire about the high-risk areas, inquiring about the differences of opinion between them and management, or as someone said earlier, not so much the differences of opinion but where did you debate the issue so that they're aware of that.

Making sure there's some additional disclosure around that I think will help in the transparency side so the investor will see that a lot has happened. There's always room to improve, but the more that we can share that actually happens the better off the investor will be. And I think that as we start to improve the communication either whether it's mandated or if it becomes best practice, if it becomes best practice we're going to copy it, as well.

MR. HIRSCHMANN: I think if you ask professors, I know you have, many of them will tell you that it's been a sea change in the last 10 years in terms of boards that are willing to meet with investors, in terms of investor access to the board and management of the company in terms of the nature and quality of the discussions that are already taking place between the investor and company.

We've looked at barriers to that communication, including maybe whether Reg D might be getting in the way of some of that. So, I think, you know, as a general rule we want to continue that trend.

What I have not heard is investors say that the failure of mandatory firm rotation every number of years is contributing to that problem.

CHAIRMAN DOTY: Thank you all.

MR. PARSONS: I just want to add one last comment. My whole thinking -- my response in my comment letter was that you guys put out a possible cure, and my view has been you're looking to all of us to say hey, what -- not just hey, we do agree or we don't agree with mandatory rotation, but what do we recommend, what do we think? So, you know, I've come up with a recommendation, and I think you're probably hearing a lot about audit committees. And I also commented on your other -- the proposal on communication with the audit committees, but they're at the heart of all this, so I think it kind of gets you thinking about that, as well. But I think you guys are doing the right thing, and I appreciate you're doing this Concept Release and focusing on the key issues.

CHAIRMAN DOTY: Thank you. That's helpful. Thanks for sitting through all of this. Thanks for doing this.

Next panel is going to be an academic panel, and there's been a lot of interest in data and research. These are two scholars who have some data and have done some research. I said two scholars we have three, Barbara Arel.

Dr. Arel, Assistant Professor, School of Business Administration, the University of Vermont, joined the faculty in 2006 completing a Ph.D. at Arizona State. Prior to her doctoral study she worked as a senior auditor in a registered public accounting firm, and is currently licensed as a CPA. A member of the American Accounting Association, her teaching interests are in the area of auditing, accounting information systems and financial accounting. Her research focuses on the judgment and decision making process of auditors. Her research has been published in Auditing, a Journal of Practice and Theory, and in Advances in Accounting, and in the CPA Journal.

Al Ghosh, Professor of Accountancy and Stan Ross Scholar, Zicklin School of Business, Baruch College, City University of New York. He is a professor also in the financial accounting faculty at Columbia University School of Continuing Education, Director of the Executive MS and Financial Statement Analysis and Securities Valuation and the doctoral program coordinator of accountancy at the Zicklin School of Business. He holds a Ph.D. in business and economics from Tulane. He has taught in many universities including in Milan, in Italy at Puccini. And he has been an accounting academic fellow at the SEC.

Ghosh holds a Ph.D. in business economics from Tulane, New Orleans, published in leading accounting and finance journals. And we're glad to have him here.

Arnold Wright, Arnie, the Joseph Golemme Research Chair, College of Business Administration, Northwestern University. Professor Wright is a CPA who has worked in public accounting with Deloitte and in private industry as a Chief Accountant. Prior to working at Northwestern University's College of Business Administration, he held the Andersen Chair of Accounting at the Carroll School of Management Boston College.

Professor Wright has served as a reviewer, and on the editorial board of many journals. Most notably, he's the past editor of Auditing, a Journal of Practice and Theory, the premier research journal in worldwide auditing. That's not an opinion of the Public Company Accounting Oversight Board, but it is an item in your bio. It's not that we don't believe, it's just we're not -- it's not a position of the Board.

Professor Wright has also served in the auditing section of the American Accounting Association. He's a member in a number of capacities including been President and Historian.

Thank you all for being here, and we will begin with Barbara Arel. Thank you.

MS. AREL: Thank you, Chairman Doty and members of the Board. Thank you for inviting me to appear before you today to comment on the Concept Release, and to address the important topics of auditor independence and audit firm rotation.

I'm going to focus my remarks on a paper that I published with Kurt Pany and Rich Brody, and the title of the paper is "Findings on the Effects of Audit Firm Rotation on the Audit Process Under Varying Strengths of Corporate Governance."

Auditor independence, objectivity

and professional skepticism, as we've heard are the cornerstones of the audit profession. And efforts focused on enhancing them to increase audit quality and restore investor confidence in the capital markets needs to continue.

In order for the audit report to have credibility with investors, auditors need to be independent in both fact and appearance when providing audit services. Permitting an unlimited period of association between audit firms and clients represents a potential threat to independence.

Long periods of auditor tenure potentially may lead to a troublesome degree of closeness between auditors and management, and auditor financial dependence on the client which threatens their ability to act independently during the audit. While mandatory audit firm rotation may not eliminate the auditor financial dependence upon clients, it is movement in that direction.

Research directly addressing the impact of audit firm rotation in the United States has been limited due to a combination of no regulatory requirement for rotation, and a limited number of companies voluntarily establishing such a policy.

To overcome these limitations experimental research allows researchers to create an environment that can focus on a variable interest such as the impact of mandatory rotation while holding other potential influencing factors constant or randomized.

My coauthors, Kurt Pany and Rich Brody and I conduct an experiment designed to directly examine the influence of audit firm rotation on auditor independence in fact. We asked 105 CPA firm employees to read a scenario describing a hypothetical audit client in which management refused to record or write down an inventory to market values that would reduce net income below that of any of the four preceding years.

After reading the scenario, auditor participants were asked to respond to the likelihood the audit report would be modified for the departure from GAAP. Our results show auditors in the rotation condition believed the report modification was significantly more likely than those in a situation that mirrors the current requirements and expected continuing relationship with the client with enforced audit partner rotation.

Our research does not address disadvantages of required audit firm rotation such as those discussed at this meeting. Also, most of our respondents were not partners, the individuals who would be extremely involved with a situation such as that described in our case. Nonetheless, again, our results did reveal different anticipated reactions based on whether firm rotation was imminent.

These results are consistent with a number of studies addressing this general area. We believe the results of these studies do not on their own justify a decision to require rotation but they also do not lead to the conclusion that rotation is unnecessary.

Thank you for your time and the opportunity to discuss this issue with you.

CHAIRMAN DOTY: Thank you. Professor Ghosh.

MR. GHOSH: Hi. I thank the Board and especially Chairman Doty for inviting me to comment on whether imposing mandatory auditor rotation would significantly enhance auditor's independence, objectivity, and professional skepticism.

I come from an academic background, so the idea would be to come up with some stylized facts that emerge from academia, and then a few of my suggestions.

Does longer tenure impose a cost? And as discussed, of course, there is perceived to be a cost, and the cost would be that there's a loss of independence of the auditors, and the auditors might acquiesce to the management pressures, so the net result is an erosion in audit quality, and possibly erosion in financial report equality.

Are there benefits? And, of course, there are benefits, the benefits from serving over a longer period which would be development of client-specific knowledge, greater investments in those, greater investments in industry-specific knowledge and, therefore, it's going to lead to higher audit quality and financial reporting quality. And why would that happen? Well, the answer is because there are high returns from these investments.

The analogy would be very similar to R&D. You invest in R&D and if there are successful payoffs then over a period of time you're able to recoup some of these returns. Of course, the difference is, in the context of client and audit firms is these periods are not mandated, so clients still -- the auditor still will have to provide high audit quality to the client.

What are the consequences? The consequences would be that the capital markets would presumably reward the client firms for high quality in terms of charging lower cost of equity which is beneficial for the firm and, therefore, the auditors are rendered higher in quality.

So, the question is, the costs are apparent, the benefits are apparent, and what is the net result? And the answer is -- and you have to look back. So, one of the things that I did, and I couldn't find a paper that kind of summarizes all this work. So, what I did was I sat down and I took some of the leading papers in accounting and finance, mostly accounting, and there are 20 papers that actually look at specifically mandatory auditor rotation.

Now, of those 20 papers 25 percent of these research papers exclusively and conclusively conclude that mandatory auditor rotation would improve audit quality, 25 percent. The remaining 75 percent conclude that it would not improve audit quality, that these are based in the U.S. and outside, Spain, Italy, South Korea and things like that.

What about other studies which would be the majority of the studies, about 35 studies that are focusing on auditor tenure, and the reason they are focusing on auditor tenure is predominantly across the world there is no mandatory auditor rotation. So, they want to see whether longer tenure improves audit quality.

Again, the stylized facts emerge that 24 percent, 25 percent find that mandatory auditor -- longer tenure does not improve audit quality. And the other hand, 75 percent, which is overwhelming majority, find that longer tenure does improve the audit quality and financial reporting quality.

And more importantly, that's where probably I come in, is one of my papers what we did was rather than look at the audit quality, in fact, but we were looking at perceptions, and what is the market feel. And we find very strong evidence to suggest that the market seems to reward companies with longer tenure. So, it seems to me that the capital markets are in favor of longer association because the net benefits are larger.

So, what would be the consequences in this setting if you were to impose mandatory auditor rotation? Unfortunately, the benefits would be lost, and it's unlikely that the reduction in the cost would lead to overwhelming increase to outweigh the benefits.

One aspect would be definitely that the audit fees would increase. And the other aspect to remember is there are only four companies, so this would be rotation within the big four.

And, finally, what I would say is in this context is what might I request or urge the Board to consider is I think one of the aspects that's probably overlooked a lot is the fact of disclosures. We accountants have popularized this important notion of disclosures, and believe it or not the notion of auditor tenure is actually not disclosed anywhere in the financials. So, a first step would be to require and mandate that the audit -- the length of the auditor/client relationship be disclosed.

And, clearly, there are advantages because this reporting of the tenure could act as a deterrent because the audit firm knows that the market is watching this very closely. And because the client also knows that the market is watching, even if they were to pressure or they are pressuring now over longer tenure they would conceivably back up because the penalties may be very large.

In the same context, I would urge the Board to consider the audit committee disclosures, because at this point the audit committee does not disclose what is the basis of the auditor choice? Why are the fees appropriate? Was the auditor retained or not retained, and what were the reasons? These disclosures are not forthcoming, and that might help the investors better understand the mechanics of this relationship. And this would be important from the point of the PCAOB and SEC because the mandate of the PCAOB and the SEC is in a large way to protect the investors.

And, finally, my comment would be if the Board is convinced that mandatory auditor rotation is the right way to go, then I would urge the Board to consider limiting the longest tenures, and the data seems to point that it's only in the case of very, very long tenures, and when I say long I really mean long, 25 years or more, probably there is a question of impairment of independence. Thank you.

CHAIRMAN DOTY: Professor Wright.

MR. WRIGHT: I'm very pleased to be here, and one correction I should note, though, is I'm from Northeastern University. I think I've heard of that other school, Northwestern, but Northeastern University in Boston. And I am speaking on behalf of a research team consisting of myself, Jeff Cohen at Boston College, and Ganesh Krishnamoorthy of Northeastern University. So, again, we are very pleased to provide our views on ways to strength auditor independence and skepticism for consideration by the PCAOB. These views are based on research findings for studies we have conducted as well as other related academic research that I'll make reference to.

We understand that a major issue under consideration, obviously the last couple of days is the advisability of requiring audit firm rotation. The research we have conducted over the last decade has focused on corporate governance, however, and its impact on financial reporting and audit quality; in particular, the interactions between management, the audit committee and external auditors.

