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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

+ + + + +

THURSDAY,
OCTOBER 18, 2012

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The public meeting convened in the Auditorium at the Jones School of Business, Rice University, 6100 Main Street, Houston, Texas, at 8:00 a.m., James R. Doty, PCAOB Chairman, presiding.

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MICHELLE EDKINS, Managing Director, Global Head of Corporate Governance & Responsible Investment, BlackRock

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

ERIK F. GERDING, Associate Professor of Law, University of Colorado Law School

GAYLEN R. HANSEN, Partner, Ehrhardt Keefe Steiner & Hottman PC; Chairman-Elect, National Association of State Boards of Accountancy

HENRY T. C. HU, Allan Shivers Chair in the Law of Banking and Finance, The University of Texas at Austin School of Law

PATRICK T. MULVA, Vice President and Controller, ExxonMobil Corporation

KAREN NELSON, Harmon Whittington Professor of Accounting, Jones Graduate School of Business, Rice University

MARK NELSON, Eleanora & George Landew Professor of Management and Professor of Accounting, S. C. Johnson Graduate School of Management, Cornell University

ROBERT A. PRENTICE, Interim Chair and Professor, Business, Government & Society Department, McCombs School of Business, The University of Texas at Austin

LARRY RITTENBERG, Professor Emeritus, Accounting & Information Systems, Wisconsin School of Business; Audit Committee Chairman, Woodward, Inc.; former Chairman of The Committee of Sponsoring Organizations of the Treadway Commission

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SCOTT WHISENANT, Associate Professor of Accounting,
University of Kansas School of Business
STEPHEN A. ZEFF, Herbert S. Autrey Professor of
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1 requiring audit firm rotation to improve auditor
2 independence but the final statute, as enacted, stepped
3 back. Instead, it provided for partner rotation on
4 public company audits. In addition, it asked for further
5 study of firm rotation.

6 Shortly thereafter, in 2003, the Government
7 Accountability Office embarked on a review of the
8 arguments for and against audit firm rotation. The
9 review was preliminary in light of other Sarbanes-Oxley
10 reforms that were only beginning to be implemented; thus,
11 it concluded that the SEC and the board would need
12 several years to evaluate whether the Sarbanes-Oxley
13 reforms, including audit partner rotation, were
14 sufficient or whether further independence measures were
15 necessary to protect investors. And we're fortunate in
16 addition to having on the board a draftsman of the
17 statute, one of the drafters of that GAO report to help
18 us put it in context.

19 Since then, the financial crisis of 2008 has
20 caused us as a nation to reflect on how dependent our
21 financial system is on high-quality, unbiased, credible
22 audits. It has prompted us to look again at auditor

1 independence, objectivity, and professional skepticism,
2 and to ask whether features of our financial system have
3 allowed companies to become too close to their auditors,
4 and to consider whether there are ways we can improve the
5 reliability and the usefulness of audit reports to the
6 public.

7 We're not alone in this inquiry. Many other
8 countries have commenced their own reviews of the audit
9 practices. We are fortunate to be able to hear from a
10 representative of the European Commission later today
11 about potential reforms that are currently under
12 consideration in Europe. Just last month the United
13 Kingdom published a regulation that would entail
14 mandatory re-tendering every ten years for FTSE 350
15 companies, the FTSE 350, with corresponding disclosure
16 requirements.

17 I don't mean to exclude other important actions
18 in other countries; there are many. The UK's is just the
19 most recent. Given the breadth of the international
20 debate, it's not surprising that people disagree on what
21 best reforms will be or how to implement them, or,
22 indeed, whether reform is necessary, or whether the cost

1 to those who would incur them outweigh the benefits to
2 those who would receive them.

3 I hear no doubt in any corner, however, about the
4 importance of independent audits. Let me say I believe
5 it's the rare case in which an auditor knowingly
6 compromises his or her integrity, but well-intentioned
7 auditors, as with other people, sometimes fail to
8 recognize and guard against their own unconscious biases.

9 We're nearly ten years from the adoption of
10 Sarbanes-Oxley, during which we've had time to observe
11 whether its reforms were sufficient. Against this
12 historical background, in August 2011 the PCAOB issued
13 a concept release -- a concept release seeking public
14 comment on a variety of questions about how to improve
15 auditor independence, objectivity, and professional
16 skepticism. The concept release notes the importance of
17 auditor independence to the viability of auditing as a
18 profession and highlights the risk in independence
19 arising from the client-pays model.

20 As noted in the concept release, the PCAOB
21 inspectors continue to find what is to me an unacceptable
22 level of deficient audits. In addition, inspectors

1 continue to find troubling suggestions of firms showing
2 willingness to put management's short-term interest ahead
3 of investors.

4 The concept release seeks public comment on ways
5 that auditor independence, objectivity, and professional
6 skepticism can be enhanced. In this regard, the release
7 notes that there may be risks to professional skepticism
8 in both the relatively new audit that the auditor may
9 hope to turn into a long-term engagement as well as the
10 very long engagement that no partner wants to be the one
11 to lose.

12 We've received more than 600 comment letters,
13 primarily from auditors and their clients. On the whole,
14 they counsel for more time, study, and more modest
15 reform. To be sure, I want to be cautious in making any
16 decisions and that's why I have asked for meetings such
17 as this one, two previous meetings in Washington, DC, and
18 San Francisco.

19 We have the benefit of the record of our first
20 two meetings, however, and although today's panelists
21 have been invited to provide views on any of the issues
22 raised in the board's concept release, they have also

1 been asked to comment specifically on certain themes,
2 issues, and suggestions from the prior public meetings.

3 I want to thank the panelists, my fellow board
4 members, the SEC's Deputy Chief Accountant Brian Croteau,
5 all of whom have joined us today, and especially the
6 PCAOB staff who have made this meeting possible. I look
7 forward to a thoughtful discussion that will help the
8 board in advancing its inquiry.

9 As is our custom in these public meetings, I want
10 to call on my colleagues on the board to make such
11 statements as they wish to make as a predicate to
12 beginning our panels.

13 Jeanette Franzel?

14 MS. FRANZEL: Thank you, Chairman Doty, for
15 calling this meeting to further explore some of the
16 themes that have emerged in the feedback that the board
17 has received in response to the concept release issued
18 last year. The board has received more than 670 comment
19 letters and heard from 77 speakers on this topic to date,
20 and today we will hear from a number of very qualified
21 panelists.

22 Throughout this process, the board has received

1 rich feedback on the complex issues that impact auditor
2 independence and audit quality. Commenters have
3 acknowledged the fundamental importance of auditor
4 independence as the underpinning of confidence in the
5 auditing profession. They also express support for the
6 board's efforts to ensure or enhance auditors'
7 independence, objectivity, professional skepticism,
8 although suggestions for how this might be advanced have
9 varied widely.

10 It is certainly public knowledge that the
11 majority of the commenters on this issue were opposed to
12 a requirement for mandatory audit firm rotation for a
13 variety of reasons. I'm personally committed to
14 exploring the broad range of themes and issues that
15 influence auditor independence, objectivity, and
16 professional skepticism, as well as audit quality, and
17 advancing the board's efforts to protect investors and
18 the public interest through high-quality independent
19 audits.

20 I believe that we need concerted and sustained
21 action from the full range of parties who have
22 responsibility for these issues, including those

1 responsible for accounting education, audit firm
2 recruitment and training, audit firm culture and tone at
3 the top, audit committee and board oversight, as well as
4 the PCAOB inspection process and other regulatory
5 activities. It is paramount, of course, that all of the
6 parties with responsibility throughout the process keep
7 the interests of investors front and center.

8 One of the major themes that has emerged during
9 the board's efforts is a consensus on the importance of
10 audit committees in overseeing the auditor and the audit
11 process. PCAOB does not have regulatory jurisdiction
12 over audit committees but we should not overlook the
13 tremendous value in coordinating and leveraging our
14 efforts, avoiding duplication and/or fragmentation, and
15 providing for a seamless system of effective governance
16 and audit oversight.

17 I believe investors will be well served if the
18 various organizations and groups charged with protecting
19 investors and the public interest and the integrity of
20 the US capital markets work together effectively to
21 achieve these goals. The bottom line is we need to come
22 up with a package of solutions that will be solid and

1 effective in protecting investors and the public interest
2 through independent high-quality financial audits. We
3 also need to carefully consider and analyze the potential
4 costs and benefits of various actions, as well as the
5 risks associated with unintended consequences.

6 I want to thank all the panelists and their staff
7 and their constituencies for taking the time and effort
8 to assist us in exploring these very important issues.
9 Thank you.

10 MR. HANSON: Good morning. I'd like to thank
11 Chairman Doty and my fellow board members in welcoming
12 the panelists and the Rice University community for their
13 warm welcome and thank our staff for all the effort
14 they've put into getting us here.

15 It was just about 14 months ago that we issued
16 our concept release on independence and objectivity and
17 skepticism and we have received nearly 700 comment
18 letters and heard from lots of people, and it's
19 interesting that the overwhelming majority of those
20 letters do not support a mandatory rotation but have come
21 up with a lot of interesting ideas for us to consider.
22 Some commenters, on the other hand, do believe that

1 mandatory rotation is the only way to overcome the
2 challenges that auditors face.

3 So we've received a lot of input and have a lot
4 to think about and I think we'll get some more
5 information today which will benefit all of us and
6 hopefully fill in the gaps in some of the ideas that
7 we've heard about. So I very much look forward to
8 hearing from the panelists today about areas other than
9 rotation that they might have some thoughts about and
10 hear their experiences with those areas as well.

11 So we've spent a lot of time talking about audit
12 committees and I do believe that they are a critical part
13 of the improvements that the Sarbanes-Oxley Act has
14 brought and that they can do even more. We hear directly
15 from some audit committee members that do a really good
16 job of policing their auditors and challenging them, but
17 yet we hear from other that suggest that that's not
18 universal and there's a long ways to go by many.

19 So some of the things we've done recently
20 including our standard on audit committee communications,
21 AS16, as well as the release we put out to help auditors
22 and audit committees -- I have a framework for discussion

1 about our inspection findings that I think will be very
2 helpful and we've received positive feedback, and I'm
3 interested in doing even more to help audit committees
4 achieve their goals and enhance audit quality.

5 So thank you, and I'll turn it over to my fellow
6 board members.

7 MR. FERGUSON: Yes, I'd like to join the chorus
8 of thanks for my fellow panelists here to thank the
9 panelists who will be appearing before us today, thank
10 Rice University for hosting this event in this really
11 quite wonderful venue, thank our PCAOB staff for the
12 marvelous work you've done in preparing us and getting
13 ready for this, but particularly thank the commentators
14 who will be appearing before us that the thoughtful
15 comments provided by experts to us on issues like this
16 which are difficult and contentious are vital to the work
17 that we do.

18 We really couldn't do what we're required to do
19 here and what the statute requires of us without help
20 from people like you who are coming here today. We
21 understand that you're busy; we understand that this
22 takes time out of your normal work and normal life to

1 give us our thoughts. And for that we are profoundly
2 grateful. So thank you.

3 MR. DOTY: Steven Harris.

4 MR. HARRIS: I join my colleagues in welcoming
5 our distinguished panelists today as well. I think it
6 would be very hard to overstate the importance of auditor
7 independence and auditor skepticism to capital formation
8 in this country, to the functioning of our securities
9 markets, and to the auditing profession itself.

10 In 1984 the Supreme Court stated that the SEC
11 requires the filing of audited financial statements in
12 order to obviate the fear of loss from reliance on
13 inaccurate information, thereby encouraging public
14 investment in the nation's industries and that the
15 independent auditor's obligation to serve the public
16 interest assures that the integrity of the securities
17 markets will be preserved. The Court also noted that the
18 independent auditor assumes a public responsibility,
19 transcending any employment relationship with the client,
20 and that this public watchdog function demands complete
21 fidelity to the public trust.

22 While these basic auditor independence concepts

1 are clear, the application of these concepts in a world
2 where auditing firms are for-profit, multi-service
3 enterprises paid by the companies being audited has been
4 debated for many years and continues to challenge both
5 the firms and audit regulators.

6 The board is holding these roundtables because,
7 as the chairman noted, our inspectors are continuing to
8 find numerous instances where auditors are not
9 approaching at least some aspects of their work with the
10 independence, objectivity and professional skepticism
11 demanded by PCAOB standards.

12 And our inspectors are not alone. Reports are
13 published by the inspection staffs of other countries.
14 Audit regulators frequently identify issues related to
15 auditors' independence and skepticism. Not surprisingly,
16 the last two press releases issued by the International
17 Forum of Independent Audit Regulators, IFIAR, after their
18 meetings this year in Busan, South Korea, in April and
19 in London, England, last month addressed the issue of
20 "how to improve auditor independence, objectivity, and
21 professional skepticism and the benefits and problems
22 that might result from mandatory rotation."

1 Many countries, as the chairman pointed out, are
2 moving ahead with solutions tailored to their markets.
3 For example, as he mentioned, in late September the
4 Financial Reporting Council of the United Kingdom
5 announced that all FTSE 350 companies should put the
6 external audit contract out to tender at least every ten
7 years or explain why they haven't done so.

8 The Australian Parliament has passed legislation
9 that allows its securities regulator to convey
10 confidential information to audit committees in order to
11 improve communication between audit committees and
12 auditors. The Canadian audit regulator recently launched
13 an initiative on enhancing audit quality and has
14 established working groups to address auditor
15 independence reporting and the role of audit committees.
16 The French audit regulator has suggested a maximum audit
17 engagement period of 12 years unless joint auditing is
18 being implemented. The lower chamber of the Dutch
19 Parliament just passed a bill that calls for audit
20 rotation. And later today we will hear from one of our
21 panelists, Ms. Nathalie Berger, who leads the audit unit
22 at the European Union about the numerous changes that

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1 have been proposed to the structure of the EU audit
2 market.

3 During the board's first public meeting in
4 Washington, DC, in March and our second in San Francisco
5 four months ago, our panelists suggested a number of
6 methods for enhancing auditor independence in the United
7 States including, but certainly not limited to, re-
8 tendering, enhanced independence, independent audit
9 committees, greater transparency of audit tenure, and
10 mandatory rotation. I look forward to hearing more about
11 possible solutions from our panelists today.

12 In short across the globe there appears to be an
13 emerging consensus among regulators that more must be
14 done to ensure the independence, objectivity, and
15 skepticism of auditors so investors will have confidence
16 that high-quality audits are being performed to test the
17 accuracy and reliability of corporate disclosures.

18 These roundtables are an excellent opportunity
19 for the board to create a thorough and lasting hearing
20 record before taking any action to explore each of the
21 recommendations brought to our attention. They allow us
22 to very carefully consider the intended and unintended

1 consequences of each recommended course of action
2 including importantly their potential costs and benefits.

3 Once again, I thank our panelists for joining us
4 today.

5 MR. DOTY: Our first contributor is Professor
6 Stephen Zeff, the Herbert Autrey Professor of Accounting
7 at the Jones Graduate School of Business at Rice
8 University. Professor Zeff, in the world of financial
9 accounting, is a giant. There are few academics who have
10 worn as many mantles or won as many medals as Professor
11 Zeff.

12 He's the author or editor of more than 25 books.
13 He has written more than 150 articles and comments. He
14 has been the visiting professor of most of the nation's
15 major academic institutions in accounting.

16 He was the 70th member of the Accounting Hall of
17 Fame at Ohio State University and the honors go on and
18 on. He is the only non-British member of the Academic
19 Panel of the Accounting Standards Board in the United
20 Kingdom and he is in Great Britain now working on a book
21 on the history of the International Accounting Standards
22 Board. He joins us today by video link from The

1 Netherlands. I suppose the work is going on in The
2 Netherlands.

3 But Professor Zeff has gone to great lengths to
4 make himself available for this. We thank you and
5 welcome you and recognize you for your portion of the
6 program.

7 MR. ZEFF: Thank you, Mr. Chairman, and I thank
8 the staff for setting up this video link. I know it
9 wasn't easy to arrange.

10 What I would like to do in my remarks is to takes
11 up a few themes from my written statement, which you
12 already have. One of them is the potential for
13 management influence over the selection of audit
14 committees and the other is some suggested causes of
15 professional skepticism among auditors.

16 On the first theme, where I'm concerned about
17 this potential, the origin of the problem is that it's
18 the prevalent practice in the United States for the CEO
19 to double as the board chairman. In Germany, and here
20 in The Netherlands, the law prohibits members of
21 management from sitting on the supervisory board which
22 oversees the performance of management. In the United

1 Kingdom well over 90 percent of listed companies separate
2 these two functions; in Canada, well over 80 percent; in
3 the United States, perhaps as many as 40 percent, but no
4 more than that; and quite a few of the separated
5 positions reflect, in effect, not independent chairmen
6 but chairmen who are just not members of top management
7 right now.

8 This is a concern and I raise the question as
9 should an oversight body be chaired by the head of the
10 body being overseen? It's almost as if the person in
11 charge of an audit engagement team should be the
12 company's chief accounting officer. Despite the New York
13 Stock Exchange and NASDAQ's corporate governing codes,
14 top management, as I understand it, can still exert
15 influence in choosing directors. The question is do the
16 CEO and the board take corporate governance seriously,
17 and that's not true in all corporations.

18 Now as I understand it, the board of directors
19 chooses the membership of the audit committee. But that
20 could mean nothing more than the decision is driven, or
21 at least orchestrated, by the chairman. And if the
22 chairman is also the CEO, we need to ask whether the CEO

1 should be choosing the members of the audit committee.

2 There are independent directors and independent
3 directors. I understand that, as a result of Sarbanes-
4 Oxley, only independent directors may serve in the audit
5 committee. But as I say, the independent directors
6 should be the ones who are most qualified to serve. They
7 must be proactive and probing; they must be financially
8 literate. They should possess deep or at least good
9 industry knowledge. They should evince an awareness of
10 how financial reporting services are served in investor
11 needs and not have any social and professional ties with
12 top management.

13 These are qualities the independent director
14 should have and it seems to me it should be a chairman
15 who is not a CPO who is making the selections. I think
16 it's essential to have an audit committee independent of
17 management. Ms. Franzel said earlier it's evidently not
18 within the authority of PCAOB to make any kind of a
19 change. Perhaps the SEC can but I think this matter
20 needs to be addressed. The United States is the odd
21 country out here among major countries in the world.

22 Now, to some causes of professional skepticism

1 among auditors which the board has been finding. If one
2 can judge by the textbooks which are used in universities
3 throughout the United States, the way in which accounting
4 is taught in American universities and college
5 effectively is a massive indoctrination or memorization
6 of Generally Accepted Accounting Principles, teaching to
7 the CPA examination.

8 That kind of teaching does not engage students'
9 critical faculty. It makes it seem as if GAAP, Generally
10 Accepted Accounting Principles, is without defects,
11 without deficiencies, cannot be improved. Typically, in
12 the textbooks, it's pure --

13 MR. DOTY: I think we should invite our next
14 panel to come to the place where they would present. If
15 we can't get Steven Zeff back online quickly, we'll
16 simply move to the second panel and then bring him back
17 in.

18 MR. FERGUSON: Do we have the audio link? Is
19 that what --

20 MR. DOTY: I don't know. I think they're working
21 on Skype.

22 MR. FERGUSON: Could we just do it by telephone

1 line?

2 MR. DOTY: This did not happen in the space
3 shots, of course. This was the good thing but --

4 This is very largely an academic program. We
5 have audit committee members. We have financial
6 preparers and professional accountants on the program but
7 there's a very heavy bias here toward academic input and
8 institutional knowledge.

9 We are fortunate the panel that is going to be on
10 is Professor Karen Nelson. Karen K. Nelson is the Harmon
11 Whittington Professor of Accounting and Accounting Area
12 Coordinator at the Jones Graduate School of Business here
13 at Rice. She earned her PhD from the University of
14 Michigan, holds a bachelor's degree summa from the
15 University of Colorado, is a certified public accountant.

16 She joined the Rice faculty in 2003, teaches
17 financial reporting in the MBA and executive MBA
18 programs. She has won many accolades for teaching
19 excellence. She's been a visiting professor at major
20 institutions. Her work focuses on financial reporting
21 and disclosure issues, including the role of regulators,
22 auditors, and private securities litigation in monitoring

1 financial reporting quality.

2 She's held research seminars at over 40 leading
3 business schools in the US. Her research is cited by the
4 AAA Research and Impact Task Force on the Role of
5 Academic Accounting Research on Professional Practice.
6 She's been featured in the financial press and
7 publications such as the *Wall Street Journal*, *Business*
8 *Week*, and *Forbes* --

9 Ah, Professor Zeff, you're back and it's good to
10 hear you. Please proceed.

11 MR. ZEFF: I'm very sorry. We lost our
12 connection. Let me pick up where I think we may have
13 dropped off, saying that this kind of teaching does not
14 engage the students' critical faculty. Typically, in
15 textbooks today, there is a distinction drawn between
16 IFRS and US GAAP that seldom, if ever, do the authors say
17 which is to be preferred? Which is the better? Which
18 is one that perhaps we ought to abandon? There simply
19 is a description and no analysis.

20 This kind of teaching does not stimulate
21 students' intellectual curiosity about the problems that
22 gave rise to the standards and the political lobbying

1 that may have diluted the quality of the standards. A
2 good example is the distinction between available for
3 sale and trading securities in Statement 115 of the FASB
4 in 1993. Seldom is it mentioned that this unholy
5 compromise was driven by intense lobbying by the banking
6 industry, or why the lobbying occurred, which helps us
7 understand that this was not really the preference by the
8 FASB and perhaps is going to be changed very soon, but
9 it's still with us today in US GAAP.

10 This kind of teaching does not provide any sense
11 of the historical development of attempts at setting
12 standards over the decades. For example, there have been
13 attempts since the 1940s by standard setters in the
14 United States to change from historical cost accounting
15 to current cost accounting or current value accounting
16 or general price level accounting for property, plant and
17 equipment. Virtually all of these have failed.

18 But nothing is said in the textbooks about these
19 attempts and nor why they have failed. They have failed
20 because the Securities and Exchange Commission,
21 especially the staff of the Securities and Exchange
22 Commission, is very conservative and every time these

1 have been raised, the SEC's accounting staff has opposed
2 them. This has not been true in other countries.

3 In the UK and Australia and New Zealand for many
4 decades they have allowed reevaluations of property,
5 plant and equipment. Why is the United States different?
6 This is simply not brought into the courses. So,
7 therefore, one has to raise the question as to whether
8 this kind of teaching is likely to turn out the
9 individuals who will go with audit firms who will exhibit
10 professional skepticism.

11 Finally, another possible explanation is that one
12 consequence of the descent from professionalism into
13 commercialism in accounting in the United States, the
14 almost singled-minded pursuit of growth, profitability,
15 and global reach of business values, and not professional
16 values, has led to a lack of intellectual vitality in the
17 US accounting profession.

18 Prior to the 1980s, audit firm partners would
19 give speeches, and write articles and even books,
20 expressing their views on controversial accounting
21 issues. But not today. The profession is bland and
22 partners are uninterested in stimulating a dialogue on

1 how best to solve the pressing problems of the day.

2 There is no incentive to speak out publicly as partners
3 and firms seek to avoid offending clients.

4 In the 1980s a partner in one of the major
5 accounting firms said that the worst thing a partner can
6 do is to lose a client over a matter of principle. In
7 view of the way we teach accounting and the absence of
8 any debate or controversy in accounting principles in the
9 literature, I am not surprised that the PCAOB finds that
10 the professional skepticism to be wanting.

11 Thank you very much.

12 MR. DOTY: I would suggest that we introduce the
13 other panelists in the first segment.

14 Professor Zeff, do you have time to stay on with
15 us and listen to this and receive questions and
16 participate, and if you do, it would be a good thing, I
17 think, if we had a round robin with you and the panelists
18 here present. Is that all right? Can you do that?

19 MR. ZEFF: That's fine with me.

20 MR. DOTY: I've just introduced Karen Nelson, a
21 distinguished professor here at Rice. She is joined by
22 Professor Mark Nelson, the Landew Professor of Accounting

1 at Cornell University's Johnson Graduate School of
2 Management.

3 Mark received his BBA degree from Iowa State, MA
4 and PhD degrees from Ohio State. He currently teaches
5 intermediate financial accounting to MBA students. He's
6 the co-author of *Intermediate Accounting*. His research
7 examines psychological and economic factors that
8 influence how people interpret and apply accounting,
9 auditing, and tax regulations in trade and financial
10 markets.

11 His research has been published widely. He's won
12 the American Accounting Association's Notable
13 Contribution to Literature and the Wildman Medal as well
14 as the Johnson School's Faculty Research Award. He has
15 served four years on the FASB's Financial Accounting
16 Standards Advisory Council.

17 Welcome, Mark. We're glad to have you here.

18 Scott Whisenant, Associate Professor, a Fred Ball
19 professor, a fellow at the University of Kansas where he
20 is director of doctoral program in the accounting
21 department. He has a PhD in accounting from the
22 University of Oklahoma, has previously been a member of

1 the faculty of Georgetown, MIT, and the University of
2 Houston.

3 His research investigates factors related both to
4 earnings quality and audit quality. He's been published
5 widely in *The Accounting Review*, *Journal of Accounting*
6 *Research*, and numerous other financial accounting
7 journals.

8 Welcome, Scott.

9 So I think, consistent with our practice, we
10 would like to begin with Professor Nelson, go through the
11 panel, and then we will have question time and board
12 members will engage in questions with all four of you.
13 Thank you.

14 Karen?

15 MS. NELSON: Good morning, and thank you very
16 much for allowing me to speak with you this morning.
17 It's an honor to be with you here today. I start my
18 remarks maybe following on a little bit of the historical
19 perspective of my colleague Steve Zeff earlier in noting
20 that it's interesting that although concerns about
21 conflicts of interest in auditing and other professions
22 seem commonplace today, the term and, indeed, the concept

1 itself, has a relatively short history, first appearing
2 in law dictionaries and codes of ethics only beginning
3 in the 1970s.

4 This relatively recent awareness of the problems
5 caused by conflicts of interest has likely been driven
6 by the types of advisory relationships inherent in an
7 increasingly complex business environment. In short, we
8 have become much more dependent on the judgment of others
9 and much less able to evaluate those judgments.

10 This trend is perhaps nowhere more evident than
11 in accounting where standards increasingly require an
12 extraordinary level of judgment by managers in preparing
13 financial statements and by auditors in assessing whether
14 those financial statements present fairly the company's
15 financial position and performance. In this environment,
16 it's not surprising that concerns arise about whether we
17 have the best model to allow auditors to maintain their
18 objectivity and effectively exercise professional
19 skepticism.

20 So what can be done about conflicts of interest?
21 I believe there are three categories of responses that
22 are typically proposed. The first is to fundamentally

1 redefine the underlying relationship to remove that
2 conflict. For example, a judge with financial or other
3 conflicts in a case before her court may recuse herself
4 in favor of another judge with no such conflicts. Short
5 of a radical overhaul of the existing auditor-client
6 relationship, including, but not limited to, the
7 client-payer model, we must accept that this is probably
8 not a possible solution to completely eliminate the
9 auditor's inherent conflict of interest.

10 A second response that is frequently proposed is
11 to disclose the nature of the conflict, and that was
12 mentioned, I believe, earlier in some of the introductory
13 comments. In this vein, some have suggested that
14 companies be required to disclose the length of the audit
15 relationship and other clarifying information in the
16 proxy or 10-K. It is argued that the public, thus
17 informed, should be able to assess the potential for the
18 auditor's independence to be compromised and adjust the
19 reliance on the associated financial statements
20 accordingly.

21 However, research casts doubt on the
22 effectiveness of conflicts of interest disclosures. The

1 simple fact is that people do not discount the judgment
2 of advisors with misaligned incentives as much as they
3 should, even when those conflicts of interest are
4 disclosed, and I should also note that this is
5 particularly the case for small investors.

6 This leaves the third type of response which is
7 to manage the conflict; in essence, to partially realign
8 the auditor's interests, albeit not enough to completely
9 eliminate the conflict. Mandatory audit firm rotation
10 is one such response intended to realign the interests
11 of auditors more closely with those of the investing
12 public. It is important to recognize, however, that
13 mandatory rotation may not be enough to significantly
14 improve independence if auditors continue to face the
15 threat of dismissal at the discretion of the client.

16 As a result, I believe there are really four
17 possible regimes to consider: first, neither mandatory
18 rotation nor mandatory retention; second, mandatory
19 rotation only; third, mandatory retention only; and
20 finally, mandatory rotation coupled with mandatory
21 retention.

22 A research experiment comparing these four

1 regimes shows that auditors are significantly more likely
2 to issue a report biased in favor of the client in the
3 regime with neither a mandatory retention nor rotation,
4 in other words, the model currently employed in practice,
5 relative to each of the other three regimes.

6 Auditors are most conservative, or have the
7 lowest frequency of biased reports, in the regime with
8 both mandatory rotation and retention. Overall, these
9 findings suggest that mandatory rotation can increase
10 independence either as a standalone rule or in
11 conjunction with mandatory retention.

12 A compromise position to mandatory audit firm
13 rotation is mandatory audit tendering, also mentioned
14 this morning. There are few examples of this model in
15 practice and it has not been studied widely by accounting
16 researchers. I was able to identify only two related
17 studies based on public sector experience in Australia
18 where local councils called open tenders for audit
19 services every six years for a guaranteed six-year tenure
20 period.

21 The evidence suggests that audit fees decreased
22 following the introduction of mandatory tendering, but

1 that fees were secondary to audit quality considerations
2 in the decision to either retain the incumbent or appoint
3 a successor. If the incumbent did participate in the
4 tender, however, there was a high probability of
5 retention. Although these findings are difficult to
6 generalize and should be interpreted with caution, there
7 is nothing to suggest here that mandatory tendering would
8 impair audit quality or auditor independence.

9 Of these two options, namely, mandatory rotation
10 versus mandatory tendering, I believe that rotation,
11 particularly when coupled with mandatory retention,
12 offers the greatest potential to fundamentally realign
13 auditors' interests to the benefit of the investing
14 public, in other words, to alleviate the conflict of
15 interest inherent in the client-payer model.

16 Tendering is more likely to result in a form-
17 over-substance solution with little effective change in
18 the auditor-client relationship beyond a periodic
19 justification for retention.

20 In closing, I'd like to comment on two additional
21 issues inherent in managing conflicts of interest. The
22 first is the cost-benefit tradeoff of various proposed

1 solutions. If these were easy to quantify, then the
2 solution would be much more straightforward and we would
3 likely not be here today. Compounding the problem is
4 that the costs of mandatory audit firm rotation are
5 concentrated while the benefits are diffuse.

6 Audits, as we know, are a public good. However,
7 the benefits to investors of high-quality financial
8 statements are substantial. Continuing with the status
9 quo at a time when more and increasingly complex
10 judgments are being demanded of auditors is likely to
11 increase the probability of audit failures and the
12 resulting losses suffered by investors.

13 And my second and final comment is that managing
14 conflict of interest can involve structural changes in
15 the auditor-client relationship, such as mandatory audit
16 firm rotation, but also require ongoing and independent
17 oversight to ensure that the auditor's conflict of
18 interest does not interfere with the proper exercise of
19 judgment.

20 The first line of defense in this situation is a
21 strong and capable audit committee. By all accounts,
22 audit committees have improved in the post-SOX era but

1 more could and should be done to strengthen their role.
2 Research shows that all too often management still plays
3 a dominant role in overseeing the audit function.
4 Moreover, criteria for qualifying as a financial expert
5 do not ensure the level of knowledge and experience
6 necessary to provide adequate oversight.

7 The audit committee should include members that
8 not only have demonstrable expertise and experience in
9 financial accounting and auditing but the entire
10 committee, in my belief, should be required to complete
11 a minimum number of accounting and auditing continuing
12 education hours each year, such as accountants
13 themselves, auditors themselves do.

14 In conclusion, I support the PCAOB's efforts to
15 consider mandatory audit firm rotation and other
16 meaningful reforms that will enhance auditor independence
17 and objectivity. And thank you again for allowing me to
18 participate in this important and timely discussion.

19 MR. DOTY: Thank you.

20 And Mark Nelson, please proceed.

21 MR. NELSON: Chairman Doty, Board members, it's
22 an honor to speak with you today.

1 Much of my research examines issues related to
2 audit judgment and auditors' professional skepticism and
3 one recent project synthesizes over 250 research studies
4 and develops a model of the determinants of professional
5 skepticism. So I'll be drawing primarily on that
6 research today.

7 Consistent with the PCAOB's concept release, I'll
8 make my remarks within the context of the current
9 client-payer audit model, and focus on the potential
10 effects of rotating audit firms on the professional
11 skepticism of auditors within those firms.

12 My model views an auditor's professional
13 skepticism as influenced by three factors: first, traits,
14 or innate person-specific characteristics that determine
15 personality and tendency towards skepticism; second,
16 knowledge, gleaned from education, training and
17 experience; and third, incentives, defined broadly to
18 include such considerations as expected future fees from
19 a valuable client, potential costs associated with
20 negative inspections and audit failures, and the desire
21 by auditors in the field to be evaluated highly and to
22 meet their time budgets.

1 These three factors combine with features of the
2 auditing context and with various auditor judgment
3 processes to determine the extent to which individual
4 auditor's judgments and actions reflect professional
5 skepticism. When I consider mandatory firm rotation from
6 the perspective of this model, a number of points stand
7 out.

8 First, I'll ignore traits, assuming that firm
9 rotation results in assignment of auditors who possess
10 roughly the same levels of innate professional
11 skepticism. I'll focus on knowledge and incentives.
12 Regarding knowledge, we already have mandatory rotation
13 of individual audit partners, but mandatory rotation of
14 audit firms could affect the knowledge applied on an
15 audit in at least two ways: first, client-specific
16 knowledge. An audit firm develops a detailed
17 understanding of their client, and that knowledge is
18 updated over time through repeated interactions. And a
19 cost of mandatory rotation is that it nullifies that
20 client-specific knowledge and requires auditors at a new
21 firm to replicate it, putting auditors at the new firm
22 at an initial disadvantage.

1 And I think that you could have industry
2 knowledge as a sort of a related subset to that category.

3 Second is the idea of a "fresh look" where audit
4 firms may not by updating their knowledge to the extent
5 that they should so a benefit of mandatory rotation is
6 a forced reconsideration that provides that fresh look
7 beyond what would occur by only rotating personnel within
8 the same firm.

9 One approach to reducing the loss of
10 client-specific knowledge associated with mandatory
11 rotation could be to enhance predecessor-successor
12 auditor communications. However, I think it's important
13 to note that that enhanced communication likely would
14 reduce the extent to which the successor auditor actually
15 provides a fresh look.

16 So now let's talk about auditor incentives. Much
17 research indicates that incentives can affect auditors'
18 judgments consciously as well as unconsciously. So I
19 don't think the question is whether incentives will
20 influence auditors' judgments, but rather how a
21 particular institutional change like mandatory firm
22 rotation will affect the balance of the incentives of the

1 auditors that do the work.

2 And I think that there are four changes in
3 incentives that we should talk about. The first is the
4 idea of reduced economic bonding so an obvious benefit
5 of mandatory firm rotation is that it reduces the stream
6 of future payments that the audit firm risks when an
7 auditor disagrees with their client and that change
8 should reduce the auditor's incentive to please that
9 client.

10 I think this benefit would occur primarily in the
11 couple of years immediately preceding mandatory rotation,
12 as prior to that point the future fee stream at risk
13 still would be very large. Instituting a rule that
14 prevents the client from dismissing their auditor would
15 extend those benefits over the life of the audit
16 engagement, but might unduly restrict a client from
17 changing auditors, particularly over long rotation
18 periods.

19 Next, another potential benefit of mandatory firm
20 rotation is that it exposes the auditor to second
21 guessing by a successor auditor. If that second guessing
22 adds to the exposure that auditors currently face from

1 PCAOB inspections, incentives for audit quality should
2 be enhanced. Once again, I think this benefit would
3 occur primarily in the couple of years immediately
4 preceding mandatory rotation.

5 A potential cost of mandatory firm rotation is
6 that auditors may perceive little incentive to deal with
7 smaller but escalating problems just prior to rotation.
8 Shifting those problems to the successor auditor might
9 be particularly attractive if the current auditor depends
10 on recommendations from their current clients as they
11 seek new clients.

12 And finally, I'm concerned about pressures to
13 enhance audit efficiency. Another cost of mandatory
14 rotation arises because auditors may have to price their
15 services lower and absorb setup costs in order to compete
16 effectively as they aggressively pursue new clients in
17 this new regime. Audit firms may respond by decreasing
18 the resources they devote to audits and performing
19 engagements under greater time pressure, which I believe
20 compromises professional skepticism.

21 So, overall, the model and the extant research,
22 I think, highlight multiple ways that mandatory rotation

1 could increase or decrease auditors' professional
2 skepticism. Under a very short rotation period, I think
3 it's likely that the costs associated with obtaining and
4 setting up new clients would dominate the benefits and
5 under a longer rotation period, the costs are spread over
6 more years, but the benefits of rotation are reduced.
7 And so, on balance, I don't see a persuasive case for
8 mandatory firm rotation increasing auditors' professional
9 skepticism over the life of the engagement.

10 It also might be useful to use this framework to
11 consider mandatory re-tendering, whereby companies don't
12 have to rotate auditors, but instead must put the audit
13 up for bid. I'm concerned about that approach. An
14 advantage of re-tendering is that clients could choose
15 to retain auditors if they believed the auditor has a
16 particular knowledge advantage. However, as the re-
17 tendering date neared, I think auditors would be
18 particularly concerned about pleasing their client to
19 avoid losing the engagement, while still being exposed
20 to high fee pressure due to competitive bidding.

21 And also, second guessing by a successor auditor
22 may be a low-probability event, rather than a sure thing,

1 reducing that benefit. So, on balance, I don't see
2 mandatory re-tendering is likely to improve professional
3 skepticism, and there are circumstances in which in which
4 it might be counterproductive.

5 I'd like to close by encouraging the PCAOB to
6 also consider other changes in the current audit setting
7 besides mandatory firm rotation that could be used to
8 address some of the concerns about professional
9 skepticism indicated in the PCAOB's concept release.

10 As one example, the concept release indicates
11 concern that some auditors do not sufficiently challenge
12 management's assumptions with respect to critical
13 accounting estimates. I'm involved in a research project
14 right now that provides evidence that at least some of
15 that problem might be exacerbated by the way in which
16 standards and procedures are written.

