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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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DAVID M. BECKER, Partner, Cleary Gottlieb
Steen & Hamilton LLP; former General
Counsel and Senior Policy Director,
U.S. Securities and Exchange
Commission

PAUL W. CHELLGREN, Chairman of the Audit
Committee, PNC Financial Services
Group, Inc.

JACK T. CIESIELSKI, President, R.G.
Associates, Inc.

CYNTHIA M. FORNELLI, Executive Director,
Center for Audit Quality

AL GHOSH, Professor of Accountancy, Stan
Ross Scholar, Zicklin School of
Business, Baruch College - The City
University of New York

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

DAVID HIRSCHMANN, President and CEO, Center
for Capital Markets Competitiveness,
U.S. Chamber of Commerce

WAYNE KOLINS, Global Head of Audit and
Accounting, BDO International Limited

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

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

MIA MARTINEZ, Deputy Director for the Black
Economic Council, Latino Business
Chamber of Greater Los Angeles and
National Asian American Coalition

MARY HARTMAN MORRIS, Investment Officer,
Corporate Governance, The California
Public Employees' Retirement System
(CalPERS)

DONALD T. NICOLAISEN, Chairman of the Audit
Committee, Morgan Stanley, Verizon
Communications, Inc. and Zurich
Financial Services Group; former Chief
Accountant, U.S. Securities and
Exchange Commission

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

2 8:45 a.m.

3 CHAIRMAN DOTY: Ladies and
4 gentlemen, it is 8:45 PCAOB time and we have
5 15 minutes before this panel is scheduled to
6 begin. And I thought I would say two things.
7 Welcome. We are very grateful for the
8 attention that members of the audience and the
9 panels gave us yesterday. We believe we had
10 an outstanding day in which we heard a lot of
11 wonderful and stimulating comments from a wide
12 range of participants in the financial
13 services and auditing industry with comments
14 that were not unexpected to us and much of it
15 was comment that we had heard in one form or
16 another before, but we thought it was
17 especially well presented yesterday and it was
18 important to have on the public record.

19 Today, we are continuing with
20 audit committees, with former Commission and
21 accounting officers, and academic opinion. We
22 will move right through these panels. And I

1 thought I would introduce the first panel and
2 we could get going and save a little time,
3 have more time for questions.

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

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

1 the Committee.

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

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

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

14 Paul W. Chellgren is Chairman of
15 the Audit Committee of PNC Financial Services
16 Group. He is the operating partner with Snow
17 Phipps Group LLC, Private Equity. He has
18 served some of the giants in American
19 industry. He's been the Chief Executive
20 Officer of Ashland, a big specialty chemical
21 company. He was involved with McKinsey &
22 Company early in his career, became an

1 operations analyst in the Department of
2 Defense. He has served in senior executive
3 positions with Boise Cascade, Universal
4 Capital. He holds a degree from University
5 College Oxford and he is adjunct professor at
6 the College of Business at Northern Kentucky.
7 So welcome. Welcome to you, Paul.

8 Chairman Hills. Chairman Roderick
9 Hills is a partner of Hills, Stern & Morley,
10 LLP. He is former Chairman of the United
11 States Securities and Exchange Commission, but
12 knowing him as I do, I think that of which he
13 is the most proud is that he is the Chairman
14 of the Hills Program on Governance at the
15 Center for Strategic and International
16 Studies. And he has a very active program in
17 the Peoples Republic of China at this point
18 and spends as much of his time as a
19 distinguished Fellow of the Yale Law School of
20 Organization and Management and a lecturer in
21 the School of Law at Stanford and supporting
22 any number of important initiatives abroad as

1 he does with his law practice.

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

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

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

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

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

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

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

17 We come to the conclusion for
18 several reasons. We start with the absence of
19 any compelling evidence that mandatory audit
20 firm rotation is like to provide meaningful
21 enhancement to our audit quality. On the
22 contrary, we are concerned about the impact of

1 the costs and added risks of mandatory
2 rotation, including the very real risk to
3 audit quality for a period of time following
4 a change in external auditor magnified by
5 making those changes on a regular recurring
6 basis. We're also keenly aware of a wide
7 range of practical difficulties with forcing
8 public companies to change auditors every few
9 years.

10 In our comment letters, we and
11 others have put significant details around
12 these costs, risks, and practical
13 difficulties. Let me focus today on our first
14 objection to mandatory rotation. Frankly, it
15 usurps the role of the audit committee. We
16 believe mandatory audit firm rotation
17 undercuts the primacy of the role of the audit
18 committee in supervising the relationship with
19 the external auditor. One of the important
20 reforms coming out of Sarbanes-Oxley was to
21 put to the audit committee clearly and firmly
22 in charge of the relationship with the

1 issuer's audit firm. Under Sarbanes, the
2 decision to change audit firms is the
3 responsibility of the company's audit
4 committee. In our case, that decision and our
5 annual selection of our auditor is ratified by
6 the entire board and our shareholders.

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

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

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

20 Indeed, five years ago, during my
21 tenure as committee chair, we changed audit
22 firms and thus have a pretty good idea what it

1 entails at a large, complex, financial
2 services company such as ours to change
3 external auditors.

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

1 firm.

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

7 CHAIRMAN DOTY: Thank you.

8 Chairman Hills.

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

1 back in 1976, '77.

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

13 I think it's fair to say that was
14 the first time the SEC took seriously the
15 question of auditor independence, the first
16 time that somebody said you guys are supposed
17 to protect that independence. Twenty-five
18 years later, Enron, Global Crossing, Waste
19 Management gave us Sarbanes-Oxley which has
20 some of the DNA of what was done back in the
21 '70s at the SEC. In particular, as Paul said,
22 put new responsibility on the outside audit

1 committee.

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

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

18 The better way to protect the
19 independence of the auditors is to enhance the
20 independence of the audit committee members.

21 Let me quote from a report on corporate
22 governance of the Committee for Economic

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

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

1 committee members have appropriate
2 independence.

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

21 Mandatory rotation would make
22 salesmanship the single most important quality

1 an audit committee partner. Think of the
2 chaos that mandatory rotation would cause, 7-
3 year rotation, 14 percent of all clients would
4 have to be kicked out every year and to
5 maintain the integrity of the firm you'd have
6 to get 14 percent in. You can just imagine
7 the swaps that would occur. Who are you
8 losing this year? What is our chance of
9 getting him? You have non-audit fees. You're
10 losing an audit partner. How long is it going
11 to take the audit partner to try to figure out
12 a way to get the assignment for non-audit
13 fees?

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

19 CHAIRMAN DOTY: Thank you. Cathy
20 Lego.

21 MS. LEGO: Thank you, Chairman,
22 and thank you, Board, for having me here to

1 participate as an audit committee chair. I
2 have chaired audit committees of private,
3 small companies in my capacity as a venture
4 capitalist for 25 years. In the most recent
5 time, I've been the audit chair of a number of
6 public companies and the current two public
7 companies are large multi-national
8 corporations.

9 I appreciate a chance to also tell
10 you our goal is the same. As the audit
11 committee chair of a company, it is the
12 integrity of the financials and the
13 information that's provided to shareholders
14 which is our number one objective is to ensure
15 high quality, to ensure that we have hired and
16 retained and evaluate the external auditors
17 that are independent, are skeptical, and can
18 provide the judgment on the other side of
19 management's judgment on all of the items of
20 revenue recognition and tax and the complexity
21 of the financials to the point where unless
22 you're extremely current on today's financial

1 standards, you need these professionals to
2 give you as an audit committee member
3 guidance.

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

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

21 Yes, we have brought new firms up
22 and that first year takes more time. On the

1 audit committee, it takes more time on behalf
2 of the financial staff of the organizations.

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

13 I'm concerned about the costs
14 increasing because as I've asked people, the
15 bidding process is not one of no cost. The
16 cost of supplying the audit committee chair
17 with a quality bid could be 5 or 1,000 hours
18 of a firm's time. That will be embedded in
19 everyone's costs. If we're adding more
20 rotation, we're going to see a lot more
21 bidding and lot more time to bring the
22 financial team into the bids as well as

1 bringing up the new partners. So I'm
2 concerned with more cost to companies where we
3 already have significant costs in this area.

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

22 I do underscore rotating people

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

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

1 but we do do it.

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

13 The audit committees have really
14 stepped up their game in the last ten years
15 from merely attending quarterly meetings to
16 review the financials and discuss the judgment
17 items with the outside auditors. The number
18 of meetings we have is enhanced by quarterly
19 meetings with internal audit, quarterly
20 meetings with internal compliance, reviews of
21 auditors, references of partners, interviewing
22 new partners of rotation. The amount of time

1 it takes to be an audit committee chair, an
2 audit committee member is increased
3 significantly.

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

17 What I would like to see is and
18 encourage the PCAOB to dialogue with us,
19 what's on your mind? If pricing policies is
20 the issue, you're going to discuss this year,
21 let us scope it in. Let us set the scope at
22 a higher bar. Let us view what you have

1 before the audit takes place, before your
2 review takes place. Work with us.

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

8 CHAIRMAN DOTY: Thank you. Alex
9 Mandl.

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

20 One of the advantages of being
21 around for a while is that you have seen,
22 there's this whole topic that's evolved over

1 many years and I have been part of audit
2 committees in one form or another for more
3 than three decades. And so with it, I have a
4 bit of a perspective as to how things have
5 evolved.

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

20 So the point is the audit
21 committee today has -- and there's always room
22 for improvement -- but the audit committees

1 today do have real accountabilities, real
2 responsibilities, and take their job very,
3 very seriously. I'm not saying 25 years ago
4 people didn't take that job seriously, but
5 there's a different degree of sincerity, of
6 commitment, of homework, of gathering the
7 right resources and I guess the point is and
8 it was made before, don't change that. I mean
9 taking that away from what has evolved to be
10 a really solid resource in the overall
11 governance process I think would be a mistake
12 and mandatory rotation would, I think, take
13 some of that way. So that's one point I
14 wanted to make.

15 The second point I was going to
16 touch on relates to the institutional
17 knowledge topic. I've been with Dell now for
18 a long time. I won't tell you exactly how
19 many years, but I'll tell the revenue of Dell
20 when I joined was \$3 billion and it's roughly
21 \$65 billion this year in that range.

22 (Laughter.)

1 CHAIRMAN DOTY: That is not a Reg
2 FD violation.

3 (Laughter.)

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

6 (Laughter.)

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

21 So the institutional knowledge
22 that gets developed over time by virtue of a

1 firm being closely involved with many people
2 over a longer period of time is something we
3 need to respect and something we need to
4 appreciate in the context of assessing the
5 quality of the work that gets done.

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

12 CHAIRMAN DOTY: Thank you. Rich
13 Roedel

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

22 I spent the first 30 years, three

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

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

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

22 One thing we mentioned as the

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

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

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

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

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

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

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

20 In closing, we applaud the efforts
21 of the PCAOB and the audit firms to continue
22 to improve the quality of financial audits for

1 the benefit of our investors. Thank you again
2 for the opportunity to present the views of
3 Lorillard's audit committee.

4 CHAIRMAN DOTY: Thank you all.

5 It's been my practice in the meeting to call
6 on my colleagues on the Board first, but I
7 want to make an exception here because there's
8 one overhanging question that comes out of all
9 of your comments, I think.

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

21 Are you concerned or does it
22 remain an issue as to whether independence

1 should be in the terms of the audit committee
2 and in terms of the reevaluation, should be
3 assessed by us in a review, retain, and
4 explain format. We heard a lot about this
5 yesterday. In other words, would you be of
6 the view that audit committees should disclose
7 how often they review. If they don't review
8 in say 15 years, that somehow this Board
9 should make a judgment, a presumption, a
10 rebuttable presumption about the independence
11 of the auditors and require them to review.
12 And if not reviewed, and if retained, and not
13 explained by the audit committee, then we
14 would have a more questionable set of facts.

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

18 MR. HILLS: I think that in simple
19 terms an audit committee that does not do
20 exactly what you suggested, constitutes a
21 material weakness in the internal controls of
22 the company. It's something that is

1 actionable. Frankly, the auditor should be
2 responsible for checking it. It is -- I don't
3 see it as anything different from anything
4 else you send your auditors for. The auditors
5 have material weaknesses in the way they do
6 the books, you say something about it, and ask
7 them to fix it.

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

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

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

6 Cathy?

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

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

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

20 MR. CHELLGREN: Cathy made, I
21 thought, a good point. This is not a static
22 situation. There are at least three sets of

1 interpersonal dynamics that work here, changes
2 within company management, CEO, CFO,
3 controller, senior accounting personnel,
4 number one. Number two, changes in the board
5 and the audit committee composition. And
6 three, with mandatory engagement partner
7 rotation, changes in the external auditor
8 staffing as well. So those dynamics are going
9 on on a regular recurring basis.

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

13 Rich?

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

1 independent auditors.

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

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

18 In specific answer to your
19 question, maybe the place for the audit
20 committee to tell its investors what it has
21 done is in the audit committee report that
22 finds its way into a proxy. So maybe as part

1 of our communication the audit committee's
2 communication with investors is a place for us
3 to say what we've done in context of
4 exercising those ownership rights and
5 obligations.

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

10 Alex?

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

17 The additional comment I would
18 make, however, is beyond that annual review
19 that should go on at the audit committee and
20 ensure that the audit function, the external
21 audit function is being performed the right
22 way, there should also be another level of

1 question or concern and that is some kind of
2 event, a merger of the company, or an
3 accounting, a serious accounting problem, or
4 some extraordinary event whereby that would
5 trigger an even more comprehensive analysis
6 and review of the audit committee to assess
7 whether or not the current provider of those
8 services is still appropriate.

9 CHAIRMAN DOTY: It may happen for
10 these other reasons.

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

20 MR. ROEDEL: One other point, Mr.
21 Chairman, it also, this annual review I think
22 is important because it also underscores what

1 we're talking about here. And that is that
2 the audit committee owns that relationship.
3 And for us to exercise those rights and
4 obligations and annual review of the firm's
5 performance is paramount because it
6 underscores where the relationship exists
7 between audit committee and auditor and not
8 financial management and auditor.

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

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

17 And certainly, one of the things
18 that I've observed both in this position and
19 in many, many, many years of private law
20 practice is that in the thousands of U.S.
21 public companies, the skill levels of audit
22 committees varies widely. There are many

1 audit committees that simply have neither the
2 skills nor perform the diligence that's
3 necessary to do the kinds of things that you
4 do which I applaud. I mean I think certainly
5 the structure is in place to provide adequate
6 oversight if it's done. So how do we deal
7 with that?

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

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

21 I think a good audit committee
22 charter says that every five years, give or

1 take, six years, four years, seven years, they
2 must go through a procedure to test the
3 efficacy of the auditors and the independence
4 of the auditors.

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

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

21 You mentioned, Mr. Ferguson, the
22 structure to do all of this exists at the

1 moment. Audit committees, if they're
2 knowledgeable, if they're experienced, if they
3 are truly independent, if they're engaged, if
4 they take their job seriously, if they have
5 the right skills and experience resident on
6 that committee, can really do an effective job
7 in managing and therefore mitigating the
8 issues that concern all of us here today and
9 that is making sure that there's an
10 environment where there is healthy skepticism
11 and undying independence.

12 And so I think the structure
13 exists. Audit committees, I think Alex
14 mentioned it before, audit committees are so
15 different today. The first 30 years of my
16 career, as I've mentioned twice already, was
17 on the other side of this issue. I saw audit
18 committees. I saw how they were constructed.
19 I saw what they did, and sometimes I saw what
20 they didn't do. The audit committees that I'm
21 associated with, the people that I know who
22 are in positions similar to mine, suggest that

1 there has been a huge, a huge amount of change
2 in the quality of those audit committees and,
3 importantly, how they execute their fiduciary
4 responsibilities.

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

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

19 I think it's important really in
20 the role of the chair to assure that the
21 constitution of his or her committee is of
22 people who can bring the skepticism, can bring

1 the talent, so that it's not one financial
2 expert's view. So I just don't want it to be
3 do you have these people that can do this.
4 The board should be looking at it do we have
5 the people who are doing this. Thank you.

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

15 But to Catherine's point, there's
16 a necessary second step. And that's the
17 annual evaluation process that if performed
18 with some independent resource from the
19 outside usually, that really assesses how are
20 these committees performing including the
21 audit committee. I think the combination of
22 those two factors I think can address your

1 point. There's always room for improvement,
2 and I'm not disagreeing with you that there
3 are some audit committees that clearly
4 probably are not at the peak level. But if
5 you have that kind of process in place and
6 provide assurance that that process is
7 working, I think that's a way to address your
8 question.

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

21 CHAIRMAN DOTY: Steven.

22 MEMBER HARRIS: Chairman Hills,

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

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

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

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

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

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

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

1 and often does.

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

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

1 independent sources.

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

6 CHAIRMAN DOTY: Jay?

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

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

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

16 So, one, I'm trying to get your
17 blood pressure to react to that a little bit,
18 but, two, I've got a very specific question.
19 If you could -- well, many times the report
20 that gets included in the proxy kind of looks
21 like boilerplate, and you kind of question
22 what was behind it, and when things are going

1 well, everybody is happy. That's one thing.
2 But could you provide some examples of
3 situations where you had to kind of call an
4 auditor to task over their objectivity or
5 skepticism or independence and you were kind
6 of on the bubble about are we going to get
7 there or not and maybe some of the real color
8 behind how you discharge your
9 responsibilities. That's my real question.

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

22 The main point I think that's come

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

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

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

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

18 But I would argue that the world
19 has changed a great deal in the last 10 or 12
20 years since the implementation of the
21 Sarbanes-Oxley Act which was an
22 extraordinarily important piece of

1 legislation, I believe. I've seen it in
2 operation for over a decade now. And as the
3 world has changed, so has the audit
4 committees.

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

13 So the question is how do you make
14 that work? Mr. Ferguson said before, and I
15 agree, that the structure is well in place
16 today for audit committees to be highly
17 effective and to make a difference in the
18 areas that we're speaking of today. And I
19 think that there are several things that
20 contributed to that. But first and foremost
21 it's the development of the relationship
22 between the audit committee and okay, it's

1 chairmen, but the audit committee in general
2 and the independent auditor. There's got to
3 be a high level of frequent and transparent
4 communication between the audit committee and
5 the independent auditor fostered by reviewing
6 objectives and audit plan and reviewing
7 performance at the end of the year and
8 approving, negotiating and approving audit
9 fees. But there has to be this high level of
10 communication so that the auditor knows what
11 is of concern to the audit committee and the
12 audit committee understands what's of concern
13 to the auditor. Those communications are
14 taking place routinely through the year, and
15 if they're transparent, then a lot of what
16 we're discussing here today is mitigated by
17 that process.

18 MR. CHELLGREN: Thank you. You
19 made what was clearly an effort to create some
20 debate in terms of this provocative comment
21 that you heard yesterday. I was not present
22 during that, but I would be interested and if

1 you will, the experience and judgment of the
2 individuals making those comments and how
3 current they are in terms of today's
4 situation. Because as many of my colleagues
5 have observed, the situation has changed quite
6 dramatically over a relatively short period of
7 time.

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

17 To some extent, also to the point
18 that Commissioner Ferguson made, that there
19 are more general criticisms or comments of
20 boards generally. I think my observation, I
21 haven't been on nearly as many public boards
22 as some of my colleagues here, but I've been

1 on six. In some ways the audit committees
2 today are the most robust committee of all the
3 committees on the board for a lot of reasons.
4 And Sarbanes-Oxley was a big part of it. The
5 requirements for audit committee financial
6 experts, the requirements for financial
7 literacy on all members of the audit
8 committee, the roles of the external auditors,
9 the increased robustness of internal audit in
10 almost all of our firms.

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

22 MR. HILLS: I hope I didn't leave

1 the impression that I thought things were just
2 fine.

3 (Laughter.)

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

16 And I think yesterday we heard a
17 large number of various viewpoints and various
18 suggestions that were brought to bear in terms
19 of things that the profession might want to
20 think about doing on their own or that we at
21 the PCAOB ought to think about doing, but I do
22 get the impression from this panel that

1 virtually the status quo is fine. And as
2 everybody in the -- not everybody, but the
3 leaders of the profession and investors all
4 would tell us, the status quo is not an
5 option. There ought to be change.

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

18 But if you could respond to the
19 comments that Jay teed up and I'm following
20 up, what specific changes are you recommending
21 except for enforcement of charter provisions
22 with respect to audit committees, and how can

1 we move the process forward a little bit?

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

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

19 I said yes there's a couple of
20 reasons. But if you have read that testimony
21 of ten years ago, one part said that the audit
22 had become a commodity with no intrinsic

1 value. I think Sarbanes-Oxley largely fixed
2 that. I think the external audit has become
3 more of a management tool today.

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

12 The notion that the audit
13 committee is looking at numbers and the notion
14 that the auditors are saying these numbers are
15 correct is at the heart of the mischief we
16 have. Most of the numbers on a financial
17 statement are forged out of the assumptions
18 and -- estimates made by management and looked
19 at by the auditors. It's not clear to me at
20 all that a whole lot of audit committees sit
21 down with the auditors and say what were the
22 alternatives available to management in

1 creating that financial statement? What was
2 the range of alternatives? What was the range
3 of discretion?

4 Even the most honorable of
5 management has enormous discretion in the
6 numbers they put up there. And bringing in
7 the audit committee into the room of the
8 auditor to say okay, of these alternatives
9 management has picked fair ones is an area
10 that's almost left untouched. And bringing
11 the auditors into an audit report to say
12 exactly what they've done in this respect, it
13 seems to me important, and particularly
14 important for the auditors to say that they
15 have examined these alternatives with the
16 audit committee and what they've done is
17 attest to the fact that the process used to
18 get these numbers was fair and the audit
19 committee examined that process. That's a
20 realm that should be more used that's not
21 used, but I think when you heard from
22 everybody here that you have several

1 mechanisms at the PCAOB to move the standard
2 up to the kind of standard that I think all of
3 us here share.

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

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

22 I do think though that there is

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

10 My understanding was that -- and
11 I'll ask a question of the chairman, my
12 understanding was that the inspection process
13 did ask the question about effectiveness of
14 audit committees. I've been called once to
15 explain what we do and maybe what we don't do,
16 but only once during the process. So I think
17 that that's another way for the PCAOB to gain
18 an understanding of whether this structure,
19 which we've all argued can and should work to
20 promote skepticism and independence is, in
21 fact, working. And I think the auditors in
22 the conduct of their audit ought to be asking

1 that same question as well because the conduct
2 of an audit committee is paramount to doing
3 their job right.