Our research provides specific avenues for improving the effectiveness of the audit committee, we would argue, and thereby strengthening audit quality, and in the end financial reporting quality. Therefore, I will focus my remarks on improving the strength of corporate governance as it affects the audit process and audit quality.

Our research, first of all, has in addition to other studies has validated the critical role of the audit committee in enhancing the audit, as well as financial reporting quality. We find, for instance, that auditors obtain significantly greater negotiation power with management when dealing with a contentious reporting issue if they are bolstered by a strong audit committee that can serve as an ally and an independent body.

We also find management concedes to a more conservative reporting stance in the presence of a strong audit committee, so the audit committee also serves as a deterrent effect on management in our research.

We conducted two -- now I'm going to talk about a couple of other studies here that deal with audit committees. We've conducted two interview studies capturing auditor's experiences in working with audit committees and management. And one of these was done about 10 years ago before Sarbanes-Oxley, about 12 years ago to be more accurate. And one after, again 12 years later after Sarbanes-Oxley. And what did we find from our auditor's experiences, and these were audit partners for the most part. Pre-Sarbanes-Oxley no surprise, auditors often found audit committees to be largely ineffectual. Post-Sarbanes we see dramatic improvement in terms of audit committee expertise, authority, power, and diligence. So, the world really has changed there.

However, a disturbing finding was despite the audit committee's legal authority for hiring and firing auditors of public companies a majority of the auditors that we interviewed indicated that management is still playing the dominant role in these decisions. And we believe that auditor independence is greatly strengthened when the audit committee is the party that hires and is the principal party overseeing the audit function. We think we can go further along that route.

We also find that in many instances the audit committee is seen to play a passive role in helping to resolve disputes on contentious accounting matters between the auditor and management. And in our view, the audit committee can be more effectual if it takes more active role in understanding and working to resolve contentious accounting and disclosure matters rather than the passive role which seems to be somewhat common.

Other research we have done has looked at the issue of the independence of the audit committee in form versus substance. And what do I mean by that is audit committee members may have social ties with management, for example belonging to the same country club, or professional ties, for instance, having worked together or served on other boards together; that although in full compliance in form with Sarbanes-Oxley related regulations may nonetheless potentially threaten their independence in substance.

We find auditors are more willing to stand firm in disputes with management if they perceive the audit committee to be substantively independent rather than merely fulfilling regulatory requirements.

Further, a recent study by Carello

et al report that companies are more likely to have restatements when the CEO has influence over the nomination committee that selects audit committee members. The disclosures on these ties between the audit committee and management is somewhat ad hoc, particularly there are no disclosures on social ties. And we believe that ties -- if companies were required to disclose the social ties that management has with board members this could mitigate the influence that management may have over the substantive independence of audit committee members.

And a final area of research that I'll comment on that we've recently conducted deals with audit committees and industry expertise. So, we find that audit committees may have strong financial expertise. They may, nonetheless, lack sufficient industry expertise to understand and, thus, properly monitor complex industry-specific accounting issues.

For instance, industry expertise is important in assessing accounting estimates, and the application of accounting methods that are tied to business operations. Recent research that we have conducted finds that the industry knowledge on the audit committee significantly and incrementally improves financial reporting quality above and beyond industry expertise by the external auditors.

So, we would argue that by encouraging or even requiring audit committees to have members with industry expertise, which is not a current requirement, the SEC can help enhance the monitoring abilities of audit committees in overseeing financial reporting. So, in summary, our research findings highlight the importance of the audit committee in the strengthening of the independence and effectiveness of the audit function.

We identified four areas in which

the audit committee may be strengthened, and these are fulfilling its function as the primary party that hires or fires the auditor and oversees the audit function. Secondly, playing a more active role in working to resolve accounting disputes. Third, insuring audit committee members do not have social or professional ties with management that would impede audit committee independence in fact or in appearance. And, finally, appointing audit committee members with industry expertise.

We appreciate this opportunity to share our research findings and insights with the PCAOB. Thank you.

CHAIRMAN DOTY: Thank you. Jay, do you want to start us?

MEMBER HANSON: Thank you all for coming. This is very educational for all of us. And, Professor Wright, I just want to pick up on a couple of points that you just summarized.

We've been hearing from a lot of

folks these last couple of days, and we had a very distinguished panel of audit committee members and chairs here this morning. And I think if I had any one of those individuals as an audit committee chair I wouldn't worry too much about how the audit committee was functioning.

One of things that I really struggle with, though, is I don't know if the proportion of really, really good audit committees versus ones that really aren't very good, if that's 5 percent are good and 95 percent are needs improvement, or if it's 95 percent are good and 5 percent need improvement. Do you have any sense on that continuum as to the predominance of the best practices and that people are really doing the right thing versus the ones that might not be equipped to do the job, and aren't doing the job?

MR. WRIGHT: Yes, I think that's an important question. I'm not aware of any survey data that looks across this. Part of this would be how do you assess a high-quality audit committee. From our research, which is representative of public companies of all sizes, we see a real divergence that -- in terms of some of the parameters I talked about, like being actively involved in hiring the auditor, overseeing the audit function, and so forth.

So, we see a 40 percent-50 percent split. But, again, we're looking at a company -- public companies of varying size, so if you were to look at public companies of the Fortune 500, that might be a different -- we may have a different result there. But just general audit experiences, a lot of partners that we dealt with is there's real variance out there.

MEMBER HANSON: I'll pass the baton here in a second, just an observation on the social ties which the members of the public accounting profession in the room won't want to hear me say this, but I don't think there are any independence rules that we put out or what these guys have put out that prohibits social ties between audit partners and professionals and their clients, so that same situation could very well exist directly between the auditors and management.

MR. FERGUSON: I'd like to ask Professor Ghosh a question here. You mentioned almost a throw-away at the end of your comments that you that very long audit tenure, 35 years might be problematic. I guess I'd like to hear from you, and then hear from all of you whether you would agree with that. But first of all, what evidence is there for that, and why do you think -- why would time alone change what the evidence appears to be for shorter periods of time, at least based on the studies you've cited?

MR. GHOSH: That's a very good question, and the reality is that there is not enough evidence to directly answer your question. And while I was writing the -- my opening remarks I realized that there is no paper that explicitly looks at very long tenures. Studies -- most they have done is they have looked at the cutoff points of zero to seven, seven to fifteen, and more than fifteen, and they find that there's some evidence that when it's 15 years or more that the benefits that you see from the first 15 years are not apparent, but I think the idea of very long tenure, whether there is any impairment or not, that has not been done by any of the 50 studies that I looked at. In fact, that propelled me to look into this question a little bit more so we're actively engaging in this to answer questions directly.

And if I may just speak, one point that you raised in the prior panel, which if I could take the liberty of going to a question that you asked, which I thought was very, very pointed, is why is it that in the case of partner there is consensus, but when it comes to the audit firm there is no consensus. And one point that was not raised by the panel, and I think it's a very important point, is it's a lot like client and law firm. Over time there is privileged information that accrues to the audit firm, that is essentially lost when you bring in another audit firm because you can't share this information. This is attorney/client privilege information. However, even if the partner is rotated, this privileged information will remain with the company and will presumably be passed on to the next partner and, therefore, it benefits the audit firm and the client.

MR. FERGUSON: One commentator yesterday, in fact, Charles Bowsher, the former Controller General who suggested that if you were going to have rotation the way you would deal with that problem would be in the last year of the departing auditor he would essentially conduct a joint audit with the incoming auditor so that that information would be passed on.

MR. GHOSH: And that's precisely right, exactly correct.

MS. AREL: I could comment on the over 25 years. I'm not sure where the number would come from, as well, but I think the research that I'm aware of is any time you have the longer tenure with a client, you're going to lose your objectivity, which is important, and is the basis for your independent assessment. So, is it 10 years, is it 15 years, is it 25 years? Like you said, we don't have any research yet that examines that, but I think the longer tenure you have with the client, the more close you get to the client, and the less objective you are.

MR. WRIGHT: Yes, I also can't think of a reason that 25 would be any magic number. This longer bond is the basic question. Now, whether that takes five years, or ten years is an open question, I think.

MR. FERGUSON: Does it exist?

MR. WRIGHT: Twenty-five years?

MR. FERGUSON: Any -- I mean, is there anything that's time-related? Is there any reason to believe that there's anything that's time-related or not?

MR. WRIGHT: There's been work on a partner rotation which seems to look at the five-seven year period as an important time to change partner rotation. Now, did you look at firm cutoff there?

MR. GHOSH: Let me be -- maybe I was not very specific in my response. Your question translated into the academic parlance would be what we've done is essentially we fitted a linear model. In other words, we looked at tenure, or maybe take a long transformation, but essentially we are saying that this relationship is linear, and we tried to fit this model and see over time does the benefits improve, or the cost increase? And we find that overall that the benefits improve, that the costs don't increase.

However, the point that you raised is what about the fact that when tenure actually becomes very high, does this relationship change dramatically? So, in other words, is it a U-shape relationship, or is it a step function? And that's a question that I don't think academics have looked at that will provide direct answers to your question.

MEMBER FRANZEL: I think there is general consensus that the audit committees play a very important role here, and that there is variability out there in practice. And there have been some disclosures suggested.

I would appreciate the views of the panelists in how do we get there? Can audit committees sort of just get there through implementing best practices or are there some additional rules and standards needed?

MR. WRIGHT: Well, I think you can play a role in advocating and working with the SEC and others that oversee audit committees and their composition. The research -- disclosures I think can also be a benefit. We did a research study that looks at disclosures of social ties and how it affects average investors. And it does make a big difference to them when they know of these ties. They think the independence of the audit committee is substantially lessened, so I think it's an evolving thing. We've had -- as I reported, we've had dramatic changes in strengthening of the audit committee over the last 10, 12 years. There's a lot of good news here.

I think we have to continue looking at our problems, and advocating both as external auditors, you the PCAOB, the SEC, that we can do better, a recognition of these best practices and problems that we're having out there.

MR. GHOSH: If I may highlight some

of the issues that I was talking about the audit committees. I think the problem is from the outside world when we are looking at the financials or we're looking at the company-specific data. For us, it's a black box. We can't tell what were the real questions that were asked and the deliberations that took place that resulted in the auditor remaining, or the auditor being dismissed, or the auditor resigned. And that's a question that a disclosure would provide more information into the black box.

I think some great examples that the SEC has done would be the disclosures of the compensation for the top five executives that are now included in the proxies that have led to a lot of debate and thoughtful comments, conversations on compensation. So, in the same regard once you have the data available, then that leads to thoughtful conversation. So, disclosure is an important part of this process, and I think that aspect of the deliberations that take place behind the scenes for audit committees -- for instance, the audit committees are all required to be independent right now. There's got to be an expert, so the structures are in place, so presumably they are doing their due diligence when they come or arrive at a conclusion. So, the question is that what did they go through that resulted in this outcome? That information is simply not available to outside members.

MS. AREL: Yes, I would only add some of this research that has been done on audit firm rotations also looked at the corporate governance side, and in that respect they've looked at the composition of the audit committee. And in a few of these papers, in fact, being minimally compliant with the current requirements actually leads to a lower confidence level on the non-professional investor's perceptions of auditor independence.

So, in terms of what is ideal, we can only look at it in our experiments as to maybe strengthening the audit committee, whether that be increasing the financial expertise, or increasing the number of meetings that they have, and then seeing how it affects, but we don't have an ideal situation yet.

MEMBER HARRIS: Over time we've heard divergent views on whether mandatory rotation will promote or inhibit competition. And I was wondering whether or not you have any views on that, and also with respect to the larger question of competition we've heard some statistics of firm concentration of 91 percent of the utility sector, 85 percent of the telecommunications sector, 72 percent in the energy sector, 70 percent of the commercial banking sector. So, the first question, what would mandatory rotation do in terms of either enhancing or diminishing competition? And second of all, do you have any recommendations for how we might consider increasing competition?