17 In our study, experienced audit managers
18 participate in a simulated audit planning task for a
19 level-3 fair value estimate and we vary between auditors
20 whether audit procedures are framed positively, as is
21 done in current standards and practice, or negatively.

22 For example, a procedure described with a

1 positive frame is "determine whether client assumptions
2 are reasonable," while the same procedure described with
3 a negative frame is "determine whether client assumptions
4 are not reasonable." Our results indicate that auditors
5 given a positive frame plan significantly fewer hours
6 than do auditors given a negative frame, particularly
7 with respect to procedures that the auditors view as less
8 verifiable, like those that assess the reasonableness of
9 assumptions.

10 This occurs if even the most auditors indicate
11 later that they'd plan the same level of effort
12 regardless of frame. So an implication is that other
13 changes in auditing standards and practice besides
14 mandatory firm rotation potentially could improve
15 professional skepticism with respect to some of the
16 issues that are indicated in the concept release.

17 In our study we also vary whether the audit
18 managers are under pressure to design a particularly
19 efficient audit. Similar to prior research, our results
20 indicate that auditors plan significantly fewer hours
21 when under high efficiency pressure. These results
22 suggest that increasing efficiency pressure, as might

1 occur with more frequent competitive bidding that could
2 accompany mandatory firm rotation, might reduce planned
3 audit effort and thus potentially reduce professional
4 skepticism.

5 As a last point, I hope we get more of a change
6 during the Q&A period to talk about research because I
7 think that the PCAOB has an opportunity to use research
8 to help improve auditors' professional skepticism. In
9 particular, the PCAOB has an absolute treasure trove of
10 data from the inspections that you do and I think it
11 could be put to very good use.

12 I hope you find these remarks to be helpful as
13 you consider this important topic. I'm happy to provide
14 further information and thank you very much.

15 MR. DOTY: Thank you.

16 Scott.

17 MR. WHISENANT: Chairman Doty, and other members
18 of the PCAOB and PCAOB staff, and the SEC that's with us,
19 it's an honor to speak with you this morning about this
20 very important topic.

21 I'd like to start by saying that in my 30 years
22 in the accounting profession as a student, an auditor,

1 and now an academic, I believe the intensity of the
2 discussions about independence, objectivity and
3 professional skepticism is well justified given the
4 importance of the topic to our profession and to the
5 efficient functioning of our capital markets. The issue
6 before the Board today, and in Brussels, is one that
7 clearly represents a structural shift and warrants
8 careful consideration of the cost as well as the
9 benefits.

10 As a co-author of the BNA portfolio entitled
11 *Auditor Independence*, I document with my co-author
12 changes to auditor independence rules for almost a
13 century in the US. Admittedly, a few represent
14 structural shifts; most merely represent tinkering around
15 with the edges.

16 In my research for that portfolio on auditor
17 independence for BNA and my other professional
18 experiences, an overriding theme for auditor independence
19 rules is clear. The rules serve two related public
20 policy goals. First, the rules are intended to minimize
21 the possibility that external factors will influence an
22 auditor's judgments while performing financial statement

1 attestation functions. Second, the rules are intended
2 to promote investor confidence in the financial
3 statements of public companies.

4 Before discussing some of the literature on
5 auditor rotation, I note that in the US, we currently
6 operate in a regulatory environment in most of the value
7 of the auditor-client relationship to audit firms can be
8 estimated at the present value of the annuity stream for
9 decades. Indeed, the auditor tenure at Enron, Waste
10 Management, and many other corporate failures can be
11 traced back not just decades but to the very IPOs of
12 those registrants. The length of the relationship has
13 to be a consideration in what we deliberate today.

14 Thus, investigating audit quality in a voluntary
15 auditor-switching environment may not yield generalizable
16 audit evidence to a regulated rotation environment since
17 voluntary changes could indicate non-public problems with
18 the clients. On the other hand, one of my colleagues,
19 Karen Nelson, has done some research that suggests that
20 audit firms are quite capable of responding efficiently
21 to changes in capacity.

22 With that in mind, in a study of voluntary

1 switching environment in the US, my two co-authors,
2 Professor Sankaraguruswamy and Willenborg and I control
3 for some of the confounding effects associated with
4 auditor switches in a voluntary environment. We try to
5 analyze simply changes that are a result of price
6 competition. We show, contrary to some predictions, that
7 in the US which now requires audit fee disclosure that
8 price competition does continue to exist. However, the
9 price competition that has shown up in these initial
10 audit discountings goes away in the second year.

11 More importantly, at least to the discussion
12 today, we found no evidence that lower audit quality
13 exists for clients receiving initial audit discounts
14 using both restatements and going-concern opinions as
15 proxies for measuring audit quality.

16 Much has been made of the potential cost of
17 mandatory auditor rotation, but few studies have reported
18 on or attempted to document the benefits of mandatory
19 auditor rotation. This is in part due to the fact that
20 only a few countries have adopted such a regulatory
21 practice.

22 Ann Vanstraelen's 2000 study is one of the

1 exceptions to this. She investigates the impact of
2 renewable long-term audit mandates on audit quality. The
3 results of her study suggest that long-term auditor-
4 client relationships significantly increase the
5 likelihood of an unqualified opinion; that is, they lower
6 audit quality except when the long-term audit mandate is
7 in its last year. It appears, as one of my colleagues
8 said last week in an audit symposium, that in this final
9 year the auditors finally drop the hammer down on their
10 clients. She concludes that the findings could be in
11 favor of mandatory auditor rotation to maintain the value
12 of an audit to external users.

13 In a study in which the goal was, however, to
14 provide the evidence on the debate on mandatory auditor
15 rotation, my colleague Kathleen Harris and I provide
16 empirical evidence on the potential costs and benefits
17 of mandatory auditor rotation rules by investigating
18 whether rotation rules are associated with changes in
19 audit quality in audit markets, most especially those
20 that have adopted mandatory auditor rotation rules.

21 Using available data from these countries, we
22 investigate the debonding effect of a rotation policy,

1 that is, the enhancement of audit quality in those
2 countries. A comparison of all years with available data
3 pre-adoption to those post-adoption yields some very
4 interesting results, in our opinion.

5 The data indicate that there is evidence of less
6 earnings management, less managing to earnings targets,
7 and more timely loss recognition in the post-adoption
8 periods compared with the pre-adoption periods. We
9 conclude that the quality of audit markets, as defined
10 in our study, improves, on average, after enactment of
11 rotation rules.

12 We also investigate the allowed discretion in the
13 year before and after auditor changes in countries that
14 have adopted rotation rules and we find evidence of lower
15 audit quality in both of these years. The finding stands
16 in stark contrast to the voluntary auditor-switching
17 evidence in the US, as well to Ann Vanstraelen's work.

18 The results highlight the importance,
19 particularly to audit market regulators, of considering
20 ways to mitigate the erosion of audit quality during the
21 transition to new auditors under rotation rules, for
22 example, the use of detailed handover files between

1 predecessor and successor audit firms or two-auditor
2 involvement in years of initial audits, that is, the
3 "four eyes" concepts.

4 I'd like to note that, depending on the
5 statistics that we investigated, the benefit to audit
6 quality of adopting rotation rules appears to be larger
7 by a factor of at least two, and in some cases more, than
8 the costs of audit quality erosion at the forced-rotation
9 audit engagements.

10 In closing, I applaud you and others,
11 particularly those in Brussels, for taking on the very
12 important issue of the potential costs and benefits of
13 rotation rules and I appreciate the opportunity to speak
14 with you on this issue this morning.

15 MR. DOTY: Well, thank you all. This is where we
16 wanted to get to with the concept release. Our custom
17 here is to have -- to go through the board, allow board
18 members to engage with you, and some staff members to
19 engage with you.

20 To summarize briefly though, Steven Zeff, I
21 think, has given us something of a keynote. He has said,
22 essentially, something must change in the United States

1 in conduct in the board room, in conduct in the
2 governance structure, at the risk of the US becoming an
3 outlier, that we, in fact, may be behind the rest of the
4 world in a governance structure that people can have
5 confidence in, unless some things change.

6 I note with some interest, Professor Zeff, that
7 one of your early papers has a vivid illustration of the
8 fact that DuPont changed -- it rotated its auditors every
9 year for an extended period of time, up until the '50s.
10 So we have major companies that have engaged in firm
11 rotation.

12 Given Professor Zeff's strong injunction that
13 principles endure, practices change; concepts endure,
14 practices change, we're dealing here with a concept which
15 has endured, which is independence, and how we continue
16 to preserve it and protect in the fact of changing
17 practices in our business community.

18 Professor Nelson has pointed us to experimental
19 data, in both cases with and without rotation, and with
20 rotation and retention, and has raised some interesting
21 questions that sound -- that go to rest in a subject that
22 Professor Hu is going to get into later which is what are

1 the risks to us if we do nothing in the face of what we
2 know is going to be a rapidly changing commercial and
3 complex environment.

4 Mark Nelson comes on and raises a cautionary
5 note. I think though that it could be said safely that
6 he recognizes that familiarity is something to be
7 concerned about as an issue in terms of objectivity and
8 independence, but he is cautioning us on the things that
9 must be considered to avoid unintended consequences
10 unless we run into a system in which changing a rule or
11 a structure on independence would accomplish nothing we
12 want and may accomplish things we don't want. These are
13 questions that will occupy us, I think, for some time.

14 And then we got Scott Whisenant who has done
15 something very important here because he has drawn the
16 causal nexus between independence, rotation, tenure, and
17 he has done that with data. The one thing that we hear
18 a great deal in this discussion, in this debate, is
19 there's no evidence; there's no data; there's nothing
20 empirical that supports the issue that one might achieve
21 an improvement in independence through audit rotation.
22 Scott, in his research, has charged at that head on.

1 The issue is joined as to whether there is an
2 empirical basis for seeing audit improve with some kind
3 of mandatory rotation. There will be disputes; there'll
4 be discussions, of course, about the data. Scott, I
5 would have to say, is remarkable in that his papers --
6 he lists or he lays out; he dissects at the end of his
7 own analysis the areas where he thinks the data or the
8 research has stopped short and where more research is
9 needed.

10 So we have an extraordinary array here of views
11 on this subject, and with that background I'm going to
12 start the questioning and the engagement by our members
13 of the board.

14 Our former GAO member, Jeanette Franzel.

15 MS. FRANZEL: Thank you, Mr. Chairman. Thank you
16 to all of the panelists for a very rich discussion and
17 there are many topics here that I'd love to explore so
18 I feel very constrained in limiting myself, but please
19 feel free to chime in on any other issues if I don't ask
20 about them and you feel like you really want to elaborate
21 further.

22 Professor Zeff, I was especially intrigued by

1 your statements that the United States might be an
2 outlier in terms of corporate governance and that might
3 be really driving some of the incentives, and I'd be
4 interested in hearing more from you about that.

5 In your written statement, you also talk about
6 accounting education in the United States and I'm going
7 to ask all the panelists for views on really how can we
8 better train and educate accountants, not just at the
9 university level but throughout their careers because
10 knowledge is one of the main -- we've got personal
11 traits, knowledge, and incentives.

12 So it's that knowledge issue that's very
13 important because when you look at accounting and
14 auditing issues, practitioners encounter situation
15 frequently that they've never seen before, situations
16 that can't be taught in a classroom. Business evolves
17 quickly and there are new types of transactions all of
18 the time.

19 How can the education and training of
20 professionals really give them the framework and the
21 basis for thinking critically and making professional
22 judgments and using skepticism in these types of cases

1 because oftentimes auditors are faced by a point of view
2 being presented to them and this is something brand new.
3 And so I'd be very curious to hear from all of your views
4 on how education and training could be changed throughout
5 the entire career of accountants and auditors.

6 This is really true for preparers as well and,
7 Karen, I know you teach financial reporting and you also
8 teach executive programs, and so you see people later in
9 their careers. So I'd be very interested in hearing your
10 perspectives on maybe how people struggle with this and
11 different ways of emphasizing that professional
12 skepticism in the professional.

13 And, Mark, I'm very intrigued by a statement you
14 made in your written statement about how the way auditing
15 standards and procedures are written may actually be
16 causing people not to use the proper amount of
17 professional skepticism. So auditors aren't sort of
18 asked to prove why something is not correct but rather
19 go out and say that this is okay.

20 And, Scott, the lower audit quality during
21 transitions, this must be also related to knowledge so
22 I'd love to hear all of your perspectives on education

1 and training and, Steve, also the statement about the US
2 being an outlier.

3 MR. DOTY: Would you all like seriatim to bump
4 the Franzel menu? We have until 10:20 so this is going
5 to be an open discussion.

6 Professor Zeff?

7 MR. ZEFF: One of the problems we have in the
8 corporate boardroom is there's been a very strong
9 resistance, as I understand it, to a separation of the
10 two positions. Every year a few companies add on but
11 there's a general belief apparently among chief executive
12 officers that they want to work with the board as
13 partners. In my mind, this is totally opposite the
14 entire purpose of having a board of directors
15 representing the shareholders overseeing the performance
16 of top management and other countries have recognized
17 that.

18 I don't know what movement or what momentum there
19 is in this country or, indeed, what legislative or
20 regulatory organ can do anything about it. Obviously,
21 Congress can; possibly the SEC can. I believe that the
22 New York Stock Exchange and NASDAQ requirements or rules

1 do not indicate a preference here. I could be wrong; I
2 haven't studied them in depth.

3 But I think we must have some movement here
4 because until we see a separation of those two positions,
5 I think we face the problem that the chief executive
6 officer essentially is in a position of choosing the
7 members of the audit committee, and I do not believe that
8 this is a healthy situation at all.

9 MS. NELSON: Let me ask you. Did you, Ms.
10 Franzel, wish for me to address that issue or the
11 education issue more directly in your question?

12 MS. FRANZEL: I'm interested in the education
13 issue, yes.

14 MS. NELSON: As you point out, my teaching has
15 been not to people who are training to be accountants at
16 Stanford. I taught the full-time MBA program here at
17 Rice; I teach the executive MBA and executive programs.
18 And so my teaching is not like what Professor Zeff
19 described earlier, I think. He's correct in the way that
20 we teach accountants. We teach to the test; we teach the
21 detailed rules; we don't think people how to think.
22 Because I'm not teaching accountants, I take an opposite

1 approach. I teach people how to think about the
2 structure, the framework of accounting. I don't teach
3 the rules because they are not training to be
4 accountants.

5 And so, I think, particularly for the executives,
6 those who are going to be on the user side, the preparer
7 side -- often not the accounting side but the manager and
8 user side, that that helps them frame a broader
9 perspective on the judgments and decisions required in
10 accounting and not be so wedded to the notion of the
11 rules and things that Mark touched on, what are the rules
12 and how do we get to satisfy those rules.

13 I think some blending of that teaching approach
14 at both the undergraduate level to those who are pursuing
15 a career in accounting and to the auditing ranks with the
16 needing to know what the structure of the rules are would
17 be definitely beneficial, but I don't think -- and I
18 agree with Professor Zeff on this, that it's practice
19 today for the most part.

20 MR. NELSON: If I could respond both to the
21 education question and then also to the framing question
22 that you posed -- first off, I'm a textbook author so I'm

1 public enemy number one on this to some extent, and I can
2 tell you that when you're writing an intermediate
3 accounting textbook you face this balancing act because
4 you want it to be comprehensive and you want it be
5 rigorous and you do worry that the people who are
6 consuming this book have to be able to pass the CPA exam
7 but more broadly have to be cognizant of GAAP.

8 And at the same time, you want it to be real
9 world and you want to build in critical analysis and
10 critical thinking. So the books are big and they're full
11 and it's tough to fit a lot more into that particular
12 segment of our current conventional curriculum. There
13 is some balancing act but I'd agree that at the
14 undergraduate level, there isn't as much critical
15 thinking and critical analysis as we'd like.

16 I agree with Steve completely that understanding
17 history better is really an important perspective for our
18 students. I think it's really unfortunate that we don't
19 have accounting theory courses in most curriculum today,
20 even though we have a 150-hour program. So I think
21 that's a way to go to really address this head on.

22 One thing as an aside, I'd say, is that IFRS

1 convergence, while in some ways difficult for teachers
2 and for textbook authors, has given you a really nice
3 opportunity both to observe a political process in action
4 and also to say, look, here's two different regimes that
5 are handling the same thing. Why? So it gets you away
6 from the idea that accounting rules were written by God
7 and handed to Moses on tablets and you can actually talk
8 about the evolution of accounting and disagreements and
9 what that means. So that's been an opportunity for me
10 in the classroom.

11 In terms of how this extends, I think Karen made
12 a really good point when she said ongoing training for
13 audit committee members is critical, and I think a
14 challenge for public accounting firms is realizing when
15 the person in the field doesn't have the necessary
16 knowledge and when to appeal to their professional
17 practice folks or when to appeal to a specialist, and to
18 pull that trigger early rather than late. I think that's
19 very important.

20 In terms of the framing aspect of the research
21 that I was talking about, my main concern here is that
22 when you're dealing with complex estimates -- there's a

1 paper by Griffith, Hammersley and Kadous that look at
2 PCAOB inspection reports in '08 and '09, and they
3 identify sort of two-thirds of these involving estimates
4 broadly defined. I think, is that reasonable to say that
5 it's roughly in that category?

6 Anyway, a lot of the problem here is in estimates
7 and so when you think about that situation, the current
8 way that we tack this is the auditor is supposed to get
9 an understanding of the client's process for coming up
10 with the estimate and then the auditor is supposed to
11 determine whether that estimate is reasonable.

12 They can do that in a number of ways including
13 auditing the client's process as well as looking at
14 subsequent events and forming an independent estimate.
15 And so when I look at that, I think it's kind of set up
16 for confirmation bias to kick in to confirming the
17 reasonableness rather than questioning the
18 unreasonableness of the estimate.

19 And then time pressure kicks in and you have
20 people that are struggling to get the work done in the
21 field and the thing that I'm worried that they give short
22 shrift to is critically evaluating the assumptions that

1 underlie those estimates. So that's something -- and our
2 research is holding constant a mandatory rotation regime
3 or a non-mandatory rotation regime, and it's getting at
4 saying if you're focusing people instead on why this
5 might be wrong and if you're trying to shore up the
6 guidelines and the standards and the practices that
7 they're using, to try to be pushing people to be
8 critically evaluating that, that might address a lot of
9 the things that you guys are concerned about.

10 Does that help?

11 MR. WHISENANT: I hate to beat a dead horse here
12 but I think Steve Zeff has really hit one of the
13 problems, at least in the profession, our academy. I am
14 the product of a traditional accounting model where I
15 came through a state-supported accounting degree program
16 taking all the required courses. I decided to throw in
17 a few additional elective course. I echo Mark's comments
18 that they probably shouldn't be elective but one of them
19 was accounting theory and one of them was financial
20 statement analysis.

21 And it was at that point, in my mind-set, as an
22 instructor that I can recall that that was the first

1 moment that I truly understood what we're trying to teach
2 the accounting students, and I've vowed ever since then
3 to make sure that I focus on what we're trying to do as
4 opposed to what we need to do. And I think that's
5 critical for us in our classrooms to really teach from
6 the perspective of how do we provide critical thinking
7 for the students and help them foster critical thinking,
8 and not just teach them rules.

9 I, as well as my two colleagues here, have been
10 at universities where we were not really degree mills for
11 CPA firms and we have a little more latitude in the
12 classroom than I think that other accounting courses
13 might have had, but it is a tough balance that we wage
14 between trying to respond to the ones who employ our
15 students who want CPA-prepped students as opposed to
16 providing critical skills. I opt for the latter; I think
17 it's a better approach. I learned more in three or four
18 months of my auditing than I did in two courses of
19 auditing.

20 The other point that you mentioned, and I think
21 it's a good one, and it's one that -- we struggle often
22 with definitions in our profession about what is audit

1 quality and it's a difficult question to answer. As
2 difficult to answer is what is audit cost. In my mind
3 I tend to align myself with something Andy Bailey said
4 in San Francisco, that the cost of an audit is not the
5 cost that we pay in audit fees; it is the cost of
6 failure. And that cost of failure is quite substantial
7 as many in Houston know from corporate failures such as
8 Enron.

9 So it is when in our research we focus on the
10 transition points to highlight the potential costs as you
11 roll off of an audit and as new auditors come onto the
12 audit -- I think our profession is made up of very
13 talented people who will respond to that very quickly and
14 will develop the necessary skills to efficiently handle
15 these transition points so I don't want to over-emphasize
16 those costs. They are important, and particularly for
17 you guys thinking about as a monitoring activity and a
18 regulatory activity, it is important for you to give
19 guidance to the firms as those transition periods occur
20 in a rotation-regulatory rule environment. But they are
21 real costs and they're real activities that need to be
22 monitored.

1 I don't want to minimize them but the overall
2 benefits to the rotation policy in South Korea and Brazil
3 and Italy easily exceeded by, as I said, a factor of two
4 or three, those potential costs around those transition
5 points you mentioned. I hope that helps.

6 MR. DOTY: That's very interesting.

7 Jay, do you have questions for the panelists?

8 MR. HANSON: Yes. Thank you for coming today.
9 The work that you do in educating the future accountants
10 and auditors is incredibly important and accountants are
11 such an incredibly important part of the capital market.
12 So I thank you for the job that you do.

13 The question around a second look because I think
14 you've, in using different words, suggested that a fresh
15 set of eyes, a second look, new perspectives, is a
16 benefit of the rotation. One of the panelists this
17 afternoon who's a CEO of a pension fund has a sentence
18 in his statement that says mandatory audit firm rotation
19 is too blunt an instrument to be used at this time.

20 I want you to tell me ideas that you would have,
21 other than rotation, to get a fresh set of eyes, that
22 would not be the "blunt instrument" that, quoting Dan

1 Slack, that might be doable in today's environment to
2 enable the audit committee, the board -- someone to get
3 a fresh look without changing auditors.

4 MR. DOTY: This is called a jump ball.

5 (Laughter.)

6 MR. DOTY: Karen, do you have a response?

7 MS. NELSON: You know, I think back to my
8 experience as an auditor, as a young staff auditor, and
9 granted, it was only a few years but I think the issue
10 of a fresh look is that you start with what was done last
11 year. You open the files from last year and you repeat
12 the procedures from last year. There is no sense of sort
13 of starting afresh when it's the same set of auditors or
14 new staff members coming in and wanting to repeat what
15 was done the prior year because everything was fine in
16 the prior year and we don't want to upset the apple cart
17 and say that the staff auditors even or the more senior
18 auditors hadn't done the procedures or looked at it
19 appropriately.

20 So I think part of it, this notion of a fresh
21 look, starts at the very most junior level in the firm
22 with any sort of audit is the notion of maybe not start

1 with last year's files. Think about -- take a mind-set
2 of this is a new client; this isn't a client that we've
3 had for ten, 15, 20, 30, 50 years. This is a client that
4 we don't have any prior audit papers on. This is a
5 client that we need to think of from a fresh view
6 internally so that we don't fall into that trap of
7 opening up the audit papers from the past year.

8 And you can see my age here that I still talk
9 about audit papers rather than electronic files, but
10 opening up the files from the last year and just saying,
11 well, this is the way they did it last year -- let me
12 repeat exactly what was done last year; that must be the
13 right way to do it.

14 And I don't know what can be done in terms of
15 encouraging or providing some sort of framework where
16 auditors need to start -- even though it is the same
17 client, start with a fresh look internally where they
18 don't look at what they've done prior years, where they
19 start it as if it is a new client that they've had. And
20 I don't know how feasible that is but that's the only way
21 I can think of when you have the same auditor to really
22 get a fresh look.

1 MR. NELSON: If I could pile on -- just to back
2 up what Karen said, right now we've got partner rotation,
3 and in the past we've experimented with peer review and
4 that didn't seem to work that great, and we've got PCAOB
5 inspections. And those are all, in their way, giving a
6 fresh look but it's nowhere near what you get with a
7 complete blind rotation.

8 As Karen was saying, there's actually research
9 that points out, number one, that when you give auditors
10 something easy to base an expectation on, for example,
11 a client's book value, they'll base their expectation of
12 what book value should be on the client book value and
13 they don't tend to find much difference between client
14 book value and what their expectation is, so shielding
15 that is really challenging in terms of operationally
16 doing it but coming up with an independent expectation
17 is really useful.

18 Getting back to the idea of auditing estimates,
19 this Griffith, Hammersley, Kadous working paper -- they
20 interview auditors, audit partners, in addition to
21 looking at PCAOB inspections and they find a real
22 emphasis on auditing the client's process as opposed to

1 developing independent expectations so a circumstance
2 where you're moving people in the direction of a fresh
3 look in the sense of saying don't be focusing on
4 corroborating management's assertions but, as much as
5 possible, coming up with your own independent estimate,
6 I think, is a really helpful way to get as much of that
7 as you can. That's about all I have to share for you on
8 that one.

9 MR. WHISENANT: Jay, I have to say I disagree
10 with Dan on many levels. First, the characterization
11 that mandatory audit rotation is a blunt instrument. I
12 think effectively employed and monitored it's an
13 instrument that can be used to enhance audit quality.
14 Having said that, if we didn't go that direction, there
15 are other things. Karen mentioned one of them, tendering
16 the contracts as well as making them multi-year
17 contracts. I think none of them are going to have the
18 benefits of rotation policies.

19 And I heard someone from Enron -- I brought them
20 in my class recently and we asked him some questions
21 about what happened. And I got the sense from him --
22 similar experience that I had when I was 26 years old

1 when I went in for an eye exam and I walked out with
2 glasses, not knowing that I needed the glasses. But when
3 I walked outside and had this contraption on my head, I
4 could see trees and read signs.

5 And the Enron executive told my class, and I
6 think this is right, there was nothing that he could
7 point to that was when ethics were eroded. It was just
8 a gradual shift, a gradual erosion sort of like the
9 stream just whittling away at the bank until one day they
10 knew they were in a place they didn't want to be but they
11 couldn't do anything about it. Fresh eyes are an attempt
12 to circumvent that. If we get individuals into the audit
13 engagement that have not seen the audit engagement, the
14 audit workpapers, done the risk analysis before, we get
15 a fresh set of eyes.

16 Admittedly, the first year has some problems
17 because of the loss of client-specific knowledge but I
18 think that -- it's used today at DuPont; it's used today
19 at CalPERS; it's used at several organizations in a
20 voluntary way to try to enhance audit quality, and I
21 think if it were applied at an audit market level that
22 we would see firms respond to the challenges very

1 quickly.

2 MR. FERGUSON: Thank you. I'm going to have a
3 predicate for my question here to ask you, questions
4 about research here, because the environment that we face
5 in considering this question and considering mandatory
6 rotation is frankly an environment of fierce -- one might
7 even say life-threatening opposition. Of the 670 letters
8 that Jay mentioned, I would venture what? -- 90 percent
9 of them were opposed, Jay, to mandatory rotation.

10 The second thing is the reality of life in
11 Washington today is that when we do things we must do
12 rigorous analysis of why we're doing it. You can call
13 it cost-benefit analysis. Under the Dodd-Frank Act we
14 have to analyze what are the effects on efficiency,
15 competition and capital formation for emerging growth
16 companies. And I think that's a good thing. I don't
17 think sensible people do difficult things without being
18 able to explain the costs and the benefits. But that's
19 the reality that we live in today.

20 And the second thing is we are faced with and
21 shown evidence, for example, of where audits change
22 hands, fees go down -- the great concern that when fees

1 go down inevitably audit quality will suffer. And
2 secondly that the evidence from our inspections is that
3 in the case -- and this is in the context of voluntary
4 rotation, not mandatory rotation, but voluntary, where
5 auditors do change. And there's a lot of that that
6 happens. We tend to find more audit failures in the
7 early years after an audit change than later.

8 So in the face of that evidence, can you point us
9 to rigorous evidence that will help us if we were to make
10 a decision that mandatory rotation is the right way to
11 go here, rigorous evidence that will support the kind of
12 analysis that we have to do in order to make this
13 argument sustainable because we can't do it simply on the
14 basis of a philosophic belief.

15 MR. DOTY: I think we'll have to start with Scott
16 and work through on this one.

17 MR. WHISENANT: Yes, I cited at least a study
18 where we attempted to control for that. Let me back up
19 by saying that we have a selection-bias problem in the
20 US in that when we study auditor changes those tend to
21 be associated with either some type of misalignment, that
22 Karen's looked at in her research, or a problem that the

1 auditor knows about and the audit firm is no longer
2 willing to accept that level of liability or that level
3 of client risk anymore.

4 So it's not surprising to me that if we're going
5 to study audit changes when an auditor has just given up
6 this audit that there might be an inherent problem with
7 those firms and that they could potentially have a higher
8 degree of failure than others. So what we tried to do --
9 Mike Willenborg and Mr. Srinivasan Sankaraguruswamy and
10 I tried to do is we tried to remove all of those.

11 We focused the playing field on only the Big Four
12 and we examined Big-Four-to-Big-Four changes. Presumably
13 the Big Four has sufficient industry expertise that they
14 could audit one another's clients. And we examined those
15 auditor changes, and in those auditor changes, we found
16 no evidence of a decrease in the audit quality when there
17 was a voluntary change using restatements, going
18 concerns, and even, to some degree, initial evidence that
19 the unexpected accruals -- assuming that we can build
20 expectation models on accruals effectively, those three
21 different measures did not indicate any level of erosion
22 of audit quality.

1 MR. NELSON: I think it's very difficult to find
2 evidence that directly bears -- I think Scott's research
3 is really important. They're trying to control for
4 things that are part of the US market and work.
5 Examining rotation in other regimes is of interest but,
6 of course, those other regimes have very different
7 corporate governance environments and so you have to
8 worry about generality there. It's important research
9 but it's not the definitive silver bullet I hear you
10 looking for.

11 So my view is you're never going to find
12 something that just definitively, dead on, tells you --
13 you know what, here are the costs, here are the benefits,
14 here's the difference, and so here's what you should do.

15 I worry about the unintended consequences aspect
16 of this that relates to the idea of when there is change,
17 fees are lowered and therefore likely audit quality might
18 suffer. And the thought experiment that we have to do
19 because we don't have the data is what happens in the US
20 when you're having so many changes happen, and what are
21 firms competing on, and if it's, to some extent, fees,
22 how that translates into efficiency pressure which my

1 work and other work suggests translates into deficiencies
2 in audits. And I think that's a real concern.

3 So I think you're right to think about these
4 different dimensions and I just think it's never going
5 to be a situation where you can line up research that
6 directly addresses all of them.

7 MS. NELSON: I would agree with my colleagues
8 that to find research that would give you that silver
9 bullet is not going to happen. What I would say that --
10 oftentimes research is used inappropriately by those who
11 are not academics and frankly by academics as well to
12 justify people's positions.

13 And so you started your comments with that
14 there's research that shows in the early years after an
15 auditor switch that there are more audit failures, more
16 problems, and as you noted, those were on voluntary
17 changes. And that is making -- to extrapolate that to
18 a mandatory-change situation, I think, is taking
19 advantage of the research to justify a position. So I
20 would say one thing would be to have some pushback that
21 you can't just use research to justify a position because
22 it has a result that seems to be in line with the

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1 position that you want to take.

2 I think that some of the research that Scott is
3 currently doing in terms of switches in mandatory
4 environments would be the closest to some of the
5 informativeness that we would have in this environment.
6 The research that he referred to of mine came maybe a
7 little bit closer in that it was looking at auditor
8 switches after the Enron blowup and how all of those
9 clients then needed to move away from Andersen into new
10 auditors.

11 And what we did see at that time is that the
12 audit firms, particularly these lateral switches between
13 the remaining Big Four firms -- that there was a
14 concerted effort to realign client portfolios. There
15 wasn't so much risk-driving what that the remaining
16 auditors kept in their portfolio and the new clients they
17 tried to bring into the portfolio but it was alignment
18 with what portfolio they already had there.

19 So I think there is a sense that when presented
20 with a pool of vast new clients there wasn't a reluctance
21 on the part of the auditors to bring on new clients as
22 we're hearing under a mandatory rotation situation. They

1 were very happy to bring on those new clients at that
2 point in time.

3 My closing comment I would say is with respect to
4 the lower fees, that after a switch in a voluntary regime
5 we do see lower fees and what implications does that have
6 to auditor quality. Again, it's a small study in a
7 specialized environment but I would point you to that
8 study I cited with respect to the mandatory tendering by
9 the Australian local councils. There they did find,
10 after the tendering was implemented, there was a fee
11 reduction but they didn't find a reduction in quality,
12 and also after the second mandatory tendering period,
13 they were only able to study two periods during their
14 time frame of a six-year tendering period. They didn't
15 find further fee reductions.

16 And so some of the question about fee reductions,
17 I think, as well, is done in a voluntary environment
18 where to get the new clients as a voluntary switch you
19 do need to make a fee reduction. I have some questions
20 as to whether we would continue to see that fee
21 discounting if we move to a mandatory regime where there
22 there's always going to be available clients coming onto

1 the market and that the fees at that point won't need to
2 be as discounted as we see in a voluntary market. So,
3 again, there, I would caution about extrapolating too
4 much from the voluntary-change literature into what we
5 might observe in a mandatory-audit-rotation environment.

6 MR. DOTY: Professor Zeff, any wrap-up on this
7 one?

8 MR. ZEFF: One point. I'd like to add a comment
9 to what Mark said where he said one has to be careful in
10 trying to apply to the United States research done
11 overseas when the corporate governance context is
12 different. We have to add, as well, the litigation
13 context is very different than other countries, and so
14 therefore, it may be very difficult to apply to the
15 United States findings from research done in totally
16 different regulatory environments and litigation
17 requirements.

18 MR. HARRIS: Mark, you mentioned in your
19 statement other changes in audit standards and practice
20 beside mandatory firm rotation potentially could improve
21 professional skepticism. Because we're creating a record
22 here, what are the three or four specific recommendations

1 that you would leave with us in terms of improving,
2 objectivity, independence, professional skepticism? And
3 at this point, I resist the temptation to talk about
4 corporate governance because that's largely within the
5 purview of the SEC, but there is a common theme with
6 respect to the independence of independent audit
7 committees. For example, going back to a statement by
8 Rod Hills, he agrees with, I think, a couple of you and
9 some other panelists that we're going to hear from later
10 on today that the key to enhancing the independence of
11 external auditors is take substantial action to better
12 ensure the independence of audit committees. But I don't
13 want to go there, I don't want to go to cover corporate
14 governance because that's not within the PCAOB.

15 I'd like to get from each of you, starting with
16 you, Mark, since you mentioned it, what specific
17 priorities would you recommend in terms of dealing with
18 the issues that we've got before us today?

19 MR. NELSON: Thanks for the question, Steve.

20 A few possibilities here. The first is and I
21 know you do this to some extent now, but I don't know
22 how much to mine your inspection data, to really focus

1 in on for each deficiency you identify, ask not only what
2 the remediation approach would be for the firm but also
3 say what sort of guidance could you give for potentially
4 a change in standard could you make that would yield an
5 outcome that you would prefer to what you saw. And I was
6 talking from the perspective of auditing estimates, is
7 it possible that you want to give best practices guidance
8 or even effect standards in a way that moves auditors'
9 approaches to something that you wish you were seeing
10 when you're seeing so many problems in a particular area.
11 And I think mining your inspection data to think about
12 that is really useful.

13 By the way, as an aside, there are lots of eager
14 young academics that would love to help you do that. I
15 know that confidentiality is a challenge, but if you can
16 anonymize it, they'll do it for free and be very excited.
17 So that's something to think about.

18 The second then -- and I'm going to talk about
19 communication with audit committees -- I know also that
20 you provide audit committees with some best practices
21 information and some information from inspections but
22 it's at a pretty high level. So could you drill down to

1 a level where you're providing pretty explicit ideas
2 about the ways that auditors should be approaching these
3 high risk areas and require audit committees to require
4 their auditors to be very explicit about how they're
5 doing that.

6 One thing that was interesting to me when I was
7 reading over some prior testimony was that audit
8 committees were saying we sure wish we could have access
9 to the inspection reports for our audit that the PCAOB
10 was doing, and I realize that by statute you're prevented
11 from disclosing that information at the audit committee.
12 I'm not sure whether one best practice for an audit
13 committee would be to require access to that report as
14 a condition of retaining the auditor. I don't know if
15 they can do that. But pushing from their perspective to
16 get that information, I think would be useful

17 And then the final thing is when you've got these
18 areas that are really clear that you're seeing repeated
19 deficiencies on, I think very clearly signaling to the
20 firms that that's going to show up in inspections and
21 there are going to be very clear problems, penalties for
22 the firms, up to and including required rotation of firm

1 off a client. If those problems are not being rectified,
2 I think that would be very reasonable. That would be a
3 rotation for cause as opposed to rotation generally.

4 MR. WHISENANT: Steve, one of the things that I
5 think is important, and I teach in my class and I'm sure
6 Mark and Karen do as well, is this illusion of exactitude
7 that we have with accounting as though an EPS of 372 is
8 the actual number. I think one of the things that we can
9 do in enhancing the reporting model is following some
10 sense the lead that the French have done, and that is
11 they've thought about the reporting model being one of
12 reporting the statutory requirements of what they've done
13 and what they've found, but also highlighting the areas
14 of the risk on the audit that gave them the greatest
15 amount of pause. And I don't mean just a restatement of
16 the critical accounting policies in the 10(k), these are
17 the issues that the audit firms themselves found.

18 And I've read some of these and I'd have to say
19 50 percent of them are boilerplate, but the other 50
20 percent I found to be quite informative. And so the 40
21 model, I think, is one that certainly needs to change,
22 and you guys have addressed this, the SEC has thought

1 about this, so I don't think that this or my other
2 suggestion is going to be that profound, but the Treasury
3 came up with a proposal a few years ago about audit
4 quality, and I don't think many of us in this room could
5 even agree on what audit quality is, but getting more
6 insights into the audit production function I think would
7 help investors.

8 South Korea has gone far in this in that they
9 now report audit fees and audit hours on the job. Now,
10 I can see the potential for gaming this, but
11 nevertheless, that may not be the perfect metric we use
12 but at least having more metrics about audit quality so
13 that the investors can see the types of personnel, the
14 types of hours that were put on the job. We already know
15 the fees, and if fees are a proxy for effort, then it's
16 not clear to me why they would have such a push-back on
17 providing that level of information.