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

14 I would love to be able to say
15 well, while you're in there, take a look at
16 this because that's part of what our role is.
17 I don't think every audit committee works at
18 the level it could work. I don't -- from my
19 meetings with roundtables, there are a lot of
20 people who don't know what to do. They're
21 poorly trained for their role. I think the
22 PCAOB could, with the NACD, come up with what

1 are best practices, assure people who are new
2 to the role, there are people new to audit
3 committee participation who don't know how to
4 conduct an internal review, who have never
5 done forensic analysis, who don't know really
6 what they should do with FCPA, how to assure
7 that. They don't know what to do with the IT
8 department within organization and how to test
9 it and what to do with many elements because
10 they've never seen it.

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

1 to you. That's your responsibility.

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

8 CHAIRMAN DOTY: That is very
9 interesting and helpful.

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

14 Go Jim.

15 MR. KROEKER: I certainly didn't
16 want to get in front of Board Member Franzel,
17 but I just had a follow up as to whether or
18 not and we heard a little bit yesterday that
19 information might not be readily available or
20 enough information might not be available for
21 audit committees in making an assessment about
22 retention of auditors including information

1 about the PCAOB's inspection findings. And so
2 just the perspective of audit committee
3 members of whether you're getting enough
4 information in making those assessments.

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

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

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

1 2 is something that we pay a bunch of
2 attention to.

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

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

19 I guess what I would like to ask
20 each of you is what are the specific actions
21 that PCAOB or SEC or others could take to help
22 ensure consistent strong performance of audit

1 committees out there, to do some of the best
2 practices in terms of the annual review of the
3 audit firm's performance, the oversight of the
4 audit firm's independence, et cetera, how do
5 we get that in place across the board?

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

1 balanced is absolutely critical, well balanced
2 and knowledgeable and certainly engaged.

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

15 Second, I go back to the audit
16 report contained in the proxy. It may be the
17 place that audit committees are obligated to
18 tell more than they're telling at the moment,
19 not only about their relationship with the
20 outside auditors and how they effect those
21 responsibilities, but two, how they execute
22 their responsibilities and what processes they

1 employ in that context. So I think some of
2 what you need to know can come from the audit
3 committees themselves, both through your
4 process and through communication of audit
5 committees to the investor in the proxy.

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

14 Number two, clearly audit
15 committees need ongoing training, continuing
16 education, professional standards, if you
17 will, along the lines that has been discussed
18 earlier. We made a suggestion that within the
19 external auditor, there could be in addition
20 to mandatory rotation of engagement partner,
21 there could be some mandatory rotation of the
22 consenting review partners, for example, as

1 another more mechanical kind of thing to help
2 ensure independence and skepticism and
3 professional changes.

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

16 Chairman Hill made the statement
17 that he wasn't sure we really get involved in
18 more granular analysis of certain accounts.
19 I know in our business and when you're in a
20 regulated business you know we have a \$160
21 billion loan portfolio and a \$60 billion
22 securities portfolio. At every meeting we

1 review provisions, allowances, charge offs, in
2 our loan portfolio and valuation issues in
3 Level 2, Level 3, and our securities
4 portfolio. I mean that's the fundamental
5 assets of the organization. We really try to
6 look at that on a reasonably granular kind of
7 a basis.

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

19 MR. HILLS: To be simple about it,
20 I think you need to have a charter that is
21 precise about what audit committees should do,
22 and you have to have a way of judging whether

1 the charter is being complied with. I think
2 that's the weapon that the PCAOB has and I'll
3 say it again. I think that until we change
4 the way in which members are selected for
5 board membership, you're not going to have the
6 degree of independence you need for the
7 objective you're seeking.

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

22 We'll always see some human error

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

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

14 MR. MANDL: I just wanted to take
15 a minute and come back to Mr. Harris's point
16 earlier which was that this panel seems to be
17 saying everything is rosy and everything is
18 okay. And I don't want to speak for the
19 panel, but at least my strong sense is that
20 the main point is a lot of progress has taken
21 place in the last ten years, and I think we
22 should feel good about that and no doubt about

1 that, but it's progress. And it does not
2 suggest that all is perfect, that every audit
3 committee performs at a peak level, that
4 everything is hunky dory or words to that
5 effect.

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

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

20 MR. BAUMANN: Thank you, Mr.
21 Chairman. I, too, would like to thank all of
22 the panelists for the great insights that

1 you've shared with us today.

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

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

20 Your letter to us, and thanks for
21 the letter, but among other things the letter
22 says "we're concerned that it is likely that

1 rotation will result in more errors and less
2 effective audits in the early years of an
3 engagement due to the learning curve of the
4 new auditor." So you expressed the same
5 concern.

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

12 (Laughter.)

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

21 But going back to that concern you
22 expressed and others have expressed that even

1 in a voluntary environment, what did your
2 audit committee do and your auditor do to
3 mitigate that significant risk we've heard
4 about that there could be less effective
5 audits in the early years after a rotation.
6 And even if we're in a voluntary rotation
7 environment which we are today, as the Chief
8 Auditor and head of standard setting of the
9 PCAOB, do we need to set additional auditing
10 standards or additional requirements in the
11 early years of an audit because of these
12 increased risks that so many expressed
13 yesterday and you expressed in your letter.

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

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

22 The reasons that triggered the

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

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

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

20 So we've implemented the strategy
21 that the board collectively had embarked upon.
22 So frankly, we wanted an organization that

1 could help us move to the kind of level we
2 wanted to be as an organization. We also
3 found, frankly, our list of potential
4 candidates to use was relatively short. We
5 had some issues with one of the other Big Four
6 firms. Frankly, in the banking business, one
7 of the other Big Four firms, we were their
8 lead bank and we were their recommended bank
9 for their partners and their partners' lines
10 of credit, and we and they decided that they
11 didn't want to make all those changes nor
12 necessarily did we, so therefore we were left
13 with two potential candidates.

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

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

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

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

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

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

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

20 MS. LEGO: Maybe I just can add
21 that you do have a risk at the staff level.
22 The work papers are new. They don't know the

1 process. They don't know the people. So the
2 time commitment is much larger, and the risk
3 of something not getting revealed or
4 questioned because there's a lot of new people
5 could just be one issue. The other issue is
6 the staff people are spending more time
7 bringing these people, doing the flow charts
8 again, doing the work papers again, and they
9 don't have their eye on the ball at the
10 company during that period of time. So I
11 think that adds a bit of a risk.

12 CHAIRMAN DOTY: We began this
13 panel a bit early. We have a little bit of
14 time here, but if we broke, if we took a break
15 at 20 past, we could stay on schedule. It is
16 10:12 PCAOB time. Why don't we see if Board
17 members have any other questions for about
18 five -- an additional five minutes or eight
19 minutes of questions.

20 Jay?

21 MEMBER HANSON: One question and
22 I'll start with an observation that many have

1 observed that the A in our name, the Public
2 Company Accounting Oversight Board is kind of
3 a misnomer because we regulate auditors, we
4 don't regulate accountants. And what's
5 interesting is in your comments you've made
6 about the discussions that you've had with
7 your auditors it's generally about accounting
8 matters.

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

18 So my question for you, and you
19 don't need to all answer this, just maybe a
20 couple of observations, in your discussions
21 with your auditors, how much time do you spend
22 talking about what they do to audit the

1 complex transactions and the reserves and the
2 fair value of the financial instruments and
3 the leveling of the financial instruments
4 versus the accounting and disclosure? And has
5 it changed over time at all?

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

15 And then all during the year, each
16 and every year, we take the most critical
17 portions of our accounting, those that require
18 the most -- the exercise of the most judgment,
19 and we talk about that collectively. We talk
20 about that from the internal perspective,
21 about the choices of accounting policies,
22 about controls over the accounting for those

1 areas. We talk about what we can do from an
2 internal control perspective to make sure that
3 our controls are right and then in that same
4 room, in that same discussion are our external
5 auditors are talking about what they do to
6 make sure that financial management has gotten
7 it right.

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

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

1 make sure we understand the alternatives.

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

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

20 Let's take a ten-minute break.
21 We'll get back here and get started with three
22 of the SEC and accounting world's rock stars

1 at 10:30. Big panel coming up. Thank you.

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

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

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

16 David Becker, Partner of Cleary
17 Gottlieb Stein & Hamilton, LLP, former General
18 Counsel, Senior Policy Director of the United
19 States Securities and Exchange Commission. He
20 has the distinction of having served two
21 chairman in two different stints in that
22 office and having distinguished himself as

1 being one of the great sources of wisdom for
2 the Commissioners and the staff.

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

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

20 He serves in a variety of advisory
21 capacities to other Fortune 25 companies, and
22 there is no major financial service

1 institution I think in the world that hasn't
2 wanted Don Nicolaisen's advice both when he
3 was the Chief Accountant and later and
4 otherwise.

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

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

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

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

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

18 The views I express today are mine
19 alone. They may or may not coincide with the
20 views of others. Experience suggests they
21 rarely do. But they are not intended to
22 reflect the views of any persons with whom I'm

1 associated or have ever been associated or any
2 of my former or current clients.

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

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

15 The second point is that unlike
16 most of the existing independence rules, a
17 requirement for firm rotation would not
18 address relatively narrow circumstances that
19 are thought to raise significant risk of
20 auditor bias. For the most part, the existing
21 independence rules prohibit the auditor from
22 having relationships with the audit client

1 that in the opinion of regulators are likely
2 to breed a pro-management bias in the auditor
3 and, as a result of the bias, a loss of
4 professional skepticism.

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

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

18 What the proposal -- or what the
19 proposal under discussion seeks to do is to
20 lessen that leverage by limiting what an
21 auditor stands to lose if management were to
22 contrive to get her replaced. Cost aside, I

1 would think that it is much harder to
2 demonstrate the utility of this approach than
3 one that is more narrowly drawn to problematic
4 relationships.

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

19 I'm not sure how the Board or any
20 regulator or any group of five lawyers and
21 auditors can sense how much isn't too much at
22 risk to preserve an unbiased and objective

1 mind. But even if the Board could sensibly
2 draw that line, I can't see how it could be
3 done on the basis of years as opposed to some
4 other measurement, like dollars, as to what's
5 at risk.

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

17 The third point I want to make is
18 that independence is not the same as
19 professional skepticism. Independence is an
20 absence of bias. The absence of bias is
21 distinct from the presence of other necessary
22 attributes for professional competence. Bias

1 in favor of or against client management is,
2 if it's significant enough, disables the
3 auditor from acting with professional
4 skepticism.

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

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

21 It's important for the Board to be
22 able to articulate the dangers it sees fully

1 and to draw the connection between the dangers
2 it sees and the remedy that it is proposing.
3 And that's why this is not merely a pedantic
4 distinction, but I think something that the
5 Board should take into account in deciding
6 what to do.

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

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

20 Now after I've said finally I have
21 one last point. The Chief Accountant was kind
22 enough in his gracious way to point out an

1 error in my written statement and I would like
2 to correct it. I said I was concerned about
3 lack of consultation at the Commission.

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

11 CHAIRMAN DOTY: Is the apology
12 accepted?

13 MR. KROEKER: Absolutely.

14 CHAIRMAN DOTY: Yes. Don
15 Nicolaisen.

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

1 long period of time.

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

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

18 That, to me, is just unbelievable
19 and incomprehensible that in today's
20 environment that someone would rely -- that an
21 auditor would not audit. That they would rely
22 on the representations of management without

1 doing any testing.

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

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

19 As far as the concept of requiring
20 all firms or some firms to rotate audits
21 outside of the judgment of the audit
22 committee, it seems to me that that's a very

1 blunt instrument. That essentially throws out
2 the good to deal with what are perceived to be
3 bad situations, situations where auditors are
4 not independent. And it may well result in
5 unintended consequences, including a firm that
6 has a good auditor, that has a challenging
7 environment, being replaced by one of those
8 firms whose culture you've described in the
9 Concept Release as lacking.

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

1 be able to simply plug in and replace an audit
2 firm.

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

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

19 Midway through, if the firm starts
20 to lose some of its talented people, I would
21 be concerned whether they would be replaced.
22 I'd be concerned whether if technology changes

1 and new ways of auditing are introduced,
2 whether there would be an investment appetite
3 by a firm to put that in place to make that
4 work. At the end, I'd be concerned that staff
5 partners in the firm would be looking for the
6 next client to serve and would be fixated more
7 on that, or possibly equally on that, as they
8 are on the audit itself.

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

16 I really like the idea of the
17 audit partners signing the opinion. I like
18 the idea of better training. I think that
19 stronger enforcement actions, where you find
20 situations where an auditor is not
21 appropriately performing an audit, that that's
22 perfectly doable. In extreme situations you

1 may even choose to put a monitor in over the
2 firm to make sure that they do the things that
3 you've required them to do.

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

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

17 CHAIRMAN DOTY: Thank you.

18 Mr. Pozen.

19 MR. POZEN: Thank you this
20 opportunity and I have a lot of sympathy with
21 the Board. Yesterday it seemed like you heard
22 a lot of people who were saying that the

1 auditors were too beholden to management.

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

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

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

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

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

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

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

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

16 And, third of all, it's been my
17 experience, and I have run RFPs when I was at
18 Fidelity, when I was running that board
19 process, that it does have some real benefits.
20 The auditors, even if they're chosen again,
21 pay a lot more attention. You do get better
22 focus, better quality and, quite frankly, you

1 get lower fees. So that seems like a good
2 thing.

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

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

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

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

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

21 But I believe that's a solvable
22 problem. It's a solvable problem. First of

1 all, I think you have very good bidding
2 process if you have the existing auditor in
3 two firms. And, second of all, I think PCAOB
4 would have to come out with some rule that
5 says even though you had done non-audit
6 services in the last year, that's okay because
7 now you're in a different role.

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

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

20 So my answer is, if the auditor is
21 selling the firm and how good they are and
22 what a good job they are to the audit

1 committee, that's a good thing, because we
2 want that audit committee to feel that these
3 auditors are really helping them hold
4 management accountable. And everyone on an
5 audit committee knows that there's limit to
6 what you can know on an audit committee. And
7 you really need the help of the external
8 auditors. And you want them to feel really
9 that they're accountable to you and that
10 they're going to do a really good job for you.

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

22 So we eliminate those problems

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

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

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

21 CHAIRMAN DOTY: Thank you all,
22 Jeanette Franzel.

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

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

19 MR. BECKER: I'm all for it. I
20 think it's a fine idea. I think it's probably
21 something that would -- there may be some
22 legal issues with it, but I haven't thought

1 very hard about it, and there may be ways to
2 get from here to there. I don't think -- I
3 mean, the Board doesn't have direct authority
4 over audit committees. Whether you could get
5 there through requirements for auditors, I
6 suspect you could.

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

16 But even the rules that the Board
17 has are media for expressing values,
18 expressing the Board's view, backed with some
19 coercive power as to what folks ought to do.
20 I think regulatory bodies including the Board,
21 including the SEC, tend to underestimate the
22 values of their communicative processes, all

1 of which is a fancy way of saying, I think
2 it's great. I think you ought to be talking
3 to audit committees. You ought to tell them
4 what you're seeing, what you're concerned
5 about and what you think they ought to do.
6 And you'll learn in the process.

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

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

22 As far as periodic tendering of

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

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

18 And, in part, it's because perhaps
19 one or more firms are doing other work that
20 would disqualify them as independent. Or one
21 of the firms audits a subsidiary on behalf of
22 another investor where you have a joint

1 venture operation and both parties want their
2 own auditors looking at things. So you
3 wouldn't -- you can't in those situations just
4 replace in kind with that firm.

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

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

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

21 In terms of disclosure vis ... vis -
22 - I agree with both Don and David. As a

1 member of the audit committee, you sort of
2 feel like you get a very -- I don't know --
3 summary would be actually too broad a word.
4 You get this slice of what happened. You know
5 your auditor comes and tells you, "Well, the
6 PCAOB, I can't really tell you what happened,
7 but it wasn't so bad."

8 "Was there any problem?"

9 "Well." It's all very vague.

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

20 I would encourage the Board to try
21 to figure out some sort of communication
22 vehicle that would give audit committees more

1 specific information and would yet not violate
2 the rights of other people. And I think every
3 audit committee would really welcome that.

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

8 Jay.

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

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

19 And I'm just having a hard time
20 wrapping my head around the tendering process
21 when a firm would credibly have to effectively
22 figure out in those 75 countries do they have

1 the right resources, do they have any
2 independence issues and effectively what would
3 it take for multiple firms to be ready to say,
4 "Yes, I can do this around the world," and
5 whether that effort could be expended in a
6 different way to get to the same objectives.
7 I just maybe pose that as an observation.

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

14 But then a second question, you've
15 mentioned a benefit of the tendering process
16 of reduced fees. And I'm having a little hard
17 time reconciling that with the idea that
18 auditors are under a lot of pressure already
19 with fee issues. And we're giving them a lot
20 of pressure to do more because they're not
21 complying with the standards as they are
22 written today and the world is getting more

1 and more complex. So just curious as to your
2 thoughts about the reconciling of the audit
3 quality concept with reduction in fees.

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

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

20 As to the question of fees, I
21 think every audit committee is engaged in sort
22 of hand-to-hand combat with their auditors on

1 fees. I'm sure Don is, too. And that
2 involves a lot of things, scope, how much will
3 be done by internal auditors, what do we
4 actually mean by risk based things. As firms
5 go overseas more, you know, how will that be
6 done?

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

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

21 I don't think that there's any
22 audit committee that I know of that's saying,

1 "We want to bring down audit fees by 50
2 percent or 30 percent," because we all know
3 that that would be a big problem in terms of
4 functionality.

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

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

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

22 MR. NICOLAISEN: Just I don't

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

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

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

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

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

22 And in terms of the incentive for

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

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

1 interest to go through the process.

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

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

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

1 CHAIRMAN DOTY: Lewis Ferguson.

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

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

21 So are there things that can be
22 done short of mandatory rotation that will

1 give the kind of fresh view of an audit and of
2 the kinds of things the auditor is doing that
3 I think we all would find useful? I think in
4 all of our human experience bringing a fresh
5 set of eyes to something is a useful thing to
6 do.

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

20 A second suggestion was that after
21 a certain period of time if you're going to
22 continue the tenure of your auditor you need,

1 perhaps in accordance with guidance either
2 from the SEC or the PCAOB, to have the audit
3 committee go through a specific set of steps
4 to evaluate what the auditor is doing, the
5 quality of what they're doing, and actually to
6 justify to the shareholders in a public way,
7 why they're electing to continue the tenure of
8 the auditor.

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

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

20 And then there is the sort of fear
21 factor that someone else is going to look at
22 something. My own view is I suspect that will

1 cause people to behave differently. Whether
2 it will cause them to behave better, I don't
3 know. I think that the freshness of it is
4 important.

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

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

22 With respect to if you're

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

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

14 The second suggestion, I guess if
15 you're really going to go to the trouble,
16 let's say, every ten years to go through an
17 elaborate process of justifying why you're
18 keeping on your current auditor, I guess I
19 would rather see a tendering because you're
20 going to have to do almost as much work, but
21 it's going to be a bit artificial. I'm sure
22 within no time you'll have boilerplate answers

1 that everyone will copy from everybody else's
2 statements. That's the way this thing tends
3 to go.

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

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

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

21 MR. POZEN: Yes. Though I don't
22 think, Lew, I don't think you'd want to do

1 both, would you?

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

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

8 MEMBER FERGUSON: Not necessarily,
9 no.

10 MR. POZEN: Okay.

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

20 And you see, despite it being the
21 same firm, that there are personality
22 differences. There are experience

1 differences. There are things that a new
2 person brings to the table, not the least of
3 which is they'd rather not be associated with
4 somebody else's problem. So if they're there,
5 they want to identify issues that relate and
6 deal with them as quickly as they possibly
7 can.

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

22 CHAIRMAN DOTY: Steven. We're

1 going to run over.

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

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

17 And I was wondering if the three
18 of you have specific recommendations in terms
19 of, absent mandatory rotation, how you would
20 increase independence, in terms of how you
21 would define it, and how you would increase
22 objectivity, and how you would increase

1 professional skepticism. And I'm not sure
2 whether there were recommendations under each
3 of those categories. But because words do
4 matter and you drew the distinction, I'm
5 wondering whether or not there are options in
6 each of those three areas.

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

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

20 Having had the experience for a
21 couple years recently of being with the SEC
22 where we were audited by the GAO, I've got to

1 tell you that's a very different set of
2 dynamics. Very interesting sort of laboratory
3 experiment for me.

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

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

16 MR. NICOLAISEN: I think it's hard
17 to disagree with David's observations. I
18 would say I would look for ways to reinforce
19 what the role of the auditor is with great
20 clarity. And it is: good auditors are
21 skeptics; good auditors are critical; good
22 auditors are a pain; they ask the kinds of

1 questions that you really know are right at
2 the heart of what the company does, or its
3 operations, or its strategy or its plans for
4 the future, and so on.

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

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

21 And so the way -- and David knows
22 and I'm sure Lew knows more about this -- most

1 auditors would say that if there is a
2 significant disagreement where they actually
3 disagree with management, then they have to
4 bring it to the audit committee. But really
5 as an audit committee member, I'm interesting
6 in knowing where were the areas of debate, not
7 where they ultimately disagree. But I want to
8 know where they had a big debate and then they
9 came out and they might have resolved it.

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

19 But that is the biggest issue.
20 Because if you look at something like Lehman
21 and Repo 105, the audit committee didn't know
22 that that was happening recurrently. So they

1 never had a chance to say "Is this right or is
2 this wrong?" And apparently the auditor
3 agreed with management. You can argue
4 whatever you want on technicalities, but they
5 did agree.

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

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

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

1 productively.

2 And that's all in the record.

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

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

10 (Whereupon, a short recess was
11 taken.)

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

21 It also will prove definitively
22 that there are some things that are more

1 important than lunch to the PCAOB, that this
2 kind of intelligence is more important than
3 lunch.

4 We have an outstanding panel.

5 Jack Ciesielski is the President of R.G.
6 Associates, Inc., but he is also the publisher
7 of the Analyst Accounting Observer. He spent
8 seven years as a security analyst with Legg
9 Mason. He has had a career with Coopers and
10 Lybrand, internal auditor for Black and
11 Decker.