MR. WRIGHT: Well, I think there's alternative arguments on this one, so I'm giving you my view rather than a specific research that I've done. And you, over the last day you may have heard these arguments but some view that this is a really significant problem and there are only X number of firms that have the talent to be able to do these audits. So, this is a very, very significant problem.

Others think that this will actually break up and get more firms involved in banking or whatever than we've had in the past, and open up competition in various areas having to develop that expertise. So, you sort of hear balanced views on this one, and to me it's not clear that we have evidence that it's going to be a dire problem, or it's going to be something that would stop moving forward on this front.

I just got back from the Netherlands, and as you know they've now required mandatory firm rotation, and that's their thinking. In talking to them they think well, this might break up competition, make competition more -- but we'll see what happens.

MR. GHOSH: Based on the academic research and the findings from the academic research, I would conclude, and I think it would be safe to conclude that we wouldn't expect or predict that there would be net benefits. So, in other words, the cost that we talk about in terms of a regime without any mandatory auditor rotation, that means 10 years can go along, there are costs, so those costs would be minimized or removed. But the problem is the benefits would be lost. These investments that the audit firms are making in client-specific investments or industry-specific investments, those would be lost. And if those are lost then what happens? And I don't think we can say conclusively that the result would be an improvement in audit quality or not. The evidence seems to suggest that the net benefits may not be there. It may be lost. That's what I would conclude.

MS. AREL: I'd just add, again, my opinion, but I think what we've heard over the last two days, or at least I heard yesterday was that some of the bigger companies are actually using all four firms for something, either the audit, the internal audit, or consulting type of services. So, naturally, if we could get the fifth or sixth largest firm to become one of the players in the rotation that could increase the competition. And it might be needed for some of these big companies that are using all the firms right now.

And increasing competition, I think the firms would also look at it as an advantage, maybe an opportunity to increase their expertise in different industries so that they could then offer or propose for a new audit company.

MR. GHOSH: I would add just one point I forgot to mention, that one stylized fact that emerges which would be fair to conclude is the audit fees would increase. But that, I don't think audit firms would necessarily see that as a bad thing.

CHAIRMAN DOTY: Michael Gurbutt.

MR. GURBUTT: Thanks, Jim. Yes, I just would like to ask a question of each of the panelists based upon your opening statements, and maybe I'll just go down the line, and then give you a chance to respond once I've asked the questions.

But, Barbara, I'm just interested in finding out a little bit more about the experiment that you described in your opening statement, interested in understanding who were the subjects, whether or not they were from large or from small firms, and whether or not the results might be different in small firms as opposed to the large firms. And, also, whether the people that you asked about were senior-level employees or lower-level employees? So, I'll give you some time to think about that.

MEMBER HANSON: Michael, can I pile on one more question to that? I haven't thoroughly read your paper, but from the dates it appears like that the most research was done like in 2002, 2003, 2004. So, maybe your thoughts on since we've now been regulating audit firms with a rigorous inspection for the better part of nine years, if you think the results might be different today. Thanks.

MR. GURBUTT: And then just finally, to what extent these experimental-type studies translate to the real world. I'd be interested in your thoughts on that, too.

Professor Ghosh, you mentioned you've done some synthesis of the literature regarding the impact of rotation on audit quality. I'm just interested to some of the proxies that the academic research used to measure audit quality, and what the strengths and weaknesses of some of those approaches might be.

And then, Professor Wright, I think you mentioned that management seems to, in fact, play quite a dominant role in the hiring and firing of the auditor. And that seems to have potentially some quite significant implications for auditor independence. And I'm just interested as to what reforms you think might be able to be put in place to address that issue. So maybe, Barbara, if I start with you.

MS. AREL: Sure. So, our experiment, yes we did run it fairly close to when Sarbanes-Oxley was passed, so it is a little dated, the data at this point is a little dated. But the subjects that we did use were all in the northeast, so that is a limitation as to whether or not they are representative of CPAs across the country.

And, in fact, they did come from mostly smaller firms, only about 15 percent or 16 percent came from national or big four firms. So, we got the responses of auditors at regional or one office or smaller firms that are doing the same type of audits. And the senior versus the lower level, like I mentioned in my remarks, we did have a low number of partners, that was only about 27 percent, but 80 percent of them were above the senior level, so they have experience. They've been through the audit process. Average experience was actually almost 14 years, so these were experienced auditors. They're not fresh staff people by any means.

So, would it be different today? There's been a couple of recent research papers that have come out. One came out in 2009 from Wang and Tuttle that actually supported our results, and they found similar results that auditors are less cooperative in client negotiations when rotation is mandated.

So, there is some recent research, also some working papers in the process of trying to be published at the moment that support our results as well, that rotation does matter. But both of those examples, they were more of a experiment, the economics type of paper than a true experiment, so a little difference in the method. But in our case, we do believe that the result of our research do extend to the real world.

MEMBER FRANZEL: I did have a follow-up question on your study, as well. You concluded that the effect is largest in situations with weak corporate governance. Can you explain that a little bit?

MS. AREL: Yes. So, in our experiment in addition to manipulating audit firm rotation, we also manipulated the audit committee. So, we did a weak condition in which that was compliant with the current requirements, and then a stronger condition in which the audit committee met more often, they had more financial expertise on it, and they were more independent of management. So, in our case the rotation was actually stronger under the weak condition, but we want to note that that weak condition is what's currently required of the audit committee, so it's stronger in the fact that we got a bigger difference in the average responses between the rotation and the non-rotation condition. So, that's where that result comes from.

MR. GURBUTT: And, Barbara, you just mentioned that you think that your experiment would translate to the real world. Can you explain why you believe that's the case?

MS. AREL: Yes. Well, because the auditors were put in the situation in which they're familiar with. It is a hypothetical audit client, but in the case of a departure from GAAP, what we would expect is that everybody in our experiment would have answered that they needed to modify the audit report. But, in fact, we found that not everybody was willing to go there, and that it did depend on whether it was a rotation or a no-rotation condition, so the situation that we put the auditors in is definitely something they would see in the real world, and something they would encounter on any client.

MR. GHOSH: It's a very good question, Mike. Your question was that what proxies do academics research tend to focus on for measuring audit quality. And the problem is audit quality is just not measurable, so you have to consider constructs, proxies that would conceivably measure audit quality. And that becomes a challenge for academics, so the more direct -- so, the best way of thinking about this would be independence in fact, and independence in appearance, so let's focus on independence in fact.

Independence in fact is how do you go about measuring it. Direct measure of audit quality would be whether the auditor is issuing an unqualified versus a qualified opinion, because that's directly under their jurisdiction. And the propensity to issue a qualified or an unqualified opinion for a client that subsequently went bankrupt, that's an easy test to measure whether there was a conflict of interest or not. So, that's what studies tend to use.

The problem is there aren't that many qualified opinions, and there aren't that many, and we are happy to say that, there aren't that many companies that go bankrupt. So, while that's a good outcome, the tests become weaker. So, then we have to look at restatements, whether the tenure was associated with the restatement. Again, that's a powerful test, but the problem again is while there are restatements, there are not that many restatements compared to the number of registrants with the SEC, which is about close to 18,000. Those number of restatements also have gone down significantly since SOX, so that also comes to a dead end.

So, the overwhelming majority of the studies relying on independence in fact tend to use some kind of managerial discretion which is in common parlance called accruals or deferrals. These are based on managerial estimates, bad debt expense, restructuring charges, the allowance. So, whether the management had a lot of discretion and whether that is associated with tenure, and the inference is if the management had a lot of discretion, presumably the auditors were signing off also on that. So, that's a very popular measure of auditor independence in fact that is what we call discretionary accruals.

Some studies have kind of pushed it even more and said well, just not look at accounting estimates, let's also look at the investments that companies are making, which is with respect to R&D, the discretionary real investments, and whether these are subject to manipulation, especially when there are some goals to meet like forecast -- propensity to meet forecast estimates or last year's benchmark. So that's, again, another measure of independence in fact.

And then, finally, the independence in appearance, and that's kind of fairly easy to test because you're essentially using a market model, so you're looking at the bond holders, you're looking at ratings, or you're looking at cost of debt at the issuance, or on a daily or monthly basis. And the context of investors it's very easy because you have the return data that is easily available, so you're looking at changes in market prices. And you're directly correlating that with tenure that's observable, so that -- the independence in appearance is a lot easier test.

And the independence in appearance, that test if you kind of set it on tenure, the result seems to be overwhelming with that tenure does lead to benefits at least as perceived by the capital markets, which would include the debt holders, the equity holders, and the rating agencies at approval. Thanks.

MR. BAUMANN: Can I just ask a follow-up on that? How do you control for other factors in that -- right here -- sorry. How did you control for other factors in the case?

MR. GHOSH: That's, again, an excellent follow-up question, and I'll give you -- the hard thing that we had specifically with our paper which was published in Accounting Review on independence in appearance, and I guess the referee and the editor was -- could have been you, Marty -- had a lot of concern about the control. So, eventually I was so frustrated because we had, I counted, 35 control variables, and that's a very important point to make sure that tenure is not essentially correlated with either the firm characteristics, which is the client firm characteristics, or the audit firm characteristics. So, they are the standard measures that you can use.

So, I would add a caveat to this, is you're right, it's entirely possible that tenure is correlated with some other firm-specific line, firm-specific for the audit, firm-specific factors that we're essentially not controlling for, and this stylized result that we are getting is really not a causal relationship. That's the point.

MR. WRIGHT: I might add to that question that studies in this area that look at audit quality often for those reasons look at multiple measures. So, do we get that same picture if we use discretionary accruals, and restatements and whatever, we get more confidence when there's more measures. But your question was how can we -- I guess it's easier to point out problems than it is solutions. So, you pinned me down a little bit there.

I guess, again, recognizing that this is a problem as the beginning, that audit committees even though by law are supposed to be hiring and firing auditors, they in many cases seem to usurp this to management, so awareness is the first part, I would argue.

I think then there's -- the external auditor has communications with the audit committee, they work together, try to encourage that their -- the audit committee really is playing a critical role in the decision to hire and fire the auditor. You know, strong chair of the audit committee, just recognition that that's a very fundamental role for the audit committee to play, and it's not something that we can usurp to management even though they have to work with the auditors a lot, not just pass that over to management and then rubber stamp it so to speak. So, again, your efforts and the SEC's efforts to make sure that audit committees realize that this is there by law, but it has to also happen.

MR. GURBUTT: Thanks, Arnie.

CHAIRMAN DOTY: Thank you all. Why don't we take a bit of a break before the last panel for the firm representatives. But this has been an illuminating discussion for us, and we thank you, and we hope that we can continue to pursue these questions with each of you at a subsequent time. Thank you.

(Whereupon, the proceedings in the foregoing matter went off the record at 3:20 p.m. and went back on the record at 3:33 p.m.)

CHAIRMAN DOTY: Ladies and gentlemen, it's 3:32 PCAOB time. Actually, 3:33.

This is one of the most important panels of the entire two days. This is where we have the chance to speak with the heads of the audit firms other than the Big Four. We have had a practice in introducing the audit firm heads not to recite all of the civic and other business achievements that they have made but to identify them for who they are, that being really enough.

We have with us Joe Adams, the Managing Partner and the Chief Executive Officer of McGladrey & Pullen. Joe has come to that position in May of 2011, so this is the first time we have had the chance to sit down with him in this way, in this capacity. We are grateful for it.