18 So those are two examples that I think you have
19 considered before but I think may be helpful.

20 MS. NELSON: I guess I would echo some of the
21 comments of my colleagues here. One point I would start
22 with is if mandatory audit firm rotation is taken off of

1 the table for looking at other options -- which I believe
2 is kind of where your question is going, what else can
3 we do -- I think the next best solution might be the
4 mandatory re-tendering in the sense that at that point
5 it's a less blunt instrument, you're not making everyone
6 rotate, whether cause is there or not, but the notion
7 that at least at that point there's a rigorous, careful
8 look at what we've been doing, at what the auditor has
9 been doing, at the audit committee, rather than just
10 assuming that everything is fine and continuing to move
11 forward.

12 So I think a notion of mandatory re-tendering
13 might be something that would be less of a cliff to jump
14 off of for a lot of the constituencies that are involved
15 in this debate. That being said, I do see that as more
16 of a compromise position to sort of fixing the underlying
17 inherent problem.

18 I would also reiterate one of the issues if
19 you're thinking of a less blunt instrument is mandatory
20 rotation only when cause has been shown as a result of
21 a PCAOB inspection and that significant deficiencies have
22 been identified, at that point triggering a forced

1 rotation for that particular client-auditor pair rather
2 than for the entire marketplace. But again, I see both
3 of those as nibbling around the edges of the problem
4 rather than tackling the main problem on its face.

5 MR. DOTY: Professor Zeff.

6 MR. ZEFF: Yes. I have a recommendation. You
7 have had some testimony from Roderick Hills and John
8 Bogle, and I've made some remarks about the performance
9 of the audit committee, and I certainly understand that
10 this comes under the purview of the SEC and not the
11 PCAOB, but clearly, you have a right and a responsibility
12 to be concerned about the performance of the audit
13 committee, and I think that what you ought to do is as
14 a result of investigations such as these is to make some
15 recommendations to the Securities and Exchange Commission
16 saying that in order to perform your function more
17 effectively that the audit committee performance needs
18 to be improved by certain changes in the corporate
19 governance structure. So I think you have a role to play
20 in terms of making a recommendation to the SEC, even
21 though the final decision may not be yours.

22 MR. DOTY: We invite the SEC to these sessions

1 and they've been very tolerant in coming because we know
2 they get is straight from the horse's mouth here. But
3 it's also been our custom to invite some questions from
4 our senior staff. Marty Bauman is our chief auditor.
5 We have a good 15-20 minutes.

6 MR. BAUMAN: I do have a question. Thank you
7 very much. And all the comments have been outstanding
8 and we appreciate the panel. But as the in-charge of
9 standard-setting is very interested, aside from the
10 comments on rotation, the comments made by Professor
11 Nelson that auditing standards too often are written in
12 the positive sense of determine that the assumptions, or
13 whatever it might be, is reasonable or correct as opposed
14 to determine that the assumption is not reasonable. I
15 agree with that observation, that's how standards have
16 historically been written, so I have a couple of
17 questions for you.

18 But I do think we've made some progress in this
19 direction. SAS-99, for instance, now AU-316, at least
20 began to change that to some degree in statements such
21 as do not assume that management is honest and has
22 integrity, and so assume that there's bias and things of

1 that nature, to get the auditor in their brainstorming
2 to think that yes, this management that I've been
3 associated with for 10, 20 or 30 years could be
4 dishonest.

5 I think the risk assessment standards that we
6 recently issued do that to some degree. They do require
7 the auditor to search for and think of contrary evidence,
8 and just the standard that says the auditor has to look
9 for the risk of material misstatement, by its very nature
10 requires the auditors to think about where there could
11 be risks of material misstatement. And AS-17 encourages
12 auditors to communicate with audit committees around
13 matters that are controversial, so that's helpful too.

14 But having said all of that, if you could expand
15 a little bit about the strength of that study that you
16 did in terms of how much you think the audit quality
17 really does improve by these negative requirements,
18 search for contrary evidence, getting the auditor to
19 think more in that negative mindset, if you could expand
20 a little bit on that.

21 And then one other specific question, either for
22 you or anybody else, if you want to add to this, as a

1 standard-setter, I can tell you that rulemaking in our
2 current U.S. environment is a multi-year process, and we
3 have many standards on our standard-setting agenda that
4 we want to get to but it's a very lengthy process to
5 rewrite standards and to change the tone of them in the
6 context in which you're talking about. Do you have any
7 ideas how we could get the auditor to think that way by
8 doing something else before we get around to rewriting
9 so many of the standards that we have on our agenda?

10 So I'd be interested in your response and any
11 other comments. Thanks.

12 MR. NELSON: Certainly. So first off, I agree
13 with what you said about recent standards that you guys
14 have been putting out and I think that's very, very
15 helpful.

16 In general, when we're thinking about this from
17 sort of a judgment, decision-making standpoint, the
18 concern would be that once you start someone down an
19 alley of thinking about reasonableness rather than
20 unreasonableness, that pretty strong forces for
21 confirmation bias kick in, and particularly under time
22 pressure people might not think about the converse as

1 much. So the basic idea is that moving people down a
2 line where even though if you ask them what the standards
3 right next to each other, do these differ, they'll tell
4 you no, that would have me do the same thing.

5 In our study we had that move, the planned hours
6 on this fair value from three days to four days. Now,
7 it's very important to not over-interpret effect sizes
8 in that kind of study, but the direction of the effect
9 I feel pretty confident about.

10 There's another couple of things, I think, to
11 think about. One is does that sort of reframing where
12 you're not really changing the underlying standard, does
13 that persist over multiple periods, or do people just
14 adapt back to what they had before. And my
15 characterization of the evidence on that is overall that
16 it's kind of mixed and there's not that much.

17 Another question, though, is whether you would
18 move from where you are right now to something more along
19 the lines of a presumptive doubt or even almost a
20 forensic view of some of these procedures. So in other
21 words, it wouldn't be a reframing but it would be going
22 back through and identifying circumstances where

1 professional skepticism was being described as sort of
2 a suspension of disbelief kind of thing and saying, no,
3 we're really looking for circumstances where we want the
4 auditor to have a heightened view that management's
5 assertion is incorrect, conditional on the evidence
6 available to the auditor.

7 And my reading of the standards is that
8 sometimes, and particularly like the SAS-99 stuff that
9 you're describing, with respect to revenue recognition
10 in particular, it's saying you have to really be thinking
11 about the potential for fraud here but that it isn't as
12 strong in other circumstances.

13 I guess the question if you can't change the
14 standards, what to do, and that, to me, goes back to the
15 idea of saying, you know what, we've identified the
16 particular deficiencies that we're seeing and here's what
17 we're going to recommend as a best practice for how to
18 go about this. How do we, the PCAOB, think you should
19 think about satisfying our standards with respect to this
20 particular area, and what are we going to be looking for
21 from the perspective of our future inspections.

22 So it's trying to give auditors a tool for

1 thinking about how you implement the standards, sort of
2 how the SEC has with different statements that they've
3 made where they're saying we're not changing GAAP, we're
4 helping you understand our interpretation of GAAP. Maybe
5 you can do some things along those lines.

6 MR. DOTY: I know some other questions are here,
7 we have a little extra time, but you could be interpreted
8 as suggesting, Mark -- and I think this is, again, fresh
9 thinking -- one could take your comments as suggesting
10 that to stop short of a dramatic effect that a rule
11 change would have, the Board might instruct its
12 inspectors, and tell the profession that we were going
13 to instruct our inspectors, to look for evidence of
14 presumptive doubt. Where we find it lacking, we will
15 report it, it will be part of our findings, it will go
16 into our assessment of tone from the top and of culture
17 of the firm.

18 Now, we know that these decisions by us are grave
19 decisions, there is gravamen about this because they
20 affect careers, but it is a fair assessment of what your
21 approach is to say that you think that let us suppose
22 rule proposals became impossible because, as Stephen Zeff

1 says, we could not meet the challenge of showing the
2 benefits. If that were the case we actually found, are
3 you suggesting then we should go in the direction of
4 heightening the sensitivity of our own inspection process
5 to where we do not see presumptive doubt and reporting
6 that?

7 MR. NELSON: So let me be clear, I'm not
8 suggesting an end-around on the rule-setting process, so
9 I wouldn't want you to be in the position of saying we
10 can't demonstrate convincingly enough for various
11 stakeholders the cost-benefit tradeoff that we need to
12 demonstrate, so instead, we're going to de facto pass a
13 rule.

14 MR. DOTY: Assume a court tells us we can't.

15 MR. NELSON: Right. What I do think is fair is
16 for you to say so, first off, my understanding is that
17 the definition of professional skepticism in PCAOB
18 standards is certainly within your purview, and so
19 working to communicate that definition clearly, and you
20 think a presumptive doubt definition is appropriate,
21 working to communicate that clearly, and then that is
22 reasonable for you to be having, in the inspection

1 process, your inspectors searching for.

2 But I just want to be clear, my view would be
3 that would be you talking either about how your standards
4 are written or how you interpret how your standards are
5 written and communicating that to your inspection regime.
6 Does that make sense?

7 MR. DOTY: Exactly. And others may have had
8 responses to Marty, I didn't want to cut those off.

9 MS. NELSON: I would add, I think, the question
10 was what could be done in the interim, given sometimes
11 the long lead time to any standard changes, should they
12 occur, and I'll go back to our earlier discussion on
13 education, that this is something that if we can get them
14 young and tackle it at that point, whether it be at the
15 undergraduate level or even continuing education. We had
16 a lot of talk about textbooks and other materials and how
17 that forms people's views as they go through the
18 educational system, there's also a lot of educational
19 materials that are put out by the firms that are used by
20 faculty and other sources, and to the extent that
21 educational materials can be provided to faculty, we're
22 always looking for good educational materials to use in

1 the classroom that would maybe bring out some of these
2 thought processes, the PCAOB's view on, and helping
3 educators provide those supplemental materials to
4 textbooks and to other information provided by firms and
5 other sources, I think that would be something that would
6 be very useful.

7 MR. WHISENANT: Marty, I might want to add, since
8 Brian is here, to something the SEC is tackling, but the
9 Committee on the Improvement of Financial Reporting, the
10 CIFR report, has done something I think somewhat
11 remarkable in that it's tried to develop a framework for
12 professional judgment. I audited for a firm that had a
13 structured professional judgment framework, not nearly,
14 I think, as good as the CIFR report, so with some
15 movement along at the SEC or the PCAOB through their
16 inspections, evaluating the engagement by saying what
17 professional judgment framework did you follow, if any,
18 will put pressure on the firms to say we need to follow
19 the CIFR report or this professional judgment framework,
20 even if it's not been passed yet by the SEC, because I
21 do think it's a sound way to make decisions and it makes
22 them consider the alternatives and focus as much on

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1 support of the one that they want or the client wants as
2 the other alternatives.

3 MR. DOTY: Stephen, do you have any follow on
4 this?

5 MR. ZEFF: Yes. I have a remark that probably
6 will be interpreted as somewhat off the wall, and that
7 is we put a lot of emphasis, understandably, in the
8 United States on rules and perhaps not as much on
9 concepts and principles because we tend to be so
10 litigious and people want to defend themselves by citing
11 rules. Back in October 2005 there was a standing
12 advisory group meeting that devoted about 25 minutes to
13 the topic of possibly decoupling present fairly from in
14 conformity with Generally Accepted Accounting Principles,
15 as was done by a major accounting firm for quite a few
16 years. And I feel that if more of a burden were placed
17 on the auditor and on the audit committee to think in
18 terms of ideas presumed fairly, something in relation to
19 economic reality as opposed to being satisfied with
20 following whether it's auditing rules or accounting rules
21 in particular, we might begin working ourselves out of
22 this condition that we are in where we don't pay

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1 attention to the big ideas, but in particular we feel
2 once we have met the rule, the big ideas fall into place.

3 This is not exactly what Marty was suggesting or
4 asking about, but I really think it's an idea whose time
5 has come and we should think about it. I believe
6 expanding the scope of professional judgment is really
7 important. Unfortunately, in our litigious environment,
8 people are fearful about doing it.

9 MR. DOTY: We'll hear later from Ken Daly and
10 others who will be able to respond to that.

11 Did you have one more question?

12 MR. HARRIS: I couldn't resist the temptation,
13 Professor Zeff, in reading your resumé you worked at the
14 Institute of Chartered Accountants of Scotland and you've
15 talked about in your statement continuing education, and
16 I understand that the Chartered Accountants of Scotland
17 are required to give an oath of their commitment to act
18 in the public interest and conduct themselves with
19 integrity and objectivity, and I'm wondering in your view
20 is this oath effective in reminding auditors of the need
21 to remain objective and should the United States consider
22 adopting such a practice.

1 And the oath reads as follows -- this is from the
2 ICAS: I declare that I will conduct myself in a manner
3 that maintains and enhances my professional reputation,
4 that of my fellow members, and ICAS. As a CA chartered
5 accountant, I commit myself to acting in the public
6 interest and will conduct myself with integrity,
7 objectivity, and in accordance with the highest ethical
8 standards of ICAS.

9 In the nature of continuing education courses,
10 should such an oath even be considered in the United
11 States, and has it had any impact at all in Scotland?

12 MR. ZEFF: Well, I can't really say about the
13 effect, and I don't know of any studies that have tried
14 to examine the impact, but the accounting profession in
15 Scotland is a very strong one and is indeed, I guess we
16 would say, the oldest of the public accounting
17 professions in the world. And it is very strong, they
18 have required university education for a long time, they
19 are not faced with anything like our uniform CPA
20 examination, and as a result, I think that the Scottish
21 accountants have a very high reputation around the world.

22 In the latter part of the 19th Century, many of

1 them went around the world and created professions,
2 including in the United States. Arthur Young himself was
3 from Scotland, although, in fact, in his case he was a
4 lawyer and not an accountant. And so an awful lot of the
5 early accountants and chartered accountants in Canada and
6 the United States did come from Scotland and they still
7 have a very strong profession. And so I don't know how
8 much this would have contributed to it because they
9 already are on a very high plane, as I would see it.

10 MR. HARRIS: Do the panelists have any ideas on
11 requiring such an oath?

12 MR. DOTY: We have, I think, five minutes. Are
13 there any other comments, thoughts from what you have
14 heard here by the panelists or the Board members? One
15 of the things I would note is that it seemed to me the
16 entire discussion proceeded with the assumption that we
17 must recognize ongoing risks from the client-pays model,
18 the scale of the client and the loyalty that pressures
19 that can exert on the auditor, and that the subject under
20 discussion is what do we do, what is the right thing to
21 do as a regulator, as an educational community and as a
22 profession itself about that.

1 I don't think coming out of this there's a view
2 yet that, in fact, it's not a problem. There are people
3 who will tell us that, in fact, objectivity is fine,
4 their auditors are independent, and that know this is a
5 problem. But I think one of the things I am hearing from
6 all of you is it may not be currently precipitating an
7 economic crisis, it may not have precipitated economic
8 crises in the past, but it is a continual concern that
9 we have to keep in the forefront of our minds.

10 Brian, yes.

11 MS. CROTEAU: Thank you very much, and thank you
12 for inviting me to be here today.

13 I just had one question for any of the panelists,
14 but I think Mark, in particular, mentioned a couple of
15 times the importance of mining inspection data, and I
16 guess Scott and Karen, as you think about choices as to
17 what should be done from a policy perspective relative
18 to improving quality, I'm wondering to what extent you've
19 given thought to the public information that's available
20 relative to inspection results and identifying the
21 varying problems that exist that might be the underlying
22 basis and the root cause of those inspection findings,

1 and in fact, whether you believe it's a necessary
2 precursor to go through that analysis and actually have
3 more information relative to the root causes of
4 inspection data in making the policy decisions that we're
5 talking about today.

6 Thank you.

7 MR. NELSON: So first off, the fact that there's
8 information provided now is very helpful and appreciated.
9 The closest I can come to in terms of describing the
10 process in mind is a project that I was engaged in about
11 ten years ago where we actually asked auditors to give
12 us their examples of circumstances where a client tried
13 to manage earnings, and they gave it to us down to the
14 level of what was the journal entry in question. And we
15 went very carefully through a process of identifying the
16 particular aspect of GAAP that applied and coding that
17 GAAP as to whether or not it gave precise versus
18 imprecise guidance and we used that in our analyses. So
19 it was down to the level literally of what line of a
20 financial accounting standard was the key thing in play
21 here.

22 And it may be that behind closed doors when

1 you're going through your inspection data the PCAOB is
2 taking it down to that level, and if it is, then this
3 suggestion isn't worthwhile. But the idea would be to
4 go down and to say, okay, not only we had a deficiency
5 and broadly we expect auditors to comply with this
6 particular standard and they don't see to have, and
7 that's a problem, they need to do better. But to drill
8 down as precisely as possible, then for purposes of
9 saying could there be a change in how this standard is
10 provided, or could there be additional guidance to
11 auditors and to audit committees.

12 And again, I don't understand, I don't have
13 access to the process that you guys do internally, and
14 I don't mean to be prejudging that, I'm just saying that
15 as precise as you can get and then have that precision
16 inform not just the remediation recommendation to the
17 auditor, but also to sit back and to say, okay, how would
18 we make changes in what we're promulgating, and perhaps
19 advise the SEC on aspects of financial accounting
20 standards, the FASB, that are coming into play there,
21 that could be useful.

22 MR. WHISENANT: Brian, I would add to that that

1 in many contexts we need to protect the confidentiality
2 of the data, whether it's the tax preparer or the public
3 company that's providing the data, but there are ways to
4 work around that so that we can get to that issues.
5 Karen and I do very similar research and we are often
6 challenged by the level of aggregation of the data that
7 we get, as well as looking at deficiency reports that we
8 can't tie back to the underlying financial statements.

9 So they look good in general, we can talk about them
10 specifically, but it's very difficult for us to then
11 analyze and ask really interesting research questions.

12 Along that line, a colleague of mine, Clive
13 Lennox, and I have made a proposal to try to get access
14 to audit deficiency data. I think this would speak to
15 Lew's comment that can we provide good empirical evidence
16 about audit failures and the consequences of audit
17 failures, and I think that's going to be one of the ways
18 that we're going to move the literature forward. It's
19 going to have to be a partnership with the regulators and
20 the academics in trying to analyze that data in a better
21 way.

22 MS. NELSON: I would concur. I believe that the

1 more data as academics we can get, the more helpful that
2 we can be. I've tried in several instances, relating to
3 this line of research that I do, as well as other lines
4 of research, to convince people who have data that I want
5 that I'm really not interested at all in the individual
6 line item data, I'm interested in the aggregate, that I
7 would never disclose anything about the individual. That
8 is not of interest to me, it's the aggregate conclusions
9 that can be drawn from that data. Sometimes I meet with
10 more or less success in getting that data.

11 I would suggest, to the extent that this is being
12 considered, perhaps partnering with the American
13 Accounting Association, so there is some more oversight
14 function rather than with individual academics and not
15 kind of knowing where the data is going. I believe that
16 the AAA has some processes where we have been working
17 with the FASB and getting data and encouraging research
18 projects of that nature.

19 The only other thing I would mention is actually
20 with respect to a comment that Chairman Doty made, and
21 that was with this client-pays model. The more that I
22 think about it that I think we focus on the payment

1 aspect of it, and there's been proposals, the insurance
2 proposal and so forth, where is the money coming from,
3 it's the payments that's causing the problem. The more
4 I think of it, it's not, per se, the payment, it's that
5 the client hires and fires, that's where it's really the
6 problem, the incentive is coming from. And so to
7 continue to call it a client-pays model I think maybe is
8 diverting our attention from the true underlying cause
9 of the incentive problem.

10 It's not the payment -- the insurance model that
11 was proposed was directed at that -- in my view, from
12 what I've thought about and looked at, it's not so much,
13 again, where that money is coming from but as long as the
14 power, the authority to hire and fire at will lies with
15 the client, I think that that's where the underlying
16 incentive problems come from. So for what it's worth,
17 I think it's a semantic issue but I think it's an
18 important one in how we think about the problem.

19 MR. DOTY: Stephen Zeff is in the Netherlands
20 where it is getting late, and we thank you, Stephen.
21 Karen Nelson, as with all professors at Rice, has to
22 teach, and for Mark Nelson and Scott Whisenant, we are

1 very grateful.

2 Let's take a break and be back here promptly at
3 10:40 to take up with Professor Hu -- a nine-minute
4 break.

5 (Whereupon, a brief recess was taken.)

6 MR. DOTY: It gives me great pleasure to
7 introduce to you, to those of you who may not know him,
8 Henry T.C. Hu. Henry Hu holds the Allan Shivers Chair
9 in the law of banking and finance at the University of
10 Texas Law School. Appointed by Securities and Exchange
11 Commissioner Mary Shapiro, Professor Hu was the inaugural
12 director of the Division of Risk, Strategy and Financial
13 Innovation, it was the first new division created by the
14 Commission in 37 years.

15 From a research standpoint, he's best known for
16 his articles on law and economics of modern capital
17 markets, financial innovation, and corporate governance.
18 His latest article, June of this year, suggests that the
19 SEC's disclosure paradigm, in place since the Depression,
20 is increasingly undermined by innovation in financial
21 theory and practice and offers ways forward. A series
22 of articles offered the first systematic analysis of debt

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1 and equity decoupling and coined terms that have come
2 into worldwide use such as empty creditor and empty
3 voter.

4 His 1993 *Yale Law Journal* article, which is
5 receiving renewed attention in the wake of the global
6 financial crisis, showed how cognitive bias, compensation
7 structure, financial science, and other factors were
8 likely to cause major financial institutions to make
9 mistakes as to derivatives.

10 In 2010, the National Association of Corporate
11 Directors named him as one of the 100 most influential
12 people in corporate governance. He holds a BS in
13 molecular biophysics and biochemistry, MA in economics
14 and JD from Yale.

15 Today he will be making a 20-minute presentation
16 entitled "Informational Dilemmas: A New Auditor Rotation
17 Idea and "Too Complex to Depict?" This is going to take
18 us to the frontier of theory and knowledge on this
19 subject, and there will be a lively discussion following.

20 Professor Hu.

21 MR. HU: Thank you, Chairman Doty, other Board
22 members, for inviting me to participate today.

1 There's a joke that made the rounds in the old
2 Soviet Union. The CIA, FBI and KGB each had declared
3 their agency to be the best crime fighting unit in the
4 world. At long last, a contest was structured to
5 determine who really was the best. A hare was released
6 into each of three forests, after which each of the best
7 and brightest of each agency was set to prove their
8 mettle. The CIA recruited various animal informants
9 throughout the forest. All the plants, streams and
10 minerals were interrogated. After months of search and
11 analysis, the CIA declared the forest, in fact, contains
12 no hare. The FBI spent two weeks crisscrossing the
13 forest. Having turned up nothing at all, the FBI agents
14 burned the whole forest to the ground, all animal life,
15 the hare included, goes up in flame. The FBI issues a
16 highly publicized report trumpeting their success. The
17 KGB was much more efficient. A mere two hours after the
18 start of the contest, triumphant KGB agents, the whole
19 search team, emerged from the forest. They drag out a
20 large bear beaten to an inch of its life, howling at the
21 top of its lungs: Yes, yes, I'm the hare, a hare I tell
22 you.

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1 (General laughter.)

2 MR. HU: Academics, such as myself, like the CIA,
3 FBI and KGB, also suffer from our own biases, so I ask
4 for you indulgence as I offer views on two different
5 matters that you've asked me to talk about, both of which
6 relate to the quality of information.

7 The first matter is a possible new approach to
8 the mandatory rotation issue that, from a very
9 preliminary standpoint, might be worth considering.
10 Under what one might perhaps call a future exemplary
11 performance approach, it might be possible to further the
12 goals of those who savor mandatory rotation while
13 simultaneously avoiding some of the very high costs and
14 possible audit quality problems that could undermine from
15 a purely mechanistic mandatory rotation approach.

16 The second matter that I've been asked to talk
17 about is an article I wrote that was published in June,
18 an article that offers a new conception of how
19 corporations had been providing information to investors
20 ever since the Great Depression, the nature of
21 information, if you will, and how it must be conveyed in
22 this new world.

1 The first matter, this future exemplary
2 performance approach. The PCAOB has already benefitted
3 from lots of very thoughtful input as to the mandatory
4 rotation concept release. Every link in the chain, from
5 auditors, audit committee members to regulators and
6 academics have weighed in for and against mandatory
7 rotation, and during the course of a conversation, a fun
8 conversation with Michael Gerbutt over the summer about
9 this ongoing debate, I happened to raise one new
10 possibility, and it was very much a back-of-the-envelope
11 stage then, and certainly still is today, and it's a
12 possibly innovated by two concepts.

13 First, recognition that both those who advocate
14 mandatory rotation and those against mandatory rotation
15 have legitimate concerns. Having a single accounting
16 firm for multiple decades does raise the potential for
17 capture, for too much bonding. On the other hand,
18 mandatory rotation based on some kind of hard mechanistic
19 mandatory rotation term limits can be quite costly, and
20 a new accounting firm may, in fact, sometimes not only
21 fail to yield benefits but at least in your first year
22 or two may lead to lower audit quality. So this kind of

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1 mechanistic mandatory rotation system I suspect is too
2 blunt an instrument.

3 Second concept. We might consider fine-tuning
4 this instrument, fine-tuning it with information that's
5 really not being used. Take advantage, for instance, of
6 the special expertise and knowledge on the part of the
7 PCAOB, that the PCAOB has uniquely, as well as the
8 special expertise of the existing outside accounting
9 firm. Instead of using a blunt one-size-fits-all
10 approach, totally blind to individual facts and
11 circumstances, we can consider moving to an approach that
12 is much more informationally based and attuned to
13 individual circumstances.

14 PCAOB, in particular, has expertise, has the
15 institutional credibility, and has unparalleled access
16 to information by which to judge accounting firm
17 performance, much of which is never made publicly
18 available. This information, if you will, is going to
19 waste. We should take advantage of this information.

20 In broad outline, this future exemplary
21 performance approach would work as follows. As a general
22 matter, there will be a fixed rotation period of some

1 type, some length, let's pretend ten years, however, the
2 existing accounting firm could seek a waiver from the
3 PCAOB. And what's the overarching standard that the
4 PCAOB might want to use in terms of deciding whether to
5 grant such a waiver? Well, the standard is who would
6 have a greater likelihood of delivering truly exemplary
7 performance over the next ten years.

8 And in terms of determining this, would it be,
9 for instance, the existing accounting firm or might it
10 be some alternative accounting firms? How do you
11 determine this, how do you determine the likelihood of
12 the chances of future exemplary performance? Well, of
13 course, one obvious way is to look at past performance.
14 Right? Past is prologue, to a certain extent.

15 So that the PCAOB could consider the quality of
16 the existing accounting firm's past performance, and one
17 possibility is not only to consider the past performance
18 with respect to this particular company, the current
19 company, but in fact, in terms of its performance across
20 various companies that it has audited, including small
21 companies, that this kind of system -- in fact, when you
22 think about incentives, this kind of system may lead to

1 all kinds of benefits where smaller companies, who
2 otherwise might feel neglected, that these accounting
3 firms want to show boy, they are exemplary or close to
4 exemplary all the way through.

5 And certainly, if there's a major accounting
6 fraud uncovered, whether at this particular company or
7 perhaps another company that this accounting firm is
8 involved in, that should, perhaps, be considered.

9 Now, we don't want, in effect -- I mean, there's
10 been a lot of excellent discussion this morning about how
11 to make use of, in effect, the private information, the
12 non-disclosed Part II type information that the PCAOB has
13 which all kinds of interesting raw data, all kinds of
14 interesting judgments and so forth that, in a sense,
15 outsiders don't get, and audit committees frequently
16 generally don't get. This approach where the PCAOB in
17 a sense can rely in part on this information, this
18 valuable information will be a way, in a sense, of not
19 taking advantage of this information without necessarily
20 some of the disabilities in terms of actually disclosing
21 this information.

22 But past performance is only one aspect in terms

1 of this approach. That is, we also want to take
2 advantage, for instance, of the unique information the
3 existing outside accounting firm may have in terms of
4 assessing the likelihood of future exemplary performance.
5 The existing accounting firm really does have special
6 information as to the particulars of that particular
7 company, of what might be involved in terms of the
8 learning curve in terms of bringing new people in. We
9 should benefit from that. In terms of its decision-
10 making, this is valuable information.

11 Sure, they have incentives, a certain structure
12 when they provide this kind of information, but
13 nevertheless, they have valuable insights and those
14 insights could help inform as to whether or not there
15 should be a switch. They may be able to suggest that not
16 only, perhaps, might it be very costly, especially costly
17 in that particular company's case, or that it suspects
18 that with this particular kind of company the learning
19 curve will be an especially long one, that the audit
20 quality for a number of years in terms of a new
21 accounting firm may not really be very high.

22 This is a relative issue, not an absolute issue

1 in terms of exemplary performance. That is, the existing
2 accounting firm may only have done a B-plus job on the
3 usual inflated grade curve, B-plus job, but if that
4 existing accounting firm can show that despite one's
5 hopes for some new accounting firm coming in, swooping
6 in and delivering exemplary performance, maybe this
7 existing accounting firm can show that even if you bring
8 this new person with all the attendant costs and so
9 forth, learning curve and so forth, you'll still end up
10 with a B-plus performance, hey, maybe you should be
11 satisfied with B-plus performance and keep the same
12 person, keep the same accounting firm.

13 We have to be realistic. We're not assuming
14 that, in fact, there will be exemplary performance. The
15 likelihood of future exemplary performance may be 30
16 percent, but if 30 percent is what we can get, we need
17 to live with that.

18 In terms of possible effects, this, again, avoids
19 a blunt mechanistic approach that ignores totally
20 information that's relevant to a particular case, and
21 that we don't fall into the trap of the grass is always
22 greener on the other side of the fence, that somehow the

1 new accounting firm will get everything right. That's
2 not realistic. This offers, perhaps, more of an apples
3 to apples comparison and some more reasoned information-
4 driven, fine-tuned approach.

5 And in terms of the incentive structure, it gives
6 an existing audit firm incredible incentives to do a
7 great job all along the way, to show that they come close
8 to exemplary performance. They want to keep their
9 client, and if the PCAOB decides that they're not only
10 going to look at the performance at this particular
11 company but its performance as to all companies, large
12 and small, even small companies could benefit, perhaps,
13 from this kind of approach.

14 And it also gives audit committees incentives to
15 manage the relationship better, that in terms of audit
16 committees that they, like other board members who have
17 who have an incentive in terms of reducing costs --
18 right? -- and they would try to basically work with the
19 existing accounting firm to try to make sure they are
20 delivering close to exemplary performance along the way
21 so that they can somehow get a waiver from the PCAOB.

22 Lots of big caveats, lots of open questions: you

1 know, how long should a term be, what data should be
2 looked at, to what extent should the various inspection
3 reports, the efficiency analysis play a role. And there
4 are lots of costs. Frankly, this may tax the resources
5 of the PCAOB. Making a determination whether or not to
6 give a waiver has huge consequences for an accounting
7 firm. Will the PCAOB have resources, the necessary sheer
8 manpower and specialized expertise to make these
9 judgments, and keeping in mind that inevitably people
10 will be concerned about the centralization of power in
11 the PCAOB, that people may be very concerned about the
12 centralization of power in terms of PCAOB forcing or not
13 forcing, in effect, rotation.

14 I now want to turn to the second matter that it's
15 my understanding the Board wanted me to talk about, an
16 article entitled "Too Complex to Depict: Innovation,
17 Peer Information, and the SEC Disclosure Paradigm" that
18 was published in June. That article offers a new
19 conceptualization of the SEC's disclosure paradigm that's
20 been in place since the Depression, shows how that
21 paradigm has been undermined by the modern process of
22 financial innovation and offers possible ways ahead

1 Because that article is over 110 pages, I
2 apologize if you went past your airline weight limit as
3 a result of the article, and because it can be downloaded
4 from the web, I'm only going to touch very lightly on a
5 few of the key aspects of this very long article.

6 Since its creation, like the PCAOB, the SEC's
7 totemic philosophy has been to promote a robust
8 informational foundation. The article starts by
9 suggesting that the SEC's disclosure philosophy has
10 always been largely implemented through what can be
11 conceptualized as an intermediary depiction model. An
12 intermediary, that is, for instance, a corporation
13 issuing shares, stands between the investor in an
14 objective reality. This intermediary observes the
15 reality and, with the help of accountants, lawyers,
16 underwriters and others, crafts a depiction of the
17 reality's pertinent aspects and transmits the depiction
18 to investors. Information, when you're talking to
19 lawyers at least, and perhaps to accountants, information
20 is largely conceived of, if not equated to, such
21 depictions.

22 The article's main thesis is that this

1 longstanding intermediary depiction model is increasingly
2 undermined by modern financial innovation, and that the
3 disclosure paradigm must metamorphosize to comprehend
4 what I term pure information models, as well as the full
5 spectrum of possibilities between these polar models,
6 between these polar extremes.

7 Modern financial innovation is creating objective
8 realities far more complex than in the past, often beyond
9 the capacity of the English language, accounting
10 terminology, visual display, risk measurement and other
11 tools on which all depictions must primarily rely. Given
12 such rudimentary tools and such complex realities, the
13 depictions may sometimes offer little more than shadowy,
14 gross outlines of the objective reality.

15 Financial innovation sometimes poses a second
16 roadblock to depiction, and this is so even assuming a
17 completely well-intentioned, very sophisticated
18 intermediary, completely well-intentioned, sophisticated
19 intermediary. The intermediary, even the sophisticated
20 one, either may not truly understand or may not function
21 as if it understands the reality that the corporation is
22 charged with depicting.

1 The second roadblock may flow both from the
2 complexities of the financial innovation itself, as well
3 as from the organizational complexities associated with
4 the intermediary. If the intermediary doesn't understand
5 the objective reality, what good is its depiction, how
6 can its story be accurate or complete?

7 The article illustrates these problems with the
8 intermediary depiction model and the potential of what
9 I've been referring to as pure or moderately pure
10 information models, primarily in two contexts: first,
11 the depictions involved offered to shareholders by some
12 major money-sender banks heavily involved in financial
13 innovation activities, derivatives, mortgage-backed
14 securities, and the like; second context where I
15 illustrated these themes was that depictions offered by
16 issuers of asset-backed securities.

17 In a sense I first offered these ideas in
18 February at a symposium that Chairman Doty was kind
19 enough to come to, the article was in final stages of
20 editing in mid May of this year when the JPMorgan Chase
21 chief investment office, also known as the London Whale
22 problems, derivatives problems starting emerging. So I

1 managed to quickly add a section to the article dealing
2 with JPMorgan Chase, and I used this JPMORGAN Chase chief
3 investment office, these derivatives issues to
4 illustrate, in fact, these very themes that I had been
5 arguing. Which points out that academics have a conflict
6 of interest -- right? -- we profit from disaster. But
7 anyway, so I used the JPMORGAN thing to illustrate some
8 of these kinds of roadblocks to good depictions, and also
9 to illustrate some of the potential solutions.

10 If complexities related to financial innovation
11 are creating problems for the disclosure paradigm,
12 technological innovation may contribute to a solution.
13 With advances in computer and internet technologies, it
14 is no longer essential to rely exclusively on
15 intermediary depictions of reality, i.e., the
16 intermediary may not need to always stand between the
17 investor and an objective reality, recounting to the
18 investor what the intermediary sees. Figuratively, if
19 the intermediary steps out of the way, the investor may
20 now be able to see for himself, to download the objective
21 reality in full gigabyte richness.

22 Such pure information can, theoretically, be more

1 granular, more accurate than the intermediary's depiction
2 and free from possible intermediary biases and
3 misunderstandings. However, at the same time, this
4 intermediation will also leave investors bereft of an
5 intermediary's efforts to analyze and distill the object
6 reality and incorporate their resulting very valuable
7 insights in the intermediary's depiction.

8 The article shows that a disclosure paradigm that
9 relies both on the intermediary depiction model and the
10 pure information and the full spectrum of strategies
11 between these extremes is necessary. For instance, as
12 to too big to fail banks, involved heavily in
13 derivatives, the article outlines some possible models
14 along this spectrum, including strategies that would
15 generate moderately pure information, as well as
16 strategies involving the simplification of reality.

17 As my use of those words might suggest, this kind
18 of analytical framework for information may actually
19 raise important issues of a substantive nature. If, for
20 instance, a too big to fail bank is too complex to depict
21 and pure information type models are insufficient, you
22 have to ask the question are those banks also too complex

1 to exist.

2 Let me conclude. Both of the matters I've talked
3 about, this future exemplary performance approach to
4 rotation, and the pure information concepts that I set
5 out in "Too Complex to Depict?" revolve around the
6 incredible difficulties in assuring that investors have
7 the information that they really need. The PCAOB plays
8 an absolutely crucial role in this enterprise and has
9 already contributed so much. Some of the ideas I set out
10 today, especially the ones relating to this future
11 exemplary performance approach, are highly preliminary,
12 back-of-the-envelope stuff, and that's to provoke
13 thinking. But as to all of the ideas I offer today, I
14 emphasize that while academics don't torture large bears
15 dragged out of the forest, we do torture data until the
16 data tells us what we want to hear.

17 So thank you very much.

18 MR. DOTY: Well, first, the practice here for me
19 to turn to my Board members, but while I allow them to
20 gather their thoughts on what you've just said, I would
21 explain or I would say that I found the article
22 terrifying, absolutely terrifying, and it relates to some

1 issues that Phil Wiedemeier, who is in the audience here,
2 and others have brought up with us from time to time, and
3 they bear directly on the Board and its mission. In
4 addition to containing some statements by Judge Landes
5 and by Joe Kennedy about how they never found the
6 accounting profession on the right side of the investor
7 issues, we'll put that in the historical footnote area.

8 You note in the JPMORGAN London Whale, you see
9 four areas of slippage between what the company
10 understood or could have understood and what happened.
11 You note slippage between the intended mathematical
12 concept and the contract provisions of the derivatives,
13 slippage between the contract provisions of the
14 derivatives and the computer program, the computer's
15 depiction of reality as effective reality, slippage
16 between the prospectus selling the securities and both
17 the contractual provisions and the computer program --
18 that's the prospectus depiction versus true reality
19 theory -- and then slippages in the mapping of the
20 prospectus depiction of the reality and the true reality.

21 MR. HU: Yes. And that's also asset-backed
22 securities. Yes, absolutely.

1 MR. DOTY: And what hit me is that they're all
2 audit areas, these are all areas which, if we expect
3 auditors to audit and understand, it's going to become
4 more complicated and more difficult for them to
5 understand, and I don't know how they do that if we don't
6 have standards and audit practice alerts that direct them
7 to do it. Whether it can be done, one of the things that
8 you serve up is whether or not the reality is so complex
9 that if the depiction model fails, the auditor is
10 auditing something which may be fundamentally flawed,
11 unable to be depicted. It may be that we have got to
12 rethink those areas where we instruct the auditor to look
13 in the depiction model to test -- that's cost.