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

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

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

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

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

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

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

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

22 She has been at CalPERS for more

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

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

13 Jack, do you want to start us off?

14 MR. CIESIELSKI: Thanks, Jim.

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

1 reporting quality.

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

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

18 Rather than encouraging skepticism
19 and increasing financial reporting quality,
20 auditor rotation might actually work counter
21 to investor interests. I recommend that the
22 Board should try to align the interests of

1 auditors and shareholders in more fundamental
2 ways than through auditor rotation.

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

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

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

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

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

19 It may be difficult to expect
20 auditors to feel allegiance to a shifting,
21 faceless group of investors who only seem to
22 act as a cohesive bunch only when there's a

1 legal threat. Again, that's not a situation
2 that will engender strong auditor-investor
3 relations.

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

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

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

21 You could think of it as a
22 guarantee by the insurance company that the

1 financial statements are fit for use by
2 investors. If you will, they could be
3 providing warranty of merchantability of use
4 of the financial statements by investors.

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

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

17 The insurer wants to minimize
18 losses so as to preserve profitability of the
19 financial statement insurance product and will
20 charge what it needs to obtain comfort that it
21 won't lose. The issuer will want to make its
22 reporting as clean as possible in order to

1 prove to the insurer that it deserves the
2 lowest possible premium.

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

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

16 The insurer would gain comfort
17 about the reliability and suitability of the
18 financial statements because they would be the
19 ones to hire and pay auditors to act as their
20 agents. Auditors wouldn't have to worry about
21 favor with an auditee firm's managers to
22 insure a flow of future revenues. They would

1 be more incentivized to provide a high degree
2 of audit assurance to the insurance company
3 that hired them.

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

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

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

19 A sub-par audit causing the
20 insurer to pay unacceptably high claims could
21 damage the auditing firm relationship with the
22 insurer and cause a loss of revenues far

1 beyond those stemming from one sub-par audit.

2 Contrast that to the current
3 consequences of a substandard audit.

4 Scattered investors are rounded up by the
5 legal profession into a class of litigants and
6 take the auditor to court, which is an
7 inefficient process.

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

18 In short, the proposed insurance
19 model would provide proper incentives and
20 penalties for all parties to report more
21 effectively for the benefit of investors.
22 While I commend the Board for taking a big

1 step in considering auditor rotation, I
2 strongly encourage the Board to think bigger
3 and give serious consideration to the more
4 sweeping reform potential of the insurance
5 model.

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

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

15 CHAIRMAN DOTY: Thank you.

16 Ms. Martinez?

17 MS. MARTINEZ: Good morning. The
18 Black Economic Council, the Latino Business
19 Chamber of Greater Los Angeles, and the
20 National Asian American Coalition, thank
21 Chairman Doty and the PCAOB for the
22 opportunity to be on the panel and commend

1 them for their efforts on behalf of consumers.

2 We also wish to thank you for welcoming a
3 consumer perspective on the matter.

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

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

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

22 Our analysis was submitted to the

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

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

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

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

1 of commercial banks' market capital."

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

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

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

20 For example, Monday's American
21 Banker demonstrates our concerns regarding the
22 entire financial industry, where 5 of the 14

1 servicers subject to the Federal Reserve/OCC
2 consent order in mortgage fraud has as their
3 chief adviser for management services Big Four
4 CPA firms.

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

20 We offer examples of the adverse
21 impact of the present system of long-time
22 auditors who have failed to protect the

1 public, but similar examples abound across the
2 nation. For example, Sempra Energy is seeking
3 a \$2.4 billion rate increase to be paid by
4 consumers based in large measure on the
5 accounting services of its long-time prime
6 auditor for 50 years: Deloitte and Touche.

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

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

22 And, as to the importance of this

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

8 We have examined ten of the
9 largest financial institutions that were
10 involved in financial fraud that have been
11 bailed out and/or failed and were audited by
12 the Big Four firms. Ameritrust, Bear Stearns,
13 Merrill Lynch, and Washington Mutual were
14 audited by Deloitte. Countrywide, New Century
15 Financial, and Wachovia were audited by KPMG.
16 IndyMac and Lehman Brothers were audited by
17 Ernst and Young. And AIG was audited by
18 PricewaterhouseCoopers.

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

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

3 And if other reforms are put into
4 place by other government bodies, up to 100
5 firms could effectively compete to audit most
6 Fortune 500 and Fortune 1,000 corporations.
7 One suggested government reform would be for
8 the federal government to refuse to allow its
9 \$500 billion in contracts to be awarded to any
10 corporation that has been audited by the CPA
11 firm whose accounting practices have been
12 criticized by the PCAOB.

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

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

1 Thank you.

2 CHAIRMAN DOTY: Thank you.

3 Ms. Morris?

4 MS. MORRIS: Thank you.

5 Chairman Doty, Board Members

6 Ferguson, Franzel, Hanson, Harris,

7 distinguished panel members, and guests, my

8 name is Mary Hartman Morris. I'm an

9 investment officer with the California Public

10 Employees' Retirement System, CalPERS. I

11 would like to thank you for the opportunity to

12 provide an institutional investor's

13 perspective, a share owner's perspective, an

14 asset owner.

15 I would like to thank you for the

16 discussion on the ways to enhance auditor

17 independence, objectivity, and professional

18 skepticism through mandatory rotation or term

19 limits for audit firms.

20 One point I would like to make

21 sure that we know is that corporate governance

22 now at CalPERS is across all of our asset

1 classes because although before we used to
2 report to global equity, now we feel it needs
3 to be elevated because these are really
4 important issues.

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

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

21 The primary objective of an
22 external auditor should be to provide

1 consumers with an independent opinion. I have
2 four points that I would like to emphasize
3 from an investor's perspective this morning.
4 Number one, audit committees should promote
5 the rotation of auditors to ensure a fresh
6 perspective and review of the financial
7 reporting framework.

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

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

21 Number three, the need for
22 professional skepticism and objectivity in an

1 audit cannot be overemphasized.

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

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

19 CalPERS' global principles state
20 the audit committees should promote the
21 rotation of auditor to ensure a fresh
22 perspective and review of the financial

1 reporting framework. So I'm emphasizing that.

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

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

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

1 basis.

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

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

13 Again, our principles recommend
14 that audit committees require the external
15 auditor to provide written disclosures of the
16 following on an annual basis; and I think it
17 is really important that the audit committee
18 really go through and determine the
19 relationship: All relationships between the
20 registered public accounting firm or any
21 affiliates of their firm and potential audit
22 clients or persons in a financial reporting

1 oversight role that may have a bearing on
2 independence; the potential effects of those
3 relationships on the independence in both
4 appearance and fact of the public registered
5 public accounting firm; the substance of the
6 registered accounting firm's discussions with
7 the audit committee; skepticism and
8 objectivity.

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

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

20 We believe the application of an
21 appropriate degree of professional skepticism
22 is a crucial skill for auditors. Unless

1 auditors are prepared to challenge
2 management's assertions, they will not act as
3 a deterrent to fraud or be able to confirm,
4 with confidence, that a company's financial
5 statements are fairly stated in all material
6 aspects.

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

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

21 Clearly understanding a client's
22 business operation is crucial to performing a

1 high-quality audit. However, over-familiarity
2 could lead to an erosion of skepticism and
3 improper reliance on assumptions and clients'
4 representations. It may be valuable to
5 request that audit partners and audit staff
6 document how they demonstrate and apply the
7 skepticism.

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

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

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

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

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

17 CHAIRMAN DOTY: Thank you.

18 Steven? Steve Harris?

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

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

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

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

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

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

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

18 Recognizing the retirement systems
19 at CalPERS are different from traditional
20 issuers, we have heard over the past day and
21 a half how costly and how disruptive audit
22 rotation would be. How costly and disruptive

1 has it been for you? And why did you decide
2 to go five years?

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

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

16 So, Jack, one of the things that
17 you had cited was your proposal that insurance
18 companies would write a contract that
19 guarantees that the financial statements are
20 fit for use by investors. And I would like to
21 hear your thoughts on how that differs from
22 that the financial statements are fairly

1 stated in accordance with GAAP. So think
2 about that one.

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

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

20 And then, Ms. Morris, just a
21 broader question for you about how CalPERS,
22 and how you personally feel about the job that

1 audit committees are doing today. That's a
2 softball question. I'll throw it to you first.

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

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

21 And I think that when we go out
22 and engage companies, we do, we ask to speak

1 with the audit committee chair. And I think
2 that we are looking at other options about how
3 to get that message across and the importance
4 of that.

5 So I appreciate the question. So
6 thank you.

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

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

21 MR. CIESIELSKI: What would
22 useability or merchantability or reliability

1 of financial statements mean in the insurance
2 model? What's in the auditor's report? Not
3 any deviation from GAAP. What's in the
4 financial statements represents the economic
5 reality; if they have X dollars of cash on the
6 balance sheet, X dollars exists.

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

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

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

17 MR. CIESIELSKI: Yes.

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

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

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

17 MEMBER FERGUSON: I have both a
18 comment and a question. Mr. Ciesielski, I
19 think your idea of an insurance scheme is an
20 interesting one, but it strikes me as being
21 way beyond the statutory mandate and the
22 powers of this Board and probably beyond the

1 powers of the Securities and Exchange
2 Commission. It seems to me if we want that,
3 you probably would be having this discussion
4 on Capitol Hill because it strikes me to take
5 changes to the statutory structure.

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

1 have to rotate.

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

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

14 At the same time, I can't think of
15 any body that exists in Washington that is
16 better positioned to tee-up such an issue. If
17 you really want to get out of the rut with
18 auditor rotation, which I think you are going
19 to find yourself in, what's the right number
20 of years? What's the right number of firms?
21 If we need more firms, how do we make more
22 firms? I think you have to think something a

1 little bit more sweeping than just let's
2 reinvent some of the old rules.

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

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

18 So Mia?

19 MS. MARTINEZ: So for auditor
20 rotation, we go back again to our comparison
21 with other industries, such as the medical and
22 legal industries, where we have more

1 competition. And we don't think that it's the
2 answer, of course.

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

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

20 CHAIRMAN DOTY: I have a few
21 questions, but we have plenty of time. So I
22 want to give the chance to other Board

1 members, who may not have gotten through.

2 Jeanette, did you have some more?

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

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

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

20 And so we use our principles as
21 our building block, our guidelines, and in
22 voting our proxies, in identifying our

1 ownership and also in identifying the
2 companies that we want to own as a
3 shareholder.

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

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

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

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

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

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

20 The second would be my own
21 experience as a lawyer is that once you get
22 insurance companies involved in settling a

1 dispute, you have just bought yourself major
2 litigation. And have you thought about the
3 fact that the audit may be the last stop? The
4 auditor and the independent auditor may be
5 where things do come to rest ultimately and
6 that by adding an insurance company, you have
7 moved on or deferred the very difficult cause
8 and the very difficult issues about whether or
9 not the auditor has done a good audit. Get
10 some time to think about that.

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

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

21 I would be interested in your
22 comments on that because while we recognized

1 that diversity in the audit profession is a
2 goal for the audit firms as well as the rest
3 of us in society and while our scholarship
4 program, which -- we have now instituted a
5 scholarship program which encourages
6 universities taking our scholarships to
7 consider the award of our scholarship to
8 groups of people who have been historically
9 under-represented in the audit profession.

10 So we're trying to do our bit, but
11 it would seem to me that one of the most
12 important things that your society could do
13 and your efforts could be directed towards is
14 monitoring and putting out some concrete
15 information on how progress is being made in
16 diversity in the board room and diversity on
17 the audit committee because in my own
18 experience, some of the best audit committees
19 and board members I have seen have come to the
20 Board in that role. That has really
21 positively I think affected positively and
22 constructively the cause of diversity in our

1 commercial life. So I'll leave you to think
2 about whether you can do something to help us
3 on that.

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

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

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

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

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

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

20 We are also as a Board told that
21 we are wasting resources and that we shouldn't
22 be engaged in considering auditor independence

1 in the context of firm rotation at all. There
2 are people we will hear from later today who
3 have said, "You never should have taken the
4 subject up. And you should certainly drop it
5 now" because 99 percent of your comment
6 letters are against mandatory firm rotation.

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

16 We heard from the panel before you
17 a number of very interesting issues, very
18 interesting proposals and ideas on how to
19 manage the tenure issue. Yesterday Arthur
20 Levitt said we should simply feel better about
21 an audit arrangement that is reexamined at
22 least once every 25 years. And it goes 25

1 years, and it's unexamined. We just don't
2 feel as good about that.

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

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

17 I would suppose that they found
18 rotation a very interesting concept to use.
19 But he thinks it ought to be really just a
20 reevaluation of tenure at the end of 14 years.
21 He's in favor of simply reevaluating tenure at
22 the end of 14 years at the audit committee

1 level and making a decision. And if you
2 retain the existing audit firm, which he
3 thinks may well happen, you explain it.

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

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

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

20 I think that from a global
21 perspective and ownership -- and the reason
22 why we say that -- I mean, we do agree. I

1 mean, the PCAOB has to form a viewpoint on
2 this. And I think that it is important, but
3 we are a global owner. And the world has
4 become more global. And there is no stopping
5 that.

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

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

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

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

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

13 Our dialogue with others -- I was
14 just in London. I flew in from London. We
15 were talking to members from all kinds of
16 different institutional investors around the
17 world about this topic. And there are lots
18 different ideas. So do you go with tenure
19 after six and then you can have a second term?
20 But if you have a second term, then you go
21 with four years only or do you go with six
22 years and six years. And then you must

1 mandatorily rotate the auditor. You know, I
2 don't believe that we have a perspective on
3 saying that this is the right key. We don't
4 have that evidence.

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

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

1 California model where diversity should be
2 part of our DNAs.

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

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

17 So for the seven Supreme Court
18 justices, four of them are women. And so the
19 goal of our three organizations is that for
20 the Big Four firms, other CPA firms to reflect
21 the diversity, to reflect those they serve and
22 who they protect in terms of diversity, one

1 model that we have also represented to other
2 federal regulatory bodies is that which is
3 being used in California before the California
4 Public Utilities Commission. It's the GO-156
5 provision, where they collect diversity data
6 from the companies who they oversee. So this
7 way it is out in the open. So we have seen
8 very positive responses from the
9 telecommunications companies, for example.
10 They have increased their numbers throughout
11 the years.

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

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

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

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

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

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

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

22 So thank you.

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

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

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

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

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

22 As Ronen describes in his paper,

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

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

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

22 CHAIRMAN DOTY: That is helpful.

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

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

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

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

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

22 (Whereupon the above-entitled

1 matter went off the record at
2 12:36 p.m. and resumed at 1:30
3 p.m.)

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

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

22 He's been with Aetna, he's been

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

8 Jack Parsons, Independent

9 Financial Consultant. He was the Chief
10 Operating Officer and Chief Financial Officer
11 of AIM Technologies, an early stage direct
12 marketing database company specializing in in-
13 venue loyalty programs operated for
14 professional and collegiate sports teams. CFO
15 and Vice President of Macromedia, the Learning
16 Company. He had a 16-year career with Coopers
17 & Lybrand, and received the Professional
18 Accounting Fellowship in the Office of the
19 Chief Accountant to the United States
20 Securities and Exchange Commission, so he's
21 one of Mr. Kroeker's star pupils and products.
22 And he has the kind of information and

1 background that we're going to find useful
2 going forward in this discussion.

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

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

18 Bob is the second energy giant
19 executive that we have had in this colloquium,
20 in this series and that's an important area
21 for us to hear from. He's a member of the
22 Board of the Society of Corporate Secretaries

1 and Governance Professionals, and takes an
2 active part in a number of those -- in that
3 society's activities.

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

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

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

21 Internal auditors, external
22 auditors, management, and boards work together

1 as cornerstones of effective corporate
2 governance. Internal and external auditors
3 have interlocking goals, and internal auditors
4 work closely with external auditors to bring
5 a systematic disciplined approach to
6 evaluating the effectiveness of internal
7 controls over financial reporting and related
8 disclosure controls.

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

16 We support additional efforts to
17 further increase the quality of and the
18 confidence in financial statements. However,
19 we believe the costs and the unintended
20 negative consequences of mandatory rotation
21 outweigh the benefits, and therefore we oppose
22 the concept. Further, we believe the proposed

1 requirement could damage the quality of
2 financial statements by mandating a one size
3 fits all approach to auditor selection.

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

14 Number two, mandatory rotation of
15 lead and reviewing audit partners,
16 prohibitions on the provision of most non-
17 auditing services by the external auditing
18 firm, requirements for the audit committee to
19 pre-approve all audit and non-audit services
20 not otherwise prohibited, and other
21 initiatives to improve audit quality have had
22 a substantial impact. Also, the availability

1 of qualified alternative firms for auditor
2 rotation is limited and/or non-existent in
3 some markets.

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

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

16 Four, auditors need significant
17 knowledge and understanding of a company to
18 effectively deal with the complex accounting
19 and auditing issues. Just as the audit of
20 certain industries requires significant
21 industry experience, the audit of highly
22 complex organizations is improved by a strong

1 knowledge of the organization under audit.

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

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

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

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

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

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

21 The Institute of Internal Auditors
22 would be honored to assist the PCAOB in this

1 or in any upcoming initiatives. Thank you very
2 much.

3 CHAIRMAN DOTY: Thank you. Jack
4 Parsons.

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

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

20 Recently, I had the opportunity to
21 sit in on a standing advisory group meeting
22 where the current Board initiatives were

1 discussed, and I've been actively following
2 the various Board initiatives.

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

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

20 This proposed solution seems to be
21 the result of various audit issues identified
22 by the Board during its inspections over the

1 past nine years or so where it appeared to the
2 Board that the auditors hadn't evidenced the
3 appropriate level of objectivity and
4 skepticism in performing their procedures.
5 However, as I noted in my comment letter on
6 this topic dated December 14th, 2011, the
7 Board stated in the release that it has found
8 no correlation between auditor tenure and the
9 number of comments in its inspection reports.

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

17 I firmly believe that the CPA
18 profession is comprised of individuals with
19 the highest integrity who perform their work
20 in a very ethical, dedicated, and
21 uncompromising manner, so it's not clear to me
22 that mandatory rotation would solve the

1 perceived issue here. However, I am concerned
2 that we've seen far too many instances where
3 companies have failed without any advance
4 warning from the auditor, which has caused
5 some level of erosion in public confidence in
6 the role of the auditor. And, to me, it's the
7 confidence that the investor community has
8 with the audit process that this issue is all
9 about.

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

16 Now, keep in mind that the tenure
17 of the company auditor relationship is not
18 something that's disclosed to shareholders in
19 the normal course, but it will definitely get
20 highlighted if something goes wrong. And if
21 that tenure is longstanding, the reaction from
22 others will no doubt be that independence was

1 impaired, whether true or not.

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

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

1 involve.

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

9 My recommendation is instead of
10 requiring mandatory auditor rotation, the
11 Board should work with the SEC to impose a
12 requirement that a company puts its audit out
13 to bid after some defined period, say 10 or 15
14 years, and require that the audit committee
15 communicate the details of this process and
16 the basis for its final decision to the
17 company shareholders in its proxy statement
18 and possibly in its Form 10-K. That way
19 there's an expectation that the company will
20 be making periodic changes in its audit firm,
21 but if it decides to retain the existing firm
22 it will need to provide the reasons for that

1 decision in written communication to
2 shareholders. And as part of this
3 communication it should be required to
4 disclose how long the audit firm has been its
5 auditors. As a result, shareholders will have
6 this additional information on auditor tenure
7 when they vote on the auditor appointment each
8 year.

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

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

1 after some defined period.

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

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

1 CHAIRMAN DOTY: Thank you. David
2 Hirschmann.

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

12 Effective financial reporting and
13 internal controls is an important priority for
14 the Chamber. In fact, it's really one of the
15 reasons we started the Center for Capital
16 Markets at the Chamber. We began to be
17 concerned about the erosion of diverse and
18 robust sources of capital for all types of
19 businesses, and came to the conclusion that we
20 needed to modernize regulations, strengthen
21 regulation, and look at all the ways that
22 capital is threatened. And one of them is to

1 insure that investors have access to financial
2 information that is an essential part of that.

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

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

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

22 To strengthen financial reporting

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

17 Too often in the past, business
18 views have been absent from discussions around
19 accounting and auditing. We have sought to
20 remedy that, as I've indicated, by engaging
21 more actively. But we believe regulators also
22 have a responsibility to strengthen their

1 process by formalizing the way in which they
2 get early input from business even before
3 proposals are made.

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

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

19 Under the leadership of a
20 financial accounting foundation, Chairman Jack
21 Brennan and the current FASB Chair, Leslie
22 Seidman, FASB has sought to make a concerted

1 effort to reach out to all stakeholders
2 including business. I believe this
3 communication has been helpful and fruitful
4 particularly now that the agenda at FASB is so
5 full with the convergence process.

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

15 Now, an issue like mandatory audit
16 rotation you probably won't struggle to get
17 business' view. I can tell you on our end we
18 measure intensity, member interest by the
19 inbound phone calls we get, phone calls we
20 start receiving even before we solicit member
21 views. And when this proposal came out, when
22 the Concept Release came out we had an

1 abundance of inbound phone calls, so we know
2 that passions run deep. And as you saw in the
3 comment period you received a lot of input,
4 and will continue to receive input on this.
5 But that's not the case with all issues that
6 the Board will consider. So, we think having
7 a business advisory group to formalize in
8 addition to your outreach and the roundtables
9 the way you receive input from business would
10 be very helpful to the PCAOB, as well.

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

21 We are hopeful that will not be
22 the case with this proposal, and we hope that

1 not only with this roundtable but the ones
2 you've announced you're going to do later on
3 that you will not just focus on the particular
4 -- on mandatory audit firm rotation but really
5 take a step back to look at defining the
6 perception about the lack of quality of
7 audits, where audit independence is, and to
8 look at the full range of possible options to
9 deal with problems that are identified.

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

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

22 Congress in debating Sarbanes-

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

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

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

1 CHAIRMAN DOTY: Thank you. Bob
2 Smith.

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

12 The society was founded in 1946
13 and has over 3,000 members nationwide, and we
14 serve through that representation more than
15 1,500 organizations. More than half of our
16 members are from small and mid cap companies.
17 So, I'm honored to participate in this
18 roundtable, and really appreciate the robust
19 process on information gathering that you've
20 engaged in, and I'm thankful to be invited.