He has been Executive Managing Director of the Great Lakes Economic Unit, consummated with the largest integrations in the firm's history. He was an insurance partner and served in a variety -- with a variety of industries. We are glad to have you here with us.

With him is Charles Allen, Chuck Allen, Chief Executive Officer of Crowe Horwath, LLP. More than 30 years of experience in the insurance, acquisition, divestiture, corporate finance, and strategic business consulting areas, and sits on the board of Junior Achievement of Chicago.

Cynthia Fornelli, Executive Director of the Center for Audit Quality. We see Cynthia often. She is a frequent commenter, participant, in all of these forums and venues, and we are glad to have her here. She is of course -- was Deputy Director of the Division of Investment Management of the United States Securities and Exchange Commission. And that we can't forget, can't omit.

Wayne Kolins, Global Head of Audit and Accounting, BDO International. Wayne also is frequently with us. Wayne has sat for a long time on our various advisory committees and has made a great contribution. He previously served as the BDO's International Director of the U.S. Securities and Exchange Commission practice. And we are glad to have you here, Wayne.

Finally, Charles Weinstein, Charly Weinstein, Chief Executive Officer of EisnerAmper, LLP, a member of their Executive Committee. Prior to the formation, he was for more than 25 years in audit acquisition, public financing practice, particular focus on SEC reporting.

And we are glad to have you all, and we would like to turn the floor over to Joe Adams. Thank you.

MR. ADAMS: Thank you, Chairman, distinguished members of the Board. McGladrey welcomes the opportunity to participate in this public forum on auditor independence and audit firm rotation organized by the PCAOB. We appreciate the thoughtfulness with which the PCAOB board has gone to arrange this transparent, balanced, and informative process.

As the fifth largest firm in the U.S., McGladrey, like virtually all accounting firms, take the responsibility to conduct quality audits very seriously. As a result of Sarbanes-Oxley, the establishment of the PCAOB, and recent standards enacted by the PCAOB, we believe the quality of audits has improved substantially over the last 10 years. One noteworthy indication of this has been the reduction in the number of restated audited financial statements.

In addition, increased oversight and interaction with audit committees has enabled a more effective dialogue between the parties relative to maintaining independence, objectivity, and professional skepticism. I believe that McGladrey and the other large firms are clearly aligned with investors, regulators, audit committees, and management when it comes to the goal of continuing to improve the quality and reliability of the audits we perform.

We have all learned through this exploratory process, which has been led by the PCAOB, including the dialogue we have had in the past two days. We also know we must continue to work together to do more and be even more vigilant on behalf of the investors and others who rely on our audits.

As it relates to mandatory audit firm rotation, we offer the following. We have concerns that a mandatory change may limit competition, since the brands of lesser known but high quality firms may not be considered in the change process. There is a learning curve with any transition to a new audit firm. The larger and more complex a company is the steeper the learning curve.

As an auditor's knowledge about a company and the business environment that it operates in increases, the risks associated with the audit decrease. Our research supports the fact that deficiencies are higher in the initial years after a change in auditors.

Quality and risk are also impacted by the industry expertise of the audit firm, and the most qualified firm may even be excluded from consideration. The level of preparation required from the company staff is substantially higher in the first few years after an auditor change. This increases the cost of a change in auditors.

Audit firms are unique. And while methodologies and approaches to performing an audit are similar, there will be notable differences caused by experience, the human element, and personal knowledge of the auditor.

Mandatory firm rotation weakens the role of the audit committee. Many recent changes have been made by the PCAOB to strengthen this role, and many of the benefits of this are enumerated in ours and others' submitted statements. The positive impact of these changes will be eroded by mandatory firm rotation.

The number of companies needing to change auditors every year would be substantial and would serve to distract audit committees and auditing firms from the most important task at hand -- ensuring the quality of the audit.

Auditing firms and the PCAOB are currently doing significant analysis on the root causes of audit deficiencies and failures that will provide further information that should be considered before mandating audit firm rotation. The current requirements to rotate the engagement partner and engagement quality reviewer every five years, along with the normal turnover of audit engagement members, provides for a periodic fresh look at a company's critical accounting policies.

Lastly, we have seen no empirical evidence that supports the hypothesis that mandatory firm rotation would increase audit quality. We don't believe independence, skepticism, and objectivity can be legislated. Quality, objectivity, and integrity are values that auditors have embraced for many years and ones that have enabled the profession to be one of the most respected.

For the above reasons, and to enable the audit profession to continue to maintain its status as a sought after career alternative, and thus attract the best and brightest students and retain our highest performing audit partners and professionals, we do not support mandatory firm rotation.

However, this does not mean that we shouldn't take other steps to improve objectivity and professional skepticism, and ultimately audit quality. At McGladrey, we have implemented a number of changes in our quality control systems to improve objectivity, skepticism, and overall quality.

We have recently established an independent SEC Reacceptance and Client Evaluation Committee to approve not just the acceptance and continuance of our SEC clients but to ensure that those engagements are properly staffed by qualified engagement partners and managers, subject matter experts, and engagement quality reviewers.

We have also established a Quality Control Inquiry Committee that evaluates the root causes of significant engagement deficiencies and determines that the appropriate actions are taken, including, where warranted, appropriate disciplinary action.

We are modifying our partner compensation system to incorporate a longer term view of performance. As CEO, it is my responsibility to set a tone of "at the top" that emphasizes the paramount importance of audit quality. I welcome the opportunity to do that, and I intend to make sure our partner compensation system gives appropriate recognition to audit quality.

In response to some of the questions that were raised yesterday, I would also like to point out that our policies have always provided that our national office is our final authority on audit and accounting matters, and that no one can override their conclusions.

Like other major firms, we encourage, and in some cases require, our engagement teams to consult with our regional and national professional practice consultants on difficult or contentious issues. Our consultation process is collaborative and provides for a critical evaluation of all points of view. However, at the end of the day, we reach a firm conclusion and stand as one.

With the help of some leading researchers in the field of professional judgment, we have developed a professional judgment framework to assist our auditors with understanding the appropriate process for evaluating audit evidence, identifying and eliminating bias, and reaching proper conclusions.

This framework will be immediately

disseminated after our busy season concludes, and we will provide training on how to implement the framework and our continuing professional education curriculum this summer and fall.

We expect this framework will assist our professionals when making the types of objective, professional judgments the investing public has a right to expect. We look forward to continuing to work together to dialogue on ways to strengthen the quality of audits and investor reliance on audited financial statements.

On behalf of all of the partners and employees of McGladrey, we thank you for this opportunity to be included in this process and express our views.

CHAIRMAN DOTY: Thank you.

Mr. Allen.

MR. ALLEN: Thank you. I and other partners in our firm are actively engaged in industry-wide activities designed to improve audit quality. We believe it is important work.

And I want to thank you, Chairman Doty, for holding this roundtable discussion. And I also very much appreciate the opportunity to speak here in front of the Board.

It is no secret that many are strongly opposed to mandatory firm rotation. We have heard that, you know, from several people over the last two days.

And, Chairman Doty, in response to the comments that you asked, which was, if not mandatory firm rotation, then what else? I would like to share just a couple of important "what else" items in place at Crowe that are designed specifically to strengthen independence, objectivity, and skepticism.

In the remainder of my remarks I will use the term "objectivity" to refer to the three concepts all combined.

But the pressures on objectivity

fall most squarely on the engagement partner. And as a result, we have added an additional partner review beyond both the engagement partner and the engagement quality reviewer. I think this may be a different approach than some of the other larger firms.

But for every public company audit, our national office reviews the draft financial statements. They review the draft SEC filings, consultation documentation, and audit summary memos, looking for potential sources of accounting or auditing error. These reviewers look at every public company audit engagement across our firm, and, thus, have a different perspective than the engagement partner and the engagement quality reviewer.

I thought yesterday's preparer panel described the national office well. The function provides a high level of independent thought and debate, and this is exactly the reason our engagement partner decisions are subject to two reviews and not just one.

Yesterday the first panel discussed the importance of partner compensation on objectivity, and I very much agree with it as the culture of our firm. For that reason, our longstanding compensation model reduces the anxiety partners may feel about a lost client.

Our income distribution model has no direct linkage to compensation based on client retention, size of book of business or sales activity. Rather, our income in share ownership is anchored in the concept that equal sharing changes, in the firm's equity and income.

These two simple actions are simple and straightforward and serve to lessen the pressure on the engagement partner and provide support for making objective balanced decisions as we face the practice.

As CEO, I spent a great deal of time considering risk to our firms and our profession, and major audit failure is front and center in such considerations. I truly do not worry about our partners and people failing to properly confront tough issues, because they have lost their objectivity, their fear of losing the client. Our stated values and culture supports them.

I do, however, worry about the potential for audit failures from other directions. While I reflect on the root cause of failures, I find they are due to companies taking risks that they cannot appropriately manage.

Complex transactions are now found in every size of entity, and this risk is particularly acute in the companies of the size and nature that we audit, as they are continually challenged to devote the necessary resources to very complex accounting requirements.

We must recognize the fact that, as documented in a number of comment letters, auditors often become more effective over time as they learn more about the companies they audit and navigate the accounting requirements.

The PCAOB currently has a project on the agenda which can make important headway in this area, the project on the auditor's report. I believe that an appropriately designed structure using the emphasis of a material matter model would enable the auditor to point to the most significant matters.

If the PCAOB were to proceed with such a recommendation, I believe the result will be an auditors report which illustrates key risk, including complicated accounting matters, for a clear understanding for investors and the shareholders. Such reporting would provide transparency of the auditor's objective, providing deeper insight into their thinking.

Yesterday, concentration and tenure came up several times. And from my perspective, middle market and small companies have many auditor choices, and rotation is already occurring. We heard yesterday from one of the academic panels that the average company auditor relationship for the firms around this table, and our respective peers, is less than five years.

Of course, there are a variety of reasons the audit committee may choose to change firms, and that should continue to be the audit committee's decision. We have observed a substantial increase in audit committee engagement with clients of our size since the passage of SOX. And, in fact, we heard this morning from several audit committee members, demonstrating their passion in fulfilling their roles.

I believe mandatory audit firm rotation would undermine the role of the audit committee and unnecessarily restrict the choice of audit firms available to audit committees when discharging their responsibility. We certainly need to do all we can to strengthen even further the audit committee's role.

Let me conclude by suggesting that to improve audit quality we must make progress along several dimensions. We must continue to increase objectivity, and I shared with you the ways we do that at Crowe.

Chairman Doty and members of the panel, I very much appreciate again the opportunity to speak in front of you and look forward to taking your questions.

CHAIRMAN DOTY: Thank you.

Cindy, I thought we would let the audit firm heads finish and then wind up with you.

Mr. Kolins.

MR. KOLINS: Thank you, Mr. Chairman, members of the Board. On behalf of BDO, I want to welcome participation in this very important meeting. We are committed to protecting the interests of investors by sustaining a high level of audit quality and continuing to explore ways to enhance the key attributes of independence, objectivity, and professional skepticism.

These attributes reflect the auditor's mind-set, a questioning attitude free from bias. In addition to the auditor actually having this mind-set, investors should be confident that it exists. So the right environment needs to be created to promote and nurture it.

Audit quality is not a static concept, though, but rather is influenced by a multiplicity of dynamic factors. Accordingly, achieving optimal audit quality requires a broad-based effort that reflects the nature of the business environment.

The Sarbanes-Oxley Act overall, and the establishment of the PCAOB in particular, strongly contributed to enhancing audit quality through the sections of the Act dealing with auditor independence, corporate responsibility, standard-setting, and inspection of registered firms.