14 Finally, if XBRL becomes a reality and you go to
15 the areas where you see financial reporting going which
16 is to the delivery of information directly from the
17 computer-generated systems, it seems to me then we have
18 an additional question that raises for the attest
19 function which is what is the auditor auditing, are they
20 going to audit the systems and the way in which the
21 information is generated, and does the disclosure become
22 essentially, as Mike Cook would say, the caboose and not

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1 the engine.

2 I don't know where all this leads us on the
3 discussion today. I do think that in the five minutes
4 we have remaining before the next panel comes, we ought
5 to lay down a marker that we're going to need help, I
6 think, from academics about clarifying what we think is
7 auditable, inspectable and can be articulated. You have
8 deconstructed, Henry, you have deconstructed, in many
9 ways, the world that we grew up thinking of as an
10 auditable world, but you did it in a way that is
11 ruthless. Because Marty Bauman has long been talking
12 about the fact that we have got to get greater
13 correspondence between the accounting disclosure
14 principles on intangibles, on derivatives, and the audit
15 standards, that in fact, the auditing standards aren't
16 right and you can't get them right on derivatives and
17 intangibles and valuation questions, you'll not be able
18 to audit the thing -- this is a theme that Jay Hanson
19 often goes back to -- that if the accounting and the
20 depiction principles aren't doable, it puts a great
21 burden on the audit.

22 With that, I think I will shut up and tell Board

1 members and staff why I was worried about this, why
2 Henry's theory I find to be a threatening theory in the
3 way that Descartes and some of the early philosophers
4 were threatening, and let people chime in. Does anybody
5 want to chime in?

6 MR. HARRIS: First of all, I find it as
7 fascinating as the chairman did, so thank you very much,
8 and it gets to the role of the auditor in a realtime
9 reporting model, and you and Chairman Pitt and others
10 have focused very aggressively on data, and that's what
11 Lew Ferguson focused on in one of his comments earlier
12 on. And so I want to emphasize the importance of our
13 needing help from you and others in terms of what is the
14 data that we need to get in our Office of Research and
15 Analysis, because in this new paradigm, in this new world
16 you are repeating what Mike Cook and people like that
17 have told us previously.

18 But in terms of the analysis, in terms of the
19 distilling of information, what is it that our Office of
20 Research and Analysis ought to be researching, analyzing,
21 mining, whatever. So whatever thoughts you have of that,
22 maybe when you're in Washington at some point, you can

1 meet with Greg Jonas. I think it's essential that we
2 look at that. So thank you very much.

3 MR. FERGUSON: Professor Hu, I have a question on
4 your first topic which was sort of rewarding exemplary
5 performance, if you will, because I think that's
6 obviously one of the objections we hear to mandatory
7 rotation: well, why would you punish somebody who is
8 doing a terrific job with an arbitrary rule that throws
9 the baby out with the bath water, if you will.

10 Particularly, if the decision as to whether an
11 auditor should be continued or left to the PCAOB, what
12 kinds of procedural safeguards would you suggest there
13 be? Because I think the last thing we would want would
14 be an arbitrary rule of one kind replaced with arbitrary
15 performance by an agency like the PCAOB. And although
16 we're not subject to the Administrative Procedure Act,
17 I think we're very conscious, we try to follow it, we're
18 very conscious of making our decisions transparent.

19 So what kinds of procedural rules would you
20 suggest that would provide adequate protections to
21 people?

22 MR. HU: Board Member Ferguson, I agree totally

1 with you, we don't want to have a situation where we have
2 to throw anybody out. That's precisely the motivation,
3 if you will, for this kind of hybrid or halfway approach.
4 And I'm just as concerned in terms of the notion of the
5 need for proper safeguards, and you can well imagine here
6 you have -- you could characterize a Stalinist system,
7 one central body determining who gets to be auditor and
8 I'm as concerned about that, that's why I raised the
9 issue.

10 I think that this would have to be certainly
11 fleshed out, and one of the key issues is how can we take
12 advantage of something that, in effect, the PCAOB
13 possesses uniquely about the quality of the accounting
14 either at that firm or of that accounting firm generally,
15 that currently the audit committee doesn't generally have
16 access to. And so this is meant as a device to make, in
17 effect, any decisions relating to rotation of accounting
18 firms more informed.

19 And in terms of the procedural safeguards,
20 perhaps one of the things that can happen is some kind
21 of limited public greater disclosure but perhaps not the
22 whole thing, limited public disclosure so that there

1 would be greater opportunities for, in effect, challenges
2 to the deficiency analysis, public challenges and public
3 discussion and so forth. But I agree with you fully that
4 this is one of the fundamental problems with this
5 approach but it does offer something that currently is
6 not being used.

7 MR. FERGUSON: One of the problem we have with
8 disclosure, however, is that the statute, the Sarbanes-
9 Oxley statute itself, prohibits us from disclosing
10 essentially quality control material, what's called Part
11 II, unless the firm fails to remediate. So we have
12 strict limitations on what we can disclose.

13 MR. HANSON: Thank you for your comments on your
14 new auditor rotation idea and I've got an overarching
15 question and a couple more that kind of go below that,
16 and that's I'd like to hear your thoughts on how you
17 would determine what that grade was. You mentioned the
18 firm got a B-plus.

19 MR. HU: A would be above average in terms of
20 PCAOB deficiency findings. Right?

21 MR. HANSON: Right. And the context that we
22 don't go looking for things that are done right, we only

1 go looking for problems and we have a very sophisticated
2 screening mechanism looking through the issuers to say
3 where do we think the problems are, and we match that up
4 with the data we know about the firm and the office and
5 the individual partners, so we go in looking for problems
6 and we're very good at finding that here. And so we
7 don't, within any given engagement and for any one of the
8 major firms, we maybe only look at 5 percent of their
9 audits in a year and we don't look at the whole
10 engagement, we don't go looking for what did they do
11 right.

12 So my overarching question is how do you view
13 audit quality, and then maybe a more granular question
14 about how you envision applying an exemplary performance
15 approach. Would you apply that for the larger firms at
16 the firm level or at the engagement level?

17 MR. HU: Well, you bring up a very rich set of
18 issues. I guess my general notion was kind of a holistic
19 approach to grading, if you will, but with certain
20 criteria that you identify here among the factors and
21 perhaps you might give some sense of the weight you apply
22 to it, but not purely mechanistic because mechanistic

1 rules can be gamed.

2 Now, you could flip it around that one, the gray
3 things that you're really good at identifying
4 deficiencies, rather than giving the overall grade, But
5 that, in fact, is very useful because when you think
6 about it, in terms of whether or not you ought to rotate,
7 in effect you're motivated in part about the deficiencies
8 aspect. Right? So that is, in effect, the worst case,
9 the bad outcomes and so forth, so that even in a holistic
10 approach where you take into account a whole variety of
11 factors, I think the element of deficiency that you
12 really give up lots of expertise and credibility in.
13 That is, you have credibility here, and that helps in
14 terms of the concern over centralization of power. So
15 that's one aspect.

16 I'm sorry, the second question relates to?

17 MR. HANSON: If a firm had a significant number
18 of findings, would you say you'd never get the waiver as
19 a firm because your findings are such, versus you'd look
20 to what we saw in that engagement.

21 MR. HU: Right. I am leaning -- that's why I was
22 thinking about throwing out the idea, perhaps you

1 actually care about its overall performance across a lot
2 of engagements. Because , number one, if you simply zoom
3 in on a couple of firms, a couple of company audits as
4 being subject of the special rotation system, if you
5 will, that accounting firm may, to some extent, neglect
6 in terms of be rather loose in terms of how it approaches
7 audits of smaller companies or companies not subject to
8 it. And so that you might want a system where, in fact,
9 you look across engagements simply because you want that
10 firm to have quality control across companies, so that
11 there is some incidental benefits to this beyond that
12 particular company.

13 And that was one of my kind of goals of this
14 approach, that it not only affects the particular
15 company, so even if you decide we're only going to
16 subject the 100 largest companies to this, still perhaps
17 the other companies might benefit from this.

18 MR. DOTY: Other questions?

19 MS. FRANZEL: You've presented us with some very
20 intriguing and insightful comments. With regard to your
21 comments about the banks, the very large banks that might
22 be too big to fail, too complex to depict and too complex

1 to exist, I have to question how they can possibly be
2 auditable, and I think that's something we all need to
3 come to terms with and it's going to take a long time to
4 figure that out.

5 But I want to also talk about the exemplary
6 performance. I think your comments there point to the
7 huge need that we have for a comprehensive and common set
8 of audit quality indicators and measurements that
9 everybody in the system can agree to and aspire to and
10 measure to. And so I think we really need some
11 development in that area. And then also on who really
12 takes responsibility for which parts of those and who
13 really takes responsibility for which parts of those and
14 who's the double-checker in the system.

15 I remember back in the late '90s and even while
16 Sarbanes-Oxley was being debated, a number of people came
17 to GAO and said we've got the answer for firm
18 independence: GAO can pick the auditors for public
19 companies. And we said, Wait a minute, let's think about
20 the role of government in capital markets.

21 MR. HU: Quality control at the GAO.

22 MS. FRANZEL: Exactly. And I think we would want

1 to work through some of those issues here too, you know,
2 what is the role of each of the parties, including the
3 PCAOB, in a system where firms would be measured prior
4 to this type of system being put in place.

5 So I'm very intrigued by your comments, and to
6 what extent, I guess, are you developing some of these
7 quality indicators for exemplary performance, is there
8 research out there?

9 MR. HU: As Chairman Doty noted, my area of
10 research is really kind of law and economics of capital
11 markets, and that's why I kept on trying to emphasize how
12 back-of-the-envelope this idea is because of a wonderful
13 conversation that I had with Michael, so I haven't
14 thought about these issues very carefully at all. But
15 in terms of a couple of points in terms of what you just
16 said, first in terms of the really complex banks, too big
17 to fail banks, very quickly, one of the things I point
18 out in the article is it's much easier to describe that
19 abstract painting white on white than to describe the
20 Triptych Garden of Earthly Delights. In effect,
21 simplification of banks would help a lot, but of course,
22 that's one of the factors. There are pluses and minuses

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1 to making banks simpler, obviously, but this is a fact
2 to be considered.

3 In terms of the notion of developing various
4 indicators of auditor performance, I think that might
5 be a good thing, that if we go with this kind of approach
6 or a test pilot version of this approach, it would force
7 us to think through more carefully what measures are
8 valid and how much weight do you put on various things
9 in terms of deficiencies versus other things.

10 And a third aspect that I do want to emphasize is
11 I'm not just talking about, in a sense, the problems or
12 the potential of the current accounting firm, I think
13 that the current accounting firm would have some real
14 insights in terms of the likelihood of the new person
15 coming in actually being able to do any better. It may
16 well be, being realistic, they might not do much better,
17 that we have to figure out how we evaluate those claims
18 in terms of the learning curve costs and how that should
19 figure into the entire analysis.

20 MR. DOTY: Henry, whose back-of-the-envelope is
21 more incisive than most people's years of study, but
22 there's work to be done on all of this, and we thank you.

1 We are going to move to the next panel, and I see
2 Robert Blakely entered the back of the room, I think.
3 My eyesight not being what it used to, I think we've got
4 our panelists here.

5 Robert Blakely is the audit committee chair of
6 Allied Financial and Westlake Chemical Corporation. He
7 serves on the audit committees of Natural Resource
8 Partners, LLC, and Greenhill & Company. He has extensive
9 public company experience, having served as executive VP
10 and chief financial officer for several companies. He
11 was the executive VP and chief financial officer of the
12 Federal National Mortgage Association, Fannie Mae, from
13 January 2006 through January of 2008. Prior to that,
14 executive VP and CFO of MCI from April 2003 to January
15 2006. Historians will recognize that that was a
16 particularly turbulent and important period in the
17 history of MCI. CFO at Lyondell Chemical, Tenneco, a
18 career in which he finished as a managing director of
19 Morgan Stanley. Member of the Financial Accounting
20 Standards Advisory council from 1999 to 2003. A BME
21 degree in mechanical engineering and an MBA in business
22 from Cornell and a PhD from the Massachusetts Institute

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1 of Technology.

2 Kenneth Daly. President and CEO of the National
3 Association of Corporate Directors, NACD, a position he's
4 held since May 2007, the nation's largest member-based
5 organization for board directors, a recognized expert on
6 governance and board transformation. And under his
7 leadership, the NACD has grown in size and scope, more
8 than doubling in revenue, increasing its membership by
9 100 percent. He was an audit partner at KPMG. Served
10 as partner in charge of the National Risk Management
11 Practice. Served on and chaired audit committees,
12 extensive audit partner experience. Routinely lends his
13 expertise to counsel audit committees in critical areas.

14 He regularly appears in media. Received his
15 bachelor in accounting from the University of Delaware,
16 a CPA in Pennsylvania. Ken is a force for good in our
17 corporate environment and he is here today with our
18 gratitude.

19 Michelle Edkins. Managing director at Blackrock
20 and global head of the corporate governance and
21 responsible investment team for 20 specialists based in
22 five key regions internationally. Responsible for her

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1 team's engagement and proxy voting activities in relation
2 to the companies in which Blackrock invests on behalf of
3 the clients, and she is on the firm's government
4 relations steering committee. Active participant in
5 public corporate governance debate. Regularly speaks and
6 writes. Chairman of the board of governors of the
7 International Corporate Governance Network. An economist
8 by training, Michelle has also worked in the UK in a
9 number of governance-related roles and in government
10 roles in her native New Zealand.

11 Larry Rittenberg. PhD, CPA, CIA, professor
12 emeritus, accounting and information systems, University
13 of Wisconsin. He's been on the faculty of the university
14 since 1976, has served as the chair of the accounting
15 department for eleven years. He's the audit committee
16 chair of Woodward, Inc. and has served as a director of
17 Woodward since 2004. They integrate leading edge
18 technologies into fuel, combustion, fluid actuation and
19 electronic control systems for the aerospace and energy
20 markets. He has also served in leadership positions wit
21 h the AICPA, the AAA, VP of finance for the American
22 Accounting Association. Chairman of the Committee of

1 Sponsoring Organizations of the Treadway Commission,
2 COSO, from 2004 to 2009, so he was present at the
3 creation of the concern for internal control of financial
4 reporting. He has served as a financial advisor
5 providing counsel on Sarbanes-Oxley compliance to audit
6 committees of the board of Petro China, the largest
7 publicly listed company in China. We'll have a
8 discussion about that, I expect, at some point.

9 But this is a distinguished panel of audit
10 committee chairs and governance experts, and we welcome
11 you all and invite your comments, look forward to your
12 comments.

13 Robert, start us off.

14 MR. BLAKELY: Thank you, Chairman Doty. I
15 appreciate the opportunity to speak before this board on
16 mandatory rotation, external auditor effectiveness, and
17 the recently instituted PCAOB inspection process. I'd
18 also like to commend you on the excellent work that's
19 been done thus far and how supportive I feel for the work
20 that I've seen to date.

21 What I'd like to do today is comment and make
22 suggestions that the Sarbanes-Oxley Act actually offers

1 audit committees, and particularly audit committee
2 chairs, significantly more opportunity than I think is
3 generally understood to mitigate the concerns regarding
4 lack of professional skepticism, independence, and
5 auditor- management coziness.

6 I'd like to briefly amplify on Chairman Doty's
7 comments on my own experience because I think they are
8 relative to what I will say a little bit later on. As
9 Chairman Doty said, I actually served for over 30 years
10 as a CFO of four major New York Stock Exchange listed
11 companies. I think, as you all would appreciate, I
12 served at the pleasure of the audit committee and I was
13 the principal interface between the audit committee and
14 the senior management of each of those four companies.

15 To speak briefly about the last two positions,
16 Chairman Doty characterized MCI, I think you should also
17 recognize I stepped in immediately after the bankruptcy
18 of WorldCom, the largest bankruptcy in history and the
19 largest restatement that was to be done up to that point
20 in the years 2003 to 2006. We took a \$10 billion income
21 statement and after the restatement it was a loss of some
22 \$60 billion.

1 From 2006 to 2008 I served as the CFO at Fannie
2 Mae. Under my responsibility I had 2,400 contractors,
3 we were spending \$50 million a month and we spent 18
4 months doing the restatement. We also had 27 categories
5 of material weakness. I think we all get upset when we
6 think about one material weakness, this was 27 separate
7 categories. I want to come down to a point a little bit
8 later, I actually stepped down, although I did not need
9 to, immediately the day the restatement was finished.

10 I currently sit on four audit committees of New
11 York Stock Exchange listed companies, and two of which
12 I serve as the audit chair. I'd briefly like to mention
13 Allied Financial, which I think you would better know as
14 GMAC, where I serve as the audit chair. I think you're
15 aware it was the subject of a \$15 billion
16 recapitalization as part of the auto industry bailout,
17 and shortly after the new board was appointed, there was
18 a significant downsizing and sale of assets. More
19 recently there was an announcement of the sale of all the
20 international businesses and the mortgage subsidiaries
21 of Allied Financial filed for bankruptcy earlier this
22 year.

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1 I can't envision an environment in which the
2 dynamics of accounting and financial disclosure should
3 be more apparent and more topical, and I think these
4 particular experiences provide me with a perspective on
5 auditor rotation, professional skepticism, and auditor
6 independence.

7 As to my responsibilities as an audit committee
8 chair, obviously I have those in two audit committees and
9 I would share that I believe the two other audit
10 committees where I serve as a member, the chairs
11 effectively take about the same approach. You'll have
12 to be patient with me for one moment. First, as a
13 director I have the duty of loyalty and care and I'm
14 always concerned about reputational risk, as I think you
15 would appreciate.

16 What are my general expectations as a board
17 member? That I'm provided adequate access to
18 information, it comes in a timely manner, and there's
19 sufficient detail to allow thoughtful analysis and
20 adequate to provide the opportunity to develop an
21 informed point of view. Part of that process is reaching
22 out in a very proactive way, whether it be to management,

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1 consultants or the external auditors, to satisfy what's
2 required to reach the judgments that have to be rendered.
3 I have to be comfortable in the end that I understand the
4 issue and have an informed point of view. In 2011,
5 Allied had over 50 board meetings, so it just goes to
6 show a monthly board meeting typically in a high stress
7 situation is far from enough.

8 So how does this translate to the chair of the
9 audit committee? A couple of general observations.
10 You're all aware that the SOX Act transferred substantial
11 additional powers to the audit committee. I also believe
12 that the chairman of the audit committee has additional
13 responsibilities and is more equal than other members of
14 the audit committee. That's typically recognized in a
15 higher fee to the chairman of the audit committee by
16 virtue of the work that's required.

17 So how do I approach these responsibilities? I
18 proactively work to have a good and very open
19 relationship with the finance staff, the internal
20 auditors, the external auditors, and yes, the chief risk
21 officer. I try to create a tone that instills trust and
22 confidence, that all the individuals that are involved

1 in the financial reporting process have full access to
2 the committee, I create the expectation they're expected
3 to proactively come forward, and also that there will be
4 a constant dialogue and it will be much more than just
5 the formal meetings.

6 I reach out and actually attend staff meetings of
7 the finance staff, the internal audit staff, as well as
8 I've met the staff separately and offsite with the
9 external audit of over 40 members. And I drive these
10 same messages about transparency and the need to have a
11 full understanding.

12 The other thing I'd point out in these messages,
13 we never can be in a rush, we have to take the time to
14 be deliberate and make sure we fully understand. There
15 can be no bias in favor of better earnings, and we have
16 to be in a position that while I may understand a
17 particular matter, we have to bring it to the point where
18 it can be understood by the full audit committee.

19 So why do I go through this detail? I believe a
20 full, well developed audit committee process fosters
21 professional objectivity and promotes skepticism on the
22 part of auditors as well as creating a full and open

1 process.

2 I'm going to read from a quote from former SEC
3 Chairman Williams. "I recognize that many audit
4 committees have been much more active and proactive in
5 discharging their responsibilities under the Sarbanes-
6 Oxley Act. I do not believe, however, the audit
7 committee is capable of addressing the issues of lack of
8 professional skepticism, bias and lack of independence
9 addressed by the concept release."

10 I guess I'm of a contrary review that I believe
11 with proper technical background, good process, and
12 leadership on the part of the audit committee, it goes
13 a very, very long way to refute those comments. I also
14 believe the SOX Act has provided a catalyst, if not a
15 detailed roadmap for audit committees to substantially
16 influence the quality of the process, implementing
17 accounting pronouncements and appropriate accounting
18 changes, setting the incentives related to external
19 auditor fees and financial disclosures. At least that's
20 the perspective I have from the audit committees that I
21 serve on.

22 A couple of observations. I'm reading from

1 Harvey Pitt's testimony of March of this year. "Thus,
2 in addressing the question of mandatory auditor rotation,
3 the first principle, those who come before you should
4 acknowledge, is that at least for the question of
5 mandatory auditor rotation there is no absolute truth.
6 The board should reject the notion, explicit or implicit,
7 that anything it might do can eliminate all future audit
8 failures."

9 I concur with that view, and let me provide one
10 humble and very real example. On one of the audit
11 committees I sat on, we reached an accounting conclusion
12 and the lead partner of the audit firm was very
13 comfortable in rendering that judgment. We filed the 10Q
14 and at some point later the national office suggested,
15 and in fact, affirmed, that in fact the accounting was
16 not proper. Not a happy situation. The lead external
17 partner of the audit firm was an honest human error. The
18 partner had the best of intentions. Were we happy?
19 Absolutely no. Once in a while, just by random events
20 and human error, these things kind of happen, so I guess
21 I'm of the view we're all going to work as hard as we can
22 but there's no clear certainty.

1 The general financial expert criteria used by
2 both boards is not adequate for service as audit
3 committee chair for public companies with complex
4 accounting or significant business changes. I'd like to
5 read for you the standard form that's promulgated by one
6 of the major New York City law firms on financial expert.

7 Do you have an understanding of GAAP and
8 financial statements? Are you able to assess the general
9 application of GAAP in connection with the accounting for
10 estimates, accruals and reserves? Do you have experience
11 preparing, auditing, analyzing -- important word or, not
12 all -- or evaluating financial statements that present
13 a breadth and level of complexity of accounting issues
14 that are generally comparable to the company in question,
15 or -- important or -- experience actively supervising one
16 or more persons engaged in such activities?

17 In my view this criteria is necessary but not
18 sufficient for a chair of an audit committee. A couple
19 of recommendations. The audit committee process, in
20 effect, the audit committee chair should be held to a
21 higher bar for qualifications to serve as chair of an
22 audit committee. I think we need criteria that relate

1 to judgment, maturity and experience, and also
2 substantial experience with process of setting accounting
3 standards, implementing accounting standards and
4 financial disclosures is important to provide the
5 leadership for the process. Frankly, I would also add
6 an additional educational requirement for audit committee
7 chairs over and above those for audit committee members.

8 I do believe with proper appointments the audit
9 committee, and the work of the audit committee chair,
10 should go a long way to enhance auditor independence and
11 skepticism, and mitigate any thoughts of coziness. One
12 example from my own experience: the management of one of
13 the companies that I serve on the audit committee came
14 forward with a view as to what we should pay the external
15 auditors for the fee for a given year. My judgment,
16 after discussion, is the management was pushing too hard.
17 They could cut it that thin, but in terms of having the
18 proper and appropriate relationship and the correct one,
19 we actually ended up raising the fee. I only indicate
20 that to give you some sense of direct influence that the
21 audit committee can have when it's necessary.

22 I'd like to read from the testimony of John

1 Bogle, and I'll be finished shortly here, for 3/21/2002.
2 "Like the section of Sarbanes-Oxley that puts the audit
3 committee rather than management in charge of hiring the
4 auditor and overseeing the engagement, that extraordinary
5 latent power is limited by the fact that it's management
6 that appoints the audit committee, and that even the most
7 qualified of audit committee members rarely have the
8 knowledge to analyze the issue."

9 I do not think we should or need to accept Mr.
10 Bogle's conclusions that the proper education and
11 training can put us in a very different place. As to the
12 appointment of the audit committee by the management, I
13 don't serve on one board where that is the case.

14 So what do I worry about? The first thing I
15 worry about may be something that you would turn over to
16 the FASB rather than deal with the PCAOB, but it's
17 sufficiently important that I did want to mention it.
18 I worry as accounting becomes more complex and subtle
19 that we begin to lose the linkage between corporate
20 earnings and corporate operations; what's actually going
21 on in the business. As I indicated earlier, the day
22 after I finished the restatement at Fannie Mae I stepped

1 down. Why did I do that? I felt I was ultimately
2 qualified to drive the process to do the restatement, but
3 in looking at the restatements, I didn't feel I had the
4 ability to see the same level of linkage between the
5 operating results and what the accounting statements were
6 saying, and I felt someone who had substantially more
7 experience as a CFO in financial services could better
8 serve at that point than I could, so I stepped down.

9 Another comment, I think it's very important that
10 the audit committee process go deliberately with
11 appropriate tempo so that all issues are thoroughly
12 understood, and transparency and understanding is
13 created.

14 There's another item which is new to me, and I've
15 just been made aware of and I'd share it with you, and
16 it may be something that you actually understand better
17 than I, but I found in an engagement letter from external
18 auditors, there's the concept of offshoring where they
19 can actually move a portion of the audit work offshore.
20 I guess it may turn out that all this is fine and okay,
21 but I guess I want to understand the level of
22 professionalism, the training, the security, the controls

1 around the work that actually moves outside the United
2 States for companies based in the U.S.

3 A couple more conclusions if I could. I'm
4 quoting from Harvey Pitt and I'll try to make it short.
5 "Studies over the last three decades suggest that the
6 number of financial frauds in the first years of a new
7 auditor's engagement is unacceptably high. Mandatory
8 periodic rotation of firms also could lead to opinion
9 shopping of the decision on which new firms select.
10 Among concern is the unique strengths particular audit
11 firms bring to clients in certain industries. Large
12 audit firms are not fungible."

13 I agree with those comments. I further believe
14 that with proper training and education, proper maturity
15 and experience, team outreach, and dynamic a proper
16 process can be established which goes an awful long way
17 to deal with the issues which are the reference of the
18 talk today.

19 I'd like to comment, just in conclusion, on the
20 August 1 release regarding the inspection process. On
21 the two audit committees I chair, the external auditors
22 did bring their reports forward. We discussed the Part

1 I, were we the subject of any of the comments of the
2 firms that were audited or were any of the findings
3 relevant. Part II for me was a bit more troublesome.
4 Finally, I actually read a speech by Chairman Doty, and
5 while Part II is private, as you know, it also turns out
6 that it is disclosable to the audit clients and we moved
7 ahead on that basis, and in the two instances where I'm
8 involved, we actually had a dialogue on Part II, and most
9 of this was actually before the release but I certainly
10 think the release on August 1 substantially formalizes
11 and broadens that understanding to those that it might
12 not have been available.

13 In conclusion, thank you for the opportunity to
14 share my experience. As you'll note, my focus is very
15 heavily toward the audit committee and the chair of the
16 audit committee and how much more can be done in that
17 arena. I hope it's helpful to the work of the PCAOB.

18 MR. DOTY: Thanks, Bob.

19 Ken.

20 MR. DALY: I, too, would like to express my
21 sincere appreciation to the Board allowing me to speak
22 today regarding the Board's concept release on auditor

1 independence and audit firm rotation. As you're aware,
2 I have provided a written version of this commentary.

3 I speak today on behalf of the National
4 Association of Corporate Directors, the NACD, a national,
5 non-for-profit organization of nearly 13,000 corporate
6 director members that represent boards ranging from the
7 very smallest public companies to the every largest in
8 the country.

9 Let me begin by summarizing our observations on
10 the concept release, after almost a year of vetting in
11 the United States boardrooms. We surveyed our members
12 and conducted focus group discussions among audit
13 committee chairs from March through September of this
14 year. Additionally, I have personally participated in
15 probably more than 100 discussions with members of audit
16 committees in my day-to-day work and in our director
17 training, education, and awareness menus.

18 NACD has concluded the following three things:
19 One, the corporate director community shares the PCAOB's
20 views that external auditor independence, objectivity and
21 skepticism are critical objectives to pursue. Two,
22 mandatory audit firm rotation is not seen as an effective

1 way to achieve that objective. Three, audit committees
2 can and will take a lead in the oversight of achieving
3 auditor independence, objectivity and skepticism.

4 Therefore, on behalf of our constituency, I
5 present to you today a suggested model under which audit
6 committees: one, own and execute a vigorous and
7 rigorous process for oversight, including auditor
8 evaluation; acts on results as necessary; and finally,
9 proactively communicates the process and outcomes to
10 shareholders. The NACD supports a rigorous process led
11 by the audit committee, endorsed by the board and
12 communicated to shareholders.

13 In my written commentary for this roundtable, as
14 well as in the NACD's original comment letter of December
15 14, 2011, I've underscored our concerns about mandatory
16 auditor rotation. I also shared the concerns of our
17 director constituency. You've also heard those concerns
18 from many other parties, so I simply will say that the
19 NACD continues to affirm that the audit committee should
20 decide if and when to change the auditor in the best
21 interests of the company, its financial reporting, and
22 the audit risks presented.

1 Instead, I'd like to use the remaining time to
2 share a way that audit committees can achieve our mutual
3 objective. I think it is instructive to look at what
4 boards are currently doing. Today's audit committee
5 typically uses an auditor assessment process as its
6 method of oversight for the external auditor for both
7 performance and whether or not to change. The results
8 of our member survey conducted in June showed that more
9 than 90 percent of respondents on boards, where there is
10 a defined process to-- that there is a defined process
11 to regularly evaluate the performance of the independent
12 auditor. Secondly, the vast majority of them, 80
13 percent, include criteria for determining whether to
14 reappoint or select a new audit firm. And 76 percent of
15 the respondents told us that the audit committee also
16 involves the full board in the auditor evaluation, giving
17 others a chance to weigh in.

18 There is no doubt that the auditor evaluation
19 process is a key element of the audit committee
20 oversight. We have also determined that more rigor and
21 disclosure of the auditor evaluation process is both
22 welcome and achievable by the boards of public issuers.

1 This sentiment is shared by many of our members, our
2 national board of directors and our advisory council of
3 audit committee chairs who serve on the boards of the
4 Fortune 500 companies.

5 To that end, the NACD suggests a three-pronged
6 approach to robust oversight of external auditor
7 independence, objectivity and skepticism by the audit
8 committee. In this approach, the board continues to have
9 decision-making responsibility for the selection and
10 oversight of the external auditor. The first and most
11 critical component of the plan is a rigorous evaluation
12 process by the board. We have worked with a coalition
13 of leading organizations to develop a tool to assist
14 audit committees in performing an annual evaluation of
15 the external auditor. I attached a current version of
16 that document entitled "Audit Committee Annual Evaluation
17 of the External Auditor" to my written commentary last
18 week.

19 There's some important features of this tool:
20 one, it is scalable; two, it specifically includes and
21 evaluation of the auditor's independence, objectivity and
22 skepticism; and three, it encourages audit committees to

1 advise shareholders that they've conducted the evaluation
2 of the auditor, as well as the process and scope of the
3 evaluation. It has been vetted by the NACD's national
4 Audit Committee Chair Advisory Council and our national
5 board of directors, all corporate directors themselves.

6 On Monday of this week, at the NACD's Board
7 Leadership Conference, I disseminated this tool to an
8 audience of 800. I also emphasized that the NACD's board
9 practice guidance continues to support auditor evaluation
10 enhanced by the use of the new tool and disclosure to
11 shareholders.

12 The second component of effective oversight of
13 the external auditor is found is found in the recent
14 issuances by the PCAOB itself. Newly adopted Auditing
15 Standard 16 appropriately updates the substantive matters
16 auditors should discuss with audit committees about
17 issues raised during the audit and results. This
18 includes the quality of the company's accounting. The
19 NACD is urging our constituency to participate fully in
20 the substance of the auditor-audit committee discussion,
21 while at the same time assessing the quality of the
22 auditor's communications.

1 For example, we are delivering an interactive
2 webinar on AS-16 to our members to help them understand
3 the context of the standard as well as the expectations.
4 As you're aware that, effort is supported by the Center
5 for Audit Quality.

6 We're also appreciative of PCAOB's recent release
7 of information for audit committees on the PCAOB's
8 inspection process. It provides an overview as well as
9 good insights as to how to discuss and digest the
10 contents of those reports. Coupled with a vigorous
11 process of external auditor evaluation, these issuances
12 strengthen the platform for audit committee oversight of
13 auditor independence, objectivity and skepticism.

14 A third component of effective oversight, let's
15 take a look at director education and awareness along
16 with improved disclosures. Our coalition of leading
17 organizations currently making the auditor assessment
18 tool more broadly available throughout the United States
19 boardrooms will also educate the audit committee
20 community about effective use of the tool. We convene
21 advisory councils of audit committee chairs and
22 institutional investors annually to examine how

1 committees can do a better job of communicating the rigor
2 of oversight to shareholders. On November 1, our Audit
3 Committee Chair Advisory Council will meet specifically
4 to examine enhancements to audit committee disclosure.

5 We've just rolled out, as you're probably aware,
6 a five-part series of webinars on skepticism. The first
7 module, entitled "The Etiquette and Ethics of Skepticism"
8 informs members of the financial reporting supply chain
9 about how to be skeptical without creating a chilling or
10 punitive environment, including the audit committee
11 management and the external and internal audit. The
12 reaction by board members has been extremely positive.
13 I can also say that it's already had broad awareness of
14 its content, including significant pickup of 317 business
15 media outlets as of close of business yesterday.

16 This is just one of the tools we're developing in
17 collaboration with the Financial Executives
18 International, the Institute of Internal Auditors, the
19 Center for Audit Quality, to aid in the detection and
20 deterrence of fraud. NACD promotes the sharing of
21 leading practices between corporate directors and we
22 continue to educate on a wide range of audit committee

1 responsibilities: oversight of the auditors'
2 performance, financial reporting and a need to employ a
3 healthy dose of skepticism in their work.

4 In conclusion, we at the NACD believe that audit
5 committees can do a better job of communicating with
6 shareholders about how they are fulfilling their
7 oversight responsibility for the external auditor. We
8 are dedicated to more transparency, and we want to
9 explore ways that audit committees can provide better
10 information both within and separate from the audit
11 committee report and the proxy.

12 We have also concluded that mandatory audit firm
13 rotation is unlikely to improve financial reporting and
14 that an audit committee should retain the responsibility
15 for the oversight of the external auditor. I suggest,
16 instead, that we work with boards and shareholders on
17 this issue. Let's agree on enhancements to the audit
18 committee's process of evaluation and oversight and let's
19 better clarify how the audit committee communicates that
20 process back to shareholders. The attached audit
21 assessment tool provides a framework, and the NACD and
22 our coalition are committed to educating and supporting

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1 directors on how to use it.

2 Earlier some today talked about questions/
3 concerns they had about United States board governance,
4 and to that end, I wanted to kind of set the record
5 straight on a couple of matters in my judgment. One is
6 83 percent of all public companies today have a
7 designated lead director, so there's another piece in
8 place in addition to the independent board chair. As
9 perhaps some do not know, the nomination governance
10 committee is much more active in the selection of audit
11 committee and general board members today than ever
12 before.

13 And also, the new -- well, they're not new,
14 they're recently reinvigorated, 18(a)(8), the proxy
15 access, where if you own \$2,000 of stock or had it for
16 1 percent-- or, sorry- if you have \$2,000 the lesser of
17 \$2,000, or 1 percent of the stock outstanding, you can
18 suggest a proxy access amendment that will effectively
19 change the bylaws which effectively would leave access
20 to the proxy for new or changed board members. And the
21 point that I'm trying to raise there is that there are
22 plenty of ways to change audit committee members if, in

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1 fact, there's some concern about those audit committee
2 members.

3 I believe that the changes in audit committees
4 over the last few years has really been dramatic, and I
5 think at this time, as Robert mentioned already, audit
6 committees are being very, very active and taking their
7 duties with extreme urgency.

8 Thank you.

9 MR. DOTY: Thank you, Ken.

10 Michelle.

11 MS. EDKINS: I'll just move this a little closer.
12 I am always told I have a quiet voice, which surprises
13 my husband and children a lot.

14 Thank you for the opportunity to speak today and
15 present to you Blackrock's perspective from the
16 shareholder side of our business. One of my colleagues
17 presented to an earlier meeting about our views as an
18 issuer.

19 I think you're probably aware Blackrock is a
20 major investor in public companies, both from the equity
21 side and the debt side, so this is clearly a very
22 material issue for us. Another aspect of our investment

1 strategy that informs our thinking is that we make a
2 significant number of investments through index
3 strategies, so our clients are basically locked in
4 investors over the long term. And a number of the issues
5 that come up in accounting and auditing are long-term
6 issues over the period that they play out, so this is,
7 again, clearly quite material.

8 Each year my team, which is responsible for
9 talking to companies about their board leadership, about
10 their management quality and about their environmental
11 and social impacts, we meet about 1,500 companies around
12 the world, and so the views that I'm going to communicate
13 today are really based on those conversations that we
14 have, and our focus is very much on enhancing board
15 effectiveness and obviously audit committee effectiveness
16 as a subcommittee of the board.

17 I'm not going to be able to present a director
18 perspective because I'm not a director, nor am I an audit
19 expert, so pardon me if I sort of slip up on some of the
20 technicalities.

21 Our corporate governance program is an investment
22 function. We see it as part of our fiduciary duty to

1 monitor the companies that we invest in, in relation to
2 how they are protecting and enhancing the value of our
3 clients' assets, and so we have our own policies for how
4 we do that which reflect market standards. They're
5 applied pragmatically, and the key point which builds a
6 little bit on what Ken has just said, the onus is on
7 companies to explain and justify the approach that they
8 are taking to their governance.

9 When it comes to policy development at a market
10 level, our general preference is for practitioner
11 developed policy, and there are a few reasons for that.
12 This whole area, not specifically around auditing
13 necessarily, although I think it does apply, but around
14 governance more generally, has evolved significantly over
15 the last 20 years. Our experience of rulemaking is
16 offering it solving yesterday's problem and by the time
17 the rule has actually passed, we've moved on to a
18 different set of problems, and that evolution is
19 therefore slowed down. And so best practice guidance,
20 in our experience, provides a lot of flexibility for
21 practitioners to use their professional judgment to
22 ensure that the outcomes are in the interest of the

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1 constituents that they represent.