21 We've heard many viewpoints over
22 the last day and a half from various

1 organizations, and let me just start with we
2 oppose the mandatory audit firm rotation rule.
3 And we believe that it would not be beneficial
4 to the audit quality, nor do we believe it
5 would enhance auditor independence,
6 skepticism, or objectivity.

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

18 It's our view that mandatory
19 rotation would unnecessarily impinge on the
20 audit committee's independent business
21 judgment because it would take away this
22 responsibility from a group of independent

1 engaged persons who are charged with both
2 legal and fiduciary duties to act in the best
3 interest of the company, and also in the best
4 interest of its shareholders. And it would
5 replace this with an arbitrary one-size fits
6 all requirement.

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

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

22 Secondly, we believe that the

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

7 By of example, one society member,
8 a large global company that voluntarily
9 rotated its audit firm within the past 10
10 years estimated that the time expended from
11 the start of the request for proposal through
12 retaining its new audit firm entailed
13 approximately 100 hours of audit committee
14 time, five to six hundred hours of senior
15 management time, and between two to three
16 thousand hours of finance, legal, tax,
17 accounting, and internal audit employees'
18 times. Additionally, approximately half of
19 surveyed members indicated that they believe
20 fees for audit and audit-related services
21 would increase 20 percent or more in the
22 initial years following an auditor change. In

1 fact, in 2003 the GAO estimated that
2 additional first-year audit-related costs
3 would range from between 43 percent to 128
4 percent higher than the audit costs had there
5 been no change.

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

1 a change in the audit quality as a result of
2 the new engagement.

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

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

22 Finally, we believe that mandatory

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

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

20 In conclusion, we urge the Board
21 to resist implementing rules requiring
22 mandatory firm rotation, and instead recognize

1 the important legal and fiduciary duties
2 entrusted to and indeed required for
3 independent audit committees. Thank you very
4 much.

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

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

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

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

19 But then it gets into what I think
20 David -- these seem to me to be apparent
21 factual inaccuracies. It says that we have a
22 proposed auditor discussion and analysis. Now,

1 I think our Concept Release on the ARM has not
2 yet resulted in a proposal. I don't think we
3 proposed auditor discussion and analysis. I
4 think wouldn't you agree that we've asked
5 about auditor discussion and analysis in the
6 same way we've asked about tenure issues? And
7 that's where you suggest, you say that the
8 PCAOB has engaged in mission creep. The
9 overriding impression I have had from the last
10 two days is that the subjects of this
11 colloquium and of this open meeting really are
12 not mission creep. They're within the main
13 line of what a lot of people, preparers,
14 readers, other users want us to take up,
15 including no small group of auditors.

16 And then because of these reasons
17 you say we ask the PCAOB to withdraw the
18 Concept Release. I mean, David, do you really
19 mean that? Do you think we should withdraw a
20 Concept Release that has occasioned 600
21 letters, the kind of intelligent discussion
22 you've had over the last two days, our ability

1 to consider doing what Jack Parsons says some
2 actions, but not to defer action on these
3 issues. Do you want to sign this letter now,
4 or do you want to withdraw the letter?

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

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

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

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

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

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

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

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

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

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

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

1 having communications with audit committees.

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

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

21 CHAIRMAN DOTY: But do you want us
22 not to talk to audit committees about what we

1 learn in the inspections? Do you want to seal
2 us off from audit committees so they don't
3 have the benefit of what our findings mean?

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

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

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

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

14 MR. HIRSCHMANN: What we said is --
15 you should -- if the focus of the Board is to
16 find which form of mandatory audit rotation is
17 the best form, then we urge you to take a step
18 back that. We urge you to abandon that. If the
19 focus is, instead, to really engage in a
20 constructive discussion about how to
21 strengthen auditor quality, strengthen auditor
22 independence, then count us as full in

1 partners, but let's define the problem we're
2 trying to solve. I heard a lot of disagreement
3 the last two days over even defining what an
4 audit failure is.

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

15 A Concept Release is for the
16 purpose of eliciting views of the kind we have
17 heard from your thoughtful colleagues on the
18 panel. It does not constitute a proposal. We
19 do have a proposal out, however, on
20 communications with audit committees which
21 you've opposed. But that communications with
22 audit committees proposal standard has

1 received endorsement from the audit firms in
2 the course of the last 24 hours, it's had a
3 lot of support from people who appeared on
4 behalf companies who think we should enhance
5 those communications.

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

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

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

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

5 CHAIRMAN DOTY: Yes.

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

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

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

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

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

5 (Laughter.)

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

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

21 And I'm wondering if you've seen
22 any data that your members have provided, or

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

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

19 So, I think what we did see was
20 that there was a subset of that group that had
21 been in an audit rotation situation within the
22 last 10 years, which was one of the questions

1 that we asked, so presumably they would have
2 concrete evidence as to what it would cost.
3 And I alluded to the one firm that gave us the
4 real concrete anecdotal evidence of what they
5 saw the indirect costs being.

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

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

19 MR. SMITH: No, the question was
20 separate, so that was what was anticipated
21 from an overall audit fee increase. And my
22 guess is that -- I mean, as I look at it I

1 think it probably included some shadowing from
2 -- you know, in the transition year which you
3 would think would have to take place. And then
4 you would also have digging into old issues to
5 make sure that they're understood.

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

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

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

21 I think if you ended up with a
22 mandatory requirement, I think from an

1 economic standpoint that dynamic might change
2 a bit. I mean, under the current scenario a
3 firm might be willing to discount its fees to
4 get an audit engagement knowing that it's
5 going to be in there for a while. If it knows
6 it's not going to be in there for a while,
7 then I think that economic dynamic might
8 change a bit.

9 You know, the other thing is I
10 think that the accounting firms -- I think
11 getting in -- just a little bit anecdotal, but
12 I think if you want to think about sort of
13 objectivity and auditor skepticism, you know,
14 the skeptic might say if you go in and reduce
15 your fees from what the previous auditor was
16 charging with the understanding that you're
17 going to be in there for a while, maybe that's
18 really the highest risk scenario for a
19 situation where the auditor might be less
20 skeptical or less objective, because he
21 doesn't really want to deal with the hard
22 issues the first year or the second year

1 because he knows he's going to be in there for
2 N number of years to recoup his fees, to get
3 his fees up to where he needs them to be. Just
4 a thought, just something to think about.

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

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

22 It can be disruptive when you

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

12 Just to go back to what the
13 Chairman said, I think that as we continue to
14 dialogue between yourselves, management, audit
15 committee, the firms themselves, as we better
16 understand the root causes of the issues, as
17 we apply Six Sigma techniques to why those
18 particular failures existed; in your paper,
19 you talk about the bias samples that you used,
20 which is risk-based auditing, which is the way
21 to do it. So, you go in looking for the
22 highest risk areas, and you're looking for

1 issues. So, theoretically you would find more
2 than if you just did a random audit in
3 general.

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

20 MEMBER HANSON: Just one last
21 comment, then I'll turn it over to my fellow
22 Board Members. The word you chose of

1 indoctrinate the partner into what's been done
2 plays right into the hands of those that say
3 that's why we need mandatory rotation because
4 it's -- you need a completely fresh set of
5 eyes.

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

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

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

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

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

18 Are there some best practices out
19 there that could really -- that the internal
20 auditors could assist with in terms of
21 communications and dealing with the external
22 audit to really help improve the quality of

1 financial reporting, get involved with some of
2 these tough calls. What types of structures
3 could be put in place to really tap into the
4 potential and talents of the internal audit
5 function?

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

17 A strong internal audit department
18 has an ongoing relationship with the audit
19 committee, so the Institute of Internal
20 Auditors puts out a lot of material to help
21 internal auditors and audit committees know
22 how to relate to each other, documents such as

1 questions that audit committees should be
2 asking, providing in advance meetings when you
3 -- often the chief audit executive will meet
4 one-on-one with the audit committee chair
5 before a meeting and talk about what's on the
6 agenda, what are the topics, what are the
7 kinds of questions you might want to ask,
8 where might you want to probe? Where are the
9 issues that you would want to focus on?

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

19 We're making sure that throughout
20 the year there's a constant dialogue, and
21 we're providing information to our members and
22 to audit committees through the NACD and other

1 relationships to make sure we're helping the
2 audit committee ask the right questions.

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

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

1 practices that we're sharing.

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

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

10 MR. SMITH: Yes. I'll just note,
11 having been in board rooms and in audit
12 committee meetings since 2000 or so, I've
13 noticed a significant role and increase of the
14 internal audit department and lead internal
15 auditor. And I think that's been a very
16 positive thing, so I've seen issues come up in
17 those audit committee meetings that otherwise
18 probably wouldn't have come up because of the
19 direct reporting nature of the lead auditor.
20 And I think that's been a positive
21 development, and I think further developments
22 like that can continue to help with good

1 governance and with appropriate internal
2 auditing and external audit reviews.

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

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

1 to the internal auditors as to what their
2 finding from the company perspective.

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

16 MR. SMITH: And one other comment,
17 too. I don't know if you guys are familiar
18 with the Caremark case back in 1995 or so, but
19 as a result of that you saw compliance
20 departments at companies really develop and
21 begin to flourish, and the quality of the
22 internal departments to address those types of

1 compliance issues increased greatly. I think
2 the same thing has happened with respect now
3 to the internal audit departments as a result
4 of Sarbanes-Oxley. You've seen the game really
5 increase, the level of the playing field has
6 really gotten better, and there's been a
7 quality increase that's notable.

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

19 So, why then is it so difficult to
20 rotate the firm? If we're willing to rotate
21 every -- essentially everybody who's on the
22 audit team on a regular basis, why then does

1 it seem such a leap to ask for the rotation of
2 the firm itself?

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

17 MR. SMITH: Yes, and I'll add, I
18 went through -- I was at a firm -- a company
19 that had -- Andersen, at the time that
20 Andersen went under, and I remember going
21 through the transition which was very
22 tumultuous because of the extreme nature of

1 it, the quick nature of it. There wasn't a lot
2 of planning so transition helps address this
3 to some extent, but we spent so much time
4 going through legacy issues and reinventing
5 the wheel so to speak on issues that had
6 already been documented and decided upon, but
7 now you have a different firm that has a
8 little different perspective on some of these
9 legacy issues, that I think there's a big fear
10 that when you're looking back so much and
11 trying to re-document those things in the
12 first few years of the audit term that things
13 will drop through the cracks on a current
14 basis that you really need to be focusing on
15 because so much internal time, as I talked
16 about in my opening remarks are spent on the
17 orientation process and addressing all of
18 those issues, that there's a fear that you'd
19 lose the current view, as well.

20 MR. PARSONS: Let me just add one
21 thing. I think it's a good question, it's a
22 fair question. I think you could -- I think

1 you've got enough change in auditors going on
2 right now that it's pretty clear it can
3 happen. It's not going to be the end of the
4 world when you change auditors, and I
5 guarantee you that in every engagement letter
6 or a new engagement letter is the audit firm
7 saying this is going to be a huge issue for
8 you guys. We're never going to be able to get
9 through it. We're never going to be able to
10 get up to speed. It's going to cost you --
11 there's always a way, okay, here's how we're
12 going to deal with all these issues. And there
13 is a solution, and there's a way to do it.

14 But I think the issue is whether
15 you want to mandate it. I mean, whether you
16 want to mandate rotation. I mean, I think you
17 could -- I think auditors can be rotated. I
18 think -- we know it happens, it happens all
19 the time. For me, it's just a question do we
20 want to mandate it every N years, and that's
21 where I come down saying, you know, I'm really
22 not sure that's the right answer for a lot of

1 other reasons, but to your question I think,
2 you know, it -- we could get through it if we
3 decided that was right thing. I just don't
4 think it's the right thing.

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

17 MR. SMITH: Yes, I think it's a
18 really tough issue. And that's, obviously, one
19 that needs more focus and more attention
20 specifically on that issue. And I think
21 further roundtables would be good. But I liked
22 one of the earlier panelist's suggestions of

1 education and insuring that audit committee
2 members know what their role is. And there's
3 certainly probably a role that could be played
4 by the Board, probably in conjunction with the
5 SEC to insure that appropriate education is
6 taking place. I don't know what that would
7 like, and I'm not saying that that's a
8 position that we espouse, but I think it's
9 interesting to think about.

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

20 MR. HARRINGTON: I would just add
21 that there are not a lot of shareholder
22 meetings that my members that I've talked to

1 have said that shareholders are asking
2 questions at the annual meeting to the
3 Chairman of the Audit committee specifically
4 about the audit, so I do think that confidence
5 has improved since this body was established
6 and the changes that were made, but I think
7 there's more we can do from a communication
8 standpoint.

9 Communication from audit

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

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

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

21 We've looked at barriers to that
22 communication, including maybe whether Reg D

1 might be getting in the way of some of that.
2 So, I think, you know, as a general rule we
3 want to continue that trend.

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

8 CHAIRMAN DOTY: Thank you all.

9 MR. PARSONS: I just want to add
10 one last comment. My whole thinking -- my
11 response in my comment letter was that you
12 guys put out a possible cure, and my view has
13 been you're looking to all of us to say hey,
14 what -- not just hey, we do agree or we don't
15 agree with mandatory rotation, but what do we
16 recommend, what do we think? So, you know,
17 I've come up with a recommendation, and I
18 think you're probably hearing a lot about
19 audit committees. And I also commented on your
20 other -- the proposal on communication with
21 the audit committees, but they're at the heart
22 of all this, so I think it kind of gets you

1 thinking about that, as well. But I think you
2 guys are doing the right thing, and I
3 appreciate you're doing this Concept Release
4 and focusing on the key issues.

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

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

14 Dr. Arel, Assistant Professor,
15 School of Business Administration, the
16 University of Vermont, joined the faculty in
17 2006 completing a Ph.D. at Arizona State.
18 Prior to her doctoral study she worked as a
19 senior auditor in a registered public
20 accounting firm, and is currently licensed as
21 a CPA. A member of the American Accounting
22 Association, her teaching interests are in the

1 area of auditing, accounting information
2 systems and financial accounting. Her research
3 focuses on the judgment and decision making
4 process of auditors. Her research has been
5 published in Auditing, a Journal of Practice
6 and Theory, and in Advances in Accounting, and
7 in the CPA Journal.

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

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

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

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

1 believe, it's just we're not -- it's not a
2 position of the Board.

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

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

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

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

22 Auditor independence, objectivity

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

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

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

1 direction.

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

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

15 My coauthors, Kurt Pany and Rich
16 Brody and I conduct an experiment designed to
17 directly examine the influence of audit firm
18 rotation on auditor independence in fact. We
19 asked 105 CPA firm employees to read a
20 scenario describing a hypothetical audit
21 client in which management refused to record
22 or write down an inventory to market values

1 that would reduce net income below that of any
2 of the four preceding years.

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

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

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

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

9 CHAIRMAN DOTY: Thank you.
10 Professor Ghosh.

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

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

21 Does longer tenure impose a cost?
22 And as discussed, of course, there is

1 perceived to be a cost, and the cost would be
2 that there's a loss of independence of the
3 auditors, and the auditors might acquiesce to
4 the management pressures, so the net result is
5 an erosion in audit quality, and possibly
6 erosion in financial report equality.

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

18 The analogy would be very similar
19 to R&D. You invest in R&D and if there are
20 successful payoffs then over a period of time
21 you're able to recoup some of these returns.
22 Of course, the difference is, in the context

1 of client and audit firms is these periods are
2 not mandated, so clients still -- the auditor
3 still will have to provide high audit quality
4 to the client.

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

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

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

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

18 Again, the stylized facts emerge
19 that 24 percent, 25 percent find that
20 mandatory auditor -- longer tenure does not
21 improve audit quality. And the other hand, 75
22 percent, which is overwhelming majority, find

1 that longer tenure does improve the audit
2 quality and financial reporting quality.

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

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

21 One aspect would be definitely
22 that the audit fees would increase. And the

1 other aspect to remember is there are only
2 four companies, so this would be rotation
3 within the big four.

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

16 And, clearly, there are advantages
17 because this reporting of the tenure could act
18 as a deterrent because the audit firm knows
19 that the market is watching this very closely.
20 And because the client also knows that the
21 market is watching, even if they were to
22 pressure or they are pressuring now over

1 longer tenure they would conceivably back up
2 because the penalties may be very large.

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

17 And, finally, my comment would be
18 if the Board is convinced that mandatory
19 auditor rotation is the right way to go, then
20 I would urge the Board to consider limiting
21 the longest tenures, and the data seems to
22 point that it's only in the case of very, very

1 long tenures, and when I say long I really
2 mean long, 25 years or more, probably there is
3 a question of impairment of independence.

4 Thank you.

5 CHAIRMAN DOTY: Professor Wright.

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

21 We understand that a major issue
22 under consideration, obviously the last couple

1 of days is the advisability of requiring audit
2 firm rotation. The research we have conducted
3 over the last decade has focused on corporate
4 governance, however, and its impact on
5 financial reporting and audit quality; in
6 particular, the interactions between
7 management, the audit committee and external
8 auditors.

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

17 Our research, first of all, has in
18 addition to other studies has validated the
19 critical role of the audit committee in
20 enhancing the audit, as well as financial
21 reporting quality. We find, for instance, that
22 auditors obtain significantly greater

1 negotiation power with management when dealing
2 with a contentious reporting issue if they are
3 bolstered by a strong audit committee that can
4 serve as an ally and an independent body.

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

10 We conducted two -- now I'm going
11 to talk about a couple of other studies here
12 that deal with audit committees. We've
13 conducted two interview studies capturing
14 auditor's experiences in working with audit
15 committees and management. And one of these
16 was done about 10 years ago before Sarbanes-
17 Oxley, about 12 years ago to be more accurate.
18 And one after, again 12 years later after
19 Sarbanes-Oxley. And what did we find from our
20 auditor's experiences, and these were audit
21 partners for the most part. Pre-Sarbanes-Oxley
22 no surprise, auditors often found audit

1 committees to be largely ineffectual. Post-
2 Sarbanes we see dramatic improvement in terms
3 of audit committee expertise, authority,
4 power, and diligence. So, the world really has
5 changed there.

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

17 We also find that in many
18 instances the audit committee is seen to play
19 a passive role in helping to resolve disputes
20 on contentious accounting matters between the
21 auditor and management. And in our view, the
22 audit committee can be more effectual if it

1 takes more active role in understanding and
2 working to resolve contentious accounting and
3 disclosure matters rather than the passive
4 role which seems to be somewhat common.

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

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

22 Further, a recent study by Carello

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

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

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

11 So, we would argue that by
12 encouraging or even requiring audit committees
13 to have members with industry expertise, which
14 is not a current requirement, the SEC can help
15 enhance the monitoring abilities of audit
16 committees in overseeing financial reporting.

17 So, in summary, our research findings
18 highlight the importance of the audit
19 committee in the strengthening of the
20 independence and effectiveness of the audit
21 function.

22 We identified four areas in which

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

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

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

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

22 We've been hearing from a lot of

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

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

21 MR. WRIGHT: Yes, I think that's an
22 important question. I'm not aware of any

1 survey data that looks across this. Part of
2 this would be how do you assess a high-quality
3 audit committee. From our research, which is
4 representative of public companies of all
5 sizes, we see a real divergence that -- in
6 terms of some of the parameters I talked
7 about, like being actively involved in hiring
8 the auditor, overseeing the audit function,
9 and so forth.

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

19 MEMBER HANSON: I'll pass the baton
20 here in a second, just an observation on the
21 social ties which the members of the public
22 accounting profession in the room won't want

1 to hear me say this, but I don't think there
2 are any independence rules that we put out or
3 what these guys have put out that prohibits
4 social ties between audit partners and
5 professionals and their clients, so that same
6 situation could very well exist directly
7 between the auditors and management.

8 MR. FERGUSON: I'd like to ask
9 Professor Ghosh a question here. You mentioned
10 almost a throw-away at the end of your
11 comments that you that very long audit tenure,
12 35 years might be problematic. I guess I'd
13 like to hear from you, and then hear from all
14 of you whether you would agree with that. But
15 first of all, what evidence is there for that,
16 and why do you think -- why would time alone
17 change what the evidence appears to be for
18 shorter periods of time, at least based on the
19 studies you've cited?

20 MR. GHOSH: That's a very good
21 question, and the reality is that there is not
22 enough evidence to directly answer your

1 question. And while I was writing the -- my
2 opening remarks I realized that there is no
3 paper that explicitly looks at very long
4 tenures. Studies -- most they have done is
5 they have looked at the cutoff points of zero
6 to seven, seven to fifteen, and more than
7 fifteen, and they find that there's some
8 evidence that when it's 15 years or more that
9 the benefits that you see from the first 15
10 years are not apparent, but I think the idea
11 of very long tenure, whether there is any
12 impairment or not, that has not been done by
13 any of the 50 studies that I looked at. In
14 fact, that propelled me to look into this
15 question a little bit more so we're actively
16 engaging in this to answer questions directly.

17 And if I may just speak, one point
18 that you raised in the prior panel, which if
19 I could take the liberty of going to a
20 question that you asked, which I thought was
21 very, very pointed, is why is it that in the
22 case of partner there is consensus, but when

1 it comes to the audit firm there is no
2 consensus. And one point that was not raised
3 by the panel, and I think it's a very
4 important point, is it's a lot like client and
5 law firm. Over time there is privileged
6 information that accrues to the audit firm,
7 that is essentially lost when you bring in
8 another audit firm because you can't share
9 this information. This is attorney/client
10 privilege information. However, even if the
11 partner is rotated, this privileged
12 information will remain with the company and
13 will presumably be passed on to the next
14 partner and, therefore, it benefits the audit
15 firm and the client.

16 MR. FERGUSON: One commentator
17 yesterday, in fact, Charles Bowsher, the
18 former Controller General who suggested that
19 if you were going to have rotation the way you
20 would deal with that problem would be in the
21 last year of the departing auditor he would
22 essentially conduct a joint audit with the

1 incoming auditor so that that information
2 would be passed on.