These extraordinarily robust inspections, and the potential for personal sanctions, as well as the very real threat of civil litigation, are powerful forces for influencing the right auditor mind-set.

In addition, the effectiveness with which auditors demonstrate the key attributes of audit quality is assessed by their firms during their ongoing monitoring processes, including annual internal inspections and engagement in quality reviews under AS 7.

However, despite the reforms initiated by the Act and implemented by audit firms, and the Board's belief, as stated in the Concept Release, that audit quality has improved since 2003, we recognize that the PCAOB has noted that it continues to find audit deficiencies because of an apparent lack of independence, objectivity, and professional skepticism.

We share the Board's concern regarding the continuing deficiencies. However, we don't believe mandatory firm rotation is the appropriate or necessary response to that concern. We note that the Concept Release itself acknowledges the weakness of the presumed correlation between audit quality and firm tenure.

Beyond that, we believe mandatory firm rotation could actually result in significant adverse consequences, including additional costs and potential dilution of audit quality. In contrast, we believe the first step in improving audit quality is to understand the root causes of identified deficiencies and address them with targeted responses.

The Concept Release recognizes that root causes of audit failures are complex and vary in nature, and that they continue to be explored by the Board, but that a root cause analysis has not been completed and that such an analysis would be needed before a clear cause and effect relationship could be determined.

Parallel with the PCAOB initiative, we and other firms are performing our own root cause analyses for deficiencies encountered during internal and PCAOB inspections. After identifying root causes, action should be taken by the firms and the PCAOB to consider whether changes should be made in firm quality control processes, auditing and quality control professional standards, PCAOB and internal inspection programs, and the responsibilities of audit committees.

This would get to the heart of the matter and be in the best interest of all stakeholders.

In the meantime, we suggest several areas for improving audit quality in a cost effective manner, recognizing that some would require coordination with various regulatory bodies. We are committed to working with the PCAOB, the SEC, audit committees, investors, and others, in these efforts.

The first area for improvement is strengthening communications between the audit firm and the audit committee. Audit committees have a crucial role in overseeing the integrity of the company's financial reporting process. Robust and candid communication between the auditor and audit committee is essential for the Committee to fulfill this role effectively.

As such, we support efforts by the PCAOB to strengthen the existing requirements for auditor communications with audit committees, as reflected in the Board's recent proposal on this subject, to ensure that the committees fully understand the auditor's risk assessments and audit strategy.

We believe these dialogues could

be further enhanced by informing the audit committee about the nature of the PCAOB inspections relating to the company's audit, communicating engagement level inspection findings, and discussing the audit firm's evaluation of the root causes of any deficiencies identified and the corrective actions taken.

Next, we could explore ways to enhance audit firms' internal quality control systems. This should be done in conjunction with strengthening the PCAOB's quality control standards, which is consistent with the Board's current standard-setting agenda.

Another important area for promoting improvement involves the composition of the audit committee, which is responsible for appointing and overseeing the work of the audit firm, and promoting the integrity of the financial reporting process.

We urge the PCAOB not to dilute the audit committee's critical and independent role by mandating firm rotation, but instead to work with others, including the SEC, to strengthen it. In that regard, the audit committee resources should include practical auditing experience.

This background is essential for conducting a probing dialogue with the auditor in key audit areas and for empowering the audit committee to critically assess how the auditor is addressing the issues raised, particularly as they relate to the exercise of professional skepticism in judgmental areas.

Now I will turn to mandatory firm rotation, the basic premise of which is that limitation of firm tenure could enhance independence, objectivity, and professional skepticism. However, in addition to the lack of demonstrated correlation between firm tenure and audit quality, mandatory rotation would likely produce significant unintended consequences that are addressed more fully in our December comment letter.

These include the steep learning curve that would affect many more engagements due to the exponential increase in the annual rate of audit firm changes; reduce choices for companies in specialized industries; challenges on audits of multi-national companies in relocating staff and deciding whether to change non-audit service providers around the globe; to allow those currently performing services prohibited by independence rules to be available for selection as the new auditor; exacerbating audit firm concentration by removing one firm from the pool of potential auditors, coupled with the unavailability of firms that continue to perform prohibited non-audit services; increased first year audit costs, plus costs incurred by issuers as they devote resources to assessing prospective audit firms and working with the new auditors while they climb the learning curve; and, finally, the impact on smaller audit firms that provide high quality audits of companies that have grown over the years of their engagement.

When these companies are required to rotate to other audit firms, we believe the predecessor firm generally would be less able to replace them with issuers of similar size, because of the inherent bias that still exists in many parts of the marketplace in favor of larger firms. This may drive some of the smaller firms out of the public company arena.

And thank you again for this opportunity to participate in this meeting, and I look forward to our discussion.

CHAIRMAN DOTY: Thank you.

Mr. Weinstein.

MR. WEINSTEIN: Thank you, Mr. Chairman and members of the Board. I would like to take just a moment to give the Board some brief background information about our firm. EisnerAmper is one of the 15 largest accounting firms in the country, with offices in New York, New Jersey, Pennsylvania, Illinois, and California, and nearly 1,300 partners and staff.

We provide audit, tax, and consulting services to privately owned and publicly traded clients in a broad range of industries with a focus on growth companies. I am pleased to have the opportunity on behalf of EisnerAmper to participate as a panelist in today's public meeting on auditor independence and audit firm rotation.

We commend the PCAOB's efforts to enhance auditor independence, objectivity, and professional skepticism, which are the cornerstones of the auditing profession. We believe that the systematic changes required by the Sarbanes-Oxley Act of 2002, such as partner rotation, prohibition of certain non-audit services, increased audit committee responsibilities, and the PCAOB inspection program have greatly enhanced auditor independence and, in turn, audit quality.

We agree with the underlying

assertion that the current client pay model inherently creates a conflict, since the audit firm is paid by the company being audited. Audit firms are aware of this inherent conflict, but value their professionalism and reputation and remain committed to their obligations to the investing public. Our firms spend substantial resources to monitor and mitigate this conflict.

The Concept Release focuses on mandatory audit firm rotation as a possible means by which to improve auditor independence, objectivity, and professional skepticism. While we understand the potential benefits of a fresh point of view, and the potential reduction in management pressure on auditors that mandatory rotation could provide, we believe that mandating audit firm rotation is unwarranted, and any perceived benefits do not exceed the costs and inevitable unintended consequences.

Our concerns regarding potential

unintended consequences of mandatory audit firm rotation, some of which may negatively impact audit quality, and others which may result in significant costs, without a demonstrated corresponding benefit of increased audit quality include the knowledge of a client that is built up over time is a significant factor in audit quality.

There is no mechanism to transfer much of that knowledge base to a successor firm and, hence, most of that knowledge base is lost. Auditor changes always result in disruption and additional costs, including the costs of getting the new auditor familiar with the company and its processes.

In certain cases, there may be a limited number of firms with sufficient capacity, resources, technical, and industry knowledge to perform a high quality audit. Mandatory firm rotation could require a company to hire an auditor that, in the view of the audit committee, is not the most qualified audit firm.

In this regard, MFR diminishes and undermines the role of the audit committee and reduces their discretion related to the selection and continuance of the auditor when they are in the best position to make that decision. Further, the timing of a mandatory rotation of the audit firm might come at a time that is particularly ill-suited for the company, and in the view of the audit committee not in the company's best interest.

We are concerned that mandatory firm rotation will cause increased contraction in the number of qualified registered public accounting firms as more firms decide that they do not have the resources required to continually try to replace rotating clients.

Mandating firm rotation could also impact the ability of firms to attract and retain highly qualified audit professionals by making it difficult to offer their professionals longer term career development opportunities associated with work on public companies.

One of the alleged benefits of MFR is the reduction in pressure an auditor may face from management to protect the client relationship. However, one of the unintended consequences may be the opposite of that. The increased pressure on the auditor to replace the audit with non-audit services as the rotation comes to an end.

We are not convinced that audit firm tenure is the primary cause of audit deficiencies that stem from a lack of sufficient professional skepticism. Independence, objectivity, and professional skepticism is most closely associated with individuals and not necessarily firms.

EisnerAmper's quality control policies and our culture emphasize the importance of the appropriate level of skepticism and the need to obtain corroborative evidence. While there is a risk that over time, and with increased familiarity with a client, professional skepticism may not remain as high as it should be, we believe that mandatory partner rotation sufficiently mitigates this risk.

Proponents of mandatory firm rotation believe that setting a limit on the continuous stream of audit fees would free the auditor from management pressures to preserve that relationship, and, thus, the stream of fees.

You may also want to consider the inverse of this. Instead of mandatory firm rotation, you might consider mandatory audit firm tenure, perhaps for a three-year term. During that term, a company could only dismiss the auditor for cause.

This would free the auditor from the perception of management pressure without the costs and unintended consequences of mandatory firm rotation. It still leaves the auditor selection in the hands of the audit committee, which is in the best position to evaluate the needs of the company and its shareholders.

We believe that the audit committee's role in appointing the external auditor, and overseeing the audit process, is a strong mitigating factor against management pressures on the auditor. At the end of the minimum tenure, the audit committee could decide to continue with the same firm for another minimum tenure period or select a new firm.

A strong auditing profession that can attract and retain the best and brightest is a critical component of our capital market system. We support any ideas that would improve audit quality and enhance auditor independence, objectivity, and professional skepticism. However, we do not believe that mandatory audit firm rotation would provide a benefit to investors sufficient to outweigh the costs and any unintended consequences.

Thank you.

CHAIRMAN DOTY: Thank you.

Cindy Fornelli.

MS. FORNELLI: Thank you, Mr. Chairman, and thank you, Board of the PCAOB.

On behalf of the CAQ, I welcome the opportunity to participate in this very important roundtable. One of the advantages of being the last panelist on the last panel of the last day is that you get the benefit of hearing all of the discussion that has happened before. And there has been really good dialogue and some great ideas that were shared over these past two days.

In our comment letter that we filed in December, and in my written statement, we outlined the CAQ's reasons for opposing mandatory audit firm rotation. So I would like to use my time today to further explore how each of us can and should use our respective roles to enhance audit quality, and especially auditor independence, objectivity, and skepticism.

A number of panelists have outlined the many reforms put into place through Sarbanes-Oxley that were aimed at mitigating the potential conflicts of interest that are inherent in the issuer pay model. These include enhancing the role of the independent audit committee, requiring lead partner and other partner rotation, instituting auditor independence rules, and creating the independent regulator, the PCAOB.

Yet a number of panelists seem to indicate that our current system is broken and not working. I take exception to that. Investors are confident in our capital markets. According to CAQ's annual investor confidence survey, it remains at an impressive 70 percent, even through the financial crisis. And audit quality has improved.

Having said that, however, members of the profession, as well as those of us who support a strong profession, must not let down our guard. We must be ever vigilant and unceasing in efforts to continually improve the way audits are conducted.

During yesterday's panel, you heard the leaders of the five largest public company auditing firms talk about what their firms are doing to strengthen independence, objectivity, and skepticism. And today you have heard the same from my colleagues at the table.

We at the CAQ are actively exploring what more our member audit firms can do, and we are also working collaboratively with others who have responsibilities in the financial reporting process on additional ideas to strengthen the audit process and to improve audit quality.

The CAQ's written statement and comment letter go into more detail regarding these ideas. However, I would like to highlight just a few. A critical element of Sarbanes-Oxley is the responsibility it gave to audit committees in overseeing the external auditor on behalf of investors. The CAQ believes that the audit committees should be further strengthened and encouraged to take an even more proactive role in their oversight of the independent auditor.