2 The other aspect that we have experienced of a
3 best practice of a rulemaking is that there tend to be
4 fewer unintended consequences, or if they do materialize,
5 they can be remedied and the policies or practices can
6 be flexed.

7 So our concern about mandatory auditor rotation,
8 even in light of all the evidence that you've already
9 received, is that there are clear costs, there are
10 potential issues that might emerge from it, and we also
11 are concerned that these might be brought into effect
12 without necessarily solving the problem at the core about
13 audit quality. So we believe that actually a lot of
14 improvements can be made to practice within the existing
15 framework. Now, some of those practices, I think, have
16 already improved since Sarbanes-Oxley and since other
17 changes in guidance have been issued, but I think we can
18 all, as practitioners, continue to push in that
19 direction.

20 When we talk about engagement, what we're really
21 talking about is talking to boards and management about
22 how well they're running the company and our focus is on

1 the board because that's the link between the
2 shareholders and management. One of the most powerful
3 sanctions that a shareholder has if they think the board
4 is not working in shareholder interests is to vote
5 against the reelection of directors.

6 Now, earlier speakers mentioned the difference
7 between the approach in the U.S. and that abroad. One
8 of the most significant differences is that majority
9 voting on director elections that is binding is still not
10 an across-the-board practice here. And I think that is
11 a significant thing and it's a little aside your remit,
12 I understand that, but I think as we move to that being
13 a widely adopted practice, I think you might see more
14 accountability to shareholders and more awareness of
15 shareholder perspectives around some of these issues
16 within boards.

17 The other aspect of that is an improvement in
18 disclosures or communication, and another observation I
19 would have, as someone who's only really been close to
20 the U.S. governance system for a year or so, is that too
21 many of the documents that are issued by companies around
22 governance are more a disclosure or regulatory reporting

1 type of document than a communication document. And I
2 think a lot can be done there in terms of improving
3 shareholder understanding about the approach a board is
4 taking, demonstrating board oversight of management, how
5 the board members are fulfilling their responsibilities
6 to shareholders and to the company, and explaining
7 company-specific situations. Because we are very clear
8 as an investor that governance has to be looked at on a
9 case-by-case basis, there isn't a single approach that
10 would apply to everybody, but companies have to explain
11 why the approach they are taking is in the interest of
12 the investors.

13 When all of this is applied to the audit
14 committee, our focus is definitely on the independence
15 of those members and on the expertise. I think there's
16 a lot that can be done to improve both at the level of
17 the appointment. So independence of thought is very
18 difficult to assess if you're not inside the boardroom,
19 but that is basically what we're talking about when we're
20 talking about independence. There are a number of
21 different criteria that are a proxy for what independence
22 is, but what we're really looking for is demonstrated

1 independence of thought. And we think that improving the
2 appointment process and ensuring that it is a formal
3 process and that the board explains the process that was
4 undertaken to appoint new directors, that the
5 biographical notes of directors are more fulsome than
6 they are right now. I don't know how many of you have
7 the joy of reading proxy statements, but an awful of them
8 look a lot alike.

9 When it comes to a term that I used in my written
10 document -- that I have been told by American people is
11 not widely understood in this context -- induction or on-
12 boarding, I think this is a really important process that
13 good boards do, but I think a lot of boards do not do
14 well enough, and that is about introducing new members
15 to the board, to the company, to the work of the board
16 and to the work of the committees and the history of the
17 work of the committees, so that while those people are
18 bringing in fresh perspectives, they're not reinventing
19 the wheel when they come into the group.

20 We also think that board evaluation should become
21 a formal part of the annual board process, and whether
22 that's done externally or internally is very much up to

1 the company, but as part of that succession planning so
2 that you are sure that you always have board members who
3 are willing and able to become audit committee members
4 should a gap arise. And in addition to the sort of board
5 evaluation, the succession planning, periodic refreshment
6 of the board, so the regular but periodic introduction
7 of new board members.

8 Now, there are some quite stunning statistics
9 about longevity on U.S. boards that you really don't see
10 replicated in other markets, except perhaps China and
11 Hong Kong, and I think there is room for improvement
12 there. And again, all of this ties back to the ability
13 of the audit committee to do its job and to demonstrate
14 its independence.

15 Another thing that we're quite keen to see but
16 it's, again, incredibly difficult to assess from the
17 outside, is that auditor skepticism, which is clearly
18 your focus, is matched by audit committee skepticism so
19 that they trust that the process has been a good one but
20 that they verify that. And from our perspective, that's
21 having a sense that probing questions have been asked by
22 the audit committee members, probably under the

1 leadership and guidance of the chairman -- because, you
2 know, I think that is how you have effective boards, good
3 leadership by chairmen and chairmen of subcommittees --
4 and that those probing questions are asked of the auditor
5 and of management so that the audit committee can marry
6 up the versions of the stories that they get.

7 I think another thing that we really need to
8 focus on is reinforcing that the client of the auditor
9 is the audit committee. Now, I know that that's
10 technically the case, but you don't hear it that often
11 expressed that explicitly, and I think that a lot could
12 be done by boards to communicate that and to demonstrate
13 it, because certainly in the circles I move in, many,
14 many investors are not convinced that that relationship
15 is the strongest one.

16 And when it comes to sort of assessing the audit
17 firm, I think there are a number of things that we would
18 like to be sure that audit committees were checking, and
19 it is around the continuing training that the audit firm
20 offers its staff and its senior partners, how mentoring
21 systems work, so how knowledge transfer and experience
22 is shared within the company. The culture around staff

1 professionalism, so this idea that it isn't just about
2 following rules, it is about having professional judgment
3 and exercising that judgment.

4 Having a means to assess the culture of the firm,
5 understanding the quality assurance or quality control
6 processes that the firm has in place and how that bears
7 out in practice, particularly where an audit firm has
8 been found wanting at some stage. So what were the
9 lessons learned, how were they applied, how was that
10 knowledge shared within the firm to minimize the risk of
11 repeating problems.

12 I think corporate secretaries or whoever is a
13 secretary to the audit committee can do a lot to help the
14 audit committee members stay informed about what is going
15 in the wider debate around these issues, and also to
16 monitor any PCAOB and other type reviews and reports
17 about the quality of the audit provided by the firm that
18 the company uses.

19 I think when it comes to the audit committee
20 members themselves and their continuing development, one
21 of the, I think, quite encouraging changes that we have
22 seen in the U.S. is more informal interaction between

1 board members around specific issues, so around what the
2 audit committee should be doing, what is its
3 responsibilities, how does it implement those. I know a
4 number of initiatives, NACD being one of the market
5 leaders, but also smaller groups, like the tapestry
6 networks, where they in private have these quite open
7 discussions about sharing best practice, and I think that
8 helps improve the professionalism of the directors.

9 I think there's another aspect for both the audit
10 firms and the audit committee members is having periodic
11 training or at least being aware of research around
12 cognitive biases and how framing and reframing questions
13 or problems affects decision-making and group think in
14 decision-making. And these are some of the softer
15 aspects of being either a professional or a board member
16 but I think they're quite important to be very conscious
17 of and regularly having that as a subject matter I think
18 could help.

19 When it comes to the reporting to shareholders or
20 sharing information with shareholders, I think there's
21 a lot more that could be included in audit committee
22 reports. And one thing would be having more detailed

1 terms of reference provided in public domains, either on
2 the website or in the annual report, but detailed ones,
3 not very sort of plain, boilerplate ones. Discussion in
4 the audit committee report about the level of non-audit
5 services compared to audit and the fees on both, and why
6 that is appropriate. The areas of focus of the audit
7 committee during the year, any special projects
8 undertaken, any policy changes that were approved by the
9 committee, and the policy on either rotation or re-
10 tendering and why that approach is in the best interest
11 of shareholders and how that determination was taken.
12 And also, justifying the retention of the current auditor
13 where there have been material misstatements or control
14 issues disclosed.

15 Another aspect that may, I think, be something
16 quite novel is making the audit committee chairman
17 available to meet with shareholders on request. And I
18 don't imagine that that would be picked up very often
19 because shareholders, in principle, do believe the board
20 is doing a good job and working in their interests, but
21 where there are concerns, our view is these are much
22 better expressed by the shareholders directly to the

1 board members in private rather than waiting for the
2 whole thing to blow up in public. That's a much better
3 way of protecting the value of the company.

4 Another suggestion for you is whether the PCAOB,
5 with its convening power, might bring together a group
6 of practitioners to come up with a set of guidelines
7 where you are basically sharing the best practices. Now,
8 a number of the audit firms have put out good practices
9 for audit committees, but I think a lot of people might
10 not necessarily believe that those are the most
11 independent type of guidelines. So a group of
12 shareholders, of company directors, even of company
13 management and regulators and audit firms to share what
14 is best practice, what is already being done because a
15 number of really good things have come out in these
16 submissions, and I think there is a lot of good practice,
17 but the point is to make it more uniform and wider across
18 the spectrum.

19 So in summary, I think the current framework is
20 sufficient to have really high quality audits if all of
21 the practitioners within the chain sort of optimize their
22 role within it and commit to continually improving their

1 thinking around the issues.

2 Thank you.

3 MR. DOTY: Thank you, Michelle.

4 Larry.

5 MR. RITTENBERG: Well, thank you very much for
6 this opportunity to participate. I first thought about
7 auditor independence over 35 years ago when I did my
8 doctoral dissertation on auditor independence related to
9 internal auditors. I'll just share one observation, and
10 that is that technical competence is really intertwined
11 into any kind of auditor independence model, and we
12 haven't always followed that.

13 I'll try to give you perspectives today from my
14 experience as an academic for many, many years, 35 years,
15 but also in practice, serving on audit committees and now
16 chairing an audit committee. I was asked to address
17 three fundamental questions here today. Can the audit
18 committee enhance the professional skepticism and
19 independence of the external auditor. Can the audit
20 committee evaluate the independence and professional
21 skepticism of the external auditor. And third, maybe I
22 wasn't asked this but I added it, are there other

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1 observations that I might have from my experience as
2 being an audit committee member that the PCAOB might want
3 to consider.

4 Let me start with the evaluation. There are
5 approximately five criteria -- there may be more -- that
6 I look at to assess the independence of the external
7 audit. The first one, and understand that audit
8 committee members are also board members, we have to be
9 aware of the company's strategy, its risks, its
10 operations; likewise, so does the external auditor. So
11 when we both understand that, I'm in a position to
12 evaluate whether or not the audit firm is appropriately
13 adjusting audit risk for the risk that we have. Does the
14 audit fit the risk of this client?

15 Two, I look to see whether or not the auditor is
16 proactive on important accounting issues. Are they out
17 front on these issues. Do they communicate with me about
18 both the substance of the issue, the economic substance,
19 as well as what GAAP requires. That's relevant to the
20 earlier comment on seeing the big picture this morning.
21 I think it's very important that they're able to
22 communicate in that way.

1 Third, I think we all evaluate the independence
2 and skepticism of the auditors when we sit down in our
3 executive sessions. When we're alone with the auditors,
4 what do they tell us about their concerns.

5 Fourth, I believe it's important to also have
6 conversations with management. What do they think? Now,
7 we almost tend to think that it has to be an adversarial
8 situation, but when everybody is doing their job
9 correctly, it doesn't have to be. I want to know what
10 do they think about the competence of the auditor, are
11 they getting push-back, what's the nature of the push-
12 back, so we understand all of those issues.

13 And then finally, I want to know how the audit
14 partners are compensated. Compensation influences
15 behavior. Certainly now most audit partners, if there's
16 a PCAOB inspection finding, that affects their
17 compensation.

18 I have a number of other recommendations related
19 to enhancing auditor independence, and I'll just state
20 in passing that in my paper I included a couple of
21 studies that we performed on professional skepticism, and
22 certainly what it shows is that if we do routine

1 functions time after time after time, we become less
2 skeptical. What we have to do is to understand that
3 these procedures can never be repetitious, they have to
4 be unique. And one of the things I find when I talk to
5 my students when they come back from their internships
6 is that many of the firms do not do as good enough job
7 as I'd like to see in making sure they understand the
8 uniqueness of that client, they understand its business,
9 as opposed to do a bank reconciliation, or something like
10 that.

11 So here are some things that I believe would
12 help. Number one, I absolutely believe that there's a
13 need for audit expertise on the audit committee. That's
14 much broader than financial expertise and business
15 knowledge, which are both fundamental and need to be
16 there. I had the joy of becoming audit committee
17 chairman as our external auditors announced that there
18 were some inspection findings for our company, but given
19 that I knew auditing, I could sit down with a partner or
20 I could sit down with a manager, I could look at the
21 findings, I could perform some independent evaluation of
22 what was the problem and really was it a lack of

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1 skepticism or independence or some other issue.

2 Number two, I think we have to evaluate the
3 business knowledge of the auditor. I said this before.
4 They should know the risks, they should adjust the audit
5 program. If they're not, then we have questions to ask.
6 We asked our external auditor to sit in on what we call
7 our Day Seven reviews when we get all of the critical
8 analysis of the data coming in from all of the other
9 operations. I sit in those too, and I get a chance to
10 evaluate the skepticism of our CFO and our controller,
11 as well, what questions are they asking.

12 Third, we need to have a good understanding of
13 the planned audit approach. Now, this is required by the
14 standards and it's covered. It's not always covered, in
15 my view, up front in an executive session. We tend to
16 have executive sessions at the end of audit committee
17 meetings. I suggest on something like the audit plan we
18 ought to have an executive session with the auditor,
19 which means no one else present, before we start the
20 meeting, before we're tired.

21 Four, I encourage proactive discussion of
22 controversial accounting issues. Most of these issues

1 don't arise overnight. We know in our company three or
2 four really big issues right now. I want to see if
3 they're consulting with their national office. I
4 encourage that as long as we're involved and as long as
5 management is involved. As I said before, I want to know
6 their assessment of the economics of the situation.

7 And one thing I put in here is I believe we
8 should encourage fair compensation for the audit. I
9 think not all my colleagues would agree with it, maybe
10 not all my audit committee members, but we have to retain
11 great people in this profession and we've got to figure
12 out how to do it and how to do the audits economically
13 at the same time.

14 I also suggested there are other issues related
15 to monitoring the staffing of the engagement. This is
16 a bit of a concern because you want to keep business
17 knowledge but you're rotating the partner every five or
18 six years. And finally, there's a need, as indicated
19 earlier, to continue to demonstrate that the audit
20 committee is the client.

21 I was asked to comment on previous
22 recommendations that the audit committee perform an

1 assessment of the external auditor on a periodic basis,
2 such as every five years, and report the criteria as well
3 as the evaluation in a public report. I do not support
4 that recommendation for various reasons. One, potential
5 liability. Two, I think it confuses oversight with
6 assurance, and I worry about that. I also worry that the
7 criteria could be a checklist approach. Like the example
8 this morning, signing the oath in Scotland, it kind of
9 reminded me of when you download software, you click the
10 box -- I don't like that. What I think is that the
11 evaluation of the independence of the audit firm is
12 continuous, it comes with every decision every day.

13 Finally, the last issue, some additional
14 comments, in my written comments I talk a lot about the
15 need to understand the business, that an audit firm
16 should be able to do financial analysis that's better
17 than the financial analyst, they should know the problems
18 more quickly than a short seller does. That auditing
19 isn't just a bunch of procedures, it's understanding the
20 big picture of the company and its risks.

21 Number two, I think there is a bit of divergence
22 between the PCAOB inspectors and auditors -- and I'm sure

1 you believe that's true as well -- regarding the direct
2 testing that needs to be performed. I'm not going to
3 take sides on this issue, but I would suggest that there
4 might be some value in having hearings on this issue to
5 determine if there is some sort of an expectations gap.
6 My personal experience is that there is.

7 Third, I'd like to see more attention paid to
8 internal control over financial reporting and a
9 discussion related to the reliance on internal control,
10 and that would lead to one of the questions earlier
11 regarding governance being properly constituted.

12 Finally, with my other audit colleagues in
13 academia, I believe you've got a rich data set, case
14 studies that help train our students on professional
15 skepticism.

16 Thank you very much.

17 MR. DOTY: Well, thank you, thank you all. We
18 are a minute away from lunch. Does any Board member have
19 a pressing question for one of the panelists?

20 MR. HARRIS: I've got a number of questions, but
21 since we've got one minute, I'll just take ten seconds.

22 Larry, you mentioned the need for audit expertise

1 on audit committees, and I'd just like to ask Ken, you
2 talked about an independent audit committee, why aren't
3 more auditors on independent audit committees? I've
4 asked that question of directors and they say they need
5 a larger perspective and somehow auditors are too
6 narrowly focused, and that was what we heard, at least
7 at one point, when we had some terrific chairmen in.

8 I don't quite understand that. If auditors, in
9 large part, retire at the age of 60 -- which is very
10 early -- it seems to me they've got profound expertise
11 to help out independent audit committees to do their job.
12 So what's happening, and can you maybe encourage more of
13 your flock to attract auditors, retired auditors?

14 MR. DALY: That's what happens to us, Steve,
15 after we retire we wear these very narrow ties.

16 I think you're asking an extremely good question.
17 As I heard the discussion today, we talk about accounting
18 and auditing all in one word that we mush together. I
19 would say that one of the things that's really where we
20 need to focus is on auditing knowledge on the audit
21 committees. I think it's actually way more important
22 than the accounting knowledge, and if I had more time we

1 could go into it, but I think that is important.

2 We have just published something called our
3 Diversity Blue Ribbon Commission, and it was all about
4 going from interest to action, and what we were
5 suggesting is in today's environment we need a much
6 richer look at the kind of diversity that we have on
7 boards. And specific to that to audit committees, I
8 think it is something that we ought to seriously
9 consider, I think it is something that we should try to
10 encourage our members to do which is to put accounting
11 and auditing, but specifically auditing professionals on
12 audit committees.

13 If you go back to the history of this, what you
14 found was when they came out with the concept of
15 financial experts, there was a lot of concern ten years
16 ago that you couldn't find enough people who had that
17 kind of expertise, and I think to some extent we've
18 reduced the expectation ten years ago. But I think today
19 there's a much richer opportunity there, and I agree with
20 you, I think we could do more and our association will
21 begin to do more, we're starting with that Diversity BRC,
22 Steve.

1 MR. HARRIS: Larry, I must take limited exception
2 with you, I'm not a check the box list, necessarily,
3 person, but I don't think anything focuses the mind quite
4 like certifying that you've read something, and if you
5 certify that you're independent, objective and have
6 professional skepticism and you do that on an annual
7 basis or whatnot, I think that focuses the attention very
8 aggressively on an issue, and considering that we're
9 looking at short-term, medium-term and long-term
10 solutions, and some of these proposals have greater
11 weight to them than others, the question is what can we
12 do in the short-term to make a difference, and I think
13 that certification that you know your responsibilities
14 is something that maybe ought to be considered.

15 MR. RITTENBERG: I don't disagree with you on
16 that. My point, and I see it too often because we look
17 at audits of ethics and so forth, is I want to see action
18 behind the oath, and if we are agreed on that, then we're
19 totally agreed.

20 MR. HARRIS: Absolutely.

21 MR. DOTY: It's been a terrific panel. You've
22 contributed terrific testimony and documentation that

1 will go in the record. As you've made use of the prior
2 testimony that was given in the earlier hearings, this
3 will be of the same utility going forward and it will be
4 very important. Thank you all. We'll see you in the
5 quadrangle.

6 And we will reconvene here promptly at 1:20.)

7 (Whereupon, the above-entitled matter went off
8 the record at 12:29 p.m., and resumed at 1:20 p.m.)

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1 A F T E R N O O N S E S S I O N

2 MR. DOTY: If we can begin. Since July of this
3 year, Nathalie Berger has been the head of unit for audit
4 in the Directorate General of the Internal Market and
5 Services of the European Commission. She is responsible
6 for leading the reform of the statutory audit legislative
7 framework in the European Union and the cooperation with
8 third countries on audit oversight.

9 Furthermore, the audit unit has the
10 responsibility to contribute to the endorsement of
11 international standards on auditing and the convergence
12 of standards and regulatory practice in auditing. This
13 week her unit took over responsibilities relating to
14 credit rating agencies, so she's now the head of audit
15 and credit rating.

16 Before taking up the position, Nathalie Berger
17 served for five years as deputy head of unit in charge
18 of the coordination of relations with the European
19 Parliament and Council and Political Coordination. As
20 part of that work, she contributed to the preparation of
21 proposals for a new supervisory architecture in Europe
22 as a member of the task force on financial supervision.

1 From 2004 to 2007 she had responsibility for the
2 preparation and negotiation of company law legislation
3 and the setting of future priorities for company law,
4 corporate governance, including serving as secretary to
5 the European Corporate Governance Forum, the company law
6 expert group, and organizing meetings of the
7 Transatlantic Corporate Governance Dialogue.

8 She started her career as an academic and a
9 public speaker, working in parallel as consultant in
10 European affairs for the Castell de Pol y Consignacion,
11 and also spending six months as legal advisor to the
12 Bertelsmann liaison office in Brussels. After joining
13 the European Commission in September 2000, she worked on
14 the modernization of the financial markets legislation
15 and was seconded to the commission task force on the
16 future of the union, taking part in the work of the
17 European Convention and the Intergovernmental Conference.

18 Nathalie holds a Ph.D., doctorate in law, and a
19 bachelor of art in politics. She is the author of
20 several articles and a book on European law and politics.

21 We are honored to have you here, Nathalie Berger,
22 welcome you. Please educate us.

1 MS. BERGER: Thank you very much, Chairman Doty.
2 I'm absolutely delighted to be here today, and I would
3 like to thank the PCAOB on behalf of my commissioner,
4 Michele Barnier, and he director general, Jonathon Faull,
5 for providing us the opportunity to participate in this
6 public meeting on auditor independence and audit firm
7 rotation. And of course, on behalf of my commissioner
8 and director general, I would like to commend and applaud
9 the PCAOB on this initiative to further discuss the
10 critical issues of auditor independence, objectivity, and
11 professional skepticism.

12 And today I would like to present you our
13 proposals which we presented in the European Union in
14 November 2011. I would also like to point to the reasons
15 why we have decided to table these proposals and where
16 we would like to go. We have undertaken a major reform.
17 After the financial crisis in Europe we have looked at
18 the different ways in order to enhance investors'
19 confidence, protect shareholders, stakeholders at large,
20 and try and steer towards more financial stability.

21 I will in my presentation focus on where we come
22 from, the main findings from inspections performed by

1 European audit oversight bodies. I would then like to
2 touch briefly upon the debate between mandatory rotation
3 and voluntary rotation. I would like to very briefly
4 present the current European Union legislation before
5 presenting the proposals for the reform of the EU audit
6 market.

7 This table gives an impression of the findings
8 from inspections performed by European audit oversight
9 bodies. If we look at those findings of inspections done
10 in France, Germany and the UK, we can see on this table
11 that the percentage of material findings is in the case
12 of France 12 percent, Germany 25 percent, and the UK 13
13 percent, and you see that a large number of inspections
14 have been undertaken between 2008 and 2010.

15 The main findings reveal weaknesses in the
16 internal control procedures to identify conflicts of
17 interest. For example, breaches in internal policies or
18 insufficient information, identifying conflict of
19 interest among staff. For example, the absence of
20 declaration of independence by staff members related to
21 the audit.

22 The findings also revealed insufficient

1 professional skepticism. I would give two illustrations
2 of this. For example, differing and conflicting
3 judgments accepted by the same firm for clients operating
4 in similar industries, or the use of third parties
5 pricing services to estimate the fair value of financial
6 instruments.

7 And also, the main findings revealed over-
8 reliance on management declarations. For example,
9 inappropriate consideration to existence of third party
10 evidence, or measurement of good will impairment, loan
11 losses, valuation of inventory and other intangible
12 assets, revenue recognition and long-lived assets.

13 Lack of evidence was also revealed to support the
14 audit opinion such as, for example, absence of approved
15 working papers related to some specific general ledger
16 balances, or lack of quality control, insufficient
17 safeguards to ensure that audit opinions are correct
18 and/or appropriately supported, for example, for the peer
19 review. We also observed insufficient audit control
20 procedures linked to the going concern assumption,
21 valuation of assets and debts, and completeness of
22 revenues.

1 Now, we have looked into the different solutions
2 which one could propose, and in terms of rotation, when
3 we tested the idea of proposing rotation in the
4 legislation, we faced some telling us that: Well,
5 rotation is certainly an excellent idea but we would
6 propose voluntary rotation. Then I would ask: What
7 exactly does voluntary rotation mean and what does
8 voluntary rotation encompass? Well, first of all,
9 voluntary rotation is more or less or is what is applied
10 today in the European Union apart from in one member
11 state which is Italy.

12 Voluntary rotation entails market stagnation and
13 a very low switching of audit firm. You can see on the
14 table in front of you that the length of audit tenure is
15 amazingly long with in some member states more than 30
16 years, 40 years, 50 years of companies being audited by
17 the same audit firm. When we consulted the industry, I
18 even met a major industrial group in Europe where the
19 management did not even remember when they last changed
20 auditor, it might have been more than 50 years, they had
21 absolutely no recollection, and they were perfectly happy
22 with the auditor but one could question why and one could

1 look at the familiarity risk which such kind of a long
2 relationship might entail.

3 Now, if we look at changes of audit firms which
4 were done but in a context of voluntary rotation, the
5 voluntary change of auditor may be associated with some
6 auditor issuer disagreements, and you see examples here,
7 the DPAM case or Olympus 2009 problems regarding the good
8 will estimation, or scandals related to the audit firm
9 network, or economic issues. When I refer to the case
10 of Olympus 2009, Olympus 2009 changed its auditor because
11 of an argument about accounting for its purchased
12 businesses rather than it reaching the end of its
13 contractual obligation.

14 So we agree that voluntary rotation does not mean
15 much, and certainly does not manage to bring any
16 sufficient remedy to the problems that we are facing.
17 So as a distinguished American Nobel Prize in economics
18 said recently: When you see an accident on the road, you
19 think that the driver is guilty, when you see several
20 accidents at the same place, you are wondering about the
21 quality of the road. I think this is the case today.
22 So what can we do to fix the road?

1 We have consulted largely, we have done several
2 studies and our firm belief is that keeping the status
3 quo is not an option. We already have some legislation
4 in the European Union, we already have a regulatory
5 framework for audit in the European Union and we do
6 already have some provisions which are supposed to
7 enhance the independence of auditors. Here you can see
8 an article of provision of the existing directive on
9 audit in the European Union which provides the obligation
10 for the key partner to rotate every seven years, so this
11 is already in place in the European Union, but we do
12 consider that this is not sufficient.

13 A change in the audit partner is certainly one
14 element which is important and it is part of the measures
15 which are needed in order to enhance auditor
16 independence, but that's not enough, and very often we're
17 asked a question when facing stakeholders who tell us
18 that no, a rotation of the key audit partner every seven
19 years is enough. But the immediate question then is
20 about what about the rotation of the audit team, what is
21 the real impact of the rotation of the key audit partner.
22 And there we have big doubts.

1 So in the European Union, the European Commission
2 is proposing a system of mandatory audit firm rotation.
3 A mandatory rotation of the audit firm with a maximum
4 duration of six years, that is, two combined engagements,
5 renewable once, and that is in case of solo audit, or
6 nine years in case of joint audit. We inscribed this
7 system of rotation within the general framework, so we
8 propose a gradual rotation mechanism, we propose a
9 derogation on an exceptional basis upon approval from the
10 competent authority where there can be a possible
11 extension of a tenure of two years, or three years in
12 case of joint audits, so that in the member states it
13 could be taking care of very difficult circumstances for
14 the company and of the exceptional need to have a longer
15 audit tenure.

16 We provide an obligation for the audit firm to
17 provide a handover file, and for example, the handover
18 file already exists in France where it is provided
19 between joint auditors where they rotate the scope of
20 their controls.

21 We consider that mandatory audit firm rotations
22 entails many advantages such as, for example, of course,

1 eliminating the threats to independence and reinforcing
2 professional skepticism. It addresses the shortcomings
3 of the partner rotation scenario, it avoids repetition
4 of existing errors, and of course, it would create more
5 competition in the market because in the European Union
6 we have a problem of a very, very concentrated markets
7 for the audit of, in particular, public interest audit
8 entities.

9 We do believe that mandatory audit firm rotation
10 will have a very positive impact on audit quality.
11 Recently the UK Competition Commission published a survey
12 showing that in 80 companies switching was said to have
13 resulted in a change in quality, with 70 saying that the
14 change was positive and ten saying that the change was
15 negative, at least in the first year. We consider, in
16 light of different studies, that the most appreciated
17 changes would be better audit processes and planning,
18 higher quality, having better skilled staff, better
19 sector experience, and understanding of the business, et
20 cetera, et cetera.

21 Of course, we also need to look into the downside
22 of the proposed measure which is mainly the issue of the

1 cost. Of course, mandatory rotation would entail limited
2 increase in costs for the audited entity, but that costs
3 will be diminish over time with the standardization of
4 the process of mandatory rotation. We consider in our
5 impact assessment that the tendering cost for a public
6 interest entity would range from about 7,000 euros to
7 45,000 euros per year on a nine-year basis. And we do
8 believe that the increased costs by far outweighs -- how
9 should I say, the improved quality by far outweighs the
10 increased in terms of costs.

11 So on this basis, we have proposed two
12 legislative instruments in the European Union. First of
13 all, a draft directive which amends our existing
14 directive on audit and the draft regulation on specific
15 requirements regarding audits of public interest
16 entities. And the mandatory rotation is framed within
17 the regulation on specific requirements for public
18 interest entities.

19 What are public interest entities? Listed
20 companies, credit institutions, insurance undertakings,
21 payment and electronic money institutions, investment
22 firms or alternative investment firms, UCITs, central

1 securities depositories and central counterparties. So
2 you see, financial institutions and listed companies.

3 The mandatory rotation is proposed as the key
4 measure within a general package of measures in order to
5 enhance auditors' independence, such as, for example, a
6 prohibition of Big-Four-only contractual clauses because
7 we do face the problem in the European Union that some
8 banks impose Big Four clauses on companies to offer to
9 accept giving loans. We propose prohibition of the
10 provision of certain auditing services such as, for
11 example, tax consultancy because we do not want auditors
12 to face the risk of self-review. We also submit some
13 services to the approval of the audit committee.

14 We also propose a measure called Pure Audit Firms
15 whereby the largest audit firms providing services to the
16 largest public interest entities would have to split
17 their activities, so they would have to be divided
18 between audit firm and consultancy firm.

19 We propose measures in order to enhance the
20 transparency. We propose a more detailed audit report
21 and this is based on the best practice of the German long
22 form reports. We propose an additional audit report to

1 the audit committee, we propose strengthening the role
2 of the audit committee because we consider that the audit
3 committee is very important. But I would say, if I might
4 refer to the debate this morning, we do not consider that
5 the audit committee is the clients or the only client of
6 the audit firm. We look further beyond and we consider
7 that we need to protect the investor first.

8 The audit committee plays a very important role,
9 we need to enhance the audit committee, this is a very
10 important measure but that's not the only measure, and
11 it will certainly not help providing sufficient remedies
12 to the problems observed today. We propose a system of
13 regular reporting and dialogue with the supervisors of
14 the audited entity, and of course, compliance with the
15 International Standards on Auditing.

16 We also would like to open up the audit market by
17 creating a European passport for audit firms in the
18 European Union, putting in place a European quality
19 certificate which would help second tier audit firms to
20 try and have access to the markets of the audit of public
21 interest entities, plus a mutual recognition of statutory
22 auditors approved in the member states.

1 And another very important aspect is to
2 strengthen audit supervision where we will have regular
3 dialogue between the auditors, the audit committees and
4 the supervisors. And we do also propose system of EU
5 oversight coordinated by a supervisory authority which
6 is called the European Securities and Market Authority.

7 Of course, I think at this stage I need to
8 indicate that the views expressed today are personal
9 views and not the formal views of the European
10 Commission. And thank you very much for your attention.

11 MR. DOTY: Well, thank you, and this gives us a
12 lot to think about, and I know Board members have some
13 questions.

14 Jeannette, do you want to start?

15 MS. FRANZEL: Thank you very much for coming here
16 today, Ms. Berger. I know it's been a long, tiring trip
17 for you.

18 I'd like to just ask about next steps. You've
19 got the draft directive and the draft regulation on
20 audits of public interest entities. What is the timing
21 and the next steps for some of these proposals becoming
22 final and then implemented? And then my second question

1 is I'd like a little more information about the European
2 Quality Certificate. So first, the next steps and the
3 timing, and then secondly, if you could explain a little
4 bit more about the European Quality Certificate and what
5 that means.

6 MS. BERGER: Yes, thank you.

7 First of all, our proposals are now discussed
8 with the European Parliament and the Council who are the
9 two institutions who have the legislative authority, the
10 legislative power. And in the European Parliament the
11 committees in charge of the audit reform are working now
12 on the basis of draft reports and they should adopt their
13 opinions before the end of the year. In the Council, we
14 have completed a first general examination of the
15 proposals and we are awaiting a proposal for compromise
16 from the presidency, and on that basis by the end of this
17 year or the beginning of next year we will be able to
18 start the formal negotiation with the Parliament and the
19 Council.

20 And on the issue of mandatory rotation we already
21 do see some very good support, both in the Council and
22 in the European Parliament. Now both in the Council and

1 in the European Parliament there is support regarding the
2 principle of mandatory rotation but there are still
3 discussions regarding how the mandatory rotation should
4 operate, and in particular the period of mandatory
5 rotation. We have proposed six years in case of solo
6 audits and nine years in case of joint audits. We see
7 some proposing maybe ten years, and of course, we will
8 see what will the final outcome.

9 Now, coming to the European Quality Certificate,
10 this is something which we proposed in order to confer,
11 how should I say, mid-tier audit firms, so those who do
12 not yet have full access to the audit of public interest
13 entities, a kind of a label of good quality. And
14 although the European Quality Certificate would not have
15 a legal value on which they would be able to claim access
16 to a certain market, it would certainly give them some
17 kind of empowerment in order to tender and to try to have
18 access to the market of the big firms. And this would
19 be awarded by the ESMA, which is the European Securities
20 Market Authority, so it is a common supervisory authority
21 in the European Union.

22 MR. HARRIS: Could you discuss a little bit your

1 consultation process, and particularly with respect to
2 your outreach to investors. We hear all the time from
3 various groups here that the investors don't speak with
4 any kind of a unified voice, they're scattered all over
5 the lot. Who have you outreached to in terms of your
6 investor stakeholders and to what extent are they unified
7 in terms of two or three or four or five themes, or one
8 or two, or any.

9 MS. BERGER: Well, given that audit is a very
10 sensitive and controversial issue, and particularly some
11 of the measures that we propose are quite far reaching,
12 we have based them on consultation and studies. As far
13 as consultation is related, we have launched public
14 consultation in October 2010 where we have presented
15 those measures which we were thinking of tabling, and
16 we received 700 responses to this consultation. All
17 responses are published on our website.

18 In addition to that, we organized a conference in
19 February 2011, yet again to speak with our stakeholders,
20 and afterwards we have what is done an impact assessment,
21 so we have had to test all the measures we proposed in
22 the European Union to estimate the costs and to estimate

1 the benefits, and it's only on that basis that we have
2 been able to table the proposal.

3 Now, as far as investors are concerned, there
4 are, effectively, some shared views but we do have very
5 strong support from some investors for our measures and
6 some investors calling for mandatory rotation and a
7 system of joint audit. Recently you might have seen in
8 *The Financial Times* an article which was published on a
9 public letter addressed by an investor called USS,
10 strongly asking the European Commission and the core
11 legislators to come forward with significant measures,
12 including mandatory rotation.

13 And even if I might go beyond, we do have some
14 support in the European Union from some auditors as far
15 as the mandatory rotation principle is concerned, not all
16 auditors but some. And for example, recently the German
17 Chamber of Auditors published a paper on future
18 perspectives which is calling for mandatory rotation on
19 a 10-year rotation basis and joint audits, but there I
20 should specify that this paper represents the views of
21 the German auditors except the views of the Big Four in
22 Germany. So there is strong support from a good part of

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1 the investors in the European Union for mandatory
2 rotation.

3 MR. HARRIS: And does the investor community
4 consider the audit committee to be the client or the
5 investor the client?

6 MS. BERGER: Well, I think from the responses
7 that they are extremely preoccupied about the impact that
8 some, if I may say, wrongdoing has had on the investors,
9 and of course, they consider themselves as the client and
10 they do not consider that the audit committee is the
11 client, or maybe is one of the clients, but the investors
12 are certainly a much more important client.

13 We have seen, for example, we are based in
14 Brussels, you might have heard about the recent scandal
15 of Fortis where you had lots of Belgian pensioners who
16 had invested all their savings in Fortis and some people
17 have been ruined. And I think that we need to consider
18 investor protection first.

19 MR. HARRIS: And you've also recommended
20 additional information with respect to your transparency
21 reports.

22 MS. BERGER: Yes.

1 MR. HARRIS: Could you describe those and what
2 you're doing in that area?

3 MS. BERGER: Yes. In our proposals we foresee
4 that the auditors should make public an annual
5 transparency report of the latest three months after the
6 end of each financial year, and that the annual
7 transparency report shall be published on the website of
8 the statutory auditor or audit firm and shall remain
9 available on that website for at least five years. So
10 we really tried to propose a package of measures where
11 we would enhance independence and strengthen or reinforce
12 transparency.

13 MR. FERGUSON: Yes. I'd like to ask you a
14 question about the audit-only part of your proposal.
15 What is the threshold? You said it would apply for the
16 audits of the very largest firms. What will the
17 threshold be? How will you define the kind of firm that
18 must be subject to it and audited by an audit-only firm?
19 And secondly, what are the prospects for that proposal
20 in both the Parliament and the Council?

21 MS. BERGER: In our proposal, we have a double
22 threshold for activating the pure audit firm proposal.

1 We've proposed that where an audit firm generates more
2 than one-third of its annual audit revenues from large
3 public interest entities and belongs to a network whose
4 members have combined annual audit revenues which exceed
5 1,500 million euros within the European Union, it shall
6 then separate. So the threshold which we propose is
7 quite high, but I must admit that for the moment there
8 is not much support for that proposal, neither in the
9 Council nor in the European Parliament.