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

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

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

1 MR. FERGUSON: Does it exist?

2 MR. WRIGHT: Twenty-five years?

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

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

12 MR. GHOSH: Let me be -- maybe I
13 was not very specific in my response. Your
14 question translated into the academic parlance
15 would be what we've done is essentially we
16 fitted a linear model. In other words, we
17 looked at tenure, or maybe take a long
18 transformation, but essentially we are saying
19 that this relationship is linear, and we tried
20 to fit this model and see over time does the
21 benefits improve, or the cost increase? And we
22 find that overall that the benefits improve,

1 that the costs don't increase.

2 However, the point that you raised
3 is what about the fact that when tenure
4 actually becomes very high, does this
5 relationship change dramatically? So, in
6 other words, is it a U-shape relationship, or
7 is it a step function? And that's a question
8 that I don't think academics have looked at
9 that will provide direct answers to your
10 question.

11 MEMBER FRANZEL: I think there is
12 general consensus that the audit committees
13 play a very important role here, and that
14 there is variability out there in practice.
15 And there have been some disclosures
16 suggested.

17 I would appreciate the views of
18 the panelists in how do we get there? Can
19 audit committees sort of just get there
20 through implementing best practices or are
21 there some additional rules and standards
22 needed?

1 MR. WRIGHT: Well, I think you can
2 play a role in advocating and working with the
3 SEC and others that oversee audit committees
4 and their composition. The research --
5 disclosures I think can also be a benefit. We
6 did a research study that looks at disclosures
7 of social ties and how it affects average
8 investors. And it does make a big difference
9 to them when they know of these ties. They
10 think the independence of the audit committee
11 is substantially lessened, so I think it's an
12 evolving thing. We've had -- as I reported,
13 we've had dramatic changes in strengthening of
14 the audit committee over the last 10, 12
15 years. There's a lot of good news here.

16 I think we have to continue
17 looking at our problems, and advocating both
18 as external auditors, you the PCAOB, the SEC,
19 that we can do better, a recognition of these
20 best practices and problems that we're having
21 out there.

22 MR. GHOSH: If I may highlight some

1 of the issues that I was talking about the
2 audit committees. I think the problem is from
3 the outside world when we are looking at the
4 financials or we're looking at the company-
5 specific data. For us, it's a black box. We
6 can't tell what were the real questions that
7 were asked and the deliberations that took
8 place that resulted in the auditor remaining,
9 or the auditor being dismissed, or the auditor
10 resigned. And that's a question that a
11 disclosure would provide more information into
12 the black box.

13 I think some great examples that
14 the SEC has done would be the disclosures of
15 the compensation for the top five executives
16 that are now included in the proxies that have
17 led to a lot of debate and thoughtful
18 comments, conversations on compensation. So,
19 in the same regard once you have the data
20 available, then that leads to thoughtful
21 conversation. So, disclosure is an important
22 part of this process, and I think that aspect

1 of the deliberations that take place behind
2 the scenes for audit committees -- for
3 instance, the audit committees are all
4 required to be independent right now. There's
5 got to be an expert, so the structures are in
6 place, so presumably they are doing their due
7 diligence when they come or arrive at a
8 conclusion. So, the question is that what did
9 they go through that resulted in this outcome?
10 That information is simply not available to
11 outside members.

12 MS. AREL: Yes, I would only add
13 some of this research that has been done on
14 audit firm rotations also looked at the
15 corporate governance side, and in that respect
16 they've looked at the composition of the audit
17 committee. And in a few of these papers, in
18 fact, being minimally compliant with the
19 current requirements actually leads to a lower
20 confidence level on the non-professional
21 investor's perceptions of auditor
22 independence.

1 So, in terms of what is ideal, we
2 can only look at it in our experiments as to
3 maybe strengthening the audit committee,
4 whether that be increasing the financial
5 expertise, or increasing the number of
6 meetings that they have, and then seeing how
7 it affects, but we don't have an ideal
8 situation yet.

9 MEMBER HARRIS: Over time we've
10 heard divergent views on whether mandatory
11 rotation will promote or inhibit competition.
12 And I was wondering whether or not you have
13 any views on that, and also with respect to
14 the larger question of competition we've heard
15 some statistics of firm concentration of 91
16 percent of the utility sector, 85 percent of
17 the telecommunications sector, 72 percent in
18 the energy sector, 70 percent of the
19 commercial banking sector. So, the first
20 question, what would mandatory rotation do in
21 terms of either enhancing or diminishing
22 competition? And second of all, do you have

1 any recommendations for how we might consider
2 increasing competition?

3 MR. WRIGHT: Well, I think there's
4 alternative arguments on this one, so I'm
5 giving you my view rather than a specific
6 research that I've done. And you, over the
7 last day you may have heard these arguments
8 but some view that this is a really
9 significant problem and there are only X
10 number of firms that have the talent to be
11 able to do these audits. So, this is a very,
12 very significant problem.

13 Others think that this will
14 actually break up and get more firms involved
15 in banking or whatever than we've had in the
16 past, and open up competition in various areas
17 having to develop that expertise. So, you sort
18 of hear balanced views on this one, and to me
19 it's not clear that we have evidence that it's
20 going to be a dire problem, or it's going to
21 be something that would stop moving forward on
22 this front.

1 I just got back from the
2 Netherlands, and as you know they've now
3 required mandatory firm rotation, and that's
4 their thinking. In talking to them they think
5 well, this might break up competition, make
6 competition more -- but we'll see what
7 happens.

8 MR. GHOSH: Based on the academic
9 research and the findings from the academic
10 research, I would conclude, and I think it
11 would be safe to conclude that we wouldn't
12 expect or predict that there would be net
13 benefits. So, in other words, the cost that we
14 talk about in terms of a regime without any
15 mandatory auditor rotation, that means 10
16 years can go along, there are costs, so those
17 costs would be minimized or removed. But the
18 problem is the benefits would be lost. These
19 investments that the audit firms are making in
20 client-specific investments or industry-
21 specific investments, those would be lost. And
22 if those are lost then what happens? And I

1 don't think we can say conclusively that the
2 result would be an improvement in audit
3 quality or not. The evidence seems to suggest
4 that the net benefits may not be there. It may
5 be lost. That's what I would conclude.

6 MS. AREL: I'd just add, again, my
7 opinion, but I think what we've heard over the
8 last two days, or at least I heard yesterday
9 was that some of the bigger companies are
10 actually using all four firms for something,
11 either the audit, the internal audit, or
12 consulting type of services. So, naturally, if
13 we could get the fifth or sixth largest firm
14 to become one of the players in the rotation
15 that could increase the competition. And it
16 might be needed for some of these big
17 companies that are using all the firms right
18 now.

19 And increasing competition, I
20 think the firms would also look at it as an
21 advantage, maybe an opportunity to increase
22 their expertise in different industries so

1 that they could then offer or propose for a
2 new audit company.

3 MR. GHOSH: I would add just one
4 point I forgot to mention, that one stylized
5 fact that emerges which would be fair to
6 conclude is the audit fees would increase.
7 But that, I don't think audit firms would
8 necessarily see that as a bad thing.

9 CHAIRMAN DOTY: Michael Gurbutt.

10 MR. GURBUTT: Thanks, Jim. Yes, I
11 just would like to ask a question of each of
12 the panelists based upon your opening
13 statements, and maybe I'll just go down the
14 line, and then give you a chance to respond
15 once I've asked the questions.

16 But, Barbara, I'm just interested
17 in finding out a little bit more about the
18 experiment that you described in your opening
19 statement, interested in understanding who
20 were the subjects, whether or not they were
21 from large or from small firms, and whether or
22 not the results might be different in small

1 firms as opposed to the large firms. And,
2 also, whether the people that you asked about
3 were senior-level employees or lower-level
4 employees? So, I'll give you some time to
5 think about that.

6 MEMBER HANSON: Michael, can I pile
7 on one more question to that? I haven't
8 thoroughly read your paper, but from the dates
9 it appears like that the most research was
10 done like in 2002, 2003, 2004. So, maybe your
11 thoughts on since we've now been regulating
12 audit firms with a rigorous inspection for the
13 better part of nine years, if you think the
14 results might be different today. Thanks.

15 MR. GURBUTT: And then just
16 finally, to what extent these experimental-
17 type studies translate to the real world. I'd
18 be interested in your thoughts on that, too.

19 Professor Ghosh, you mentioned
20 you've done some synthesis of the literature
21 regarding the impact of rotation on audit
22 quality. I'm just interested to some of the

1 proxies that the academic research used to
2 measure audit quality, and what the strengths
3 and weaknesses of some of those approaches
4 might be.

5 And then, Professor Wright, I
6 think you mentioned that management seems to,
7 in fact, play quite a dominant role in the
8 hiring and firing of the auditor. And that
9 seems to have potentially some quite
10 significant implications for auditor
11 independence. And I'm just interested as to
12 what reforms you think might be able to be put
13 in place to address that issue. So maybe,
14 Barbara, if I start with you.

15 MS. AREL: Sure. So, our
16 experiment, yes we did run it fairly close to
17 when Sarbanes-Oxley was passed, so it is a
18 little dated, the data at this point is a
19 little dated. But the subjects that we did use
20 were all in the northeast, so that is a
21 limitation as to whether or not they are
22 representative of CPAs across the country.

1 And, in fact, they did come from
2 mostly smaller firms, only about 15 percent or
3 16 percent came from national or big four
4 firms. So, we got the responses of auditors
5 at regional or one office or smaller firms
6 that are doing the same type of audits. And
7 the senior versus the lower level, like I
8 mentioned in my remarks, we did have a low
9 number of partners, that was only about 27
10 percent, but 80 percent of them were above the
11 senior level, so they have experience. They've
12 been through the audit process. Average
13 experience was actually almost 14 years, so
14 these were experienced auditors. They're not
15 fresh staff people by any means.

16 So, would it be different today?
17 There's been a couple of recent research
18 papers that have come out. One came out in
19 2009 from Wang and Tuttle that actually
20 supported our results, and they found similar
21 results that auditors are less cooperative in
22 client negotiations when rotation is mandated.

1 So, there is some recent research, also some
2 working papers in the process of trying to be
3 published at the moment that support our
4 results as well, that rotation does matter.
5 But both of those examples, they were more of
6 a experiment, the economics type of paper than
7 a true experiment, so a little difference in
8 the method. But in our case, we do believe
9 that the result of our research do extend to
10 the real world.

11 MEMBER FRANZEL: I did have a
12 follow-up question on your study, as well. You
13 concluded that the effect is largest in
14 situations with weak corporate governance. Can
15 you explain that a little bit?

16 MS. AREL: Yes. So, in our
17 experiment in addition to manipulating audit
18 firm rotation, we also manipulated the audit
19 committee. So, we did a weak condition in
20 which that was compliant with the current
21 requirements, and then a stronger condition in
22 which the audit committee met more often, they

1 had more financial expertise on it, and they
2 were more independent of management. So, in
3 our case the rotation was actually stronger
4 under the weak condition, but we want to note
5 that that weak condition is what's currently
6 required of the audit committee, so it's
7 stronger in the fact that we got a bigger
8 difference in the average responses between
9 the rotation and the non-rotation condition.
10 So, that's where that result comes from.

11 MR. GURBUTT: And, Barbara, you
12 just mentioned that you think that your
13 experiment would translate to the real world.
14 Can you explain why you believe that's the
15 case?

16 MS. AREL: Yes. Well, because the
17 auditors were put in the situation in which
18 they're familiar with. It is a hypothetical
19 audit client, but in the case of a departure
20 from GAAP, what we would expect is that
21 everybody in our experiment would have
22 answered that they needed to modify the audit

1 report. But, in fact, we found that not
2 everybody was willing to go there, and that it
3 did depend on whether it was a rotation or a
4 no-rotation condition, so the situation that
5 we put the auditors in is definitely something
6 they would see in the real world, and
7 something they would encounter on any client.

8 MR. GHOSH: It's a very good
9 question, Mike. Your question was that what
10 proxies do academics research tend to focus on
11 for measuring audit quality. And the problem
12 is audit quality is just not measurable, so
13 you have to consider constructs, proxies that
14 would conceivably measure audit quality. And
15 that becomes a challenge for academics, so the
16 more direct -- so, the best way of thinking
17 about this would be independence in fact, and
18 independence in appearance, so let's focus on
19 independence in fact.

20 Independence in fact is how do you
21 go about measuring it. Direct measure of audit
22 quality would be whether the auditor is

1 issuing an unqualified versus a qualified
2 opinion, because that's directly under their
3 jurisdiction. And the propensity to issue a
4 qualified or an unqualified opinion for a
5 client that subsequently went bankrupt, that's
6 an easy test to measure whether there was a
7 conflict of interest or not. So, that's what
8 studies tend to use.

9 The problem is there aren't that
10 many qualified opinions, and there aren't that
11 many, and we are happy to say that, there
12 aren't that many companies that go bankrupt.
13 So, while that's a good outcome, the tests
14 become weaker. So, then we have to look at
15 restatements, whether the tenure was
16 associated with the restatement. Again, that's
17 a powerful test, but the problem again is
18 while there are restatements, there are not
19 that many restatements compared to the number
20 of registrants with the SEC, which is about
21 close to 18,000. Those number of restatements
22 also have gone down significantly since SOX,

1 so that also comes to a dead end.

2 So, the overwhelming majority of
3 the studies relying on independence in fact
4 tend to use some kind of managerial discretion
5 which is in common parlance called accruals or
6 deferrals. These are based on managerial
7 estimates, bad debt expense, restructuring
8 charges, the allowance. So, whether the
9 management had a lot of discretion and whether
10 that is associated with tenure, and the
11 inference is if the management had a lot of
12 discretion, presumably the auditors were
13 signing off also on that. So, that's a very
14 popular measure of auditor independence in
15 fact that is what we call discretionary
16 accruals.

17 Some studies have kind of pushed
18 it even more and said well, just not look at
19 accounting estimates, let's also look at the
20 investments that companies are making, which
21 is with respect to R&D, the discretionary real
22 investments, and whether these are subject to

1 manipulation, especially when there are some
2 goals to meet like forecast -- propensity to
3 meet forecast estimates or last year's
4 benchmark. So that's, again, another measure
5 of independence in fact.

6 And then, finally, the
7 independence in appearance, and that's kind of
8 fairly easy to test because you're essentially
9 using a market model, so you're looking at the
10 bond holders, you're looking at ratings, or
11 you're looking at cost of debt at the
12 issuance, or on a daily or monthly basis. And
13 the context of investors it's very easy
14 because you have the return data that is
15 easily available, so you're looking at changes
16 in market prices. And you're directly
17 correlating that with tenure that's
18 observable, so that -- the independence in
19 appearance is a lot easier test.

20 And the independence in
21 appearance, that test if you kind of set it on
22 tenure, the result seems to be overwhelming

1 with that tenure does lead to benefits at
2 least as perceived by the capital markets,
3 which would include the debt holders, the
4 equity holders, and the rating agencies at
5 approval. Thanks.

6 MR. BAUMANN: Can I just ask a
7 follow-up on that? How do you control for
8 other factors in that -- right here -- sorry.
9 How did you control for other factors in the
10 case?

11 MR. GHOSH: That's, again, an
12 excellent follow-up question, and I'll give
13 you -- the hard thing that we had specifically
14 with our paper which was published in
15 Accounting Review on independence in
16 appearance, and I guess the referee and the
17 editor was -- could have been you, Marty --
18 had a lot of concern about the control. So,
19 eventually I was so frustrated because we had,
20 I counted, 35 control variables, and that's a
21 very important point to make sure that tenure
22 is not essentially correlated with either the

1 firm characteristics, which is the client firm
2 characteristics, or the audit firm
3 characteristics. So, they are the standard
4 measures that you can use.

5 So, I would add a caveat to this,
6 is you're right, it's entirely possible that
7 tenure is correlated with some other firm-
8 specific line, firm-specific for the audit,
9 firm-specific factors that we're essentially
10 not controlling for, and this stylized result
11 that we are getting is really not a causal
12 relationship. That's the point.

13 MR. WRIGHT: I might add to that
14 question that studies in this area that look
15 at audit quality often for those reasons look
16 at multiple measures. So, do we get that same
17 picture if we use discretionary accruals, and
18 restatements and whatever, we get more
19 confidence when there's more measures. But
20 your question was how can we -- I guess it's
21 easier to point out problems than it is
22 solutions. So, you pinned me down a little bit

1 there.

2 I guess, again, recognizing that
3 this is a problem as the beginning, that audit
4 committees even though by law are supposed to
5 be hiring and firing auditors, they in many
6 cases seem to usurp this to management, so
7 awareness is the first part, I would argue.

8 I think then there's -- the
9 external auditor has communications with the
10 audit committee, they work together, try to
11 encourage that their -- the audit committee
12 really is playing a critical role in the
13 decision to hire and fire the auditor. You
14 know, strong chair of the audit committee,
15 just recognition that that's a very
16 fundamental role for the audit committee to
17 play, and it's not something that we can usurp
18 to management even though they have to work
19 with the auditors a lot, not just pass that
20 over to management and then rubber stamp it so
21 to speak. So, again, your efforts and the
22 SEC's efforts to make sure that audit

1 committees realize that this is there by law,
2 but it has to also happen.

3 MR. GURBUTT: Thanks, Arnie.

4 CHAIRMAN DOTY: Thank you all. Why
5 don't we take a bit of a break before the last
6 panel for the firm representatives. But this
7 has been an illuminating discussion for us,
8 and we thank you, and we hope that we can
9 continue to pursue these questions with each
10 of you at a subsequent time. Thank you.

11 (Whereupon, the proceedings in the
12 foregoing matter went off the
13 record at 3:20 p.m. and went back
14 on the record at 3:33 p.m.)

15 CHAIRMAN DOTY: Ladies and
16 gentlemen, it's 3:32 PCAOB time. Actually,
17 3:33.

18 This is one of the most important
19 panels of the entire two days. This is where
20 we have the chance to speak with the heads of
21 the audit firms other than the Big Four. We
22 have had a practice in introducing the audit

1 firm heads not to recite all of the civic and
2 other business achievements that they have
3 made but to identify them for who they are,
4 that being really enough.

5 We have with us Joe Adams, the
6 Managing Partner and the Chief Executive
7 Officer of McGladrey & Pullen. Joe has come
8 to that position in May of 2011, so this is
9 the first time we have had the chance to sit
10 down with him in this way, in this capacity.
11 We are grateful for it.

12 He has been Executive Managing
13 Director of the Great Lakes Economic Unit,
14 consummated with the largest integrations in
15 the firm's history. He was an insurance
16 partner and served in a variety -- with a
17 variety of industries. We are glad to have
18 you here with us.

19 With him is Charles Allen, Chuck
20 Allen, Chief Executive Officer of Crowe
21 Horwath, LLP. More than 30 years of
22 experience in the insurance, acquisition,

1 divestiture, corporate finance, and strategic
2 business consulting areas, and sits on the
3 board of Junior Achievement of Chicago.

4 Cynthia Fornelli, Executive
5 Director of the Center for Audit Quality. We
6 see Cynthia often. She is a frequent
7 commenter, participant, in all of these forums
8 and venues, and we are glad to have her here.
9 She is of course -- was Deputy Director of the
10 Division of Investment Management of the
11 United States Securities and Exchange
12 Commission. And that we can't forget, can't
13 omit.

14 Wayne Kolins, Global Head of Audit
15 and Accounting, BDO International. Wayne also
16 is frequently with us. Wayne has sat for a
17 long time on our various advisory committees
18 and has made a great contribution. He
19 previously served as the BDO's International
20 Director of the U.S. Securities and Exchange
21 Commission practice. And we are glad to have
22 you here, Wayne.

1 Finally, Charles Weinstein, Charly
2 Weinstein, Chief Executive Officer of
3 EisnerAmper, LLP, a member of their Executive
4 Committee. Prior to the formation, he was for
5 more than 25 years in audit acquisition,
6 public financing practice, particular focus on
7 SEC reporting.

8 And we are glad to have you all,
9 and we would like to turn the floor over to
10 Joe Adams. Thank you.

11 MR. ADAMS: Thank you, Chairman,
12 distinguished members of the Board. McGladrey
13 welcomes the opportunity to participate in
14 this public forum on auditor independence and
15 audit firm rotation organized by the PCAOB.
16 We appreciate the thoughtfulness with which
17 the PCAOB board has gone to arrange this
18 transparent, balanced, and informative
19 process.

20 As the fifth largest firm in the
21 U.S., McGladrey, like virtually all accounting
22 firms, take the responsibility to conduct

1 quality audits very seriously. As a result of
2 Sarbanes-Oxley, the establishment of the
3 PCAOB, and recent standards enacted by the
4 PCAOB, we believe the quality of audits has
5 improved substantially over the last 10 years.
6 One noteworthy indication of this has been the
7 reduction in the number of restated audited
8 financial statements.

9 In addition, increased oversight
10 and interaction with audit committees has
11 enabled a more effective dialogue between the
12 parties relative to maintaining independence,
13 objectivity, and professional skepticism. I
14 believe that McGladrey and the other large
15 firms are clearly aligned with investors,
16 regulators, audit committees, and management
17 when it comes to the goal of continuing to
18 improve the quality and reliability of the
19 audits we perform.

20 We have all learned through this
21 exploratory process, which has been led by the
22 PCAOB, including the dialogue we have had in

1 the past two days. We also know we must
2 continue to work together to do more and be
3 even more vigilant on behalf of the investors
4 and others who rely on our audits.

5 As it relates to mandatory audit
6 firm rotation, we offer the following. We
7 have concerns that a mandatory change may
8 limit competition, since the brands of lesser
9 known but high quality firms may not be
10 considered in the change process. There is a
11 learning curve with any transition to a new
12 audit firm. The larger and more complex a
13 company is the steeper the learning curve.

14 As an auditor's knowledge about a
15 company and the business environment that it
16 operates in increases, the risks associated
17 with the audit decrease. Our research
18 supports the fact that deficiencies are higher
19 in the initial years after a change in
20 auditors.

21 Quality and risk are also impacted
22 by the industry expertise of the audit firm,

1 and the most qualified firm may even be
2 excluded from consideration. The level of
3 preparation required from the company staff is
4 substantially higher in the first few years
5 after an auditor change. This increases the
6 cost of a change in auditors.

7 Audit firms are unique. And while
8 methodologies and approaches to performing an
9 audit are similar, there will be notable
10 differences caused by experience, the human
11 element, and personal knowledge of the
12 auditor.