To that end, the CAQ is proud to be working with a number of audit committee organizations to start developing tools to aid audit committees in their oversight roles. One potential enhancement is the audit committee's involvement in the selection of the lead engagement partner.

By being involved in interviews of candidates and providing feedback to the audit firm regarding the selection of the lead engagement partner, audit committee members can be satisfied that the partner has the technical competence and relevant experience required for the particular audit. This will set an important tone for the audit partner's relationship with the audit committee.

As discussed this morning, another area that needs tools pertains to the audit committee's annual assessment of the external audit firm, which is an important component of the audit committee's determination whether to retain the auditor.

Best practices for the assessment process might include a review of technical competence, including inspection results for the specific company and those that bear on the audit firm as a whole, compliance with independence requirements, the quality of communications, and, importantly, the application of objectivity and professional skepticism.

We believe another key component in the assessment would be for the audit committee to publicly disclose their assessment process, and we actively are working with the audit committee community to develop these annual assessment tools.

The CAQ continues to work on

projects designed to enhance audit quality, including our role of the auditor work, support of independent academic research, and our ongoing anti-fraud collaboration, which has an emphasis on skepticism.

We support strong auditing standards as promulgated by the PCAOB, and we strive to provide productive comments during the standard-setting process. For example, we were pleased to provide constructive ideas on the audit report, including model disclosures.

But in the end, it is up to each individual on the audit team to discharge his or her professional responsibilities to perform a quality audit, and for firms to cultivate an environment where independence, objectivity, and skepticism are visibly valued attributes reinforced by their internal systems of quality control.

As you have heard yesterday and today, the firms and auditors take this responsibility very seriously.

I appreciate the opportunity to be part of this important discussion, and I am happy to answer your questions. But I would like to take a further moment to thank the PCAOB staff, who has been very helpful. I know putting on these types of roundtables are difficult, and it has gone over flawlessly. So thank you to the PCAOB staff, as well as the Board.

CHAIRMAN DOTY: Thank you, Cindy.

Jay, do you want to start us off?

MEMBER HANSON: Yesterday with the leaders of the other firms that were here, I asked some pointed questions about what they are doing to instill in their partners the sense of support around making difficult calls. The most difficult thing a partner has to do sometimes is tell a client no.

I've got a similar question, but slightly different focus. You are all representing -- except for Cindy -- firms that have a very different profile than the Big

Four firms, in that the predominant client base that you serve are private companies as opposed to public companies. That's a very unique challenge compared to the Big Four firms.

And recently I was -- being the nerdy accountant that I am, and reading my Journal of Accountancy, and reading about all of the client service opportunities that it describes -- and for many CPAs that is very appropriate, the services are just described. And I also a couple of months ago read an Outlook vision of the future article, and I was curious to note that there was not a single mention of the word "investor" in that particular article of visioning for the future.

So my question for you as leaders in these firms that serve both public clients and predominantly private clients is how you are instilling in your professionals, from the time they start until they -- all the way through when they retire -- the importance of the investor needs in serving a public company, and how that is different from the other types of services that you might provide to private companies, and whether you differentiate at all.

But the most important question is: how do you instill in those individuals that one day you might be working on Client A that is a public company and the audit committee is the client, and Client B, a very similar business the next day, which might be the sole owner, is viewed as the client. So that is a difficult struggle, I appreciate, but thoughts on how you are dealing with that.

MR. ADAMS: Well, I would say that, first of all, when it comes to tone at the top on audit quality there is no difference between the importance of getting the audit right. So I think in terms of all employees, all employees who work on audits, clearly the objective is to be independent and to exercise, you know, objectivity and professional skepticism on every audit.

I think, you know, the tendency for us is, though, to really focus on, you know, our best and brightest auditors, really working on the SEC clients, more from the standpoint of having the best qualified people working on investor-related audits, because the risk is greater for us and the importance of it is much more critical to the investors.

So we want to put our best and brightest on those, but our messaging is not any different. I will say, when you work with a smaller client, their situation is much different in that their level of sophistication is much different.

So there is a very difficult balance in ensuring that they get it right and being part of that conversation to help them get it right. In other words, they don't have the sophistication necessarily internally, so that does create additional complications for us, additional challenges, when you work with a lot of smaller public filers.

MR. ALLEN: We have had this conversation around our management committee a fair amount actually. And when we really drill into our practice, even though the public company audit practice isn't the largest part of our audit practice, if you think about companies of public interest, government organizations, regulated banks that aren't publicly traded, not-for-profit organizations, private equity firms, there is a level of sophistication, and really responsibility that we have, even though they are not public companies, but yet, you know, we call them companies of public interest.

And so we don't necessarily try to differentiate between the public company sector and the private sector. We have been challenged with some of the marketing activities. We have worked hard with our marketing team as to, you know, what type of literature we are putting into some of the channels that aren't necessarily auditing, but we are trying to very much communicate with our people.

And we do that on a monthly basis through a video webcast that I do. Almost in every monthly video I talk about our core values, I talk about quality. And we even have a hotline that is monitored by an outside third party that if our people see where someone isn't living our values, or isn't following the quality that we have tried to instill in our people, that they have the opportunity, through an outside third party, to communicate with me, to let me know that we have got issues there.

So we are very much trying to set the tone across the firm, just not in the public company audit channel.

MR. KOLINS: Yes. Just to add to that, we have about 300 publicly held clients, and yet the private practice is larger in total than the public practice. But we also do not distinguish.

In fact, a few years ago we formed what we called an audit effectiveness task force, which has gone into another series, evolutionary mode now, and to look at what are the things that can go wrong. I don't know, anything, just start with a blank sheet of paper, and really started to focus on the root causes. And certainly skepticism, an appropriate level of skepticism, is one of them.

And that focus originally actually started with just the private practice, but it evolved into covering the entire practice. But you can't really make the cut between public and private when you are trying to install certain basic auditing skills in an auditor. It is just not possible to do.

The compensation system we have reflects appropriate level of skepticism. That is one of the things we look at in evaluating the partners.

There is an award that we started giving out about four or five years ago, usually for managers, senior managers, called the Professional Integrity Award, which we actually wound up naming after one of our late partners who really embodied -- and everybody -- you kind of look at professional integrity in the dictionary and his picture was there. He was that kind of an individual.

And bring that person up in front of the stage at an annual A&A conference and you've got, you know, a thousand people in the audience, and that is significant recognition. The first part of your question that kind of evolved into the question about the private practice and what do you do was basically, how do you support tough decisions?

And there not only do we have the right level of people within the firm backing up and going to meetings if necessary with the partner on the engagement to support a tough decision with the client, with the auditee, but much like what was said, the decisions that are made, the technical decisions that are made -- accounting and auditing decisions, whatever they happen to be, reporting decisions -- is a technical decision.

There is a chain of disagreement, if the manager disagrees with a partner, if one partner disagrees with another partner, there's a chain going upstream until it gets to the professional practice leader of the A&A practice, and that is where the decision is made. It is not an operating office decision.

MR. WEINSTEIN: I would say at our firm we understand that as certified public accountants our role and responsibility is on protecting the public interest. So in some cases it is going to be the investors in a public company. In other cases it could be the creditors or private shareholders, but the responsibility doesn't change depending upon the constituency.

So we are beholden to the public interest, and we reinforce that throughout our firm. Our biggest practice area outside of public company auditing is working in the financial services industry. We audit over 1,000 hedge funds.

And similar to the investing public in a public company, we understand that our responsibility goes to the investors in that particular area as well. So it is a distinct focus in all of the training that we do, in the role models that we have in our partners, and certainly in the tone at the top of the firm.

MEMBER FRANZEL: I want to take Jay's question a step further. Auditing is very stressful and very difficult. And there are really layers of protections and safeguards needed here, and we have talked about a lot of them over the last day -- for the last two days.

So, you know, we have got

regulation, we've got standards, firms' quality control policies and procedures, tone, training, etcetera. But when it comes right down to it and the auditors are completing those engagements, there are pressures. There are pressures against those auditors that can challenge their independence and their behavior and their ability to really do a quality job.

What is that layer of protection that you all have in your firms to really, when the auditor is under duress, make the right decisions? And what do you think some of the ideal policies or actions would be to counteract those threats?

MR. KOLINS: Well, one thing that we have in place is -- on the complex, very complex engagement, is a consulting partner targeting a specific area where consultation would normally be needed. If it's a high tech company, for example, there might be a revenue recognition expert that is a consulting partner, where if there are those pressures that come to bear during and at the end of an engagement, that partner can always be called upon.

We also have regional technical directors that would be called upon for consultation on difficult issues, and these are the people that would stand side by side with the engagement partner to, you know, keep it as one face, a one-firm face when the decisions are finally met.

MR. WEINSTEIN: I would say that our partners understand -- our client service partners understand that they are not the last level of decisionmaking in the firm.

So our professional practice group makes all of the final decisions when it comes to audit or accounting matters. And ultimately we are very collaborative inside the firm, the culture -- we think the culture is right. We think we compensate partners by encouraging them to do the right thing. It's a very big part of our compensation system.

But the decision is not in the hands -- the final decision is not in the hands of the line partner. It is not in the hands of the CEO. It is in the hands of our professional practice group.

MR. KOLINS: Can I add just one more thing? There was -- one other mechanism that we put into place several years ago is decisions don't only come at the end of an audit. Significant matters can arise all during an audit, and we want to ensure that the people at the top technical level are apprised of those decisions early on.

So we require a significant decisions memo, a top memo, that encapsulates the decision, the pros and the cons in going through the judgment process. That is sent around the third quarter to the -- whether it's the regional technical director or the SEC review partner, so in the calm of that moment an issue can be addressed rather than in the heat of an imminent filing.

MR. ALLEN: I come back to the opening comments that I was making. They have the support in our firm through the national office review. I do think it is kind of a spot where they can sit back, reflect, and get the support from the firm.

I think also that, you know, because of our compensation structure, the way we equally share, that we don't pay our partner to take those kinds of risks. And so they look at the situation as a partner. They look at it as an owner of the firm. They don't look at it on an individual basis.

When one of the other firms got in trouble and, you know, there was an issue that came out about one of their partners, I got a phone call from one of the retired partners from Crowe who said to me, he said, "Chuck," he said, "I am so glad that we don't pay our partners to take those kind of risks. And it gives me real comfort that my retirement is secure and in your hands." And so that resonated with me, and I communicate that to our people, certainly to the partner group, just as often as I can.

MR. ADAMS: Yes. I would echo most of the comments up here. It really -- it has to be made clear to the partner that they are certainly not alone in making those decisions. And in fact, we have a similar oversight of a partner who is not necessarily involved in that day-to-day client process, but it really oversees them -- oversees the report and the issues as an independent third party, so that we remain and maintain that objectivity before something goes out.

MEMBER HARRIS: I have two messaging questions. And, Mr. Weinstein, you were really very direct in terms of saying that you are aware of the inherent conflicts of interest, to use your words, that your firm takes steps to address them. How do you message that concern? And then, how do the rest of you message that concern if you think there is an inherent conflict of interest?

MR. WEINSTEIN: It is interesting. In a firm like ours, being in the middle market, we do not have any client relationships that are so meaningful to either a partner or to the firm that it would serve as sort of an impediment to being able to do the right thing.

So we face perhaps a different issue than some of the larger firms or some of the firms with larger engagements might face. But in our system of compensation, it is not about your revenues, it is not about your book of business. The first item is quality, the second item is integrity, and then we go from there.

And it is difficult to find another model that would replace the client pay model. So I don't know that there is much of an alternative, other than to stress to your partners that it is not about client retention, it is about the public interest. And we are licensed as a CPA firm, and everything that we have built over the last 45 years in 45 minutes could go away. And everyone understands that.