10 MR. FERGUSON: Do you think that means it will
11 not pass? What's your guess?

12 MS. BERGER: At this stage it's a little bit too
13 difficult for me to be able to respond to that point
14 because we negotiate everything in package. So we can
15 see the support of the opposition to one specific element
16 of the package, but at a later stage we will be
17 negotiating in what we call trial logs, so in trial logs
18 we have the Council, we have the Parliament and we have
19 the Commission, and then some adjustments are still
20 possible. So it is possible that although at some stage
21 of the negotiation there might be opposition to one
22 measure, but that given the adjustments in the framework

1 of the global negotiation, these measures come back at
2 a later stage.

3 MR. HANSON: I ask myself a question a lot that
4 goes something like what's the problem we're trying to
5 solve, and I'm still struggling myself to really
6 comprehend the problem we're trying to solve. And
7 earlier today I noted that one of the panelists this
8 afternoon in his statement said that mandatory firm
9 rotation is too blunt of an instrument to be used at this
10 time, and we had some panelists say they agreed with it,
11 some didn't agree with that.

12 But when we first put out our concept release, I
13 had a statement that I included that PCAOB needs to
14 further analyze our own inspection findings to see what
15 we think the real problem is and whether that problem
16 would be solved by whatever measures, including mandatory
17 rotation, and as I sit here today, I would say we still
18 need to analyze our inspection results to do that.

19 And in your slide 3 you referenced the number of
20 inspections, the percentage of material findings, and it
21 appears like it's been over 500 inspections in France,
22 Germany and the UK, and just wondering if you could share

1 with us what you've done, or if anybody has done
2 something to analyze those inspection findings to see how
3 much is related to professional skepticism and how that
4 translates to whether mandatory rotation would help or
5 hurt.

6 MS. BERGER: Yes. Well, I think I should first
7 of all specify that, of course, the European Commission
8 does not do inspections, we are not supervisors, however,
9 we work with the supervisors and we do have a group which
10 is called the EGAOB, so that's the European Group of
11 Audit Oversight Bodies, which meets regularly, and within
12 this group the supervisors have established kind of an
13 enhanced cooperation within what they call the Inspection
14 Group. And within this Inspection Group they exchange
15 confidential information on the outcome of inspection
16 findings, and their analysis helps us to support our
17 analysis of what are the measures which are necessary.

18 We also have organized some exchanges between the
19 oversight bodies and the regulators, notably within the
20 Council, and we organized some presentations of audit
21 inspection findings between the supervisors and the
22 regulators in order to allow the exchanges and to discuss

1 what are the best possible solutions to propose remedies
2 to the problems or the shortcomings which were observed
3 within these inspection findings. And I should like to
4 say that it's interesting to note that the problem seems
5 to be the same everywhere, and that's why we believe that
6 not only do we need to have one serious and far reaching
7 solution and a consistent remedy in the European Union,
8 but of course, for us, for the European Union it is very
9 important to look at the potential developments in the
10 United States.

11 MR. HANSON: Is it possible for someone that did
12 this analysis to share with us how they did their
13 analysis and some of the results?

14 MS. BERGER: Of course. We can share with you
15 our impact assessment, we can share with you the list of
16 studies and material on which we based also. Here I
17 have, I think, nine pages of studies of all type, and I'm
18 more than happy to share with you all the elements on
19 which we have based our work, of course.

20 MR. DOTY: You mentioned the USS letter which is
21 the University Superannuation Scheme, it's the British
22 retirement scheme, and it appears from that letter that

1 the time is sort of moving out beyond five or six years.
2 Can you give us any insight on how the five- or six-year
3 term factors in your thinking now? Is that something
4 that you can see extending, perhaps, to 10-15 years,
5 based on what the USS and others are saying as a
6 predictive matter?

7 MS. BERGER: Yes, of course. I should like to
8 give you some information from where we are now in the
9 negotiation and what are the different proposals which
10 we observe. Of course, we have this very important
11 reaction from investors. We see some proposals -- we
12 based our proposal on the best practice which is observed
13 in Italy where they have mandatory rotation after nine
14 years, in Brazil they have mandatory rotation every five
15 years I think for banks, there is also rotation in
16 Indonesia. So as we have this precedent in the European
17 Union we have used it as, how should I say, our first
18 scenario.

19 Now, we see emerging more and more proposals,
20 both coming from member states, from some stakeholders
21 and in the European Parliament whereby mandatory rotation
22 would be based on the period of ten years, but we also

1 see some proposals, notably in the European Parliament,
2 to base mandatory rotation around the system of internal
3 key audit partner rotation, because in the European Union
4 the key audit partner shall rotate after seven years.
5 So for example now an MEP in the European Parliament
6 proposes to have mandatory re-tendering after seven
7 years, we have a first period of seven years, then we
8 would have mandatory re-tendering after seven years, and
9 that would make 14 years, but after these 14 years that
10 would be enough, that would be the end of it, and there
11 should be mandatory rotation.

12 The high proctor in the Parliament proposes a
13 mandatory rotation on the scheme of 25 years, but there
14 are very negative reactions to that report in the
15 European Parliament because many do consider that this
16 deprives the proposed measures of its beneficial effects.
17 So this proposal of 25 years will most certainly not fly
18 but it is possible that we will have adjustments in terms
19 of time.

20 MR. DOTY: And would the mandatory partner
21 rotation at seven years suspend for a ten-year or a 14-
22 year term, or would it continue to operate? Would you

1 still have mandatory engagement partner rotation with the
2 ultimate term?

3 MS. BERGER: It is difficult to respond at that
4 stage, of course, but yes, we see all these measures as
5 being complementary, and that's why all measures need to
6 be interlinked. So when we propose something, we don't
7 renounce something else, and proposing mandatory external
8 rotation of audit firms does not mean that the key audit
9 partner should not rotate. Precisely because we have a
10 system of a kind of a safeguard where as the competent
11 authority could possibly allow on an exceptional basis
12 the period of external rotation to be a bit longer.

13 MR. DOTY: Yes, Michael.

14 MR. GURBUTT: Thanks, Jim.

15 Nathalie, just a quick question, and you
16 mentioned, of course, that this issue has been debated
17 in many countries around the world and one of those is
18 the UK, and I think you also mentioned in your opening
19 remarks some of the Competition Commission's work in this
20 particular area in regards to the effects of switching
21 in that country, and I think there's lots of interesting
22 findings in some of these reports.

1 I was just wondering if you have any other
2 thoughts on what the UK Competition Commission are doing
3 and how that might play into the discussion, and also the
4 UK's position on mandatory re-tendering and the European
5 Commission's views on that.

6 MS. BERGER: Thank you. Yes, of course, we
7 follow very closely the work of the UK Competition
8 Commission and we are all eagerly awaiting the
9 publication of their parliamentary findings in the course
10 of November, and then they will publish their final
11 report sometime between January and March, I think, and
12 I do believe at this stage that this might also have an
13 impact on the outcome of the negotiation and it might
14 also impact maybe on the position of the British
15 government at some stage in the negotiation, but that,
16 of course, we will see, I don't know for the moment.

17 Of course, we also follow what are the different
18 reforms which are taken in the member states and we work
19 in cooperation with the Financial Reporting Council, so
20 of course, we are following the proposals and the system
21 of five plus five and mandatory tendering and re-
22 tendering on the basis of a metric-explained basis. In

1 the view of the European Commission, this might not be
2 sufficient in order to solve the problems, to solve the
3 issues.

4 MR. DOTY: We are out of time. This has been
5 immensely valuable and a very necessary part of this
6 whole process. You've come a very long way and deserve
7 a rest, but thank you, Nathalie. Thanks to Commissioner
8 Barnier for allowing you to come, and for a most
9 insightful presentation.

10 MS. BERGER: Thank you very much.

11 MR. DOTY: The next panel. Erik Gerding is an
12 associate professor of law at the University of Colorado
13 Law School. He teaches and writes in the areas of
14 securities regulation, financial institutions and markets
15 and corporate governance. He previously taught at the
16 University of New Mexico, practiced in the New York and
17 Washington, D.C. offices of the distinguished firm of
18 Cleary, Gottlieb, Steen and Hamilton. Rutledge Press is
19 publishing his book, *Bubbles, Financial Regulation and*
20 *the Law*, in April 2013. It's a fascinating article.
21 It's going to be great to hear from him.

22 Robert Prentice teaches business law, business

1 ethics, accounting ethics and the law of financial
2 regulation in the Business, Government and Society
3 Department at the McCombs School of Business, University
4 of Texas, where he is Ed and Molly Smith Professor of
5 Business Law. He's interim chair of the Business,
6 Government and Society Department, faculty director of
7 the business honors program. He has won many teaching
8 awards, he has published several books, and 60 *Law Review*
9 articles on securities law, business ethics, and
10 accounting liability. His recent research focuses on the
11 implication of recent findings in behavioral psychology
12 and behavioral ethics, a subject that is recurring
13 increasingly in this discussion.

14 Welcome to both of you. Thank you.

15 Erik, do you wish to kick us off?

16 MR. GERDING: Before I entered the academy, I
17 worked in private practice and worked with auditors both
18 in securities issuances and worked with accountants on
19 securities enforcement matters, and I had the great
20 privilege of seeing accountants in both functions perform
21 at very high levels.

22 One of the lessons that I'd like to focus on is

1 something you've already heard several times in this
2 roundtable and in previous roundtables, and that is that
3 the issuer-pays model creates perverse incentives for
4 auditors to compromise their independence, objectivity,
5 and professional skepticism. These perverse incentives
6 are powerful, persistent, and pervasive.

7 Furthermore, I know you've heard this already so
8 I want to sort of limit my remarks to things that I think
9 you have not heard. One of the things I don't think
10 you've heard is that these incentives can change over
11 time.

12 There are certain market conditions in financial
13 markets that are particularly troubling for financial
14 regulations and for the governance of the accounting
15 industry. My research into asset price bubbles and
16 financial regulations shows that there are critical
17 periods when financial markets boom, and even when we
18 have potential asset price bubbles in which compliance
19 with financial regulation, compliance with financial
20 reporting standards, and potential acquiescence by
21 auditors the risk of acquiescence increases dramatically.

22 So I'll return to the particular risk of market

1 booms and bubbles on compliance and auditor independence
2 later on when I talk about potential lessons that the
3 Board might apply.

4 The best solution then if the problem is
5 persistent and pervasive incentives created by the issuer
6 pays model is to move shareholder control of the audit
7 selection process from the audit committee to
8 shareholders. Now, I understand from some of the
9 questions that were in the morning panel that you all
10 don't want to focus so much on corporate governance in
11 this roundtable.

12 But let me bring up one potential wrinkle -- and
13 that is that you could build in shareholder control of
14 auditor selection into a mandatory audit rotation rule.
15 And it could work as follows. You could require
16 mandatory audit rotation but have a shareholder opt out.
17 So each year in which an auditor is required -- or would
18 otherwise be required to rotate out you can give
19 shareholders the vote to decide whether they actually
20 want that to occur or not. And if they affirmatively
21 vote not to have auditor rotation you could basically
22 allow shareholders to opt out of any regime. And I think

1 that that might mitigate some of the negative effects
2 that previous commentators have talked about with respect
3 to this rule.

4 Short of drastic reform I wanted to address some
5 of the other reform proposals that you've heard in
6 previous roundtables. I fundamentally believe that
7 piecemeal reforms to the audit process are not going to
8 counteract pervasive and persistent incentives to
9 compromise auditor independence and objectivity.

10 Even if we assume -- so one of the proposals that
11 you've heard is that audit committees should have greater
12 information from auditors. So you've heard various
13 information forcing proposals to enhance the ability of
14 the audit committee to do its job.

15 There's several problems with this. Even if you
16 think the audit committees have the sufficient
17 capabilities -- I'm sorry -- sufficient incentives to
18 protect shareholders and to police -- to select and
19 supervise auditors the audit committees are still at a
20 disadvantage. They still need to rely on auditors to
21 provide the audit committees with information. And the
22 auditors' judgments are going to happen on a daily, day-

1 to-day basis in the bowels of the issuer organization.

2 Will these day-to-day judgments percolate up to
3 the audit committee? I'm skeptical and I imagine that
4 my co-panelist is going to be skeptical too for various
5 reasons. One of them is that auditors may not even be
6 aware of their own biases. So my co-panelist has written
7 extensively about psychological biases affecting
8 auditors, and you've heard quite a bit about that in the
9 morning panel as well. The fundamental problems that
10 audit committees often do not know what they don't know.

11 You've also heard several proposals about
12 training and education. I am very skeptical about the
13 ability of further training or education effects to
14 adequately de-bias auditors or to counteract the deep
15 incentives that are created by the issuer pays model.

16 And I note as an educator that this is a
17 statement against interest, and I think that that's
18 probably a rarity for a public forum. But it's a
19 statement against interest because every time we have a
20 wave of corporate scandals in the United States business
21 schools and law schools come out of the woodwork with new
22 course work on ethics, professional responsibility and

1 we even get grants and donations to beef up our ethics
2 program.

3 I think we have to be extremely skeptical about
4 the sufficiency of ethics training or further education
5 of either auditors or audit committees to counteract
6 either psychological biases or deep incentives. There's
7 a value to education and training, but I don't think that
8 we should rely exclusively on enhanced education
9 requirements.

10 Let me turn now to a few design features that I
11 think could make mandatory audit rotation proposals
12 better. I do think that there is a potential for a very
13 steep learning curve as audit -- a new audit firm rotates
14 in. So I would urge the Board to consider as part of any
15 audit rotation rule a requirement that the outgoing audit
16 firm draft a handover memo to the new audit firm. Part
17 of the problem there though is that you would need to
18 design appropriate incentives to ensure that the outgoing
19 audit firm candidly and fully discloses the most
20 important issues that they faced in their audit.

21 On the one hand, auditors may worry about legal
22 liability for disclosing bad facts to a new auditor. So

1 I would urge you to consider potential safe harbors for
2 the outgoing auditor in drafting this particular handover
3 memo.

4 On the other hand, you may want to consider, in
5 addition to a carrot, a stick. The outgoing audit firm
6 may have an interest in hiding deeds that they're not
7 particularly proud of, so you may need to couple a safe
8 harbor with sanctions if the memo is not fully -- is not
9 full and candid.

10 I think, as I mentioned before, that you could
11 also consider opt out provisions for any mandatory audit
12 rotation rule. So Professor Hu this morning talked about
13 the Board's ability to grant waivers on a case-by-case
14 basis if an audit firm is performing its function well.
15 I mentioned the possibility of a shareholder vote for opt
16 out.

17 Let me talk a minute about a few alternatives
18 that the Board could consider to mandatory audit
19 rotation. One I think the Board should consider using
20 a power that likely would not need any additional
21 statutory authority -- and that is to simply make a
22 recommendation publicly and selectively to select issuers

1 you should change your audit firm -- you should rotate
2 it.

3 And with a simple sentence like that it would no
4 necessarily trigger the restrictions on the ability of
5 the Board to disclose information about its inspection
6 and proceedings -- disciplinary proceedings. That simple
7 statement, if selectively used, could send a very
8 powerful signal to shareholders, including institutional
9 shareholders, that there might be something that they
10 want to question.

11 That proposal is part of a larger series of
12 proposals of making reputational markets work. Professor
13 Hu talked about disclosing -- making greater efforts to
14 disclose the Board's inspection and enforcement efforts.
15 You all, of course, are aware that there are statutory
16 limits on your ability to do so. But as I mentioned in
17 my written statement those statutory limitations are not
18 absolute.

19 Finally, I would urge you to consider perhaps in
20 a separate rule-making initiative ways to improve the
21 disclosure in the auditors' letters that accompany
22 financial statements. Right now auditors' letters are

1 very -- have very little informational content. They're
2 either a qualified opinion or they're a clean opinion.
3 I think that we could redesign the disclosures that
4 auditors make to make a -- to give investors a much
5 richer sense of the quality of the audit and the
6 independence of the auditor.

7 So, for example, I think you could disclose
8 information about the individual audit personnel who
9 worked on the audit, including their names -- currently
10 most audit opinions are signed by the firm, not by an
11 individual -- disclosure about work that these
12 individuals did on financial statements that were later
13 restated, and disclosure about any of these individuals
14 were actually sanctioned by the Board.

15 I think you could disclose data about the
16 relationship between the audit firm and the issuer. So
17 it would be incredibly helpful for investors to
18 understand the total compensation that audit firms have
19 received from the issuer, either in the last year or over
20 the life of a relationship. It would also I think be
21 extremely valuable for investors to know to what extent
22 are there personnel at the issuer who used to work for

1 the audit firm. Finally, I think that the audit letters
2 could include information about the past performance of
3 the audit firm, including the number of restatements
4 that -- on financial statements that that firm audited.

5 So I will conclude there and look forward to any
6 questions.

7 MR. DOTY: Thank you, Erik. Professor
8 Prentice.

9 MR. PRENTICE: Thank you very much for the
10 invitation to come and speak. I've been here since early
11 this morning and I've learned something from every
12 speaker. It's been very helpful.

13 So over the weekend the New York Times ran an
14 article you may have seen about a very prominent
15 professor at the Columbia Business School, Glenn Hubbard,
16 who had written an article that supported a point of view
17 of the mutual fund trade industry lobbying group. They
18 paid him \$150,000 to write that article. And he was 100
19 percent convinced that being paid \$150,000 to take a
20 position had not affected his judgment, his neutrality,
21 his ability to take all points of view into account in
22 the slightest.

1 He's a better man than I. And I would say that
2 he's representative of most people because most of us
3 find it very easy to see how other people's judgments are
4 influenced by conflicts of interest but we truly have
5 difficulty in seeing it in ourselves. Even as I sit here
6 and say this to you, a little part of my brain is telling
7 me that I'm really not affected by all this stuff like
8 everybody else is, but we all are.

9 In some of the papers I think that I submitted,
10 I quoted a study involving some doctors where they asked
11 them, Hey, you know, those pharmaceutical companies give
12 you guys a lot of stuff. Does that affect what you
13 prescribe to your patients? And only 5 percent of the
14 physicians admitted that it did. But the studies show
15 that the actual impact of those gifts is much, much
16 greater.

17 Another study asked physicians essentially the
18 same thing -- does this affect your judgment. Well, the
19 first thing they asked them was does it affect the
20 judgment of other physicians, and they said, Yes -- 61
21 percent of them said, Yes, that probably affects the
22 prescribing conduct of other physicians, but only 16

1 percent would admit that it affected themselves.

2 And so I wish that Mr. Hubbard and those
3 physicians had been with me in Chicago two weeks ago when
4 I heard Daniel Kahneman give a talk. Nobel prize winner
5 in economics -- he's a psychologist actually and he and
6 Amos Tversky started the field of research that has led
7 to the creation of behavioral finance, behavioral
8 economics, behavioral ethics that studies how people
9 actually make decisions. And now we have a huge body of
10 work that indicates that people make decisions oftentimes
11 using shortcuts -- heuristics that don't always lead to
12 the most rational decisions.

13 And we're also often affected by various biases.
14 And the one that I address in my paper is the self-
15 serving bias, which is a fairly pervasive and influential
16 bias. And what it means is that we collect information,
17 process information, and even remember information in
18 ways that are consistent with our own -- with our view
19 of what's in our own best interest and consistent with
20 positions we've taken before.

21 So if, for example, I'm a Romney guy and I'm
22 leafing through my newspaper in the morning and I'm

1 heading towards the sports page and I run across a
2 headline that indicates to me they're going to say good
3 things about Romney I'm quite likely to stop and read
4 that article. But if I can tell from the headline it's
5 going to say bad things about my guy Romney I'm probably
6 just going to keep on going because I don't need to be
7 told that I'm wrong about stuff.

8 If I do stop and read something my self-serving
9 bias is going to affect how I react to it -- how I
10 process it. If we have a debate like I guess the last
11 one that was fairly close I'm way more likely to think
12 that Romney won than an Obama supporter is who's much
13 most likely to think that Obama won.

14 This even affects how we remember information.
15 Some folks did a study a few years ago where they showed
16 a document to two different groups of people, some who
17 supported the death penalty and some who opposed the
18 death penalty. And they processed it in completely
19 different ways. Each group read that document and
20 thought it supported their point of view.

21 They went back six months later and asked them
22 what they remembered about the document and the people

1 who supported the death penalty remembered the arguments
2 in the article that supported the death penalty. The
3 people who opposed the death penalty remember the facts
4 that were on the other side. And so, as I say, the --
5 this is a very pervasive bias and it affects all the
6 judgments that we make.

7 It's not evil; it's just human nature. But it
8 affects auditors who -- when they do audits because they
9 are, of course, human and they're affected by this. It's
10 not new news. You know, you've got to credit the AICPA
11 and the Code of Professional Conduct and, of course, the
12 rules that the SEC and the PCAOB have put out regarding
13 auditor independence because the major goal of all of
14 those rules is to keep auditors out of situations where
15 there will be conflicts of interest.

16 So we have rules about employment relationships,
17 financial relationship, family relationships, provision
18 of non-audit services all aimed at minimizing conflicts
19 of interest. But, yet, we're left with the client-pays
20 rule -- client-pays situation that we have and the client
21 decides who the auditor is and when the auditor gets
22 fired.

1 And so we remain having that conflict of interest
2 because, of course, auditors want to keep their current
3 clients, they want to have new clients, they want the
4 revenue that comes from both, and that is going to affect
5 their judgment. They are incentivized to keep the
6 clients happy, even though the responsibility is to be
7 a watchdog for the investors whether or not the clients
8 are happy.

9 So this self-serving bias can lead auditors to
10 make conscious decisions not to be the watchdogs that
11 they should be and, of course, we all think about the
12 Arthur Anderson situation where they advertised
13 themselves as being willing to partner with their clients
14 to help their clients achieve their business goals -- and
15 we all know that didn't end well.

16 But the bigger problem, of course, is the
17 unconscious bias that Erik mentioned -- the fact that,
18 again, which information we go after and look at, how we
19 process that information, and even how we remember that
20 information is affected by the self-serving bias.
21 Pursuant to the confirmation bias, if an auditor knows
22 that the client wants a particular point of view the

1 auditor's likely to go out and look for information that
2 supports that point of view and process the information
3 consistent with that viewpoint. As long as the client
4 pays the fee and as long as the client decides who the
5 auditor, that's going to be a problem.

6 Now, personally, I think there are really strong
7 arguments for auditor rotation. But I realize there are
8 some very legitimate complications with it as well. And
9 so personally I'm not going to take a point of view on
10 that ultimate issue.

11 But what I do want to emphasize is that all of
12 your efforts at trying to strengthen the independence of
13 auditors is -- that's effort well spent because this is
14 a -- certainly a legitimate concern. And one thing that
15 I think is true is that the self-serving bias tells us
16 that the auditor rotation idea could put a strong
17 counterweight in the scales against all the arguments you
18 can make on the other side. Thank you very much.

19 MR. DOTY: Well, first, before my colleagues on
20 the Board, all of whom are ready to pounce, react to what
21 I think is a very stimulating panel, I want to say -- I
22 want to give you an example of self-interested bias.

1 I thought that your article published in 2007 and
2 called -- entitled "Sarbanes-Oxley, the Evidence
3 Regarding the Impact of Section 404," was a brilliant
4 article because, first of all, it dismisses the idea that
5 the IPO market has suffered or would suffer because of
6 Section 404, Internal Control of Financial Reporting.

7 It dismisses -- it destroys the argument that we
8 have fewer listings of foreign firms here because of
9 regulation by the PCAOB and Section 404, Sarbanes-Oxley.
10 And it goes into a full-throated pen of why it is small
11 firms, in fact, achieve economic cost benefit from better
12 internal control of financial reporting.

13 Well, that's quite a lot of self-serving bias to
14 heap on the Board of the PCAOB, but we'll take it -- we
15 take it. I also take it that you're saying that you
16 think -- the two of you think the problem is self-
17 evident. It's the control of who appoints or who pays
18 or who somehow engages the audit firm -- that that's an
19 overwhelming creation of bias.

20 It is your scholarship as a behavioral scientist
21 that convinces you that this must be true -- that the --
22 and, in other words, what you're telling us is that, in

1 fact, without regard to how many restatements occur or
2 when they occur or what kind of audit quality failures
3 occur, the two of you believe that there simply is a
4 strong basis for worrying about what we will call the
5 client-pay model, but which I think Karen Nelson
6 identified is really who engages in which area -- goes
7 to it.

8 But with that predicate I'm going to give my
9 colleagues a chance to pounce. Jay, you want to pounce?

10 MR. HANSON: We've heard several different things
11 today about audit committees, and we've heard concerns
12 about the governance structure and the view by some that,
13 well, it's just management appoints them and, of course,
14 they're going to appoint people that aren't going to be
15 terribly tough on them. And, yet, we've heard audit
16 committees that -- people that served on audit committees
17 talk about what they do and the robustness of how they
18 discharge their responsibilities.

19 Thoughts on whether that -- whether there's
20 things that we can do within the current system to help
21 audit committees with their responsibilities and their
22 roles and give them more information, or if that's not

1 going to get us very far.

2 MR. PRENTICE: Well, I'll just respond briefly
3 and say that the tendency to act in a self-serving way
4 to try to police the client is strong and pervasive, but
5 it's not universal. And we also some counterweights that
6 encourage auditors to do things the right way and
7 overcome that self-serving bias. We've got professional
8 standards, we've got the potential for liability,
9 oftentimes we have very effective audit committees.

10 And I think the people that we heard from
11 today -- Mr. Daly and Mr. Blakely, for example, are doing
12 things the right way. And I think there's every chance
13 that they are helping remedy this problem. If I had
14 confidence that every audit committee all across the
15 country were meeting their standards I would feel a lot
16 better about things.

17 And I'll just say that you guys are the ones who
18 audit the auditors. You see the reports. You have a
19 feel for how high a quality of audits we have today. You
20 know I think better than I do whether or not we're
21 overcoming that self-serving bias with high quality audit
22 committees.

1 MR. GERDING: Yes, I agree. I think part of the
2 problem is that you might have a selection bias here and
3 you're inviting pretty high quality Board members to
4 these panels. So that may or may not be representative
5 of what's going out -- on out there in the market.

6 You heard from some of the earlier panelists
7 solutions -- or policy proposals about giving more
8 information to audit committees or the Board adopting
9 best practices for audit committees. I think that that's
10 all laudable and I think it is all advisable. I think
11 that we should be fairly realistic that that alone --
12 those types of reforms are not going to overcome the
13 types of incentives that we talked about.

14 And responding to your question, Chairman Doty,
15 both of us have written pretty extensively about
16 behavioral biases and behavioral economics. But I don't
17 think that you need to be a true believer in behavioral
18 economics to understand the incentives that are created
19 by the issuer pays models. So there's plenty of
20 academics in the accounting -- in accounting departments
21 and in law schools who don't necessarily take our view
22 of behavioral economics who still believe that the issuer

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1 pays model creates skewed incentives.

2 MR. FERGUSON: I have a question for Professor
3 Gerding. When I first listened to your suggestion about
4 mandatory rotation with an opt out by the shareholders
5 that was particularly appealing. And the more I thought
6 about it I thought, you know, we already have
7 shareholders vote every single year on the continuation
8 of the auditors.

9 And how different -- even assume that there was
10 a statement that there will be mandatory rotation except
11 for the -- but with the exception of an opt out vote.
12 Given the fact that management is likely to make exactly
13 the same kind of recommendation in that circumstance that
14 they make every year, even without the presumption, how
15 likely do you think it would be that there would be any
16 opt out votes -- or that there would be any votes that
17 would actually throw the auditor out?

18 MR. GERDING: I think that that depends largely
19 on the amount of information the large institutional
20 shareholders have. And there I would go back to one of
21 the first alternative proposals I have. If the Board
22 makes selective recommendations for your -- that an

1 issuer should change an auditor. If it's selective --
2 it's short -- I think that that would carry a lot of
3 weight with institutional shareholders who might be
4 concerned that maybe there's something that we need to
5 look into. Maybe there's something that we need to
6 address with the audit committee. And that that might
7 have an effect on the actual voting of shareholders.

8 MR. FERGUSON: Well, just one follow-up question
9 on that. Do you -- because I'm particularly concerned
10 about the procedural fairness of anything that we do.
11 Do you think we could make such selective recommendations
12 or selective -- to companies without going through a full
13 procedural hearing where the audit firm had the right to
14 defend itself and the right to basically --

15 MR. GERDING: I believe so. I could look into
16 the matter more if you find it helpful. I believe you
17 could. The Board does have a -- the Board can speak for
18 itself. It's not disclosing any information that's
19 prohibited by the Sarbanes-Oxley Act. And I don't think
20 that a recommendation that a issuer change auditors would
21 be viewed as a penalty or trigger additional due process
22 concerns. But if you are intrigued enough by the

1 proposal I will be happy to submit further comments to
2 show my analysis on that.

3 MR. FERGUSON: I at least would be interested in
4 that.

5 MR. GERDING: Okay.

6 MR. HARRIS: I'd be very intrigued as well. I
7 think there are a lot of due process and transparency
8 issues related to that. I'm not quite sure how we would
9 do it. I think it's an excellent recommendation and I
10 don't know whose jurisdiction that would fall under --
11 whether it would be the PCAOB or the SEC. But I think
12 it's clearly a -- you know, a significant recommendation
13 which would have an immediate impact.

14 But, as I say, with respect to the transparency,
15 due process, administrative hurdles that I think that we
16 might be faced with I'd very much like your thoughts in
17 terms of how we might do that.

18 Getting back to, you know, Jay's fundamental
19 question which I was going to actually ask Natalie about,
20 you know, earlier on, in defining what is the problem,
21 I mean, you've indicated there are powerful, pervasive,
22 persistent incentives. But what's the positive impact

1 on the marketplace should we act versus doing nothing?

2 MR. GERDING: The impact on the marketplace would
3 be -- would take several different forms. One is that
4 I think there would be greater investor confidence in the
5 quality of auditing. There would be I think ultimately,
6 if I'm right, higher prices -- investors will be willing
7 to pay higher prices for the stock of issuers. Part of
8 the reason -- anticipate a question why aren't issuers
9 doing that right now. I think that's partially a
10 collective action issue.

11 No one issuer has the incentive to signal on its
12 own by firing an auditor. And if they actually do rotate
13 an auditor I think under the current regime that actually
14 sends a very negative signal if an issuer decides to
15 change auditors. So part of what you're doing is
16 creating a structure where it's no longer seen as a
17 negative information signal to change auditors.

18 MR. PRENTICE: I would agree. I don't think
19 anybody thinks that we need less independence. I don't
20 think anybody thinks we need less information or less
21 reliable information.

22 Our stock market thrives on accurate, reliable

1 information. Investors have to -- will pay a premium for
2 that sort of thing. And anything we can do to make the
3 audit more reliable has got to be a plus for the market.

4 MS. FRANZEL: I want to thank both of you for
5 your comments and for really the multi-pronged approach
6 that you've taken to this.

7 As a career auditor I find the behavioral issues
8 fascinating. And, of course, I was at GAO so we were not
9 in a client-paying model. And we used to think a lot
10 about objectivity and professional skepticism, and our
11 work was always subjected to the public scrutiny as well.

12 I'm wondering if there are some discipline
13 decision-making frameworks that we could maybe use in the
14 professional skepticism context of audits to maybe help
15 auditors from getting off track and letting that personal
16 bias take over -- you know, sort of an additional
17 safeguard or something that could be really used in the
18 university programs and then again by the firms -- again,
19 a way to help auditors get through the decision-making
20 process without defaulting so quickly to personal bias.

21 MR. PRENTICE: One of the things I try to do in
22 the accounting ethics classes that I teach is have the

1 students fully informed of the self-serving bias among
2 others. And I give them all the examples that I talked
3 about with you and several more so that at the very least
4 they can guard against it to the extent that they can.

5 But it is a very tricky one. It's devilishly
6 difficult to completely defeat even if you are looking
7 out for it because the human mind has an incredible
8 ability to rationalize and we can always find ways that,
9 oh, this is okay.

10 Just an example that pops into my head -- lots of
11 people, you know, are worried about child labor in Asia,
12 and so they'll tell themselves they don't want to buy
13 goods made by child labor in Asia. But if you show them
14 something they really want and then they find out it's
15 made by child labor in Asia all of a sudden they think
16 child labor in Asia is a much less significant problem
17 than it was before.

18 It's the human ability to rationalize. And
19 because it is -- that is such a great ability that we
20 have we need structural mechanisms to keep conflicts of
21 interest at a minimum because when they're there it's
22 very difficult for humans to free themselves of these

1 influences completely.

2 MR. GERDING: I agree. There is a lot of
3 literature out there by behavioral economists that try
4 to make the jump from describing the problem to
5 prescribing solutions. And I think it's extremely
6 difficult to de-bias individuals.

7 There's a lot of literature that builds off of
8 Professor Kahneman's work that talks about developing
9 nudges or changing default rules to encourage to try and
10 counteract biases to act in a certain way. There's also
11 ways in which information can be framed or made more
12 salient, to put it colloquially, scare people out of
13 their pants into acting in a certain way.

14 That still being said, a lot of these proposals
15 frankly don't necessarily convince me that they're going
16 to effectively de-bias. So I think one of the problems
17 with behavioral economics is it doesn't necessarily lead
18 to powerful policy prescriptions of ways around these
19 very deep, very fundamental neurologically hard-wired
20 problems.

21 MR. FERGUSON: This goes back to Professor
22 Kahneman and at least in his book *Thinking Fast and Slow*,

1 one of the points he makes is that these fast thinking,
2 these biases are, in fact -- as you said, you called them
3 neurologically hard wired. But they are extraordinarily
4 useful survival mechanisms that we have to have, that we
5 cannot function without them.

6 Applying that insight to the structure of the
7 audit today, which is a -- particularly of a large
8 complex audit which is done on a fixed-cost basis with
9 a highly pyramided structure -- people doing work and
10 doing lots and lots of routine tasks. Does the very
11 structure of the way this business is done, in fact,
12 reinforce those biases?

13 MR. PRENTICE: I think the reinforcement comes
14 just right back to who's paying and who's choosing,
15 because I think that's where the primary incentive is for
16 the accountants; that's the main thing that they have to
17 worry about.

18 And so if you were exposed to something and the
19 first thing that pops into your mind is, Oh, I don't want
20 to lose this client, that's immediately going to affect
21 the judgment you make and how you perceive the
22 information that you're given. And what Professor

1 Kahneman's work shows in -- to a great extent is that
2 when we -- we oftentimes make a judgment just like that
3 about, Okay, my guy won this debate or this fact supports
4 my guy or this fact supports the position that my audit
5 client wants to take.

6 Once you've made that decision automatically,
7 then the rational part of your brain that kicks in and
8 starts thinking about stuff is really just rationalizing
9 the decision that your quick-start mind -- what does he
10 call it? -- stage 1 -- phase 1 -- that it is already
11 made.

12 MS. FRANZEL: I'd like to follow up. Taking that
13 point -- so let's just say that there is a new structure
14 put in place. Let's just say there is mandatory audit
15 firm rotation. But everybody still has this self-serving
16 bias, so wouldn't everybody automatically adjust all
17 these biases to benefit under the new system and wouldn't
18 we have a whole new set of problems?

19 MR. PRENTICE: I would just say again you've got
20 the self-serving bias pulling you one way, but you've got
21 a lot of other things pulling you the other way -- your
22 professional responsibility, the Code of Professional

1 Ethics, the potential for liability, the embarrassment
2 that if you screw up something shows up in the
3 newspapers, et cetera. All auditor rotation does it
4 seems to me is put one more structural feature in that
5 side of the scale to try to overcome the self-serving
6 bias.

7 MR. GERDING: Yes, let me reiterate something
8 that Professor Prentice said a minute ago. It's not just
9 that you're behaviorally biased. It's the fact -- and
10 there's quite a bit of accounting literature on this --
11 it's the fact that you combine the behavioral bias with
12 the incentives created by the issuer pays model.

13 So the incentive of who's paying combined with
14 behavioral bias is going to trigger -- or cause a biases
15 to flip in the direction of confirming what you're being
16 told by who's controlling the purse strings.

17 It's certainly possible that there might be
18 behavioral biases to please shareholders if shareholders
19 were controlling the selection of auditors, but I guess
20 in that particular scenario shareholders would want a mix
21 of different things. They would want more information,
22 but they would also not want auditors to necessarily

1 waste time or open up issues that are not materially
2 important. So I think fixing the incentive problem goes
3 a long way to fixing the bias problem as well.

4 MR. PRENTICE: Just I think in one of my written
5 submissions I talk about a study that was done where
6 auditors were construing sort of a vague rule, and they
7 would construe it in exactly the way their client wanted
8 it construed unless their client was in financial
9 trouble.

10 If the client was in financial trouble and there
11 was a good chance it would go under and, therefore, it
12 would increase a chance that the auditor would be sued
13 all of a sudden they got a little backbone and they said,
14 No, we're not going to construe it that way.

15 That shows how incentives can flip the self-
16 serving bias. And, again, I think that if you mandatory
17 auditor rotation it puts one more thing in the right side
18 of the scales.

19 MR. DOTY: Fascinating, terrific, scintillating.
20 You've done for us just what we needed to have done.
21 Thank you.

22 MR. PRENTICE: Our pleasure.

1 MR. DOTY: Oh, Michael. Sorry. Quickie. Make
2 it fast.

3 MR. GURBUTT: If I could just get one last
4 question in quickly if that's okay. And I sure want to
5 address Professor Prentice a question on his 2007 paper
6 on ethical decision-making. And I think one of the
7 things that you've highlighted which is explored in that
8 paper is the self-serving bias.

9 But there's also other biases which you discussed
10 in that. And I want to name three of them. One is
11 obedience to authority. And I want to get your remarks
12 on whether or not there's any relation there to the
13 pyramidal structure that Lew referenced with respect to
14 the way audit firms staff their engagements.

15 And then two others which you mentioned are over-
16 optimism and over-confidence. And I'm interested in your
17 remarks as to whether or not there's any tension there
18 between the concept of professional skepticism and the
19 auditing standards.

20 MR. PRENTICE: On obedience to authority, yes.
21 The pyramidal structure I think would definitely be
22 impacted there. We all are hard wired to want to please

1 authority. When we grow up we want to please our
2 parents, we want to please our teachers, we want to
3 please the cop on the beat, and we're all used to that.

4 And even when we're adults we like to please
5 authority. I realize that every time I walk into my
6 dean's office. And that definitely affects the judgments
7 that people make -- people down the rung on the audit
8 team and it often affects us unconsciously.

9 Sometimes we realize we're being asked to do
10 something we're uncomfortable with and we knuckle under
11 because we don't have the courage to stand up to our
12 superior. But oftentimes we are so focused on pleasing
13 our superior it seems like, you know, a good thing to do
14 that we're normally rewarded for we don't even realize
15 that we're doing something that later we think, you know,
16 oops, I think why didn't I see that.