13 Mandatory firm rotation weakens
14 the role of the audit committee. Many recent
15 changes have been made by the PCAOB to
16 strengthen this role, and many of the benefits
17 of this are enumerated in ours and others'
18 submitted statements. The positive impact of
19 these changes will be eroded by mandatory firm
20 rotation.

21 The number of companies needing to
22 change auditors every year would be

1 substantial and would serve to distract audit
2 committees and auditing firms from the most
3 important task at hand -- ensuring the quality
4 of the audit.

5 Auditing firms and the PCAOB are
6 currently doing significant analysis on the
7 root causes of audit deficiencies and failures
8 that will provide further information that
9 should be considered before mandating audit
10 firm rotation. The current requirements to
11 rotate the engagement partner and engagement
12 quality reviewer every five years, along with
13 the normal turnover of audit engagement
14 members, provides for a periodic fresh look at
15 a company's critical accounting policies.

16 Lastly, we have seen no empirical
17 evidence that supports the hypothesis that
18 mandatory firm rotation would increase audit
19 quality. We don't believe independence,
20 skepticism, and objectivity can be legislated.
21 Quality, objectivity, and integrity are values
22 that auditors have embraced for many years and

1 ones that have enabled the profession to be
2 one of the most respected.

3 For the above reasons, and to
4 enable the audit profession to continue to
5 maintain its status as a sought after career
6 alternative, and thus attract the best and
7 brightest students and retain our highest
8 performing audit partners and professionals,
9 we do not support mandatory firm rotation.

10 However, this does not mean that
11 we shouldn't take other steps to improve
12 objectivity and professional skepticism, and
13 ultimately audit quality. At McGladrey, we
14 have implemented a number of changes in our
15 quality control systems to improve
16 objectivity, skepticism, and overall quality.

17 We have recently established an
18 independent SEC Reacceptance and Client
19 Evaluation Committee to approve not just the
20 acceptance and continuance of our SEC clients
21 but to ensure that those engagements are
22 properly staffed by qualified engagement

1 partners and managers, subject matter experts,
2 and engagement quality reviewers.

3 We have also established a Quality
4 Control Inquiry Committee that evaluates the
5 root causes of significant engagement
6 deficiencies and determines that the
7 appropriate actions are taken, including,
8 where warranted, appropriate disciplinary
9 action.

10 We are modifying our partner
11 compensation system to incorporate a longer
12 term view of performance. As CEO, it is my
13 responsibility to set a tone of "at the top"
14 that emphasizes the paramount importance of
15 audit quality. I welcome the opportunity to
16 do that, and I intend to make sure our partner
17 compensation system gives appropriate
18 recognition to audit quality.

19 In response to some of the
20 questions that were raised yesterday, I would
21 also like to point out that our policies have
22 always provided that our national office is

1 our final authority on audit and accounting
2 matters, and that no one can override their
3 conclusions.

4 Like other major firms, we
5 encourage, and in some cases require, our
6 engagement teams to consult with our regional
7 and national professional practice consultants
8 on difficult or contentious issues. Our
9 consultation process is collaborative and
10 provides for a critical evaluation of all
11 points of view. However, at the end of the
12 day, we reach a firm conclusion and stand as
13 one.

14 With the help of some leading
15 researchers in the field of professional
16 judgment, we have developed a professional
17 judgment framework to assist our auditors with
18 understanding the appropriate process for
19 evaluating audit evidence, identifying and
20 eliminating bias, and reaching proper
21 conclusions.

22 This framework will be immediately

1 disseminated after our busy season concludes,
2 and we will provide training on how to
3 implement the framework and our continuing
4 professional education curriculum this summer
5 and fall.

6 We expect this framework will
7 assist our professionals when making the types
8 of objective, professional judgments the
9 investing public has a right to expect. We
10 look forward to continuing to work together to
11 dialogue on ways to strengthen the quality of
12 audits and investor reliance on audited
13 financial statements.

14 On behalf of all of the partners
15 and employees of McGladrey, we thank you for
16 this opportunity to be included in this
17 process and express our views.

18 CHAIRMAN DOTY: Thank you.

19 Mr. Allen.

20 MR. ALLEN: Thank you. I and
21 other partners in our firm are actively
22 engaged in industry-wide activities designed

1 to improve audit quality. We believe it is
2 important work.

3 And I want to thank you, Chairman
4 Doty, for holding this roundtable discussion.
5 And I also very much appreciate the
6 opportunity to speak here in front of the
7 Board.

8 It is no secret that many are
9 strongly opposed to mandatory firm rotation.
10 We have heard that, you know, from several
11 people over the last two days.

12 And, Chairman Doty, in response to
13 the comments that you asked, which was, if not
14 mandatory firm rotation, then what else? I
15 would like to share just a couple of important
16 "what else" items in place at Crowe that are
17 designed specifically to strengthen
18 independence, objectivity, and skepticism.

19 In the remainder of my remarks I
20 will use the term "objectivity" to refer to
21 the three concepts all combined.

22 But the pressures on objectivity

1 fall most squarely on the engagement partner.

2 And as a result, we have added an additional

3 partner review beyond both the engagement

4 partner and the engagement quality reviewer.

5 I think this may be a different approach than

6 some of the other larger firms.

7 But for every public company

8 audit, our national office reviews the draft

9 financial statements. They review the draft

10 SEC filings, consultation documentation, and

11 audit summary memos, looking for potential

12 sources of accounting or auditing error.

13 These reviewers look at every public company

14 audit engagement across our firm, and, thus,

15 have a different perspective than the

16 engagement partner and the engagement quality

17 reviewer.

18 I thought yesterday's preparer

19 panel described the national office well. The

20 function provides a high level of independent

21 thought and debate, and this is exactly the

22 reason our engagement partner decisions are

1 subject to two reviews and not just one.

2 Yesterday the first panel
3 discussed the importance of partner
4 compensation on objectivity, and I very much
5 agree with it as the culture of our firm. For
6 that reason, our longstanding compensation
7 model reduces the anxiety partners may feel
8 about a lost client.

9 Our income distribution model has
10 no direct linkage to compensation based on
11 client retention, size of book of business or
12 sales activity. Rather, our income in share
13 ownership is anchored in the concept that
14 equal sharing changes, in the firm's equity
15 and income.

16 These two simple actions are
17 simple and straightforward and serve to lessen
18 the pressure on the engagement partner and
19 provide support for making objective balanced
20 decisions as we face the practice.

21 As CEO, I spent a great deal of
22 time considering risk to our firms and our

1 profession, and major audit failure is front
2 and center in such considerations. I truly do
3 not worry about our partners and people
4 failing to properly confront tough issues,
5 because they have lost their objectivity,
6 their fear of losing the client. Our stated
7 values and culture supports them.

8 I do, however, worry about the
9 potential for audit failures from other
10 directions. While I reflect on the root cause
11 of failures, I find they are due to companies
12 taking risks that they cannot appropriately
13 manage.

14 Complex transactions are now found
15 in every size of entity, and this risk is
16 particularly acute in the companies of the
17 size and nature that we audit, as they are
18 continually challenged to devote the necessary
19 resources to very complex accounting
20 requirements.

21 We must recognize the fact that,
22 as documented in a number of comment letters,

1 auditors often become more effective over time
2 as they learn more about the companies they
3 audit and navigate the accounting
4 requirements.

5 The PCAOB currently has a project
6 on the agenda which can make important headway
7 in this area, the project on the auditor's
8 report. I believe that an appropriately
9 designed structure using the emphasis of a
10 material matter model would enable the auditor
11 to point to the most significant matters.

12 If the PCAOB were to proceed with
13 such a recommendation, I believe the result
14 will be an auditors report which illustrates
15 key risk, including complicated accounting
16 matters, for a clear understanding for
17 investors and the shareholders. Such
18 reporting would provide transparency of the
19 auditor's objective, providing deeper insight
20 into their thinking.

21 Yesterday, concentration and
22 tenure came up several times. And from my

1 perspective, middle market and small companies
2 have many auditor choices, and rotation is
3 already occurring. We heard yesterday from
4 one of the academic panels that the average
5 company auditor relationship for the firms
6 around this table, and our respective peers,
7 is less than five years.

8 Of course, there are a variety of
9 reasons the audit committee may choose to
10 change firms, and that should continue to be
11 the audit committee's decision. We have
12 observed a substantial increase in audit
13 committee engagement with clients of our size
14 since the passage of SOX. And, in fact, we
15 heard this morning from several audit
16 committee members, demonstrating their passion
17 in fulfilling their roles.

18 I believe mandatory audit firm
19 rotation would undermine the role of the audit
20 committee and unnecessarily restrict the
21 choice of audit firms available to audit
22 committees when discharging their

1 responsibility. We certainly need to do all
2 we can to strengthen even further the audit
3 committee's role.

4 Let me conclude by suggesting that
5 to improve audit quality we must make progress
6 along several dimensions. We must continue to
7 increase objectivity, and I shared with you
8 the ways we do that at Crowe.

9 Chairman Doty and members of the
10 panel, I very much appreciate again the
11 opportunity to speak in front of you and look
12 forward to taking your questions.

13 CHAIRMAN DOTY: Thank you.

14 Cindy, I thought we would let the
15 audit firm heads finish and then wind up with
16 you.

17 Mr. Kolins.

18 MR. KOLINS: Thank you, Mr.

19 Chairman, members of the Board. On behalf of
20 BDO, I want to welcome participation in this
21 very important meeting. We are committed to
22 protecting the interests of investors by

1 sustaining a high level of audit quality and
2 continuing to explore ways to enhance the key
3 attributes of independence, objectivity, and
4 professional skepticism.

5 These attributes reflect the
6 auditor's mind-set, a questioning attitude
7 free from bias. In addition to the auditor
8 actually having this mind-set, investors
9 should be confident that it exists. So the
10 right environment needs to be created to
11 promote and nurture it.

12 Audit quality is not a static
13 concept, though, but rather is influenced by
14 a multiplicity of dynamic factors.
15 Accordingly, achieving optimal audit quality
16 requires a broad-based effort that reflects
17 the nature of the business environment.

18 The Sarbanes-Oxley Act overall,
19 and the establishment of the PCAOB in
20 particular, strongly contributed to enhancing
21 audit quality through the sections of the Act
22 dealing with auditor independence, corporate

1 responsibility, standard-setting, and
2 inspection of registered firms.

3 These extraordinarily robust
4 inspections, and the potential for personal
5 sanctions, as well as the very real threat of
6 civil litigation, are powerful forces for
7 influencing the right auditor mind-set.

8 In addition, the effectiveness
9 with which auditors demonstrate the key
10 attributes of audit quality is assessed by
11 their firms during their ongoing monitoring
12 processes, including annual internal
13 inspections and engagement in quality reviews
14 under AS 7.

15 However, despite the reforms
16 initiated by the Act and implemented by audit
17 firms, and the Board's belief, as stated in
18 the Concept Release, that audit quality has
19 improved since 2003, we recognize that the
20 PCAOB has noted that it continues to find
21 audit deficiencies because of an apparent lack
22 of independence, objectivity, and professional

1 skepticism.

2 We share the Board's concern
3 regarding the continuing deficiencies.
4 However, we don't believe mandatory firm
5 rotation is the appropriate or necessary
6 response to that concern. We note that the
7 Concept Release itself acknowledges the
8 weakness of the presumed correlation between
9 audit quality and firm tenure.

10 Beyond that, we believe mandatory
11 firm rotation could actually result in
12 significant adverse consequences, including
13 additional costs and potential dilution of
14 audit quality. In contrast, we believe the
15 first step in improving audit quality is to
16 understand the root causes of identified
17 deficiencies and address them with targeted
18 responses.

19 The Concept Release recognizes
20 that root causes of audit failures are complex
21 and vary in nature, and that they continue to
22 be explored by the Board, but that a root

1 cause analysis has not been completed and that
2 such an analysis would be needed before a
3 clear cause and effect relationship could be
4 determined.

5 Parallel with the PCAOB
6 initiative, we and other firms are performing
7 our own root cause analyses for deficiencies
8 encountered during internal and PCAOB
9 inspections. After identifying root causes,
10 action should be taken by the firms and the
11 PCAOB to consider whether changes should be
12 made in firm quality control processes,
13 auditing and quality control professional
14 standards, PCAOB and internal inspection
15 programs, and the responsibilities of audit
16 committees.

17 This would get to the heart of the
18 matter and be in the best interest of all
19 stakeholders.

20 In the meantime, we suggest
21 several areas for improving audit quality in
22 a cost effective manner, recognizing that some

1 would require coordination with various
2 regulatory bodies. We are committed to
3 working with the PCAOB, the SEC, audit
4 committees, investors, and others, in these
5 efforts.

6 The first area for improvement is
7 strengthening communications between the audit
8 firm and the audit committee. Audit
9 committees have a crucial role in overseeing
10 the integrity of the company's financial
11 reporting process. Robust and candid
12 communication between the auditor and audit
13 committee is essential for the Committee to
14 fulfill this role effectively.

15 As such, we support efforts by the
16 PCAOB to strengthen the existing requirements
17 for auditor communications with audit
18 committees, as reflected in the Board's recent
19 proposal on this subject, to ensure that the
20 committees fully understand the auditor's risk
21 assessments and audit strategy.

22 We believe these dialogues could

1 be further enhanced by informing the audit
2 committee about the nature of the PCAOB
3 inspections relating to the company's audit,
4 communicating engagement level inspection
5 findings, and discussing the audit firm's
6 evaluation of the root causes of any
7 deficiencies identified and the corrective
8 actions taken.

9 Next, we could explore ways to
10 enhance audit firms' internal quality control
11 systems. This should be done in conjunction
12 with strengthening the PCAOB's quality control
13 standards, which is consistent with the
14 Board's current standard-setting agenda.

15 Another important area for
16 promoting improvement involves the composition
17 of the audit committee, which is responsible
18 for appointing and overseeing the work of the
19 audit firm, and promoting the integrity of the
20 financial reporting process.

21 We urge the PCAOB not to dilute
22 the audit committee's critical and independent

1 role by mandating firm rotation, but instead
2 to work with others, including the SEC, to
3 strengthen it. In that regard, the audit
4 committee resources should include practical
5 auditing experience.

6 This background is essential for
7 conducting a probing dialogue with the auditor
8 in key audit areas and for empowering the
9 audit committee to critically assess how the
10 auditor is addressing the issues raised,
11 particularly as they relate to the exercise of
12 professional skepticism in judgmental areas.

13 Now I will turn to mandatory firm
14 rotation, the basic premise of which is that
15 limitation of firm tenure could enhance
16 independence, objectivity, and professional
17 skepticism. However, in addition to the lack
18 of demonstrated correlation between firm
19 tenure and audit quality, mandatory rotation
20 would likely produce significant unintended
21 consequences that are addressed more fully in
22 our December comment letter.

1 These include the steep learning
2 curve that would affect many more engagements
3 due to the exponential increase in the annual
4 rate of audit firm changes; reduce choices for
5 companies in specialized industries;
6 challenges on audits of multi-national
7 companies in relocating staff and deciding
8 whether to change non-audit service providers
9 around the globe; to allow those currently
10 performing services prohibited by independence
11 rules to be available for selection as the new
12 auditor; exacerbating audit firm concentration
13 by removing one firm from the pool of
14 potential auditors, coupled with the
15 unavailability of firms that continue to
16 perform prohibited non-audit services;
17 increased first year audit costs, plus costs
18 incurred by issuers as they devote resources
19 to assessing prospective audit firms and
20 working with the new auditors while they climb
21 the learning curve; and, finally, the impact
22 on smaller audit firms that provide high

1 quality audits of companies that have grown
2 over the years of their engagement.

3 When these companies are required
4 to rotate to other audit firms, we believe the
5 predecessor firm generally would be less able
6 to replace them with issuers of similar size,
7 because of the inherent bias that still exists
8 in many parts of the marketplace in favor of
9 larger firms. This may drive some of the
10 smaller firms out of the public company arena.

11 And thank you again for this
12 opportunity to participate in this meeting,
13 and I look forward to our discussion.

14 CHAIRMAN DOTY: Thank you.

15 Mr. Weinstein.

16 MR. WEINSTEIN: Thank you, Mr.
17 Chairman and members of the Board. I would
18 like to take just a moment to give the Board
19 some brief background information about our
20 firm. EisnerAmper is one of the 15 largest
21 accounting firms in the country, with offices
22 in New York, New Jersey, Pennsylvania,

1 Illinois, and California, and nearly 1,300
2 partners and staff.

3 We provide audit, tax, and
4 consulting services to privately owned and
5 publicly traded clients in a broad range of
6 industries with a focus on growth companies.

7 I am pleased to have the opportunity on behalf
8 of EisnerAmper to participate as a panelist in
9 today's public meeting on auditor independence
10 and audit firm rotation.

11 We commend the PCAOB's efforts to
12 enhance auditor independence, objectivity, and
13 professional skepticism, which are the
14 cornerstones of the auditing profession. We
15 believe that the systematic changes required
16 by the Sarbanes-Oxley Act of 2002, such as
17 partner rotation, prohibition of certain non-
18 audit services, increased audit committee
19 responsibilities, and the PCAOB inspection
20 program have greatly enhanced auditor
21 independence and, in turn, audit quality.

22 We agree with the underlying

1 assertion that the current client pay model
2 inherently creates a conflict, since the audit
3 firm is paid by the company being audited.
4 Audit firms are aware of this inherent
5 conflict, but value their professionalism and
6 reputation and remain committed to their
7 obligations to the investing public. Our
8 firms spend substantial resources to monitor
9 and mitigate this conflict.

10 The Concept Release focuses on
11 mandatory audit firm rotation as a possible
12 means by which to improve auditor
13 independence, objectivity, and professional
14 skepticism. While we understand the potential
15 benefits of a fresh point of view, and the
16 potential reduction in management pressure on
17 auditors that mandatory rotation could
18 provide, we believe that mandating audit firm
19 rotation is unwarranted, and any perceived
20 benefits do not exceed the costs and
21 inevitable unintended consequences.

22 Our concerns regarding potential

1 unintended consequences of mandatory audit
2 firm rotation, some of which may negatively
3 impact audit quality, and others which may
4 result in significant costs, without a
5 demonstrated corresponding benefit of
6 increased audit quality include the knowledge
7 of a client that is built up over time is a
8 significant factor in audit quality.

9 There is no mechanism to transfer
10 much of that knowledge base to a successor
11 firm and, hence, most of that knowledge base
12 is lost. Auditor changes always result in
13 disruption and additional costs, including the
14 costs of getting the new auditor familiar with
15 the company and its processes.

16 In certain cases, there may be a
17 limited number of firms with sufficient
18 capacity, resources, technical, and industry
19 knowledge to perform a high quality audit.
20 Mandatory firm rotation could require a
21 company to hire an auditor that, in the view
22 of the audit committee, is not the most

1 qualified audit firm.

2 In this regard, MFR diminishes and
3 undermines the role of the audit committee and
4 reduces their discretion related to the
5 selection and continuance of the auditor when
6 they are in the best position to make that
7 decision. Further, the timing of a mandatory
8 rotation of the audit firm might come at a
9 time that is particularly ill-suited for the
10 company, and in the view of the audit
11 committee not in the company's best interest.

12 We are concerned that mandatory
13 firm rotation will cause increased contraction
14 in the number of qualified registered public
15 accounting firms as more firms decide that
16 they do not have the resources required to
17 continually try to replace rotating clients.

18 Mandating firm rotation could also
19 impact the ability of firms to attract and
20 retain highly qualified audit professionals by
21 making it difficult to offer their
22 professionals longer term career development

1 opportunities associated with work on public
2 companies.

3 One of the alleged benefits of MFR
4 is the reduction in pressure an auditor may
5 face from management to protect the client
6 relationship. However, one of the unintended
7 consequences may be the opposite of that. The
8 increased pressure on the auditor to replace
9 the audit with non-audit services as the
10 rotation comes to an end.

11 We are not convinced that audit
12 firm tenure is the primary cause of audit
13 deficiencies that stem from a lack of
14 sufficient professional skepticism.
15 Independence, objectivity, and professional
16 skepticism is most closely associated with
17 individuals and not necessarily firms.

18 EisnerAmper's quality control
19 policies and our culture emphasize the
20 importance of the appropriate level of
21 skepticism and the need to obtain
22 corroborative evidence. While there is a risk

1 that over time, and with increased familiarity
2 with a client, professional skepticism may not
3 remain as high as it should be, we believe
4 that mandatory partner rotation sufficiently
5 mitigates this risk.

6 Proponents of mandatory firm
7 rotation believe that setting a limit on the
8 continuous stream of audit fees would free the
9 auditor from management pressures to preserve
10 that relationship, and, thus, the stream of
11 fees.

12 You may also want to consider the
13 inverse of this. Instead of mandatory firm
14 rotation, you might consider mandatory audit
15 firm tenure, perhaps for a three-year term.
16 During that term, a company could only dismiss
17 the auditor for cause.

18 This would free the auditor from
19 the perception of management pressure without
20 the costs and unintended consequences of
21 mandatory firm rotation. It still leaves the
22 auditor selection in the hands of the audit

1 committee, which is in the best position to
2 evaluate the needs of the company and its
3 shareholders.

4 We believe that the audit
5 committee's role in appointing the external
6 auditor, and overseeing the audit process, is
7 a strong mitigating factor against management
8 pressures on the auditor. At the end of the
9 minimum tenure, the audit committee could
10 decide to continue with the same firm for
11 another minimum tenure period or select a new
12 firm.

13 A strong auditing profession that
14 can attract and retain the best and brightest
15 is a critical component of our capital market
16 system. We support any ideas that would
17 improve audit quality and enhance auditor
18 independence, objectivity, and professional
19 skepticism. However, we do not believe that
20 mandatory audit firm rotation would provide a
21 benefit to investors sufficient to outweigh
22 the costs and any unintended consequences.

1 Thank you.

2 CHAIRMAN DOTY: Thank you.

3 Cindy Fornelli.

4 MS. FORNELLI: Thank you, Mr.
5 Chairman, and thank you, Board of the PCAOB.

6 On behalf of the CAQ, I welcome
7 the opportunity to participate in this very
8 important roundtable. One of the advantages
9 of being the last panelist on the last panel
10 of the last day is that you get the benefit of
11 hearing all of the discussion that has
12 happened before. And there has been really
13 good dialogue and some great ideas that were
14 shared over these past two days.