MEMBER HARRIS: And how do you get that message out, though? I mean, how do you communicate that?

MR. WEINSTEIN: We communicate that directly to our partners in all of our compensation methodology and documentation. We communicate that. I speak to the incoming class of juniors when they start with our firm, and I relay the stories that I learned from Dick Eisner and Ted Levine, who founded our firm, who are outstanding -- outstanding, were outstanding practitioners and outstanding gentlemen.

But the lessons that I learned from Dick and Teddy get conveyed starting with the junior class every year, and they go throughout. So when my time is finished, someone will hopefully convey some stories, some things that I might have done right.

MR. KOLINS: I can just add to that. I go back a little further with -- J.S. Seidman was my mentor, and his mantra was, "Get it right, do the right thing." And that message really has been communicated over the years by the leaders of the firm at conferences, through written communications.

In terms of the nature of our public practice, there is really not a significant amount of non-audit work that constitutes that part of the practice, so those kinds of conflicts aren't very prevalent or potentially prevalent.

And in our partner evaluation process, we have a very big warning sign in the front that the partner cannot get compensated for selling non-audit services to a publicly held entity. So that is a continuous reminder of the potential for that kind of a conflict.

MR. ALLEN: We communicate our core values and the need for quality, you know, consistently. The way I do that is I do a monthly video to the people. I do quarterly webcasts to the partner group. And I even go on what we call a roadshow, where I go to most of the offices once a year and talk to the people about these types of things.

As we have expanded geographically in the last five years -- we have expanded a fair amount geographically -- it has been more and more of a challenge to get the new folks that are joining us ingrained in the culture and the values. And I believe the best way to do that is to continue to talk to them and use the different means of media and social media that are available to us today to do that.

MR. ADAMS: Yes, I agree. A lot of it is in the messaging, the constant reminder and constant attention to ensuring people that they have a professional responsibility, that even consultants and tax people -- and I don't mean to diminish those two areas of our practice because they are very important -- but, you know, they need to understand that there are responsibilities that come with being with a CPA firm.

And so it takes a lot of messaging and constant reminding and, you know, the reputation and brand certainly is what needs to be protected. And that is based on the audit practice, and so that is the foundation of the firm. And it is a continual process that you have to, you know, keep certainly very aggressively doing in a firm -- in any kind of a CPA firm.

MEMBER HARRIS: And then, the second messaging question I had is a follow up to what Jay brought up, and that is how specifically do you message the importance of the investor?

MR. ADAMS: Well, you know, I think it's -- that's interesting, because when it comes to public companies clearly the client is the investor in the audit committee. When it comes to an audit of a privately held company, the investor generally is the management and owner.

So you know, I think that's why we have tended to move more toward having our public company clients audited by a group of our auditors instead of having all of our auditors audit public companies because it is -- you know, not that the audit is different, but the mind-set is a little bit different in terms of who you are really protecting.

And so there is definitely a little bit of a difference there, but clearly the audit -- again, an audit needs to be done right. And it shouldn't really matter who the user is, because it is the reputation of the firm that you are protecting, and you must do the right thing under any circumstance.

MR. ALLEN: I would say that we don't -- we don't differentiate our messaging between type of organization. We try to send a consistent message across the firm in all areas of the practice. But we do not try to differentiate the messaging between one class of industrial organization or another.

MR. KOLINS: We do have internal and external communications that reference the public interest very prominently. And I think that message, you know, does get across to people.

We also have a program within BDO called the Access Program, which works with audit committees in terms of audit committee best practices. And our people -- a significant amount of our people participate in those programs. And a lot of that messaging is to furnish them the type of information they need to run an effective audit committee in the public interest. So I think it gets across from that angle also.

MR. WEINSTEIN: And I would just briefly add in terms of getting that message out that in our internal university we do bring in -- we do bring in very significant outside speakers on an annual basis to address all of our different levels of auditors with respect to their obligations, both to the investing public and to our clients at large.

MEMBER FRANZEL: Since we are picking on words, I just want to add I was pleased, Wayne, to hear you correct your terminology from "client" to "auditee." And perhaps that is more appropriate terminology to be using in these cases.

MEMBER HARRIS: I can't resist the temptation -- I'm sorry, Lew. And then I will have one question, but I want to defer to you.

MEMBER FERGUSON: No, go ahead.

MEMBER HARRIS: Cindy, you are the last day, the last panel, the last person, and so I just wanted to, you know, address one question to you.

After these hearings, I assume that whether we have additional discussions, which I think the Chairman contemplates, I think probably the Board will assimilate everything that we have heard, review it, take the recommendations, and I would actually ask you if you would do the same because I asked yesterday with Mr. Moritz, you know, where there was a recommendation by Chairman Pitt. You know, we thought that might be worth some consideration.

There have been so many recommendations that have been made over these past couple of days that if you might get back to us with respect to what you have heard, and whether there are things that -- in addition to what you have issued in your initial comment letter, I think we would be very receptive to any additional ideas

MS. FORNELLI: We would be happy to do that. We will digest what we have heard, and, like you said, there has been a lot of good -- many ideas that have been put forth that are worthy of consideration. And so we have already begun that. As you might imagine, CAQ staff is here collecting the ideas, and we will, both as the CAQ and in working with our member firms, cull through those and work with outside parties too.

We have already begun our work with the audit committee community. We are really excited about that -- and some of whom were here. We work very closely with NACD, but also Rod Hills' group.

We have been working with them as well as other audit committee organizations to already start looking at what some of these assessment tools could be. So we are happy to share with you what we have heard, what we have digested, and ideas that we have for going forward.

MEMBER FERGUSON: I want to ask you a question that I asked the panel yesterday afternoon. I ask it because I am curious to hear the answers of each of you, and not only because I am a slow learner.

But one of the few things that I

think every panel -- every panelist we have heard in the two days would agree to is the importance of communications between the audit committee and the auditor, and specifically the importance of the audit committee's annual assessment of the auditor. They reassess the relationship every year.

You know, one of the most important pieces of information that is available is what the view of the regulator, the view of the PCAOB is, of each person. I know that at least three of your firms there on the panel are inspected every single year.

Do you share our reports? And specifically, do you share part two of our reports? And not only a summary of them, but do you share the raw report with the audit committees of the public company clients that you audit? And, if not, why not?

MR. ADAMS: We do not share part two of the reports, and I would say it is certainly something that we have started to evaluate the importance of that. But quite frankly, you know, the public clients that we serve, by and large, are smaller.

They really haven't been pushing us very aggressively toward that information, but it is something that we are taking under consideration, and especially based on what we heard yesterday probably accelerates some of that conversation.

MEMBER FERGUSON: Well, do you think it would be useful to them? Whether or not they are pushing for it, do you think it would be useful in their assessment process?

MR. ADAMS: Well, I do. And I think, again, you know, the sophistication of the audit committees is very different. And I think there needs to be -- to me, there is much more of an educational process required, and also, working with management regarding the importance of the audit committee.

So I think in many respects the clear independence of the audit committee from management probably is not as great as it is with larger companies. And so it is very much an educational process in terms of reminding the audit committee of their responsibilities, and management, so that they do take their role a lot more seriously than it is.

And some do. The ones that do, they do ask about it, and we do provide, you know, an overview of what we are hearing from the PCAOB findings. But we haven't shared the actual information.

MR. ALLEN: I would say our process is very similar. We have different levels of sophistication within audit committees. Some of those committees do inquire, and we discuss the part two with them. And some do not, and we do not.

But as Joe said, as I listened to the dialogue here over the last couple of days, it appears to be a best practice that I am going to have some dialogue on when I get back with the folks that have the opportunity to push that forward. So I think it is a good observation and a best practice, and it's something that we should really think about.

MR. KOLINS: We are along the same lines. We are looking at the way that we can communicate, if not the identical language in part two, because there is that -- what was brought up as a point yesterday -- a potential waiver of confidentiality in releasing the actual part two.

But we would like to look at whatever mechanism could be brought to bear to communicate what the findings were and, maybe more importantly, what the remedial actions are and what needs to be done and how it might affect their particular company.

We do get into detail in part one where we actually -- if there is a part one comment that affects that particular issuer, they will know what the comments are very specifically. In fact, they will probably see the written comments and the response to the comments.

MR. WEINSTEIN: Similar to what Wayne just noted, we do share part one comments with our clients. We won't discuss them in detail with our clients, but those comments are readily available to them. In any case, we do not share part two at this time.

We are one of the firms that gets inspected every three years, so we have an opportunity between inspections to remediate anything that may show up in part two. I'm not saying that anything did show up in part two, however.

(Laughter.)

But we have actually not been asked by any of our audit committees that I am aware of. They also run the gamut from very sophisticated to less sophisticated audit committees. They find their own means of making an evaluation of our audit quality. But should someone choose to ask, we would probably share an overview of part two with them.

MS. FORNELLI: And if I could just very briefly talk a little bit about -- that is one of the projects that we have going on that we have begun with the audit committee community, to make sure that they ask those questions and then also to provide a framework to them so that the firms can also have -- proactively describe the audit process or the inspection process and what the findings were.

So creating that framework so that there is that two-way talk, so audit committees are interested but also firms provide the information proactively.

CHAIRMAN DOTY: I think the Chief Auditor has a question. Martin Baumann.

MR. BAUMANN: Thanks, Mr. Chairman. I have been very impressed at many of your comments, all of you, in terms of tone at the top, messaging that you have been giving in your firms, and the overall discussion has been very rich. And so thank you for participating in the panel.

I am also glad to hear -- and I know of the support that many of you have given us in connection with some of our standard-setting on audit committee communications, and we have heard that throughout the last couple of days. And the audit reporting model, we have worked closely with many of you, including the Center for Audit Quality.

We also heard some good ideas here on other quality control issues, and we have a quality control project on -- as you know, on our standard-setting agenda. In that regard, I was particularly interested in a couple of things.

Chuck, I want to talk about, first of all, your third level of review for your issuers. Question one, just curious about the reaction of your clients to the fact that you have a third level of review. Sometimes you see in proposals -- you know, you will get an answer from your engagement partner, he is the person who makes the calls, things like that. So you have a third level of review.

I am just interested in the client reaction to that and wondering, is it -- is it simply -- I don't mean that pejoratively -- review of the financial statements, or do they also ask for some memos, memo on exam kind of things as well? But it is -- so a couple of questions about that, and then I have a followup as well.

MR. ALLEN: Again, we try to provide the right experience to our client through the audit process. And I will tell you that that involves people being on call all the time to make sure that we get to the issues and we get to them quickly.

We have not had -- the pushback I get is not from the clients because it is a high quality solution and it gets to the right answers in a timely manner. But the pushback many times I get is from the partners themselves who, you know, want to continue to move things forward.

But, again, I think it is a good independent dialogue to have. And, you know, at times it bubbles up to my level where, you know, there is issues between the national office review and the partner group. And sometimes it does cause a slowdown in the delivery of the product.

But, again, I think it is something that has served us well for, you know, the 70 years that our firm has been in business, and I've said, you know, it is not something I am willing to change under my leadership. So --

MR. BAUMANN: Thanks.

MR. ALLEN: Certainly.

MR. KOLINS: We have a similar process but with an SEC reviewer, who reviews the entire filing, including, you know, the financial statements and everything else in the filing. And also, that top memo that I referred to before of the significant decisions and, again, getting those around the third quarter of the year.

We find that clients basically appreciate that, because these people can find things, because they are looking at things every day, and they could spot something that perhaps the engagement quality reviewer didn't spot.

And, similarly, from the engagement team's perspective, it is an added bit of insurance for them. So I think it -- from both sides, I think they are very receptive to it.