17 Sorry, Michael. I didn't understand your second
18 question about over-optimism and over-confidence.

19 MR. GURBUTT: Well, I was just wondering whether
20 or not there's any tension there between the requirements
21 in the auditing standards to apply professional
22 skepticism -- and maybe there's not -- and those concepts

1 of over-confidence and over-optimism.

2 MR. PRENTICE: Well, most people think they're
3 better than average drivers -- like 80 percent of people
4 think they're better than average drivers. They did a
5 study of college professors -- 94 percent said they were
6 better than average classroom teachers, which means the
7 other 6 percent must really suck.

8 And a very high percentage of auditors think they
9 are better than average auditors. And so if you're just
10 confident you're a better than average auditor then you
11 may well make decisions without adequate reflection or
12 adequate research and that over-confidence I do think can
13 lead you to not be as skeptical as you should be.

14 MR. GERDING: Can I make one additional point on
15 the pyramid structure point? In my experience -- as I
16 mentioned at the beginning, I worked with both forensic
17 accountants and auditors. And I saw just anecdotally a
18 pretty big difference in I think the way that they
19 approached problems.

20 Auditors had a responsibility for a lot of
21 different pieces of financial statements, whereas
22 forensic accountants when they interviewed in a potential

1 enforcement matter -- when they went in and interviewed
2 they had very targeted questions and it was much more
3 focused and they could get right at the heart of
4 potential problems.

5 So one potential policy wrinkle that this could
6 be is if you're concerned about the cost of mandatory
7 audit rotation one perhaps lower cost alternative would
8 be to selectively require or selectively have
9 shareholders have the right to bring in a forensic
10 accountant if the Board finds sufficient problems.

11 And that would allow for a very targeted attack
12 on particular accounting issues that I think would really
13 deal with what's really a structural problem between
14 being responsible in this pyramid for the entire
15 financial statements and going really at the most
16 critical difficult issues.

17 MR. DOTY: We're going to have to leave it there.
18 Thank you both. It's been terrific.

19 MR. PRENTICE: Thank you.

20 MR. DOTY: The next panel we have money coming to
21 the table. We have Dan Slack, Chief Executive Officer
22 of the Fire & Police Pension Association of Colorado

1 since December 2008. He served as the executive director
2 of the State University's Retirement System of Illinois.
3 He's a member of the standing advisory group of the
4 Public Company Accounting Oversight Board and holds two
5 degrees from the University of Illinois and has been the
6 assistant attorney general for the State of Illinois and
7 held a number of other very responsible positions.

8 Greg Smith joined the Public Employees'
9 Retirement Association of Colorado as general counsel in
10 2002. He was promoted to chief operating officer. In
11 addition to that role he's been named interim executive
12 director and he guides PERA's involvement and corporate
13 governance. He's also a former president for the
14 executive board for the National Association of Public
15 Pension Attorneys, is a member of the Board of Directors
16 for the Council of Institutional Investors. So Dan --
17 or Greg rather has enormous credibility here as an
18 investor.

19 Both of you are here at some expense and some
20 travel. We thank you and please proceed. Dan, do you
21 want to begin?

22 MR. SLACK: I thank you, Chairman Doty, members

1 of the Board. Thanks for the opportunity to speak on
2 this incredibly important area of auditor independence,
3 objectivity, and professional skepticism.

4 As Chairman Doty mentioned, I'm the CEO of the
5 Fire & Police Pension Association of Colorado, which
6 provides retirement and disability benefits to police
7 officers and firefighters in Colorado throughout the
8 state. We invest their contributions and their
9 employers' contributions in the capital markets here in
10 the U.S. and around the world. Integrity of the capital
11 markets and reliable and audited financial reporting is
12 of great importance to us because of that.

13 First I'd like to start off with a comment on my
14 small personal experiences with auditor independence.
15 And I've had sort of experience I want to relate to you
16 in two different regimes. So heads up -- on the first
17 one there's self-serving bias coming into play -- just
18 to sort of get that right out on the table here.

19 So my experience at Fire & Police Pension
20 Association. Like the private sector we pick our own
21 auditor. I came in -- my Board of Directors does -- I
22 don't, the Board does. But I came in as the CEO about

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1 four years ago. We had had our own audit firm -- the
2 same audit firm at the time -- for about 13 years. There
3 had been no problems. There had been no deficiencies,
4 no issues, with respect to the quality of the auditing
5 work that had been done.

6 But we wanted a review, and I wanted a review and
7 determination by the Board -- you know, should we rotate,
8 should we keep our same auditor. We did an RFP, we chose
9 a new firm, we paid a little more, but cost was really
10 not the primary consideration that we were looking at
11 there.

12 And we took great comfort -- or I personally took
13 great comfort from having a new set of eyes looking at
14 the organization, even though I will concede that there
15 was staff time involved in bringing the new auditing firm
16 up to speed on our organization and the issues and the
17 processes around it. But I felt that it was a worthwhile
18 process to go through and I was very pleased that we
19 ended up making the rotation.

20 And then the second experience that I have had is
21 I would caption that do you really want independence.
22 And I would take the model that was in place at my former

1 employer, State University's Retirement System of
2 Illinois. Our auditor rotated every five years, whether
3 we liked it or not. Our auditor was chosen by the State
4 Auditor General, not by my Board of Trustees, not by the
5 management.

6 Talk about independent. When the audit firm
7 walked in the door it was quite clear they didn't view
8 us as the client in any form. We were the auditee. And
9 that's a huge difference in tone, attitude, frame of
10 mind -- you name it. There was no question about their
11 independence -- you could feel it.

12 It sort of reminds me of -- I think it was
13 Justice Potter Stewart who made the famous remark about
14 pornography -- I know it when I see it. This was sort
15 of like independence -- you knew it when you felt it.

16 So I think that if we truly want independence we
17 have to somehow move away from the issuer pays model and
18 that sort of, you know, builds upon what the prior
19 panelists said. But I want to talk about maybe what are
20 more implementable options and more incremental
21 approaches that can be taken because I would say that I
22 am probably more of an incrementalist by nature.

1 So I want to commend the PCAOB on its recent
2 release to audit committees regarding the inspection
3 process that came out I think earlier this fall or late
4 summer. I think that that's an initiative that meshes
5 well with many of the comments that have been made by
6 prior speakers to you at these various hearings. I also
7 think that the recent release by the Center for Audit
8 Quality of their auditor assessment tools is another step
9 in the right direction. So I think those are all very
10 positive things.

11 After I submitted my written statement to you and
12 I was looking at it again in preparation for today's
13 meeting I became concerned that it might imply that I'm
14 opposed to mandatory audit rotation -- or auditor
15 rotation. And I'm not really opposed to mandatory
16 auditor rotation, I just think that it's not quite the
17 time there yet and I think that there are some interim
18 steps that might need to be taken first.

19 And so as I mention in my written statement I'm
20 in favor -- I was struck by the proposal as put forth by
21 Robert Pozen to have the mandatory re-tender or mandatory
22 RFP after a term of years. I think that that serves a

1 number of purposes that would be of value and would be
2 a good interim step.

3 I think if it's accompanied by a requirement that
4 there be articulated reasons for the retention or non-
5 retention -- I guess if it's a non-retention that's not
6 as important, but if it's a retention of the auditor
7 articulate reasons, not just boilerplate, about why there
8 was value in retaining the audit relationship. I think
9 that could be of value.

10 I also think that it could help clarify in the
11 auditing situations where there's been a decades-long
12 retention of the auditing firm by the company -- that it
13 could help clarify that really, hey, it's the audit
14 committee now that is making the decision on retention
15 not management and so clarify that hire decision.

16 I think that it could be helpful to have further
17 restrictions on the provision of non-audit services. I
18 think it's, one, just in terms of independence and
19 objectivity and then, two, in terms of perhaps clearing
20 the brush a bit for the conflicts that might exist if
21 some form of auditor rotation is implemented where the
22 Big Four firms might be so intertwined with the provision

1 of audit and non-audit services to the large multi-
2 national companies that effectively there is no
3 alternative. So a trimming back of non-audit services
4 perhaps even further than what was mandated by Sarbanes-
5 Oxley could be in order.

6 I think -- I would say my written statement
7 suggests other incremental steps that might be
8 considered. But I'll stop right here and just say thank
9 you for the opportunity to state my views and I look
10 forward to answering any questions that any of you may
11 have.

12 MR. DOTY: The other items you've directed us to
13 will be included in your written statement, which will
14 be a part of the record.

15 MR. SLACK: That is correct.

16 MR. SMITH: Thank you, members of the panel and
17 Board. I appreciate the opportunity to address you. I'm
18 Greg Smith from the Colorado Public Employees' Retirement
19 Association. I am here, I think, because we run the
20 money. And in Colorado PERA we manage about \$40 billion
21 on behalf of 495,000 current or public -- current or
22 former public employees and servants.

1 As a result of that we consider ourselves to be
2 the consumers of financial reporting. And we consume a
3 lot of them and we manage 60 percent of our assets
4 internally. We don't rely on Wall Street; we do it at
5 home. We do it with our own professionals and we rely
6 extensively on financial reports.

7 We view auditors as our eyes and ears inside the
8 corporation. We don't have the access, the ability, the
9 tools to go into each company and assess their true
10 financial condition. So the accuracy of our eyes and our
11 ears and their reporting to us are critical. We have no
12 other means of obtaining the information that they're
13 responsible for harvesting for us.

14 I want to comment for a moment about the previous
15 panel and the discussion about bias and internal bias.
16 And I agree with every bit of what was talked about
17 except that I'm not sure any of it matters because
18 whether they're biased or they're not biased or whether
19 we could train auditors to control that bias I'm not sure
20 matters because what I think really matters is the
21 perception of bias. And if people think the bias is
22 there, whether it's there or not, whether the

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1 professional is above that or not, it's going to deter
2 and detract from the quality of the audit in terms of how
3 it's perceived by the consumer of those audits.

4 In my role -- and I'm going to focus most of my
5 initial talk about some things that the Policies
6 Committee has done for the Council of Institutional
7 Investors. The Council of Institutional Investors is a
8 nonprofit organization made up of corporate pension
9 plans, labor pension plans, and public pension plans in
10 excess of \$3 trillion in management.

11 We are very strong advocates for long-term
12 shareholder rights and we think that the issue of auditor
13 rotation and auditor independence, objectivity, and
14 professional skepticism are critical and something we've
15 since done significant time on.

16 I chair the Policies Committee, and that makes me
17 responsible for developing new potential policies for the
18 Council to adopt through its membership. And since 2011
19 we have been debating the issue of mandatory rotation of
20 audit firm.

21 Despite that lengthy period of time and despite
22 the many different angles we have looked at we have not

1 reached consensus among that group as to what the right
2 solution is. We do think we've made some progress and
3 we've done some analysis that I intend to pass on to you.
4 But I do have to say at the outset that the fact that
5 this debate has gone on for 30 years -- it certainly
6 started in the eighties sometime -- makes it a pretty
7 daunting task and one I admire the Board for taking on.

8 When we started looking at this issue -- and I'm
9 going to bring a little bit of the lawyer's mindset to
10 this -- I can't purge that from my genetic makeup here.
11 One of the things we started looking at was what if we
12 do want auditor rotation -- what if that is what we think
13 is the best solution to serve long-term shareholders?
14 What does mean we have to do?

15 And I think the conclusion -- or the answer to
16 that question colors the entire process because our
17 conclusion -- or our answer to that question was, Well,
18 we need to figure out how we could possibly get it
19 passed. And in order to get it passed in the post-DC
20 circuit ruling on access regime we need to find cost
21 benefit analysis that supports mandatory rotation if
22 that's where we want to head.

1 And I don't mean to say that we're going in
2 looking for that. We go into that analysis seeing
3 whether that analysis truly support rotation. But I
4 think it's an important concept to consider -- that we've
5 got to be able to prove the value of that rotation in
6 order to ultimately have it be successful in a rulemaking
7 effort, whether before this body or elsewhere.

8 So we started trying to decide, well, how can we
9 tackle that issue. And one of the areas that we went to
10 was looking at is there really supportive evidence that
11 cost will increase if there's auditor rotation. As we
12 know, in the United States it's all voluntary rotation.
13 There is no mandated regime to go and examine of any
14 significance that would give us very much guidance.

15 But what we did was we went back to 2004 and we
16 looked at 85 companies -- well, we looked at all of the
17 companies greater than \$2.5 billion in capitalization
18 that had changed auditors since 2004. In looking at
19 those we looked at the two years preceding the change in
20 auditor and the two years after the change in auditor to
21 detect whether there had been an increase in cost
22 associated with conducting the audit. We excluded those

1 that made the change more recently than two years ago.

2 And the result of working our way through that
3 sample was that we had 85 companies that met that
4 criteria that we looked at. In some instances you had
5 a situation where the company was a split audit
6 responsibility for a given year because there was an
7 overlap between the two firms when there was a change.
8 In those instances we excluded that year of change and
9 looked at the two years preceding and the two years after
10 the year of change.

11 We don't claim this to be a scientific study --
12 let me put that out on the front end. All of us could
13 sit here and poke holes in out we did this -- whether we
14 backed out inflation, whether we examined the precise
15 nature of the scope of the audit. A variety of variables
16 are out there. But we wanted to see in a nonscientific
17 cut where we wound up.

18 And what we found was that in that 85 firms 50
19 firms experienced an increase in audit cost over the
20 subsequent two years and 35 companies experienced a
21 decrease. The median increase was 59.4 percent and the
22 median decrease was 22.4 percent. And when we put it all

1 together the net change in audit cost was 18.4 percent.
2 That's a two-year figure and doesn't consider the fact
3 that there would be some presumed escalation in the cost
4 of audit with or without a rotation.

5 We then looked at the concept of these companies
6 that had had a split where they had two auditors in a
7 given year and looked at the fact that that may well be
8 an indicator that it wasn't a desired transition and that
9 it may have been something that was forced or needed as
10 a result of some event within the company.

11 So we excluded those split cases where we were
12 looking at really a five-year term instead of the four-
13 year term. And when we did that we found that we were
14 down to 61 companies. 33 companies experienced an
15 increase in their cost, 28 experienced a decrease in
16 their cost, and the net overall change was an increase
17 of 3.4 percent for the cost of the audit.

18 As a consumer of the audited financials certainly
19 that didn't strike us as a material alteration in the
20 cost of obtaining the audit. It's those numbers that are
21 critical. And the ability of us to rely on those
22 numbers -- our analysts to know that the number they're

1 looking at are, in fact, reliable is critical.

2 Within -- one more cut that I want to cover
3 quickly for you, and that was total fees, not just audit
4 fees. Preceding numbers were based on just audit fees
5 and not total payments to the audit firms.

6 Looking at the 85 companies again and looking at
7 total expenses to the audit firms, 44 percent experienced
8 an increase, 41 -- I'm sorry -- 44 companies experienced
9 an increase, 41 companies experienced a decrease. The
10 net total change in cost was a plus 3.3 percent over that
11 examination.

12 Again, we went one more step and excluded those
13 split companies out of the 85 taking us back to the 61.
14 And in that instance it actually flipped the results.
15 We had 29 who had an increase in their cost, 32 with a
16 decrease in their cost, with the total net being a
17 decrease of 1.8 percent.

18 We don't, as I say, claim this to be the gospel
19 in terms of whether a firm would charge more or less in
20 a rotation regime, but we certainly think it's relevant
21 evidence to consider when trying to do the cost benefit
22 analysis that we're going to face in the event we pursue

1 mandatory rotation.

2 I'd also make the point that -- and it's
3 certainly my opinion and not that of the Council -- but
4 it appears that if there was a regime of known rotation
5 where the companies knew and the audit firms knew that
6 every periodic -- whether it's five years or ten years --
7 there was going to be that rotation I would certainly
8 think that there would be a development of a professional
9 expectation among the firms that that handoff would be
10 done in an appropriate manner -- that they would do
11 things in a way that wouldn't intentionally drive up
12 costs on each other.

13 They might try that once or twice, but when they
14 figured out the other guy was doing it to them too I
15 suspect it would have a chilling effect on that practice
16 and I think you would find that that handoff and that
17 ability to accomplish that transition at the same or
18 lower cost would prevail.

19 With that I'm going to stop and take your
20 questions. There are certainly many things that we think
21 would be important. I guess I should cover a few other
22 things that the Policies Committee is looking at.

1 The current Council position and policy that's in
2 place calls for a competitive bidding process for
3 auditors every five years. The Policies Committee is
4 looking at whether or not to enhance that and identify
5 specific triggering events that should require a rotation
6 or perhaps that would require a comply-or-explain type
7 of an approach. And in comply-or-explain we have looked
8 at a variety of different triggers that would require the
9 company to provide an explanation to the shareholders in
10 the event they didn't go forward with rotation or, in
11 fact, did retain the existing audit firm.

12 And those continue to be a subject of debate, but
13 they include things similar to what I've heard earlier
14 today. The presence of some former partners from the
15 audit firm that are now employees of the company, the
16 actual time of tenure for that company -- I'm sorry --
17 for the audit firm. And we even talked about the one
18 which relates to a significant financial restatement.
19 And in the event of a significant financial restatement
20 should that trigger an automatic rotation or should it
21 trigger a compliant -- or explain if you're going to
22 retain that audit firm.

1 And there was quite a bit of debate about whether
2 that would have a chilling effect on that firm coming
3 forward and being honest in terms of its assessment of
4 its prior work or whether that would motivate people to
5 hide perhaps what should be a financial restatement. So
6 that one remains in debate.

7 But we think that triggering events and the
8 looking at triggering events, and thereby when those
9 events occur enhancing the disclosure to shareholders
10 would aid shareholders in gaining confidence in the
11 financial reports generated by our corporations. So I'll
12 stop there and welcome your questions.

13 DR. DOTY: Well, thank you both. You've given us
14 a lot to chew on. Steve, do you want to comment?

15 MR. HARRIS: With respect to the competitive
16 bidding process how do you envision that working? In
17 reality in these tough economic times why wouldn't the
18 lowest bid almost always be accepted? I mean, how do you
19 envision the competitive bidding process working?

20 MR. SMITH: Well, I think any of -- any large
21 company in governmental or private we engage in a lot of
22 competitive bidding processes. And I think it would need

1 to be approached in a way that had a lot of transparency
2 to it.

3 One problem that I see with it -- and I'm not
4 saying it's all perfect -- but one problem I see is that
5 you would have to be clear and it would have to be a
6 legitimate competitive bidding process. So often what
7 we find ourselves in is, oh, we're going to do an RFP but
8 nobody really believes we're looking to change and,
9 therefore, nobody really comes forward with a legitimate
10 bid, and therefore, it's kind of a meaningless process.

11 We would have to break that mold. We would have
12 to make it clear that we're truly putting this out for
13 bid -- the company's truly putting it out for bid and
14 truly looking for legitimate response. And on top of
15 that there would have to be an increased transparency
16 about the process.

17 I want to know what the range of bids were. I
18 don't need to know the name of every bidder that made a
19 particular bid, but I want to know how big that spread
20 was as a consumer of the financial reports. I want to
21 know what their analysis was that took them to the
22 conclusion that they reached.

1 Is it always going to be a low bidder? I hope
2 not because I don't think that's healthy. I don't think
3 that's everybody's conclusion that your -- I don't hire
4 my doctors that way and I'm not going to hire my
5 accountant that way.

6 But there's other things that have to come into
7 play, and that's part of the explain process. The
8 boilerplate type of an approach of, well, we believe this
9 is in the best interest of management or best interest
10 of the shareholders and, therefore, we didn't change --
11 that's not what we're looking for. We're looking for a
12 real analysis and a real description of the decision-
13 making process from that bidding process. And I think
14 that package is what we need and not just let's do a bid
15 every five years.

16 MR. FERGUSON: Yes, I have a couple of questions.
17 First, in your own organizations -- I know you mentioned,
18 Dan, that when you came in you basically had a rotation.
19 Do you rotate your auditors in either of your home
20 institutions? I know many, many public pension firms to.

21 MR. SMITH: I do -- Colorado PERA. Not only do
22 we experience a rotation but we don't retain our own

1 auditors. We don't select our own auditors. We get to
2 pay the bill and we're happy to pay the bill because we
3 like to know our numbers are right. But the State
4 Auditor under the supervision of the Legislative Audit
5 Committee makes the selection of our auditor, defines the
6 scope of the audit, and does have a four-year rotation
7 policy on its contracting with outside firms for that
8 service.

9 MR. FERGUSON: And has that worked reasonably
10 well for you?

11 MR. SMITH: It's worked very well for us. I will
12 acknowledge that the first year's not the easy year.
13 There's a lot of learning to be done -- takes a little
14 bit more of our staff time during that year to bring them
15 up to understanding how we do things and have done them
16 historically. But the cost differentials have been
17 nominal.

18 MR. SLACK: And for us we have a little different
19 format even though we're in the same state. We -- my
20 Board of Directors does pick the auditor upon
21 recommendation of the audit committee of my Board. As
22 I said, we sort of instituted some new processes and the

1 expectation is that every five years we'll be going out
2 to bid. Will we change auditors or retain I don't know,
3 but the expectation is that every five years we'll go out
4 to bid.

5 MR. FERGUSON: My second question has to do with
6 the very interesting results of your Policy Committee
7 study on cost, which shows that, you know, kind of you
8 net it down the cost of auditor rotation appears to be
9 pretty nominal. And I think that's consistent with
10 studies elsewhere around the world that auditor rotation
11 does not necessarily raise the cost of the audit fee.

12 But the objection -- one of the big objections is
13 not so much that the audit fee will go up but that
14 auditor rotation is very costly to the client in terms
15 of management having to bring the auditor up to date.
16 It takes more people, it takes more time, takes more
17 management involvement with a new auditor. And the
18 issuers don't like that. That's a lot of the objection.
19 Do you have views on that?

20 MR. SMITH: Well, I'll take a run at it. As an
21 entity that buys and sells stock I think we would pay a
22 premium for a company whose financials we're confident

1 in. And when we look at financial reports and we have
2 skepticism about their accuracy that results in a
3 discount in their valuation of that company. And I think
4 companies would be well served by demonstrating
5 themselves to go the extra mile to give us comfort that
6 their numbers are correct.

7 MR. SLACK: Yes. And I think that there is --
8 there has been -- from my personal experience there is
9 that initial run up of management time, company time in
10 a new relationship with an auditor. That -- I think it
11 cannot be avoided. I would concur with Greg's comments
12 though that I think it's a cost that's worth bearing in
13 appropriate circumstances.

14 MR. HANSON: I want to follow up on something
15 that you just said for my first question, then I've got
16 a second question too. And that was about confidence in
17 the numbers -- that you're willing to pay more for a
18 company that you have confidence in the numbers.

19 In your mix of how you make investment decisions
20 today is auditor tenure one of the things that you
21 include in that mix of -- total mix of information when
22 you decide how much you're going to pay for your

1 particular investment and whether you're going to make
2 it at all? And if it in that mix how? So that's my
3 first question.

4 Second question is I want to explore just a
5 little bit more about the purpose of mandatory re-
6 tendering. Because as I think about it -- and three
7 things come to mind. You've already mentioned one, which
8 is fees. A second purpose I can see is to demonstrate --
9 I'll use a really simple way to say this -- who wears the
10 pants in the relationship -- that it's the audit
11 committee. And then the third thing is the threat of
12 someone second guessing the decisions that the auditors
13 made.

14 There might be a bunch more reasons for re-
15 tendering, and if there are more than that that you weigh
16 heavily I'd like to hear that. But of those three things
17 that I mentioned which ones do you weigh the most in
18 terms of the value of re-tendering, and are there ways
19 to accomplish that without re-tendering? So my two long-
20 winded questions.

21 MR. SLACK: So on the first question -- I hope I
22 can remember your questions but -- and please correct me

1 if I don't get them answered. So our process is a little
2 bit different than that followed by Colorado PERA. We
3 sort of manage the managers at our organization. So we
4 are not buying Coke, selling Pepsi, or vice versa. But,
5 you know, we talk to our managers though. I mentioned
6 in my written statement that a lot of our equities are
7 passively managed.

8 But, you know, audited financial statements are
9 of interest whether you're equities, fixed income --
10 whatever sort of investing that you're doing. And I'm
11 not aware that -- no one has told me, Oh, gee, we look
12 at auditor tenure specifically and give, you know, a
13 checkmark in a box against that. I think it just goes
14 more to the issue of, you know, is there independence
15 there, is there a feeling that they can rely upon the
16 audit financials. So I think it's just really part of
17 a bigger picture I guess.

18 And then your second question about, you know,
19 what would be the value of mandatory re-tendering and are
20 there alternatives -- I think as far as the value I would
21 weight heavier on the who-wears-the-pants argument. I
22 think that it's -- that the establishing the

1 responsibility of the audit committee that's clearly
2 been, you know, granted to them through the changes made
3 by Sarbanes-Oxley -- I think that that's of real value.

4 I think that an explication, as Greg commented
5 about, of the rationale for if there is a mandatory re-
6 tendering and yet a retention of the firm -- not just
7 boilerplate that says it was in the best interest of
8 shareholders, but more just, you know, we looked at this
9 issue and that issue and we weighed it and we came out
10 that this was the best thing to do is to retain the
11 auditing firm. I think that's what we would see of
12 value.

13 MR. SMITH: The issue of tenure I would agree
14 with Dan. I can't say that even my internal management
15 professionals coming to me and say, Well, this company's
16 had the same auditor for ten years so I think I'm going
17 to downgrade it in terms of my reliance on it. It's a
18 bigger picture. It's one piece in a bigger puzzle than
19 that.

20 But I can say that we've certainly had members of
21 our staff and our Board raise concerns about companies
22 where it's a perpetual relationship. And those concerns

1 are ones that are brought forward and ones that result
2 in increased skepticism about the reliability of those
3 financials.

4 I would also agree with Dan about -- I weigh
5 towards the who-wears-the-pants version of the priority
6 and the reason for the rotation. But I might look at it
7 a little bit different. To me the audit committee -- one
8 of their last concerns perhaps in the equation should be
9 what is management going to be put through. Because they
10 don't work for management. They work for me. They work
11 for the shareholder. They're supposed to be my boss in
12 the boardroom. I've got my eyes and my ears that are the
13 auditors and I've got my boss -- and that's the
14 directors and those that sit on the audit committee are
15 responsible for making sure that my eyes and ears are
16 getting the right job done.

17 And is that an inconvenience to management?

18 Well, then management better make it more convenient for
19 themselves, because I need the ears and the eyes to go
20 get that job done, and I need the boss in the boardroom
21 to be my directors. And if I got majority vote -- and
22 I won't go too deep into other corporate governance

1 issues, but if I knew those audit committee members were
2 really working for me and they weren't beholden to
3 management I'd be a lot more comfortable with their
4 decision about who the auditor is.

5 MR. DOTY: Let's cut to Jeanette's question and
6 then we'll go to Marty.

7 MS. FRANZEL: I think all my questions have been
8 addressed. I thank you for your very candid answers.
9 Dan, I think we've been quoting you, people have been
10 quoting you all day on your statement that mandatory
11 audit firm rotation is too blunt an instrument.

12 MR. SLACK: Yes.

13 MR. FRANZEL: But I appreciate hearing the
14 various incremental steps and other steps and really how
15 you're thinking through these issues. So thank you for
16 coming today and I'll go ahead and defer to Marty.

17 MR. BAUMANN: Thank you, Jeanette. I wanted to
18 talk -- ask a question a little bit about the mandatory
19 re-tendering, which is -- again, has not been in play for
20 very much. The U.K. has just put that in play for the
21 FTSE 350. So I guess that has some -- doesn't have a lot
22 of history behind it either.

1 If you consider the issue that we're trying to
2 tackle here -- at least the concept at least, raise the
3 problems that we saw in inspections of lack of
4 professional skepticism and that's why we're raising this
5 issue among other reasons.

6 And in an ongoing relationship there's some
7 economic bonding that takes place between -- in the
8 relationship, unconscious biases we hear about, and a
9 little bit I don't want to lose this client on my watch.
10 But I just wonder about your reaction -- how is the
11 auditor going to react when he or she knows that the
12 relationship's going to be up for tender in the next year
13 or two? Might those biases to please the client be
14 greater or do you think they'd be lesser?

15 Further, some academic studies that I've looked
16 at have shown that in selection of auditors management
17 plays a key role in helping the audit committee get
18 through that -- get through all of the documents and
19 giving their views on the auditors. Again, would the
20 auditor again be more likely to be saying, Gee, I want
21 to please the -- please management in the last couple of
22 years before this re-tendering takes place and have just

1 an opposite effect of improving audit quality but
2 exacerbating the problem.

3 MR. SLACK: I'll take a shot at that first
4 perhaps. I think that the potential unintended
5 consequence of mandatory re-tendering that you just
6 mentioned -- I think those are real potential
7 consequences. I don't think that there is a perfect
8 answer to this issue of how do you increase what, you
9 know, everyone is looking for -- independence,
10 skepticism, objectivity.

11 So, yes, could you have that? I could see that
12 you could, but I also think that there is sort of a
13 countervailing issue of if there's a mandatory re-
14 tendering that's going to take place if I'm the incumbent
15 I might feel pretty good that I've got a good shot at
16 retaining that contract. But there's always the chance
17 that I'm not going to.

18 And I think that that would also bear into the
19 process as well. And I think it would perhaps lead more
20 towards, you know, making that everything -- all the Ts
21 were crossed, all the Is were dotted in case I'm not
22 retained. And so I think that that might countervail the

1 tendency to want to try and please management to get
2 through the re-tendering process.

3 MR. SMITH: And I would think that if -- if what
4 we were doing was going to this -- and really permanently
5 going to it -- that the long-term nature of an accounting
6 firm's business is going to drive them to do it right.
7 And the community in which they function and that they
8 educate each other and they bring their junior
9 accountants up through the regime is going to change into
10 a world where they know there's going to be turnover,
11 where they know there's going to be maybe not mandatory
12 rotation but movement as a result of business forces
13 different changes in management's view, different desires
14 to accomplish different things, changes in business
15 models.

16 But they're going to always be in line for the
17 next one or the other one that just rotated away from
18 one. And it doesn't allow them to say, Well, I'm going
19 to do a biased job or I'm going to change how I do
20 business because I might be able to hold this client that
21 way when that shoots them down in terms of their
22 marketability potentially to others when they get

1 discovered for doing that.

2 I think it's -- if you look at a very short
3 period of time I can see that problem. If you look over
4 a ten-year period of that kind of regime I think it
5 regulates itself very well and controls those tendencies
6 very well.

7 MR. DOTY: We're at a break. You have one
8 quickie?

9 MR. HARRIS: You can answer it quickly. But you
10 both raised the issue of the audit report in your written
11 and prepared remarks. And, Greg, you said that the
12 auditor's report as it currently exists does not fully
13 meet the goals of investors. Could you very briefly
14 comment on what more you might be looking for in the
15 audit report and why you don't think it currently meets
16 the needs of investors?

17 MR. SMITH: I think it doesn't currently give us
18 the information that would help us make judgments about
19 that bias and whether the bias is coming into play. I'm
20 not sure I'm in a position to really specify -- you know,
21 I agree with the signature on the audit -- let's have
22 some accountability, let's know who owns it, let's

1 ascertain whether there's a history of discovery of
2 frauds, what's the average experience level for the
3 people on the audit staff, how much rotation, how much --
4 how many hours are they putting into each level of the
5 analysts within that audit -- particularly how much time
6 is the partner spending versus how many low-level people
7 are spending on it.

8 Those kinds of things I think would be helpful.
9 There's other probably better qualified, like my 55
10 investment professionals that are looking at them and
11 telling me whether they think it's getting the job done
12 for them or not than I am to get better specifics for
13 you. But that's a few of them.

14 MR. SLACK: If I could quickly respond to that as
15 well, I mean, you know, one of the things that -- when
16 our money managers come into our office or maybe
17 prospective ones I tell them, I serve on this thing
18 called the standing advisory group of the PCAOB.

19 So I want to ask you while we're, you know,
20 talking about your investment philosophy, et cetera, et
21 cetera, let's talk about financial statements. And --
22 you know, and what I come away with in those

1 conversations is probably that more information is better
2 than less information. And so that's sort of where I'm
3 coming out.

4 And so could there be -- I know we've talked
5 about at standing advisory group meetings of things like
6 auditors' discussion and analysis that might, you know,
7 talk about areas of judgment, areas of inquiry, areas of
8 disagreement -- not disagreement or discussion with
9 management. All that to the extent that that could be
10 elucidated I think that would be helpful to the
11 investment process.

12 MR. SMITH: If I could just -- one more point on
13 that is more access to your inspection reports I think
14 would go a long way -- more access, whether it's the
15 audit committee or to the investor. There's a lot of
16 good information there. More than I -- more good
17 information even that I get to see I'm sure is there.
18 And I think more timely and increased access to that
19 would be very helpful.

20 MR. DOTY: This has been one of the most
21 concrete, specific, and useful sessions we've had in the
22 entire time we've been doing this. So we thank you.

1 You've brought great preparation to it and you gave us
2 a wonderful bit of information to chew on. Thank you
3 both.

4 Let's take a break and let's reconvene here
5 promptly at 3:45.

6 (Whereupon, a short recess was taken.)

7 MR. DOTY: Well, I was explaining to our guests
8 as the Board assembled how critical it is to have
9 preparers on this panel -- how important to the integrity
10 of this process it is to hear from people that are with
11 us now.

12 Cory Bleuer, Vice President, Controller, and
13 Chief Accounting Officer for BMC Software, one of the
14 world's largest independent global public software and
15 cloud solutions companies since 2006. Previously VP and
16 Controller of EMC Corporation's Captiva Software group.
17 Following that acquisition of Captiva he was EMC's
18 corporate vice president and controller.

19 Bleuer served with -- also with HNC Software and
20 has a long, distinguished career in public accountancy.
21 He was an experienced audit manager with Price Waterhouse
22 Coopers, holding bachelor of science degrees and B.A. --

1 business administration accounting concentration from
2 Indiana.

3 Dan Cancelmi, Chief Financial Officer of Tenet
4 Healthcare Corporation, in charge of the finance,
5 accounting, investors relations, and related function.
6 Previously Tenet's senior vice president and controller,
7 principle accounting officer. Joined Tenet after serving
8 as CFO of Hahnemann University Hospital in Philadelphia.
9 Began his career with Price Waterhouse Coopers where he
10 worked for more than nine years in various positions in
11 Pittsburgh and New York City, including the company's
12 national accounting and SEC unit. A bachelor of science
13 degree from Duquesne and a certified public accountant,
14 of course.

15 Patrick Mulva, three years in the Air Force,
16 joined ExxonMobil Corporation in `76 as a financial
17 analyst at the Baton Rouge, Louisiana, refinery. A
18 variety of financial positions in upstream and downstream
19 operations. He is now vice president and controller.
20 He's been there since July 1, 2004. Chairman of the
21 American Petroleum Institute's Finance Committee. Member
22 of the Financial Executives International, its committee

1 on corporate reporting. Member of the Financial
2 Accounting Standards Advisory Council. A bachelor's
3 degree in business administration from the University of
4 Notre Dame, MBA from the University of Texas at San
5 Antonio.

6 Welcome, gentlemen. Thank you for being here.
7 And please begin. Cory, will you start us off?

8 MR. BLEUER: Thank you. Members of the Board and
9 observers, on behalf of BMC Software thank you for the
10 opportunity to present our views on auditor independence
11 and audit firm rotation.

12 As noted, my name is Cory Bleuer and I currently
13 serve as BMC's V.P., Controller, and Chief Accounting
14 Officer, a role that I've held for just over six years.

15 BMC Software is noted as one of the world's
16 largest independent public software companies operating
17 globally through approximately 75 legal entities and
18 branches worldwide. BMC operates in a specialized
19 industry where the application of accounting standards
20 requires experience industry skill sets, both by
21 preparing companies and their auditing firms.

22 BMC supports the Board's continued efforts to

1 maximize auditor independence and audit quality.
2 However, we believe there are more effective ways to
3 accomplish this goal than through mandatory firm
4 rotation. At the core we believe that independent audit
5 committees are in the best position to reinforce auditor
6 independence through their critical oversight role and
7 that mandatory rotation could, in fact, actually weaken
8 the effectiveness of this core responsibility.

9 At BMC our audit committee takes this oversight
10 responsibility very seriously as evidenced by the rigor
11 of regular interactions between our audit committee and
12 our audit firm.

13 An example that I will highlight is the process
14 undertaken by BMC's audit committee during our audit
15 firm's last mandatory partner rotation cycle. Our audit
16 committee took the opportunity to perform a critical
17 review of the entire firm relationship during which the
18 committee set the criteria for partner candidates and
19 team structure, interviewed multiple partner candidates,
20 and also reviewed the capabilities of two other global
21 accounting firms.

22 This process resulted in the engagement of our --

1 or, excuse me -- re-engagement of our audit firm under
2 a realigned team structure that included new primary and
3 independent review partners each based in separate
4 practice regions and neither previously associated with
5 the BMC engagement. This process was very rigorous, but
6 in the end a strong example of effective audit committee
7 oversight.

8 In addition to the risk of diluting corporate
9 audit committee oversight we believe the mandatory
10 rotation would also have other negative ramifications.
11 First we believe that required rotation would, in fact,
12 decrease audit quality. Auditors must develop and
13 maintain a thorough understanding of industry and company
14 specific business practices in order to deliver quality
15 audits. In our review mandatory rotation would reduce
16 audit quality during transition periods and preclude an
17 audit firm from maximizing critical company knowledge
18 over time.

19 These concerns would be particularly heightened
20 for large multinationals. Complex global companies
21 require audit firms with substantive global presence and
22 industry knowledge. And, admittedly, few firms have this

1 global reach and presence today.

2 While we recognize that audit firm changes do and
3 should occur today these instances are more conducive to
4 effective transition efforts, both by companies and audit
5 firms under the guidance of audit committee oversight.

6 In contrast, we don't believe that it would be
7 feasible for thousands of public companies and a limited
8 number of qualified firms to regularly engage and
9 mobilize resources in mass scale without harming audit
10 quality.

11 Secondly, mandatory rotation would increase audit
12 cost and create other practical constraints on companies.
13 Increased audit firm engagement costs would in our view
14 need to be passed on to companies via higher fees which
15 would be detrimental to companies and their investors.
16 Some estimates that we have seen suggest that first-year
17 audit costs alone could increase by at least 20 percent.