15 In our comment letter that we
16 filed in December, and in my written
17 statement, we outlined the CAQ's reasons for
18 opposing mandatory audit firm rotation. So I
19 would like to use my time today to further
20 explore how each of us can and should use our
21 respective roles to enhance audit quality, and
22 especially auditor independence, objectivity,

1 and skepticism.

2 A number of panelists have
3 outlined the many reforms put into place
4 through Sarbanes-Oxley that were aimed at
5 mitigating the potential conflicts of interest
6 that are inherent in the issuer pay model.
7 These include enhancing the role of the
8 independent audit committee, requiring lead
9 partner and other partner rotation,
10 instituting auditor independence rules, and
11 creating the independent regulator, the PCAOB.

12 Yet a number of panelists seem to
13 indicate that our current system is broken and
14 not working. I take exception to that.
15 Investors are confident in our capital
16 markets. According to CAQ's annual investor
17 confidence survey, it remains at an impressive
18 70 percent, even through the financial crisis.
19 And audit quality has improved.

20 Having said that, however, members
21 of the profession, as well as those of us who
22 support a strong profession, must not let down

1 our guard. We must be ever vigilant and
2 unceasing in efforts to continually improve
3 the way audits are conducted.

4 During yesterday's panel, you
5 heard the leaders of the five largest public
6 company auditing firms talk about what their
7 firms are doing to strengthen independence,
8 objectivity, and skepticism. And today you
9 have heard the same from my colleagues at the
10 table.

11 We at the CAQ are actively
12 exploring what more our member audit firms can
13 do, and we are also working collaboratively
14 with others who have responsibilities in the
15 financial reporting process on additional
16 ideas to strengthen the audit process and to
17 improve audit quality.

18 The CAQ's written statement and
19 comment letter go into more detail regarding
20 these ideas. However, I would like to
21 highlight just a few. A critical element of
22 Sarbanes-Oxley is the responsibility it gave

1 to audit committees in overseeing the external
2 auditor on behalf of investors. The CAQ
3 believes that the audit committees should be
4 further strengthened and encouraged to take an
5 even more proactive role in their oversight of
6 the independent auditor.

7 To that end, the CAQ is proud to
8 be working with a number of audit committee
9 organizations to start developing tools to aid
10 audit committees in their oversight roles.

11 One potential enhancement is the audit
12 committee's involvement in the selection of
13 the lead engagement partner.

14 By being involved in interviews of
15 candidates and providing feedback to the audit
16 firm regarding the selection of the lead
17 engagement partner, audit committee members
18 can be satisfied that the partner has the
19 technical competence and relevant experience
20 required for the particular audit. This will
21 set an important tone for the audit partner's
22 relationship with the audit committee.

1 As discussed this morning, another
2 area that needs tools pertains to the audit
3 committee's annual assessment of the external
4 audit firm, which is an important component of
5 the audit committee's determination whether to
6 retain the auditor.

7 Best practices for the assessment
8 process might include a review of technical
9 competence, including inspection results for
10 the specific company and those that bear on
11 the audit firm as a whole, compliance with
12 independence requirements, the quality of
13 communications, and, importantly, the
14 application of objectivity and professional
15 skepticism.

16 We believe another key component
17 in the assessment would be for the audit
18 committee to publicly disclose their
19 assessment process, and we actively are
20 working with the audit committee community to
21 develop these annual assessment tools.

22 The CAQ continues to work on

1 projects designed to enhance audit quality,
2 including our role of the auditor work,
3 support of independent academic research, and
4 our ongoing anti-fraud collaboration, which
5 has an emphasis on skepticism.

6 We support strong auditing
7 standards as promulgated by the PCAOB, and we
8 strive to provide productive comments during
9 the standard-setting process. For example, we
10 were pleased to provide constructive ideas on
11 the audit report, including model disclosures.

12 But in the end, it is up to each
13 individual on the audit team to discharge his
14 or her professional responsibilities to
15 perform a quality audit, and for firms to
16 cultivate an environment where independence,
17 objectivity, and skepticism are visibly valued
18 attributes reinforced by their internal
19 systems of quality control.

20 As you have heard yesterday and
21 today, the firms and auditors take this
22 responsibility very seriously.

1 I appreciate the opportunity to be
2 part of this important discussion, and I am
3 happy to answer your questions. But I would
4 like to take a further moment to thank the
5 PCAOB staff, who has been very helpful. I
6 know putting on these types of roundtables are
7 difficult, and it has gone over flawlessly.
8 So thank you to the PCAOB staff, as well as
9 the Board.

10 CHAIRMAN DOTY: Thank you, Cindy.

11 Jay, do you want to start us off?

12 MEMBER HANSON: Yesterday with the
13 leaders of the other firms that were here, I
14 asked some pointed questions about what they
15 are doing to instill in their partners the
16 sense of support around making difficult
17 calls. The most difficult thing a partner has
18 to do sometimes is tell a client no.

19 I've got a similar question, but
20 slightly different focus. You are all
21 representing -- except for Cindy -- firms that
22 have a very different profile than the Big

1 Four firms, in that the predominant client
2 base that you serve are private companies as
3 opposed to public companies. That's a very
4 unique challenge compared to the Big Four
5 firms.

6 And recently I was -- being the
7 nerdy accountant that I am, and reading my
8 Journal of Accountancy, and reading about all
9 of the client service opportunities that it
10 describes -- and for many CPAs that is very
11 appropriate, the services are just described.
12 And I also a couple of months ago read an
13 Outlook vision of the future article, and I
14 was curious to note that there was not a
15 single mention of the word "investor" in that
16 particular article of visioning for the
17 future.

18 So my question for you as leaders
19 in these firms that serve both public clients
20 and predominantly private clients is how you
21 are instilling in your professionals, from the
22 time they start until they -- all the way

1 through when they retire -- the importance of
2 the investor needs in serving a public
3 company, and how that is different from the
4 other types of services that you might provide
5 to private companies, and whether you
6 differentiate at all.

7 But the most important question
8 is: how do you instill in those individuals
9 that one day you might be working on Client A
10 that is a public company and the audit
11 committee is the client, and Client B, a very
12 similar business the next day, which might be
13 the sole owner, is viewed as the client. So
14 that is a difficult struggle, I appreciate,
15 but thoughts on how you are dealing with that.

16 MR. ADAMS: Well, I would say
17 that, first of all, when it comes to tone at
18 the top on audit quality there is no
19 difference between the importance of getting
20 the audit right. So I think in terms of all
21 employees, all employees who work on audits,
22 clearly the objective is to be independent and

1 to exercise, you know, objectivity and
2 professional skepticism on every audit.

3 I think, you know, the tendency
4 for us is, though, to really focus on, you
5 know, our best and brightest auditors, really
6 working on the SEC clients, more from the
7 standpoint of having the best qualified people
8 working on investor-related audits, because
9 the risk is greater for us and the importance
10 of it is much more critical to the investors.

11 So we want to put our best and
12 brightest on those, but our messaging is not
13 any different. I will say, when you work with
14 a smaller client, their situation is much
15 different in that their level of
16 sophistication is much different.

17 So there is a very difficult
18 balance in ensuring that they get it right and
19 being part of that conversation to help them
20 get it right. In other words, they don't have
21 the sophistication necessarily internally, so
22 that does create additional complications for

1 us, additional challenges, when you work with
2 a lot of smaller public filers.

3 MR. ALLEN: We have had this
4 conversation around our management committee
5 a fair amount actually. And when we really
6 drill into our practice, even though the
7 public company audit practice isn't the
8 largest part of our audit practice, if you
9 think about companies of public interest,
10 government organizations, regulated banks that
11 aren't publicly traded, not-for-profit
12 organizations, private equity firms, there is
13 a level of sophistication, and really
14 responsibility that we have, even though they
15 are not public companies, but yet, you know,
16 we call them companies of public interest.

17 And so we don't necessarily try to
18 differentiate between the public company
19 sector and the private sector. We have been
20 challenged with some of the marketing
21 activities. We have worked hard with our
22 marketing team as to, you know, what type of

1 literature we are putting into some of the
2 channels that aren't necessarily auditing, but
3 we are trying to very much communicate with
4 our people.

5 And we do that on a monthly basis
6 through a video webcast that I do. Almost in
7 every monthly video I talk about our core
8 values, I talk about quality. And we even
9 have a hotline that is monitored by an outside
10 third party that if our people see where
11 someone isn't living our values, or isn't
12 following the quality that we have tried to
13 instill in our people, that they have the
14 opportunity, through an outside third party,
15 to communicate with me, to let me know that we
16 have got issues there.

17 So we are very much trying to set
18 the tone across the firm, just not in the
19 public company audit channel.

20 MR. KOLINS: Yes. Just to add to
21 that, we have about 300 publicly held clients,
22 and yet the private practice is larger in

1 total than the public practice. But we also
2 do not distinguish.

3 In fact, a few years ago we formed
4 what we called an audit effectiveness task
5 force, which has gone into another series,
6 evolutionary mode now, and to look at what are
7 the things that can go wrong. I don't know,
8 anything, just start with a blank sheet of
9 paper, and really started to focus on the root
10 causes. And certainly skepticism, an
11 appropriate level of skepticism, is one of
12 them.

13 And that focus originally actually
14 started with just the private practice, but it
15 evolved into covering the entire practice.
16 But you can't really make the cut between
17 public and private when you are trying to
18 install certain basic auditing skills in an
19 auditor. It is just not possible to do.

20 The compensation system we have
21 reflects appropriate level of skepticism.
22 That is one of the things we look at in

1 evaluating the partners.

2 There is an award that we started
3 giving out about four or five years ago,
4 usually for managers, senior managers, called
5 the Professional Integrity Award, which we
6 actually wound up naming after one of our late
7 partners who really embodied -- and everybody
8 -- you kind of look at professional integrity
9 in the dictionary and his picture was there.
10 He was that kind of an individual.

11 And bring that person up in front
12 of the stage at an annual A&A conference and
13 you've got, you know, a thousand people in the
14 audience, and that is significant recognition.
15 The first part of your question that kind of
16 evolved into the question about the private
17 practice and what do you do was basically, how
18 do you support tough decisions?

19 And there not only do we have the
20 right level of people within the firm backing
21 up and going to meetings if necessary with the
22 partner on the engagement to support a tough

1 decision with the client, with the auditee,
2 but much like what was said, the decisions
3 that are made, the technical decisions that
4 are made -- accounting and auditing decisions,
5 whatever they happen to be, reporting
6 decisions -- is a technical decision.

7 There is a chain of disagreement,
8 if the manager disagrees with a partner, if
9 one partner disagrees with another partner,
10 there's a chain going upstream until it gets
11 to the professional practice leader of the A&A
12 practice, and that is where the decision is
13 made. It is not an operating office decision.

14 MR. WEINSTEIN: I would say at our
15 firm we understand that as certified public
16 accountants our role and responsibility is on
17 protecting the public interest. So in some
18 cases it is going to be the investors in a
19 public company. In other cases it could be
20 the creditors or private shareholders, but the
21 responsibility doesn't change depending upon
22 the constituency.

1 So we are beholden to the public
2 interest, and we reinforce that throughout our
3 firm. Our biggest practice area outside of
4 public company auditing is working in the
5 financial services industry. We audit over
6 1,000 hedge funds.

7 And similar to the investing
8 public in a public company, we understand that
9 our responsibility goes to the investors in
10 that particular area as well. So it is a
11 distinct focus in all of the training that we
12 do, in the role models that we have in our
13 partners, and certainly in the tone at the top
14 of the firm.

15 MEMBER FRANZEL: I want to take
16 Jay's question a step further. Auditing is
17 very stressful and very difficult. And there
18 are really layers of protections and
19 safeguards needed here, and we have talked
20 about a lot of them over the last day -- for
21 the last two days.

22 So, you know, we have got

1 regulation, we've got standards, firms'
2 quality control policies and procedures, tone,
3 training, etcetera. But when it comes right
4 down to it and the auditors are completing
5 those engagements, there are pressures. There
6 are pressures against those auditors that can
7 challenge their independence and their
8 behavior and their ability to really do a
9 quality job.

10 What is that layer of protection
11 that you all have in your firms to really,
12 when the auditor is under duress, make the
13 right decisions? And what do you think some
14 of the ideal policies or actions would be to
15 counteract those threats?

16 MR. KOLINS: Well, one thing that
17 we have in place is -- on the complex, very
18 complex engagement, is a consulting partner
19 targeting a specific area where consultation
20 would normally be needed. If it's a high tech
21 company, for example, there might be a revenue
22 recognition expert that is a consulting

1 partner, where if there are those pressures
2 that come to bear during and at the end of an
3 engagement, that partner can always be called
4 upon.

5 We also have regional technical
6 directors that would be called upon for
7 consultation on difficult issues, and these
8 are the people that would stand side by side
9 with the engagement partner to, you know, keep
10 it as one face, a one-firm face when the
11 decisions are finally met.

12 MR. WEINSTEIN: I would say that
13 our partners understand -- our client service
14 partners understand that they are not the last
15 level of decisionmaking in the firm.

16 So our professional practice group
17 makes all of the final decisions when it comes
18 to audit or accounting matters. And
19 ultimately we are very collaborative inside
20 the firm, the culture -- we think the culture
21 is right. We think we compensate partners by
22 encouraging them to do the right thing. It's

1 a very big part of our compensation system.

2 But the decision is not in the
3 hands -- the final decision is not in the
4 hands of the line partner. It is not in the
5 hands of the CEO. It is in the hands of our
6 professional practice group.

7 MR. KOLINS: Can I add just one
8 more thing? There was -- one other mechanism
9 that we put into place several years ago is
10 decisions don't only come at the end of an
11 audit. Significant matters can arise all
12 during an audit, and we want to ensure that
13 the people at the top technical level are
14 apprised of those decisions early on.

15 So we require a significant
16 decisions memo, a top memo, that encapsulates
17 the decision, the pros and the cons in going
18 through the judgment process. That is sent
19 around the third quarter to the -- whether
20 it's the regional technical director or the
21 SEC review partner, so in the calm of that
22 moment an issue can be addressed rather than

1 in the heat of an imminent filing.

2 MR. ALLEN: I come back to the
3 opening comments that I was making. They have
4 the support in our firm through the national
5 office review. I do think it is kind of a
6 spot where they can sit back, reflect, and get
7 the support from the firm.

8 I think also that, you know,
9 because of our compensation structure, the way
10 we equally share, that we don't pay our
11 partner to take those kinds of risks. And so
12 they look at the situation as a partner. They
13 look at it as an owner of the firm. They
14 don't look at it on an individual basis.

15 When one of the other firms got in
16 trouble and, you know, there was an issue that
17 came out about one of their partners, I got a
18 phone call from one of the retired partners
19 from Crowe who said to me, he said, "Chuck,"
20 he said, "I am so glad that we don't pay our
21 partners to take those kind of risks. And it
22 gives me real comfort that my retirement is

1 secure and in your hands." And so that
2 resonated with me, and I communicate that to
3 our people, certainly to the partner group,
4 just as often as I can.

5 MR. ADAMS: Yes. I would echo
6 most of the comments up here. It really -- it
7 has to be made clear to the partner that they
8 are certainly not alone in making those
9 decisions. And in fact, we have a similar
10 oversight of a partner who is not necessarily
11 involved in that day-to-day client process,
12 but it really oversees them -- oversees the
13 report and the issues as an independent third
14 party, so that we remain and maintain that
15 objectivity before something goes out.

16 MEMBER HARRIS: I have two
17 messaging questions. And, Mr. Weinstein, you
18 were really very direct in terms of saying
19 that you are aware of the inherent conflicts
20 of interest, to use your words, that your firm
21 takes steps to address them. How do you
22 message that concern? And then, how do the

1 rest of you message that concern if you think
2 there is an inherent conflict of interest?

3 MR. WEINSTEIN: It is interesting.
4 In a firm like ours, being in the middle
5 market, we do not have any client
6 relationships that are so meaningful to either
7 a partner or to the firm that it would serve
8 as sort of an impediment to being able to do
9 the right thing.

10 So we face perhaps a different
11 issue than some of the larger firms or some of
12 the firms with larger engagements might face.
13 But in our system of compensation, it is not
14 about your revenues, it is not about your book
15 of business. The first item is quality, the
16 second item is integrity, and then we go from
17 there.

18 And it is difficult to find
19 another model that would replace the client
20 pay model. So I don't know that there is much
21 of an alternative, other than to stress to
22 your partners that it is not about client

1 retention, it is about the public interest.
2 And we are licensed as a CPA firm, and
3 everything that we have built over the last 45
4 years in 45 minutes could go away. And
5 everyone understands that.

6 MEMBER HARRIS: And how do you get
7 that message out, though? I mean, how do you
8 communicate that?

9 MR. WEINSTEIN: We communicate
10 that directly to our partners in all of our
11 compensation methodology and documentation.
12 We communicate that. I speak to the incoming
13 class of juniors when they start with our
14 firm, and I relay the stories that I learned
15 from Dick Eisner and Ted Levine, who founded
16 our firm, who are outstanding -- outstanding,
17 were outstanding practitioners and outstanding
18 gentlemen.

19 But the lessons that I learned
20 from Dick and Teddy get conveyed starting with
21 the junior class every year, and they go
22 throughout. So when my time is finished,

1 someone will hopefully convey some stories,
2 some things that I might have done right.

3 MR. KOLINS: I can just add to
4 that. I go back a little further with -- J.S.
5 Seidman was my mentor, and his mantra was,
6 "Get it right, do the right thing." And that
7 message really has been communicated over the
8 years by the leaders of the firm at
9 conferences, through written communications.

10 In terms of the nature of our
11 public practice, there is really not a
12 significant amount of non-audit work that
13 constitutes that part of the practice, so
14 those kinds of conflicts aren't very prevalent
15 or potentially prevalent.

16 And in our partner evaluation
17 process, we have a very big warning sign in
18 the front that the partner cannot get
19 compensated for selling non-audit services to
20 a publicly held entity. So that is a
21 continuous reminder of the potential for that
22 kind of a conflict.

1 MR. ALLEN: We communicate our
2 core values and the need for quality, you
3 know, consistently. The way I do that is I do
4 a monthly video to the people. I do quarterly
5 webcasts to the partner group. And I even go
6 on what we call a roadshow, where I go to most
7 of the offices once a year and talk to the
8 people about these types of things.

9 As we have expanded geographically
10 in the last five years -- we have expanded a
11 fair amount geographically -- it has been more
12 and more of a challenge to get the new folks
13 that are joining us ingrained in the culture
14 and the values. And I believe the best way to
15 do that is to continue to talk to them and use
16 the different means of media and social media
17 that are available to us today to do that.

18 MR. ADAMS: Yes, I agree. A lot
19 of it is in the messaging, the constant
20 reminder and constant attention to ensuring
21 people that they have a professional
22 responsibility, that even consultants and tax

1 people -- and I don't mean to diminish those
2 two areas of our practice because they are
3 very important -- but, you know, they need to
4 understand that there are responsibilities
5 that come with being with a CPA firm.

6 And so it takes a lot of messaging
7 and constant reminding and, you know, the
8 reputation and brand certainly is what needs
9 to be protected. And that is based on the
10 audit practice, and so that is the foundation
11 of the firm. And it is a continual process
12 that you have to, you know, keep certainly
13 very aggressively doing in a firm -- in any
14 kind of a CPA firm.

15 MEMBER HARRIS: And then, the
16 second messaging question I had is a follow up
17 to what Jay brought up, and that is how
18 specifically do you message the importance of
19 the investor?

20 MR. ADAMS: Well, you know, I
21 think it's -- that's interesting, because when
22 it comes to public companies clearly the

1 client is the investor in the audit committee.
2 When it comes to an audit of a privately held
3 company, the investor generally is the
4 management and owner.

5 So you know, I think that's why we
6 have tended to move more toward having our
7 public company clients audited by a group of
8 our auditors instead of having all of our
9 auditors audit public companies because it is
10 -- you know, not that the audit is different,
11 but the mind-set is a little bit different in
12 terms of who you are really protecting.

13 And so there is definitely a
14 little bit of a difference there, but clearly
15 the audit -- again, an audit needs to be done
16 right. And it shouldn't really matter who the
17 user is, because it is the reputation of the
18 firm that you are protecting, and you must do
19 the right thing under any circumstance.

20 MR. ALLEN: I would say that we
21 don't -- we don't differentiate our messaging
22 between type of organization. We try to send

1 a consistent message across the firm in all
2 areas of the practice. But we do not try to
3 differentiate the messaging between one class
4 of industrial organization or another.

5 MR. KOLINS: We do have internal
6 and external communications that reference the
7 public interest very prominently. And I think
8 that message, you know, does get across to
9 people.

10 We also have a program within BDO
11 called the Access Program, which works with
12 audit committees in terms of audit committee
13 best practices. And our people -- a
14 significant amount of our people participate
15 in those programs. And a lot of that
16 messaging is to furnish them the type of
17 information they need to run an effective
18 audit committee in the public interest. So I
19 think it gets across from that angle also.

20 MR. WEINSTEIN: And I would just
21 briefly add in terms of getting that message
22 out that in our internal university we do

1 bring in -- we do bring in very significant
2 outside speakers on an annual basis to address
3 all of our different levels of auditors with
4 respect to their obligations, both to the
5 investing public and to our clients at large.

6 MEMBER FRANZEL: Since we are
7 picking on words, I just want to add I was
8 pleased, Wayne, to hear you correct your
9 terminology from "client" to "auditee." And
10 perhaps that is more appropriate terminology
11 to be using in these cases.

12 MEMBER HARRIS: I can't resist the
13 temptation -- I'm sorry, Lew. And then I will
14 have one question, but I want to defer to you.

15 MEMBER FERGUSON: No, go ahead.

16 MEMBER HARRIS: Cindy, you are the
17 last day, the last panel, the last person, and
18 so I just wanted to, you know, address one
19 question to you.

20 After these hearings, I assume
21 that whether we have additional discussions,
22 which I think the Chairman contemplates, I

1 think probably the Board will assimilate
2 everything that we have heard, review it, take
3 the recommendations, and I would actually ask
4 you if you would do the same because I asked
5 yesterday with Mr. Moritz, you know, where
6 there was a recommendation by Chairman Pitt.
7 You know, we thought that might be worth some
8 consideration.