MR. ALLEN: Marty, I want to come back to the second part of your question. Our audit methodology and work papers are all electronic, and so it is an easy process, because, you know, if I've got someone reviewing a file that is sitting in Chicago that is a national reviewer, he can pick up the file in California just by clicking on the file and he has access to, quite frankly, the entire audit database.

Now, his responsibilities would not be to go through every work paper, but to the extent he wants to look at a work paper he has the ability to do that, if he so chooses -- he or she.

MR. WEINSTEIN: I would just add a comment. We also have a third partner review on every public company engagement. I find that our auditees take comfort in that third partner review. They find that there is a value added to them.

The goal is to get it right, and we find that the auditees appreciate that. And the client service aspect of that is to do it on a timely basis. So we strive to provide the client service aspect of that, while at the same time getting our best and brightest minds to address the most complex issues.

MR. BAUMANN: Thanks. Those sound

like really good practices and food for thought for us.

Another area that was mentioned -- and certainly corporations, businesses put this into place largely after Sarbanes-Oxley -- and that is a hotline for accounting complaints to be made to an independent third party is really a best practice in most companies.

And I hear again, Chuck, that you have that in your company for your audit staff, for anybody to be to call and say if somebody is -- if they see something in the audit area, where somebody is not living the values or not performing in the way in which the culture of the organization is set, to call that independent third party hotline anonymously and be able to report that.

Sounds also good. I would like to hear a little bit more about that. And, again, I wonder how many other firms have put something like that in place as an extra protective mechanism.

MR. ALLEN: We call it Listen Up, and it is actually on our internet site. So if someone has the ability to click on that site, it goes to a third party administrator, and then they register, you know, whatever their issue may be.

It could be an audit quality issue. It could be a discrimination issue. It could be that someone is not being treated fairly. And then, there is a process for, you know, bringing that up through the organization based upon the level of the claim that is being submitted.

And I have oversight. I see each claim that comes through. It doesn't get to me for resolution until certain levels. But we have actually found some situations that have caused us to, you know, take fairly severe actions in regards to not only our people but to some partners.

So it is monitored by an outsider,

and we -- at the end of it, when I do my roadshow, we actually disclose to the people the number of incidents that we had and to some degree, to the extent that we can, how they were resolved. So it is very transparent, and we have found it to be, you know, again, a great way of speaking with our people on a confidential basis.

MR. ADAMS: We really had more of an informal process up until now, in fact, where the expectation certainly was to go to -- generally it's HR is where we have been telling people to go.

But we recently elevated our chief risk officer to the enterprise leadership level in our firm, and one of his tasks that he is now in the process of implementing is a hotline to have more of an external -- you know, external place to go for all of our employees. So we will be putting something in very near term.

MR. BAUMANN: Yes. As I said, it

seemed to be a best practice in corporate America to be able to go anonymously to a third party and not have to go inside.

MR. KOLINS: We also have a hotline which we call "hotline" --

(Laughter.)

-- and that's really used for everything, you know, from harassment to if there is an audit issue. And the audit issue isn't so much I disagree with him about this technical accounting matter, but the partner is putting excessive pressure on me to accede to his request or, you know, he has got -- he is yelling at the staff, those kinds of HR issues, which are very much audit quality related.

And those will ultimately come through the General Counsel's office, and then the management of the firm gets it. And people have been -- had their compensation affected, they have been fired as a result of the finalization of those inquiries, and this seems to work quite well.

CHAIRMAN DOTY: Are there any other comments or questions from Board members?

MEMBER HANSON: I have got one more. I have resisted for the last two days the question that my fellow Board members and staff don't like to hear me ask. It is the question: what is the problem that we are trying to solve? And our guest from the Chamber of Commerce that we treated so warmly just a few minutes ago, he brought up that question of, what is the problem we are trying to solve?

And as I think about it, the symptoms of the problem we are trying to solve are all the findings that we see in the reports. And I characterize what I have heard in the panel here as a lot of happy talk, because I know what your reports say and you know what they say, and hopefully the results in the reports aren't acceptable to you, because they are certainly not acceptable to us.

And we have tasked especially the larger firms with the challenge of, what is your own root cause analysis as to what is causing the problems? And I don't know how many of you we have individually asked that question, and you don't all need to answer this, but if you would just share with us maybe the top one or two things that you think in your firms are the biggest problems that you need to get after and what you are doing about it.

MR. KOLINS: Well, we have gone through -- and I will just give a little bit of background -- we have gone through a significant analysis and surveys, and we are not finished yet. And I'm not sure one is ever finished with the root cause analysis because you have to keep asking yourself the question, why? You come up with a cause, and why did that happen?

And we have met with the inspection staff. I think all the firms are meeting with the inspection staff to go over their own root cause analysis process, and we have done that in detail.

And we look at things like the supervision and review and partner accountability and those kinds of issues. Are those the issues that are central to the deficiencies that are encountered? Because it does go to a root and not just to a leaf on the tree. You really have to dig down and find out what is the central cause.

And it is in all likelihood -- that we have seen so far -- it is not one cause. There are a number of things that need to be addressed to effectively mitigate the problem.

MR. ADAMS: Yes. And I agree with that, and I think it's different on every audit. You know, sometimes it is lack of, you know, experience maybe of a person on the job, and then a miss on the review side. And in other cases it is just lack of expertise in an industry perhaps or awareness of disclosure, and it just -- because of the pressure of getting a report done and out, sometimes those things do slip through.

So I think, you know, the learnings are, you know, what do you do about it, right? How do you ensure that you have enough staff time allowed to get the job done correctly? And so those are the things we are working on.

We are still in a very -- you know, we have a deep dive on root causes scheduled in May, and we have an outside facilitator coming in to really help us with that. And our goal would be to come out of that meeting with a much deeper understanding and hopefully a better course of action on what we are going to do about it.

MR. WEINSTEIN: We haven't identified the specific deficiencies or the root cause of specific deficiencies, but we have put something in place that we hope will address the general concept of increasing audit quality. And what we have done is we have assigned the third partner that participates on an audit completely independent from the EQR, and the client partner also participants in the planning session.

So we have accelerated that process, so that we can identify issues, educate staff early on, and have a real third party independent view in the planning process. And we hope that that will -- we have done that for the last couple of years, and we hope that that will lead to a demonstrable increase in our audit quality.

MR. ALLEN: I would say that since we have been involved with the PCAOB review process, the level of our audit quality has continued to rise. And I said to the examiners that I believe it has been a good thing for us. I do believe that it has enabled us to get our audit practice to a higher level and has enabled us to take our public company audit practice to a level much higher than it was before.

So I view the process as one of continuous improvement, and certainly we have things that we need to work on, and certainly in certain segments of our practice where I think the regulatory environment is held to a higher standard. And we are certainly looking at those issues and striving for ways to improve the methodology, improve those areas where we need to bring a higher level of skepticism to the process.

CHAIRMAN DOTY: Jim?

MR. KROEKER: I think it was David Becker this morning that said an objective dud is still a dud. Maybe as concerning is actually the non-skeptical or non-objective expert in terms of they both pose risk, but an expert in an industry that isn't objective or isn't skeptical might lead to then even worse potential for, you know, bad accounting, bad auditing outcomes.

I have heard a lot of discussion about when there is partner rotation or in the context of engagement acceptance, the necessary trait of having an expert, and that actually serves potentially as an impediment to rotation. I'm wondering, internally, what is done to compensate that objective expert. Is there enough focus on core auditing skills?

Are the compensation structures, not just the technical accounting expert, not just the expert at bringing in the big client, but the core auditor, are you talking to audit committees about you want to hire us, you want this person as your partner because they are going to be like a dog on a bone. Is that the nature of the discussion with audit committees? Or is it more focused on they have the accounting acumen?

MR. ALLEN: Jim, I will tell you

that I believe at one time it was more about the industry. I think today those discussions are really twofold. One is certainly industry expertise, but it is industry expertise in regards to their accounting acumen, as you called it.

And we have moved from a firm that was very industry-focused to a firm that is still industry-focused but now industry-focused in different segments of the practice, that including on the accounting and auditing side.

And so we have made the strategic decision to build our audit practice apart from other segments of the practice, but within that to have industry specializations within the accounting/auditing side of the practice, not necessarily bringing, you know, consultants and those types into that channel, but really doing it within the accounting side of the practice.

And those are the conversations we

are having with audit committees today. They want to know that you have both; it's not one or the other.

MR. KOLINS: I think the conversation with audit committees are different at the inception or not even having gotten an engagement yet versus a year or two or three into the engagement when the audit committee should then be able to see the extent to which the partner is skeptical and is asking for evidence to support an assertion, which is kind of associated with the belief that we have that the audit committee should have either access to or a member that has practical auditing experience that can ask those kinds of probing questions to say, "Well, did you look at this? And did you look at that?"

And we do talk to them about -- we have a professional judgment framework, not quite our own. It was, you know, developed profession-wide as a process to look at the pros and the cons of an issue and what kind of evidence you need to gather to support the assertion. And those are the kinds of things that we do talk to audit committees about.

CHAIRMAN DOTY: Michael?

MR. GURBUTT: Just one question for Wayne. I think you mentioned in your opening statement that there is some bias that still exists in some parts of the marketplace in favor of the larger firms. Do you think audit quality would improve if more firms performed audits of big companies?

MR. KOLINS: Absolutely. Yes, I do. I think there are firms beyond the smaller grouping of firms that are certainly qualified.

We handle a number of very large companies, but there were, you know, several statements I heard yesterday that kind of, you know, provided evidence about there is only four auditors that boards feel comfortable with, comments like that which I jotted down.

I didn't have to go do a study of it. And I think there is a bias that if you are not already familiar with a particular firm that maybe has -- the company has grown, and the firm is able to handle it.

As the company has grown, they are familiar with it. That's fine. But is a new, fresh company coming in, of the same size, going to come to the same conclusion? So it still is a concern, and I think the quality is certainly there for other firms to handle those types of audits.

CHAIRMAN DOTY: Well, you are not the prisoners of this group. You have been very patient. As indicated, it is going to take us a while to assemble all of this information and to get it together. But we will be doing it, and we will be grouping comments and issues and formulated possible solutions to different problems. We will be grouping those topically.

It will be a great help to us to

come back to you and to be sure that we have it right, that we have what you think should be there.

I know -- I think everyone on this dais or on this panel knows what it is like to be the last panel. We have all been there. We have done it. You have done a great job with a tough assignment.

Also, we all appreciate the graciousness that Cindy showed in thanking the staff of the Public Company Accounting Oversight Board.

All of us, all of the Board members, know what a tremendous amount of work went into preparing this, the people outside, the people whom you have seen coming into the building who organized the format, the venue, as well as the panelists. It includes, as was said yesterday, the General Counsel, the Chief Auditor, and members of the staff of all of the Board members, and we are very grateful for it.

But this would not have been a success without you, the panelists. And on behalf of the Board, I want to thank all of you, and the panels that came before you. We will get something out in writing soon to memorialize our gratitude for that. We thank you.

But in the meantime, keep thinking. If in going away, in going about your business, you think of things you wish you had said, would have said, didn't say, write it up and send it to us.

I think we are adjourned.

(Whereupon, at 5:00 p.m., the proceedings in the foregoing matter were adjourned.)

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C E R T I F I C A T E

This is to certify that the foregoing transcript

In the matter of: Auditor Independence

Before: Public Company Accounting Oversight Board

Date: 03-22-12

Place: Washington, DC

was duly recorded and accurately transcribed under my direction; further, that said transcript is a true and accurate record of the proceedings.

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