9 There have been so many
10 recommendations that have been made over these
11 past couple of days that if you might get back
12 to us with respect to what you have heard, and
13 whether there are things that -- in addition
14 to what you have issued in your initial
15 comment letter, I think we would be very
16 receptive to any additional ideas

17 MS. FORNELLI: We would be happy
18 to do that. We will digest what we have
19 heard, and, like you said, there has been a
20 lot of good -- many ideas that have been put
21 forth that are worthy of consideration. And
22 so we have already begun that. As you might

1 imagine, CAQ staff is here collecting the
2 ideas, and we will, both as the CAQ and in
3 working with our member firms, cull through
4 those and work with outside parties too.

5 We have already begun our work
6 with the audit committee community. We are
7 really excited about that -- and some of whom
8 were here. We work very closely with NACD,
9 but also Rod Hills' group.

10 We have been working with them as
11 well as other audit committee organizations to
12 already start looking at what some of these
13 assessment tools could be. So we are happy to
14 share with you what we have heard, what we
15 have digested, and ideas that we have for
16 going forward.

17 MEMBER FERGUSON: I want to ask
18 you a question that I asked the panel
19 yesterday afternoon. I ask it because I am
20 curious to hear the answers of each of you,
21 and not only because I am a slow learner.

22 But one of the few things that I

1 think every panel -- every panelist we have
2 heard in the two days would agree to is the
3 importance of communications between the audit
4 committee and the auditor, and specifically
5 the importance of the audit committee's annual
6 assessment of the auditor. They reassess the
7 relationship every year.

8 You know, one of the most
9 important pieces of information that is
10 available is what the view of the regulator,
11 the view of the PCAOB is, of each person. I
12 know that at least three of your firms there
13 on the panel are inspected every single year.

14 Do you share our reports? And
15 specifically, do you share part two of our
16 reports? And not only a summary of them, but
17 do you share the raw report with the audit
18 committees of the public company clients that
19 you audit? And, if not, why not?

20 MR. ADAMS: We do not share part
21 two of the reports, and I would say it is
22 certainly something that we have started to

1 evaluate the importance of that. But quite
2 frankly, you know, the public clients that we
3 serve, by and large, are smaller.

4 They really haven't been pushing
5 us very aggressively toward that information,
6 but it is something that we are taking under
7 consideration, and especially based on what we
8 heard yesterday probably accelerates some of
9 that conversation.

10 MEMBER FERGUSON: Well, do you
11 think it would be useful to them? Whether or
12 not they are pushing for it, do you think it
13 would be useful in their assessment process?

14 MR. ADAMS: Well, I do. And I
15 think, again, you know, the sophistication of
16 the audit committees is very different. And
17 I think there needs to be -- to me, there is
18 much more of an educational process required,
19 and also, working with management regarding
20 the importance of the audit committee.

21 So I think in many respects the
22 clear independence of the audit committee from

1 management probably is not as great as it is
2 with larger companies. And so it is very much
3 an educational process in terms of reminding
4 the audit committee of their responsibilities,
5 and management, so that they do take their
6 role a lot more seriously than it is.

7 And some do. The ones that do,
8 they do ask about it, and we do provide, you
9 know, an overview of what we are hearing from
10 the PCAOB findings. But we haven't shared the
11 actual information.

12 MR. ALLEN: I would say our
13 process is very similar. We have different
14 levels of sophistication within audit
15 committees. Some of those committees do
16 inquire, and we discuss the part two with
17 them. And some do not, and we do not.

18 But as Joe said, as I listened to
19 the dialogue here over the last couple of
20 days, it appears to be a best practice that I
21 am going to have some dialogue on when I get
22 back with the folks that have the opportunity

1 to push that forward. So I think it is a good
2 observation and a best practice, and it's
3 something that we should really think about.

4 MR. KOLINS: We are along the same
5 lines. We are looking at the way that we can
6 communicate, if not the identical language in
7 part two, because there is that -- what was
8 brought up as a point yesterday -- a potential
9 waiver of confidentiality in releasing the
10 actual part two.

11 But we would like to look at
12 whatever mechanism could be brought to bear to
13 communicate what the findings were and, maybe
14 more importantly, what the remedial actions
15 are and what needs to be done and how it might
16 affect their particular company.

17 We do get into detail in part one
18 where we actually -- if there is a part one
19 comment that affects that particular issuer,
20 they will know what the comments are very
21 specifically. In fact, they will probably see
22 the written comments and the response to the

1 comments.

2 MR. WEINSTEIN: Similar to what
3 Wayne just noted, we do share part one
4 comments with our clients. We won't discuss
5 them in detail with our clients, but those
6 comments are readily available to them. In
7 any case, we do not share part two at this
8 time.

9 We are one of the firms that gets
10 inspected every three years, so we have an
11 opportunity between inspections to remediate
12 anything that may show up in part two. I'm
13 not saying that anything did show up in part
14 two, however.

15 (Laughter.)

16 But we have actually not been
17 asked by any of our audit committees that I am
18 aware of. They also run the gamut from very
19 sophisticated to less sophisticated audit
20 committees. They find their own means of
21 making an evaluation of our audit quality.
22 But should someone choose to ask, we would

1 probably share an overview of part two with
2 them.

3 MS. FORNELLI: And if I could just
4 very briefly talk a little bit about -- that
5 is one of the projects that we have going on
6 that we have begun with the audit committee
7 community, to make sure that they ask those
8 questions and then also to provide a framework
9 to them so that the firms can also have --
10 proactively describe the audit process or the
11 inspection process and what the findings were.

12 So creating that framework so that
13 there is that two-way talk, so audit
14 committees are interested but also firms
15 provide the information proactively.

16 CHAIRMAN DOTY: I think the Chief
17 Auditor has a question. Martin Baumann.

18 MR. BAUMANN: Thanks, Mr.
19 Chairman. I have been very impressed at many
20 of your comments, all of you, in terms of tone
21 at the top, messaging that you have been
22 giving in your firms, and the overall

1 discussion has been very rich. And so thank
2 you for participating in the panel.

3 I am also glad to hear -- and I
4 know of the support that many of you have
5 given us in connection with some of our
6 standard-setting on audit committee
7 communications, and we have heard that
8 throughout the last couple of days. And the
9 audit reporting model, we have worked closely
10 with many of you, including the Center for
11 Audit Quality.

12 We also heard some good ideas here
13 on other quality control issues, and we have
14 a quality control project on -- as you know,
15 on our standard-setting agenda. In that
16 regard, I was particularly interested in a
17 couple of things.

18 Chuck, I want to talk about, first
19 of all, your third level of review for your
20 issuers. Question one, just curious about the
21 reaction of your clients to the fact that you
22 have a third level of review. Sometimes you

1 see in proposals -- you know, you will get an
2 answer from your engagement partner, he is the
3 person who makes the calls, things like that.
4 So you have a third level of review.

5 I am just interested in the client
6 reaction to that and wondering, is it -- is it
7 simply -- I don't mean that pejoratively --
8 review of the financial statements, or do they
9 also ask for some memos, memo on exam kind of
10 things as well? But it is -- so a couple of
11 questions about that, and then I have a
12 followup as well.

13 MR. ALLEN: Again, we try to
14 provide the right experience to our client
15 through the audit process. And I will tell
16 you that that involves people being on call
17 all the time to make sure that we get to the
18 issues and we get to them quickly.

19 We have not had -- the pushback I
20 get is not from the clients because it is a
21 high quality solution and it gets to the right
22 answers in a timely manner. But the pushback

1 many times I get is from the partners
2 themselves who, you know, want to continue to
3 move things forward.

4 But, again, I think it is a good
5 independent dialogue to have. And, you know,
6 at times it bubbles up to my level where, you
7 know, there is issues between the national
8 office review and the partner group. And
9 sometimes it does cause a slowdown in the
10 delivery of the product.

11 But, again, I think it is
12 something that has served us well for, you
13 know, the 70 years that our firm has been in
14 business, and I've said, you know, it is not
15 something I am willing to change under my
16 leadership. So --

17 MR. BAUMANN: Thanks.

18 MR. ALLEN: Certainly.

19 MR. KOLINS: We have a similar
20 process but with an SEC reviewer, who reviews
21 the entire filing, including, you know, the
22 financial statements and everything else in

1 the filing. And also, that top memo that I
2 referred to before of the significant
3 decisions and, again, getting those around the
4 third quarter of the year.

5 We find that clients basically
6 appreciate that, because these people can find
7 things, because they are looking at things
8 every day, and they could spot something that
9 perhaps the engagement quality reviewer didn't
10 spot.

11 And, similarly, from the
12 engagement team's perspective, it is an added
13 bit of insurance for them. So I think it --
14 from both sides, I think they are very
15 receptive to it.

16 MR. ALLEN: Marty, I want to come
17 back to the second part of your question. Our
18 audit methodology and work papers are all
19 electronic, and so it is an easy process,
20 because, you know, if I've got someone
21 reviewing a file that is sitting in Chicago
22 that is a national reviewer, he can pick up

1 the file in California just by clicking on the
2 file and he has access to, quite frankly, the
3 entire audit database.

4 Now, his responsibilities would
5 not be to go through every work paper, but to
6 the extent he wants to look at a work paper he
7 has the ability to do that, if he so chooses
8 -- he or she.

9 MR. WEINSTEIN: I would just add a
10 comment. We also have a third partner review
11 on every public company engagement. I find
12 that our auditees take comfort in that third
13 partner review. They find that there is a
14 value added to them.

15 The goal is to get it right, and
16 we find that the auditees appreciate that.
17 And the client service aspect of that is to do
18 it on a timely basis. So we strive to provide
19 the client service aspect of that, while at
20 the same time getting our best and brightest
21 minds to address the most complex issues.

22 MR. BAUMANN: Thanks. Those sound

1 like really good practices and food for
2 thought for us.

3 Another area that was mentioned --
4 and certainly corporations, businesses put
5 this into place largely after Sarbanes-Oxley
6 -- and that is a hotline for accounting
7 complaints to be made to an independent third
8 party is really a best practice in most
9 companies.

10 And I hear again, Chuck, that you
11 have that in your company for your audit
12 staff, for anybody to be to call and say if
13 somebody is -- if they see something in the
14 audit area, where somebody is not living the
15 values or not performing in the way in which
16 the culture of the organization is set, to
17 call that independent third party hotline
18 anonymously and be able to report that.

19 Sounds also good. I would like to
20 hear a little bit more about that. And,
21 again, I wonder how many other firms have put
22 something like that in place as an extra

1 protective mechanism.

2 MR. ALLEN: We call it Listen Up,
3 and it is actually on our internet site. So
4 if someone has the ability to click on that
5 site, it goes to a third party administrator,
6 and then they register, you know, whatever
7 their issue may be.

8 It could be an audit quality
9 issue. It could be a discrimination issue.
10 It could be that someone is not being treated
11 fairly. And then, there is a process for, you
12 know, bringing that up through the
13 organization based upon the level of the claim
14 that is being submitted.

15 And I have oversight. I see each
16 claim that comes through. It doesn't get to
17 me for resolution until certain levels. But
18 we have actually found some situations that
19 have caused us to, you know, take fairly
20 severe actions in regards to not only our
21 people but to some partners.

22 So it is monitored by an outsider,

1 and we -- at the end of it, when I do my
2 roadshow, we actually disclose to the people
3 the number of incidents that we had and to
4 some degree, to the extent that we can, how
5 they were resolved. So it is very
6 transparent, and we have found it to be, you
7 know, again, a great way of speaking with our
8 people on a confidential basis.

9 MR. ADAMS: We really had more of
10 an informal process up until now, in fact,
11 where the expectation certainly was to go to
12 -- generally it's HR is where we have been
13 telling people to go.

14 But we recently elevated our chief
15 risk officer to the enterprise leadership
16 level in our firm, and one of his tasks that
17 he is now in the process of implementing is a
18 hotline to have more of an external -- you
19 know, external place to go for all of our
20 employees. So we will be putting something in
21 very near term.

22 MR. BAUMANN: Yes. As I said, it

1 seemed to be a best practice in corporate
2 America to be able to go anonymously to a
3 third party and not have to go inside.

4 MR. KOLINS: We also have a
5 hotline which we call "hotline" --

6 (Laughter.)

7 -- and that's really used for
8 everything, you know, from harassment to if
9 there is an audit issue. And the audit issue
10 isn't so much I disagree with him about this
11 technical accounting matter, but the partner
12 is putting excessive pressure on me to accede
13 to his request or, you know, he has got -- he
14 is yelling at the staff, those kinds of HR
15 issues, which are very much audit quality
16 related.

17 And those will ultimately come
18 through the General Counsel's office, and then
19 the management of the firm gets it. And
20 people have been -- had their compensation
21 affected, they have been fired as a result of
22 the finalization of those inquiries, and this

1 seems to work quite well.

2 CHAIRMAN DOTY: Are there any
3 other comments or questions from Board
4 members?

5 MEMBER HANSON: I have got one
6 more. I have resisted for the last two days
7 the question that my fellow Board members and
8 staff don't like to hear me ask. It is the
9 question: what is the problem that we are
10 trying to solve? And our guest from the
11 Chamber of Commerce that we treated so warmly
12 just a few minutes ago, he brought up that
13 question of, what is the problem we are trying
14 to solve?

15 And as I think about it, the
16 symptoms of the problem we are trying to solve
17 are all the findings that we see in the
18 reports. And I characterize what I have heard
19 in the panel here as a lot of happy talk,
20 because I know what your reports say and you
21 know what they say, and hopefully the results
22 in the reports aren't acceptable to you,

1 because they are certainly not acceptable to
2 us.

3 And we have tasked especially the
4 larger firms with the challenge of, what is
5 your own root cause analysis as to what is
6 causing the problems? And I don't know how
7 many of you we have individually asked that
8 question, and you don't all need to answer
9 this, but if you would just share with us
10 maybe the top one or two things that you think
11 in your firms are the biggest problems that
12 you need to get after and what you are doing
13 about it.

14 MR. KOLINS: Well, we have gone
15 through -- and I will just give a little bit
16 of background -- we have gone through a
17 significant analysis and surveys, and we are
18 not finished yet. And I'm not sure one is
19 ever finished with the root cause analysis
20 because you have to keep asking yourself the
21 question, why? You come up with a cause, and
22 why did that happen?

1 And we have met with the
2 inspection staff. I think all the firms are
3 meeting with the inspection staff to go over
4 their own root cause analysis process, and we
5 have done that in detail.

6 And we look at things like the
7 supervision and review and partner
8 accountability and those kinds of issues. Are
9 those the issues that are central to the
10 deficiencies that are encountered? Because it
11 does go to a root and not just to a leaf on
12 the tree. You really have to dig down and
13 find out what is the central cause.

14 And it is in all likelihood --
15 that we have seen so far -- it is not one
16 cause. There are a number of things that need
17 to be addressed to effectively mitigate the
18 problem.

19 MR. ADAMS: Yes. And I agree with
20 that, and I think it's different on every
21 audit. You know, sometimes it is lack of, you
22 know, experience maybe of a person on the job,

1 and then a miss on the review side. And in
2 other cases it is just lack of expertise in an
3 industry perhaps or awareness of disclosure,
4 and it just -- because of the pressure of
5 getting a report done and out, sometimes those
6 things do slip through.

7 So I think, you know, the
8 learnings are, you know, what do you do about
9 it, right? How do you ensure that you have
10 enough staff time allowed to get the job done
11 correctly? And so those are the things we are
12 working on.

13 We are still in a very -- you
14 know, we have a deep dive on root causes
15 scheduled in May, and we have an outside
16 facilitator coming in to really help us with
17 that. And our goal would be to come out of
18 that meeting with a much deeper understanding
19 and hopefully a better course of action on
20 what we are going to do about it.

21 MR. WEINSTEIN: We haven't
22 identified the specific deficiencies or the

1 root cause of specific deficiencies, but we
2 have put something in place that we hope will
3 address the general concept of increasing
4 audit quality. And what we have done is we
5 have assigned the third partner that
6 participates on an audit completely
7 independent from the EQR, and the client
8 partner also participants in the planning
9 session.

10 So we have accelerated that
11 process, so that we can identify issues,
12 educate staff early on, and have a real third
13 party independent view in the planning
14 process. And we hope that that will -- we
15 have done that for the last couple of years,
16 and we hope that that will lead to a
17 demonstrable increase in our audit quality.

18 MR. ALLEN: I would say that since
19 we have been involved with the PCAOB review
20 process, the level of our audit quality has
21 continued to rise. And I said to the
22 examiners that I believe it has been a good

1 thing for us. I do believe that it has
2 enabled us to get our audit practice to a
3 higher level and has enabled us to take our
4 public company audit practice to a level much
5 higher than it was before.

6 So I view the process as one of
7 continuous improvement, and certainly we have
8 things that we need to work on, and certainly
9 in certain segments of our practice where I
10 think the regulatory environment is held to a
11 higher standard. And we are certainly looking
12 at those issues and striving for ways to
13 improve the methodology, improve those areas
14 where we need to bring a higher level of
15 skepticism to the process.

16 CHAIRMAN DOTY: Jim?

17 MR. KROEKER: I think it was David
18 Becker this morning that said an objective dud
19 is still a dud. Maybe as concerning is
20 actually the non-skeptical or non-objective
21 expert in terms of they both pose risk, but an
22 expert in an industry that isn't objective or

1 isn't skeptical might lead to then even worse
2 potential for, you know, bad accounting, bad
3 auditing outcomes.

4 I have heard a lot of discussion
5 about when there is partner rotation or in the
6 context of engagement acceptance, the
7 necessary trait of having an expert, and that
8 actually serves potentially as an impediment
9 to rotation. I'm wondering, internally, what
10 is done to compensate that objective expert.
11 Is there enough focus on core auditing skills?

12 Are the compensation structures,
13 not just the technical accounting expert, not
14 just the expert at bringing in the big client,
15 but the core auditor, are you talking to audit
16 committees about you want to hire us, you want
17 this person as your partner because they are
18 going to be like a dog on a bone. Is that the
19 nature of the discussion with audit
20 committees? Or is it more focused on they
21 have the accounting acumen?

22 MR. ALLEN: Jim, I will tell you

1 that I believe at one time it was more about
2 the industry. I think today those discussions
3 are really twofold. One is certainly industry
4 expertise, but it is industry expertise in
5 regards to their accounting acumen, as you
6 called it.

7 And we have moved from a firm that
8 was very industry-focused to a firm that is
9 still industry-focused but now industry-
10 focused in different segments of the practice,
11 that including on the accounting and auditing
12 side.

13 And so we have made the strategic
14 decision to build our audit practice apart
15 from other segments of the practice, but
16 within that to have industry specializations
17 within the accounting/auditing side of the
18 practice, not necessarily bringing, you know,
19 consultants and those types into that channel,
20 but really doing it within the accounting side
21 of the practice.

22 And those are the conversations we

1 are having with audit committees today. They
2 want to know that you have both; it's not one
3 or the other.

4 MR. KOLINS: I think the
5 conversation with audit committees are
6 different at the inception or not even having
7 gotten an engagement yet versus a year or two
8 or three into the engagement when the audit
9 committee should then be able to see the
10 extent to which the partner is skeptical and
11 is asking for evidence to support an
12 assertion, which is kind of associated with
13 the belief that we have that the audit
14 committee should have either access to or a
15 member that has practical auditing experience
16 that can ask those kinds of probing questions
17 to say, "Well, did you look at this? And did
18 you look at that?"

19 And we do talk to them about -- we
20 have a professional judgment framework, not
21 quite our own. It was, you know, developed
22 profession-wide as a process to look at the

1 pros and the cons of an issue and what kind of
2 evidence you need to gather to support the
3 assertion. And those are the kinds of things
4 that we do talk to audit committees about.

5 CHAIRMAN DOTY: Michael?

6 MR. GURBUTT: Just one question
7 for Wayne. I think you mentioned in your
8 opening statement that there is some bias that
9 still exists in some parts of the marketplace
10 in favor of the larger firms. Do you think
11 audit quality would improve if more firms
12 performed audits of big companies?

13 MR. KOLINS: Absolutely. Yes, I
14 do. I think there are firms beyond the
15 smaller grouping of firms that are certainly
16 qualified.

17 We handle a number of very large
18 companies, but there were, you know, several
19 statements I heard yesterday that kind of, you
20 know, provided evidence about there is only
21 four auditors that boards feel comfortable
22 with, comments like that which I jotted down.

1 I didn't have to go do a study of it. And I
2 think there is a bias that if you are not
3 already familiar with a particular firm that
4 maybe has -- the company has grown, and the
5 firm is able to handle it.

6 As the company has grown, they are
7 familiar with it. That's fine. But is a new,
8 fresh company coming in, of the same size,
9 going to come to the same conclusion? So it
10 still is a concern, and I think the quality is
11 certainly there for other firms to handle
12 those types of audits.

13 CHAIRMAN DOTY: Well, you are not
14 the prisoners of this group. You have been
15 very patient. As indicated, it is going to
16 take us a while to assemble all of this
17 information and to get it together. But we
18 will be doing it, and we will be grouping
19 comments and issues and formulated possible
20 solutions to different problems. We will be
21 grouping those topically.

22 It will be a great help to us to

1 come back to you and to be sure that we have
2 it right, that we have what you think should
3 be there.

4 I know -- I think everyone on this
5 dais or on this panel knows what it is like to
6 be the last panel. We have all been there.
7 We have done it. You have done a great job
8 with a tough assignment.

9 Also, we all appreciate the
10 graciousness that Cindy showed in thanking the
11 staff of the Public Company Accounting
12 Oversight Board.

13 All of us, all of the Board
14 members, know what a tremendous amount of work
15 went into preparing this, the people outside,
16 the people whom you have seen coming into the
17 building who organized the format, the venue,
18 as well as the panelists. It includes, as was
19 said yesterday, the General Counsel, the Chief
20 Auditor, and members of the staff of all of
21 the Board members, and we are very grateful
22 for it.

1 But this would not have been a
2 success without you, the panelists. And on
3 behalf of the Board, I want to thank all of
4 you, and the panels that came before you. We
5 will get something out in writing soon to
6 memorialize our gratitude for that. We thank
7 you.

8 But in the meantime, keep
9 thinking. If in going away, in going about
10 your business, you think of things you wish
11 you had said, would have said, didn't say,
12 write it up and send it to us.

13 I think we are adjourned.

14 (Whereupon, at 5:00 p.m., the
15 proceedings in the foregoing
16 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

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