18 Mandatory rotation would also regularly distract
19 company management, personnel, and audit committees,
20 which could also harm critical financial oversight by
21 these core groups.

22 Because of independence requirements mandatory

1 rotation would also limit a company's agility to engage
2 other audit firms to provide non-audit services which
3 could create issues for many companies like us. By way
4 of example, several of the largest global accounting
5 firms could not currently serve as BMC's independent
6 auditor because of independence conflicts today.

7 Mandatory rotation would also create issues for
8 multinationals like us that routinely engage their
9 integrated auditors to serve as statutory auditors at the
10 subsidiary level. Mandatory rotation would necessitate
11 changing integrated and statutory auditors concurrently
12 which would create inefficiencies, incremental cost,
13 expanded audit risk, et cetera, and in some cases may not
14 be possible or practicable to accomplish at all.

15 In lieu of mandatory rotation I'll now offer
16 several recommendations that we have to strengthen audit
17 independence and audit quality. At the core we believe
18 that U.S. regulators should take the lead to support and
19 strengthen the role of corporate audit committees and
20 demonstrate that the U.S. believes there to be a greater
21 and broader benefit to strengthening this type of
22 governance than in taking risky and costly approaches

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1 like mandatory rotation.

2 Building on this view the Board should work with
3 appropriate parties and explore options aimed at
4 improving audit committee best practices regarding
5 independence matters recognizing that optimal audit
6 committee practices may not today exist within all public
7 company environments. We believe that strong, educated
8 audit committees will make appropriate decisions
9 holistically, including changing auditors if and when
10 necessary to protect independence.

11 The Board should also consider sharing inspection
12 results for a particular company's audit directly with
13 that company's audit committee recognizing that statute
14 change may be required here. Again, this is to better
15 enable audit committees to perform the oversight role
16 that I'm discussing.

17 Lastly, we are supportive of having audit
18 committees report additional information to shareholders
19 related to audit firm independence measures. To
20 highlight an approach taken by us I would note that one
21 of our shareholders recently submitted a proposal
22 regarding a form of audit firm independence report for

1 inclusion in our annual proxy with the goal of providing
2 insight into audit committee efforts to protect auditor
3 independence.

4 While we didn't support the shareholder's
5 proposal as submitted, after constructive dialogue with
6 the shareholder we enhanced the disclosure in our most
7 recent proxy to describe processes taken by our audit
8 committee to protect auditor independence. This
9 shareholder viewed BMC's dialogue and openness to
10 increased transparency on this important topic in a very
11 positive light and withdrew its proposal.

12 While this is just an example of an approach
13 taken by us the Board may wish to further explore
14 reporting options such as this which I know you are
15 presently. And we think there are options there that may
16 make sense. That concludes my opening remarks. Thank
17 you.

18 MR. DOTY: Thank you. Dan? Dan Cancelmi.

19 MR. CANCELMI: Thank you, Chairman Doty. On
20 behalf of Tenet Healthcare Corporation I want to thank
21 the Board for inviting me to participate in this
22 important discussion and everyone for taking time out of

1 their busy schedules to provide their feedback today.

2 I'm pleased to have this forum to provide my
3 company's perspective on the concept of mandatory audit
4 rotation and measures that can be taken to enhance
5 auditor independence, objectivity, and professional
6 skepticism. I truly appreciate the opportunity to
7 discuss the benefits and concerns of mandatory rotation.

8 In our comment letter to the Board we provided
9 several key points for consideration as the concept is
10 debated by the Board. I would like to provide a brief
11 overview of those points.

12 First and foremost we believe the creation of the
13 Board by Congress to provide oversight of registered
14 public accounting firms has been extremely beneficial in
15 restoring trust in the financial statements of public
16 companies. We fully support the Board's oversight role.

17 However, we believe the enactment of mandatory
18 rotation could create adverse perceptions regarding the
19 need of the Board's future oversight role. Having
20 previously been an auditor with a large international
21 firm and also most recently as a member of management
22 intimately involved with the external audit process I

1 can't emphasize enough the importance and benefits of the
2 Board's periodic reviews of external audits.

3 I have observed firsthand how serious our
4 external auditors take into consideration the Board's
5 findings and immediately implement changes to improve its
6 audit processes as a result of Board findings.

7 Second, we believe the current five-year rotation
8 requirement of lead audit partners captures substantially
9 all the benefits of mandatory audit firm rotation in a
10 cost effective manner, including the important attribute
11 of a fresh set of skeptical eyes.

12 My company's lead partner just rotated off after
13 five years of service. I can assure you the rotation of
14 the lead partner after five years is essentially
15 equivalent to changing audit firms. When the lead audit
16 partner rotates off management needs to review and seek
17 concurrence for each critical area of accounting judgment
18 with the new partner as well as having to provide
19 background information on all aspects of the company's
20 business, which is tantamount to the process that occurs
21 when a company changes auditors.

22 Many stakeholders have questioned whether audit

1 failures would be minimized if mandatory rotation was
2 required. We don't believe there are conclusive findings
3 or evidence to support this theory. Rather, it appears
4 that most audit failures occur due to intentional or
5 unintentional negligence by auditors and management
6 and/or lack of compliance with existing laws, rules, and
7 regulations.

8 Instead of mandatory rotation we believe
9 continued robust inspections by the Board will hold
10 individuals and their firms accountable for improper
11 actions and are a greater deterrent than mandatory
12 rotation.

13 Also, if mandatory rotation is ultimately enacted
14 in the maximum time period a firm would audit a public
15 company's too short we believe the incentive for firms
16 to fully invest in client service and audit quality could
17 be diminished.

18 Given the fact that there are only four large
19 international auditing firms one possible unintended
20 consequence of mandatory rotation is the creation of
21 financial benefits to the four large firms' business
22 models. Under mandatory rotation we believe there's a

1 strong likelihood that companies will select the four
2 firms in sequential order.

3 Another possible unintended consequence of
4 sequentially rotating firms could be a perception for
5 outside parties to suggest the auditing business should
6 be nationalized -- or is nationalized as the private
7 sector would be compelled to change auditors every so
8 many years with little choice of firms which could lead
9 to higher audit fees as the firms would have less
10 incentive to invest in a long-term business relationship.

11 I do want to point out that after deliberate
12 consideration my company decided to change auditors in
13 2007 after many years with the same firm. It made sense
14 for a company to change auditors at that point in time
15 after our audit committee carefully considered the pros
16 and cons of such a change.

17 However, there are various inefficiencies on a
18 change of auditors and we do not believe it would be in
19 the best interest of various stakeholders if such a
20 change was imposed every so many years. Although there
21 are numerous benefits of mandatory rotation we believe
22 the cost and possible unintended consequences of

1 mandatory rotation outweigh the potential benefits. As
2 a result we believe mandatory rotation is unnecessary.

3 Again, we believe the Board is adequately
4 structured and equipped to provide appropriate oversight
5 of the auditing profession. Thank you.

6 MR. DOTY: Thank you. Patrick Mulva.

7 MR. MULVA: Chairman Doty and Board members,
8 thank you very much for the opportunity to participate
9 in today's meeting to comment on the Concept Release on
10 Auditor Independence and Audit Firm Rotation. We
11 appreciate the Board's efforts to reach out to
12 stakeholders on such a very important issue.

13 We all agree that auditor independence plays a
14 key role in the audit process, which includes forming an
15 opinion as to whether company's financial statements are
16 fairly presented. Independent audits of companies'
17 financial statements provide investors with a level of
18 trust that is vital to our financial markets.

19 Investor trust has also been buoyed by the
20 PCAOB's oversight responsibilities of the registered
21 audit firms. We recognize that this oversight role has
22 improved the objectivity and independence of audits

1 performed on all public companies.

2 Despite these observed improvements, however, the
3 Board has continued to find deficiencies during the
4 inspections. The Board has concluded that the cause of
5 these deficiencies may be related to a lack of
6 professional skepticism and objectivity.

7 On this finding, we respectfully are very
8 concerned that the Board has not provided sufficient and
9 substantive evidence to support this theory. The one
10 specific suggestion in the Board's concept release to
11 address the apparent weaknesses in audit quality is to
12 implement mandatory auditor firm rotation.

13 As communicated through similar forums and
14 comment letters submitted to the PCAOB, views on
15 mandatory auditor rotation basically fall into two
16 groups. Those in one camp believe that a long-term
17 relationship between auditor and the company results in
18 an erosion of auditor independence.

19 On the other hand, those opposed to mandatory
20 auditor rotation state that such a change is not
21 supported by empirical evidence and believe that audit
22 quality would actually decline following a change,

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1 particularly during the first several years as the new
2 firm builds up its knowledge and understanding of the
3 company's policies, practices, procedures, and
4 fundamental control systems. I'd like to note that
5 mandatory auditor rotation has been met with virtually
6 universal rejection by Board audit committees, including
7 ExxonMobil's, as the proposal diminishes the audit
8 committee's role in hiring, assessing, and firing audit
9 firms.

10 If you don't happen to recall my letter
11 specifically, I won't keep you in suspense. I simply
12 don't see that a cause has been made to require mandatory
13 auditor rotation. The Board has not demonstrated the
14 audit deficiencies are directly related to the lack of
15 auditor independence. Unless that case is made, the
16 Board's suggested cure could prove far worse than the
17 perceived ailment.

18 Mandatory rotation would represent a significant
19 process change. Our experience tells us that a change
20 in any process carries with it inherently greater risk
21 of error. We do not believe a speculative marginal
22 increase in objectivity would be worth the combined risks

1 posed by unseating an experienced auditor and replacing
2 it with a new auditor possessing absolutely no
3 institutional knowledge.

4 Equally concerning is the exposure to risk that
5 the Board audit committee would face due to the smaller
6 number of audit firms that would have the global
7 organization and the technical staff to effectively audit
8 large, highly integrated, multinational companies such
9 as ExxonMobil. Suggestions by some to have multiple
10 audit firms conduct audits would simply syndicate the
11 risk and eliminate clear lines of accountability for
12 audits given the likely coordination, communication, and
13 consistency issues that undoubtedly would exist in this
14 sharing.

15 At this point, to suggest such a structural
16 change is premature and risks severely diminishing the
17 significant audit process enhancements that have been
18 made in the relatively brief existence by the PCAOB.
19 Over the last ten years, the PCAOB has continued to
20 strengthen its inspection and investigative efforts, and
21 comments received from these reviews have resulted in
22 constructive, meaningful changes to audit procedures.

1 Additionally, the PCAOB has various enforcement
2 tools which are effective at further improving audit
3 quality. The ongoing use of these tools should continue
4 to drive future audit quality improvements.

5 Within audit firms enhanced quality assurance
6 programs necessitated by the PCAOB have provided a level
7 of consistency and have been an important factor in
8 promoting independence.

9 In addition, the five-year rotation of the
10 engagement partner and the systematic rotation of a
11 portion of the staff each year provides a change in
12 personnel and new perspective and objectivity, without
13 incurring the risks associated with a wholesale,
14 mandatory change to a new audit firm.

15 In short, I believe the Board already has broad
16 powers to effect positive change and sustained
17 improvement through the various tools at your disposal
18 today, which is evident from the success achieved in
19 these years. I recommend that these tools continue to
20 be used to the full extent possible before mandatory
21 auditor rotation be considered again.

22 Many suggestions have been made to enhance or

1 strengthen various components with the current process
2 and framework, and I support the following: more
3 transparency of the inspection results, stronger
4 disciplinary action, more communications with the audit
5 committee, and better auditor training.

6 The Board should give careful and deliberate
7 consideration to these available policy tools, identify
8 those that can be implemented effectively, and then
9 assess their effectiveness prior to revisiting such a
10 drastic and potentially counterproductive approach as
11 mandatory rotation.

12 I appreciate the Board's willingness to listen to
13 all sides of the issue and I thank you for the
14 opportunity to speak to you today.

15 MR. DOTY: One of the problems we always have in
16 these roundtables is to get the panel of preparers -- of
17 chief financial officers -- to discard the ambiguity and
18 the nuances and to tell us what they really think about
19 mandatory firm rotation.

20 You have all -- each of you in one way or another
21 have -- with gratification on our side of the table I
22 must say have referred in one way or another, either

1 explicitly or inferentially, to the things we are doing
2 that are attempts to enhance the audit committee
3 effectiveness.

4 We have Audit Standard Number 16 relating to
5 communications with audit committees that's up before the
6 Commission now, and Cory has mentioned that specifically.
7 We've got a release out in August that encouraged
8 auditors to be candid and forthright with audit
9 committees about what their reports meant -- something
10 I pick up your statements, Patrick Mulva.

11 I take it -- is it -- can I assume for the record
12 that each of you in terms of what you know about auditor
13 independence, skepticism, and objectivity, and your
14 desire for an enhanced audit, you all believe that it's
15 a good thing that Audit Standard 16 and the release on
16 the information about audit inspection results -- these
17 are positive and that you would support A.S. 16.

18 MR. MULVA: Chairman Doty, yes, we support that.
19 We would encourage you to go further than that. We would
20 encourage you to release the findings of all the
21 investigation publicly. Obviously companies can't be
22 named, and obviously firms can't be named. But if we

1 want to increase the focus on objectivity and
2 independence we think that providing that information in
3 the public domain through the public accounting firms and
4 then provide the opportunity to discuss with audit
5 committees will even further enhance the progress that
6 you've achieved in the last ten years.

7 MR. CANCELMI: I would agree with what Pat says
8 about the release of the findings. It was one of the key
9 elements that our audit committee brought up in terms of
10 receiving the nature of the findings on a timely basis
11 so they can evaluate the performance of the current
12 external auditors knowing all the full set of facts and
13 circumstances at that point in time.

14 MR. DOTY: Well, if we can truthfully represent
15 that BMC Software, Tenet, and ExxonMobil all support A.S.
16 and greater transparency to our inspection results
17 this is very helpful to us and we're very grateful. I
18 would have to tell you that the Chamber of Commerce, the
19 organization which purports at times to represent you,
20 hasn't yet come around to that point of view, but I have
21 hope they will. I have some expectation they will.

22 I've been doing this to give my fellow Board

1 members time to develop their thoughts and -- Jay, do you
2 want to pounce?

3 MR. HANSON: I tend to repeat myself a lot and so
4 I'm going to ask myself a question that I asked earlier,
5 which is what's the problem we're trying to solve. And
6 I recently was in front of a group of preparers like
7 yourself and I asked them a tongue-in-cheek question and
8 I won't ask this question of you, but I'll tell you the
9 question I asked, which is, It seems to me that part of
10 the purpose of our exploring objectivity and skepticism
11 is that we don't think auditors are being tough enough
12 on you. And so my question when I had a whole bunch of
13 you sitting in front of me was, Does it feel like
14 auditors aren't being tough enough on you today, and, of
15 course, I didn't expect anybody to really answer that
16 question.

17 But my real question -- and I want to circle back
18 to something that Larry Rittenberg mentioned earlier,
19 which is around the fundamental competency of auditors.
20 And it's interesting we're in an academic institution
21 here and an institution with a mission to hopefully --
22 and the accounting program needs to educate accountants

1 and auditors. And, Pat, I know that you had one of the
2 thins in your statement about better auditor training.
3 And maybe if you could just share with us some of the on-
4 the-ground observations you see about the challenges and
5 maybe some of your frustrations with the people that come
6 to actually do the real work on the job.

7 Because we've heard a lot of questions about,
8 Well, is it the partner that's not being skeptical or is
9 worker bee not being skeptical. But, to me, competency
10 has to underlie -- has to be there before you can have
11 skepticism.

12 MR. MULVA: Thoughts on that? First I'd want to
13 comment that particularly over the last ten years and as
14 this issue's been addressed by the PCAOB I can only speak
15 about one audit firm, that firm dealing with
16 ExxonMobil -- is that they clearly have developed a very
17 comprehensive educational process for their people. So
18 we see very well trained, very competent auditors
19 arriving on our account at all levels -- junior auditors,
20 senior auditors.

21 I think though -- so I would say we've seen
22 improvements. I think though that there's an opportunity

1 to further improve where we are today. And what I would
2 suggest is some level of testing within the audit firms
3 with regard to independence and competency. We do a lot
4 of testing in our company around competencies --
5 computer-based testing where you're asked a question and
6 you get a score. And I think that that kind of focus in
7 training would in particular raise the bar even further.
8 I think it's been raised and people are much more
9 knowledgeable.

10 But in the area of independence, particularly
11 with new auditors, helping them understand what that
12 means, and even some of the people that have been around
13 a little bit longer -- help refresh them to what does
14 that independence issue mean. And the focus of the kind
15 of testing that could go on I think would be a continuing
16 reminder to those people how important that is to them
17 and is very important to us.

18 MR. CANCELMI: I'd like to point out, having been
19 in this business for a number of years, both with an
20 auditing firm as well as on the corporate side, there has
21 been a profound change in the day-to-day involvement of
22 the more senior people with the auditing firms. The day-

1 to-day involvement of the partners on the account I think
2 it's fair to say is much more extensive than it was 10,
3 15, 20 years ago.

4 So I can assure you the level of attention being
5 paid to critical areas of accounting judgment in my
6 opinion has stepped up over the past five, ten years.
7 Our partners are very involved on a day-to-day basis with
8 our organization evaluating accounting issues.

9 The other noticeable change from, say, 10, 15, 20
10 years ago is the involvement of the firm's national
11 office in evaluating issues. If you go back two or three
12 decades I think it was fair to say that you may have had
13 one or two issues that during the course of an audit was
14 raised with the national office. That is not the case
15 any more. There are issues that are routinely raised to
16 the firm's national office.

17 So in terms of addressing, you know, the
18 competence of the field personnel I think it's very good
19 and the involvement and the elevation of issues to senior
20 people within the firm has improved dramatically.

21 MR. BLEUER: I would just add, first, one of the
22 struggles that I personally have on this topic is that

1 over the past, say, ten years I haven't evidenced the
2 lack of this rigor that we're all talking about. Call
3 that fortunate or unfortunate, I would add that even pre-
4 Sarbanes-Oxley -- so go back ten years plus -- I
5 experienced in roles like I have today very strenuous,
6 tough, appropriate audits, if you will, from my audit
7 firms. And I've worked with several of the Big Four
8 global firms, by way of example.

9 So taking that into context I do struggle. And,
10 admittedly to my knowledge, my current organization has
11 not been a subject -- or my audit firm over my
12 organization of a PCAOB examination or inspection. And
13 so I haven't read the type 2 reports or the things that
14 you're all seeing.

15 But from my experience over the last decade I
16 just don't see it or sense it and would just echo the
17 comments that each of the gentlemen to my left made on
18 the teams, the competencies, the critical involvement of
19 the partners, the senior managers, all the way down to
20 staff. Even my organization -- comparing it to an Exxon,
21 if you will, this is night and day in size, but that
22 doesn't mean we don't have global complexity, accounting-

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1 specific, industry-specific issues.

2 And a corporation of my company's size sees and
3 has as part of its audit team multiple partners. I
4 mentioned in my remarks a regular and independent review
5 partner effectively on two sides of the country --
6 different experienced skill sets. Multiple national
7 review type partners touch issues at BMC or that my
8 department deals with virtually quarterly -- more often
9 than not twice or multiple times per quarter. And that's
10 just pervasive.

11 And so it's difficult to conceptualize where some
12 of these other problems are occurring because I see the
13 independence, the objectivity, my team, my CFO --
14 everyone in the group does. And I just have a hard time
15 evidencing the other things you're seeing. But I don't
16 see the problems.

17 MR. DOTY: Jeanette Franzel, we got you late last
18 time. Why don't you go this time?

19 MS. FRANZEL: I'm really following up here on
20 Jay's question and I'm pleased to hear that you all have
21 rigorous audits and I wouldn't have expected you to say
22 that, gee, our auditors are going easy on us. But one

1 thing -- you know, we see the problems, and what we
2 really need to get a good handle on is, well, how do you
3 know when things are going right -- what are your
4 auditors doing right.

5 So where do you see those pressure points
6 where -- you all take comfort I'm sure once the auditors
7 are through and you've gotten a clean opinion. And so
8 what is it about the process that really gives you
9 comfort, both from the auditor's side as well as the
10 audit committee's side because you all are also overseen
11 by the audit committees and you see much of that process.
12 So what is it that really gives you comfort that this is
13 a rigorous process and there's also proper oversight from
14 the audit committee?

15 MR. CANCELMI: One important attribute is the
16 direct one-on-one routine communication that our auditors
17 have with our audit committee without management
18 presence. And it's not just executive session at the end
19 of an audit committee meeting.

20 Routinely throughout the course of the year they
21 are having routine dialogues, meetings with our audit
22 committee discussing issues. In my role there would be

1 times I would not even know that they were going to have
2 that conversation. So it's totally independent of
3 management.

4 And it's the external auditors going to audit
5 committee saying, Here's what our issues are; this is
6 what, you know, we're focusing our audit emphasis on --
7 you know, what concerns do you as an audit committee
8 have. And in a totally independent dialogue without
9 management being involved in that process.

10 MR. MULVA: I would say we're more comprehensive.
11 That's where I get the comfort from management side.
12 And, really, if I may, reach back to -- and why not
13 rotate audit firms. These people have an in depth
14 understanding of our operations, our massive systems that
15 we run, the changes in our footprint, and they carry that
16 knowledge and build on it every day.

17 So when they come to ask the question it doesn't
18 have to be, well, what are you doing in Nigeria. It's
19 a specific question about how we're handling certain
20 controls issues, accounting issues in Nigeria with a
21 depth of knowledge. Or when we've changed a system
22 they've lived through that. And I think that -- to me,

1 where I get the comfort is these are comprehensive looks
2 at our business asking very, very good questions.

3 And then the next step is that -- again, not all
4 that clear on what is shared in the private time with our
5 audit committee, but our external audit meets with our
6 audit committee privately at each meeting. But in the
7 open part of that audit committee meeting where I am
8 there it is clear there are comprehensive discussions
9 that take place on critical accounting issues, control
10 issues -- really, to me, gives that comfort.

11 And I think I can speak at least on behalf of our
12 chairman of our Board or our committee from his comments
13 that were made to you that holistic view that our auditor
14 can bring to each issue provides them the comfort level
15 that the company is getting a very good hard look by the
16 independent auditor.

17 MR. BLEUER: I would just echo the comments made
18 and my comments on the last question. The rigor -- the
19 totality of the entire relationship is evident to me.
20 Auditors aside, my organization and I would like to think
21 and believe we maintain GAAP compliant financial
22 accounting records and would disseminate the same to the

1 public even without the audit firm.

2 I have a generally good perception of where my
3 risk is, where my accounting risk -- financial statement
4 risks are, and it's evident to me that the core focus is
5 all over those risks. I would echo, too, the number of
6 times that through regular or ad hoc meetings management
7 is not present during executive sessions between audit
8 committee members or the audit committee chair of BMC and
9 our auditors. I would say it always exceeds once per
10 quarter or your typical four per year.

11 It's just an ongoing rolling relationship. And
12 it's a triangulation -- not all three points of the
13 triangle in the same room, but once a quarter that makes
14 me feel that there's total safeguard there.

15 MR. FERGUSON: You know, it's heartening to me to
16 hear all three of you say that you think we've done a
17 good job over the past ten years. But I think as
18 Jeannette mentioned from what we see and having looked
19 at inspection reports over ten years and parts of the
20 reports that unfortunately because of the statutory
21 constraints we really can't share with you and can't
22 share with the public -- but I think we have a great

1 concern that, in fact, there hasn't been enough
2 improvement in that we keep seeing the same problems
3 again and again and again and again.

4 And I cannot tell you how many times we've seen
5 firms come and say, Oh, well, we'll do more education,
6 we'll educate more, we'll train people more -- I think
7 the point that we're highly skeptical of that.

8 And one of the interesting things that just
9 happened this year is that the international group of
10 audit regulators just completed a survey of inspection --
11 first time it's ever been done -- just completed a survey
12 of the inspection results of 40 countries around the
13 world by the independent regulators. And they found
14 virtually uniform findings about the world in audit
15 failures, in internal -- auditing of internal control
16 and auditing of estimates and auditing of compliance with
17 the independence rules, and in auditing fair value
18 calculations.

19 So this is where the pressure comes from on the
20 regulators. And it's happening around the world. I
21 mean, you heard Natalie Berger here talking about what's
22 happening in the European Union earlier. It's happening

1 in Asia as well. I mean, auditor rotation is under
2 active consideration in China, for example. It's already
3 been imposed for financial institutions.

4 I'm not sure that's the right answer, but
5 regulators are faced with the problems that these are
6 persistent problems. So let me ask you -- that's a long
7 speech as a predicate for my question -- sorry to bore
8 you with that. But some people have considered
9 alternatives to mandatory rotation because it's
10 admittedly a blunt instrument -- mandatory re-tendering,
11 for example. Periodically you have to re-tender the
12 audit -- full-blown re-tender.

13 Another alternative, which the British have
14 imposed at this point, is that you can retain the auditor
15 periodically, but if you do retain then the audit
16 committee in great detail must explain why it's retaining
17 it. And it's not just that they're the best, but it's
18 a full-blown long form, which is what do you think about
19 proposals like that.

20 MR. CANCELMI: In terms of the re-tendering, I --
21 that process is very similar to a process a company goes
22 through when they're looking acquiring a business or a

1 company is looking at selling a business. It's a very
2 extensive process -- due diligence process where data
3 rooms are set up with thousands of documents and a wide
4 variety of individuals that need to be involved in that
5 process.

6 And if there's -- if the firms do not believe
7 there's a strong likelihood that there will be a change
8 the process probably will not be as robust as it needs
9 to be. And one might argue it's a process that we're
10 just doing it to go through that process.

11 I would tell you that I think the inspection
12 findings -- if there are repeat offenders, which it's
13 individuals or firms, and that information is
14 communicated in a timely manner and in a manner that most
15 effectively puts it out in the open on that firm and on
16 that individual I believe will have a greater impact than
17 going through an RFP process every so many years.

18 I couldn't tell you -- when inspection findings
19 are identified over, you know, the past several years
20 I've heard -- as management I've heard these were the
21 findings that the Board's team -- inspection teams have
22 identified. We need to sit down with you, management,

1 and we want to go through this, this, and that. And this
2 is what we've typically done, but this is what we're
3 going to have to do differently.

4 And I find it very effective. And the public
5 disclosure of firms that -- or individuals that are not
6 following the rules or repeat offenders -- if that
7 continues there might be a need to have a mandatory
8 change at that point in time, which would create a lot
9 of pressure on firms, as well as companies.

10 Because, as a company, I can assure you that you
11 do not want to be involved with an auditing firm that's
12 been publicly embarrassed as deficient. You have your
13 internal and external constituencies, and you as an
14 organization do not necessarily want to be associated
15 with a firm that doesn't have the appropriate quality.

16 MR. MULVA: I'm concerned, like Dan, that re-
17 tendering would divert a lot of resources on both sides
18 of the equation -- the company equation and on the audit
19 firm equation around that whole process. And at the end
20 of the day I'm not sure we got any better but we spent
21 a lot of time.

22 So I go back to a couple of points that I made

1 around, if not that then what. One of them that I
2 commented upon was the overall regulatory environment and
3 the disciplinary action that could be taken. In our
4 view, when you look at the performance of any audit firm
5 with the information that you have from the investigative
6 work that you do and the testing that you do, I think
7 that you can look at an audit firm and see if there are
8 systemic issues in that audit firm and would encourage
9 that if they are systemic to lay on to the audit firms
10 actions that must be taken to address those systemic.

11 On the other hand, in some instances, the
12 problems could be performance. They could be execution.
13 There could be a particular auditor that's not doing
14 their job. And I think that certain disciplinary actions
15 should be put in place.

16 I think it's more teeth in it than spending time
17 on re-tendering and whether or not we're going to get the
18 job and all the rest. I would suggest the look at the
19 disciplinary opportunity.

20 MR. FERGUSON: What about retaining but explain?
21 After a period of time that if you're going the keep the
22 auditor for more than ten years -- whatever it is -- that

1 the audit committee on a regular basis has to explain in
2 great detail why the particular firm is being retained.

3 MR. BLEUER: I would just comment on that -- and
4 I touched upon it briefly in my remarks regarding a
5 company-specific example. I wouldn't be against that
6 speaking as a person separate from my organization that
7 I'm representing. I would prefer that to mandatory or
8 forced re-tendering or go out to bid situation.

9 Just to comment on the latter really brief, I
10 would admittedly prefer -- and I think most corporate
11 panelists would prefer -- a forced re-tendering to a
12 forced rotation. I'll state that but I don't, as well
13 as the fellow panelists here, think that that's the right
14 answer.

15 I think it gives rise to practical constraints
16 and concerns about whether there is really substance and
17 that the corporations and the auditors are really getting
18 into conversations that could likely give rise to change.
19 I believe that audit committees in my example earlier do
20 that occasionally. My situation just under two years ago
21 within BMC was one in which, although without mandate,
22 our audit committee through the partner rotation process

1 effectively re-tendered with the involvement with two
2 other local firms that played through the process.

3 I wouldn't -- to your question more
4 specifically, again, I'd reiterate I wouldn't have any
5 concern with stating a reasonable bound of information
6 or the audit committee, if you will, through proxy or
7 other reporting means as to the auditor relationship.

8 I commented on and was a little bit more fluid in
9 the written comments I pre-submitted about the situation
10 my company went through. It was brought to light as a
11 result of a shareholder actually asking that we do a bit
12 more.

13 But on principal on premise I think it would be
14 hard as a comparison to force rotation to argue that
15 reasonable -- not exhaustive, but reasonable information
16 into the public -- or put into the public as to how an
17 audit committee thinks through the independence issues
18 and why it retains or doesn't retain or how often it
19 gives what considerations to that process could not harm
20 and could only aid the industry and shareholders who
21 might have a concern. That's my opinion.

22 MR. MULVA: I think that there's always been --

1 I can only speak, of course, for one company and one
2 audit committee -- that there's been a rigorous process
3 of considering in the overall independence, but I think
4 the bar was raised following Sarbanes-Oxley and the
5 change in the rules from New York Stock Exchange.

6 And once those rules have been implemented or
7 those guidelines are in place what I see on an ongoing
8 basis, at least, again, within our audit committee, is
9 the continuing discussion around are we getting an
10 independent, comprehensive view of what's going on.

11 So I wouldn't want to tell you that we are
12 looking at re-tendering because we're not. But what I
13 would say is the objective of that is to answer the
14 question does the audit committee really test the
15 independence and the objectivity of the auditor. And I
16 can only speak for one in saying that between the
17 communication that goes on between the auditor and the
18 audit committee and the audit committee's requirements
19 and the charter of the audit committee, at least in our
20 company, that I feel that that's being done.

21 So to then increase or change the -- what I would
22 say I guess is the disclosure I look to the disclosure

1 as saying that's the audit committee's job to ensure the
2 independence and they disclose that in summary.

3 MR. HARRIS: Dan, you changed auditors --

4 MR. CANCELMI: Yes.

5 MR. HARRIS: -- and I'm curious as to your
6 experience. First of all, why did you change auditors?
7 And we hear that after you change auditors that first
8 year is a tough year. Audit risks are going to incline,
9 there's going to be a lot of difficult transition issues
10 to deal with.

11 How did you make this transition? And if you
12 were able to make it relatively easy what does that say
13 about the arguments against either re-tendering or
14 rotation? I mean, we hear these -- we hear the arguments
15 that somehow or other switching auditors, for any reason,
16 is going to be costly, difficult, risk is going to go up.
17 So could you tell us a little bit about your experience
18 and what happened in that first year?

19 MR. CANCELMI: Absolutely. As I mentioned in my
20 remarks we -- you know, our company did change auditors
21 five years ago. It is a -- it's a very comprehensive
22 process that requires a significant amount of time, not

1 only during the proposal stage because -- to be able to
2 provide the information to the four firms, for them to
3 make an appropriate assessment of this potential audit
4 for them, again, it's somewhat similar to going through
5 an acquisition or divestiture.

6 You need to pull together so much information
7 and -- as well as a multitude of individuals within the
8 company just to get at the stage of the RFP process where
9 that firm can make an appropriate assessment of this
10 potential audit. It -- just the RFP process takes a
11 number of months in terms of gathering information,
12 having the firms come in -- and they'll come in more than
13 once and for a number of different days. But very, very,
14 very time consuming. But we thought it was appropriate
15 at that point in time for our organization.

16 After the audit firm is selected I think, as most
17 people would realize, you know, the first year is
18 certainly tougher than, you know, year three or four.
19 Whether the firms would ever, you know, want to suggest
20 that, you know, audit quality in the first year is any
21 different than year four, you know, for malpractice
22 reasons no one would want to suggest that.

1 But it's, you know, significant learning curve,
2 very difficult. Management needs to be fully committed
3 to it and across the organization. And you have to
4 conclude it's in the best interest of the organization
5 to do that.

6 To have that imposed on an organization every so
7 many years, we just don't believe that's the best way to
8 get at the problem. Again -- repeating myself -- but I
9 believe the best way to get at this problem is if
10 individuals continue to perform inadequate procedures,
11 inadequate audits the threat of a mandatory change
12 because of deficient audit practices I think would have
13 a greater impact on this issue than going through a
14 mandatory RFP process every so many years.

15 The other item that many individuals have
16 suggested is having the individual audit partners be
17 personally accountable with their names on the audit
18 opinion. I think that's certainly an interesting idea.
19 It would hold them personally accountable similar to
20 management. The CEO, the CFO, the controller -- they're
21 personally signing their names. So, you know, that's
22 something I certainly would hope the Board would

1 evaluate.

2 But I think those approaches get to this problem
3 in a more effective manner than a mandatory re-tendering
4 or re-proposal process every so many years.

5 MR. HARRIS: Following up on that, first of all,
6 you'd do it again. Right? I mean, would you --

7 MR. CANCELMI: Yes.

8 MR. HARRIS: -- change your --

9 MR. CANCELMI: It was the right thing for our
10 organization. Absolutely.

11 MR. HARRIS: If it's the right thing for your
12 organization, based upon what you seem to be saying,
13 there was a very significant problem with your prior
14 auditor. And if that's the case why shouldn't the
15 regulator be all over that auditor because presumably
16 there's either a quality issue or there's a major
17 substantive problem for you to change auditors.

18 MR. CANCELMI: Well, I just want to clarify it.
19 I didn't indicate that there was a major quality problem
20 with our former auditors. However, if we were associated
21 with a firm that continued to have problems on a repeat
22 basis for a long period of time and did not seem to want

1 to change their practices and learn from their past
2 mistakes I can assure you -- not speaking for our
3 company's audit committee -- but I would assure you that
4 they would have concerns with that.

5 And it goes back to a company not wanting to be
6 associated with a firm that's not considered, you know,
7 world class. You want to be associated with a firm
8 that's world class.

9 MR. DOTY: This -- and the lingo that develops --
10 or the argot that that develops around an issue like
11 this -- this is known as the default provision solution
12 to rotation. In other words, in the event of a series
13 of adverse findings by the PCAOB or other circumstances
14 that add up a problem, combined with tenure or whatever
15 factors might be deemed relevant, as a default the firm
16 must rotate and the auditor is declared independent.

17 It raises a couple of interesting questions, one
18 of which is the one that Jay Hanson raised earlier, and
19 that is would it be -- is your approach limited to the
20 engagement level and not the firm level? In other words,
21 would you be dealing -- would you be suggesting that what
22 we should do is be thinking about building into our

1 enforcement process this as a remedy on an engagement
2 level basis, not with respect to the firm as a whole.

3 And, if not, one would have to worry I think --
4 people would be concerned that a more general
5 pronouncement might create a rush for the door in crowded
6 theater. In other words, what we would not want to do
7 is suggest that what we are saying about a particular
8 engagement suggests that the firm's quality control as
9 a whole is wrong. Can you comment on those? Those would
10 be useful.

11 MR. MULVA: Chairman, I go back to the comment
12 that I made. What I would suggest from PCAOB is looking
13 at the performance of an audit firm at two levels and
14 judging is it a systemic issue. In other words, are
15 there processes in how their doing their training and the
16 overall -- is that the issue or is it an execution
17 issue -- or is the audit itself.

18 And so I would tend to say that judging from the
19 work that's gone on in many audit firms you possibly are
20 seeing -- have very few systemic issues and then it is
21 execution. And then I would encourage specific actions
22 taken at that level as opposed to painting the entire

1 firm. There may be systemic issues and then the entire
2 firm may need to be dealt with.

3 MR. DOTY: Exactly. Exactly. What you're saying
4 is that this is the kitchen we live in -- that the PCAOB
5 is in this kitchen -- that --

6 MR. MULVA: Right.

7 MR. DOTY: -- that's the heat in our kitchen --
8 that we, in fact, are charged with making determinations
9 of whether there's a systemic problem in the firm,
10 whether it's engagement problem in a particular office --
11 that that's what our enforcement and other powers are
12 for. Do you think that -- if that's where we are do you
13 think that it's important that when we find an
14 enforcement problem or a systemic problem that we'll be
15 able to make it public promptly as opposed to having it
16 go through an extended appellate process? Would you want
17 to know, for example, that we have found that your
18 auditor has a systemic quality control problem of some
19 sort?

20 MR. MULVA: The answer -- yes. And, in addition,
21 timely from the standpoint that a lot of the information
22 that we get and we see is two or three years previous.

1 And so we would encourage a timeliness of those findings.

2 MR. DOTY: Well, those are profound comments and
3 they go to changes -- they go -- if not structural,
4 certainly significant changes in the current regime. My
5 colleagues may have other issues. We're going to save
6 a little bit of time. We have to thank you -- all three
7 of you -- for a tremendous presentation and a very
8 enlightening one. Thank you again.

9 MR. MULVA: Thank you, Chairman.

10 MR. CANCELMI: Thank you.

11 MR. DOTY: Now, Cynthia Fornelli, Executive
12 Director for the Center of Audit Quality, will be coming
13 to the rostrum. As Executive Director of the CAQ she's
14 responsible for carrying out the mission and vision of
15 the governing board comprised of eight leaders from
16 public company audit firms, the American Institute of
17 CPAs, and three independent public members.

18 Accounting Today has named Ms. Fornelli one of
19 the top most -- 100 most influential people of 2012, the
20 sixth consecutive year she's received that recognition.
21 In 2011 she was honored for the third time by NAC
22 Directorship magazine as one of the 100 most influential

1 people on corporate governance and in the boardroom.

2 She currently serves as a member of the Financial
3 Accounting Standards Advisory Council, responsible for
4 advising the FASB on technical issues, project priorities
5 and other matters, and the Securities Exchange Commission
6 Historical Society's Board of Trustees class of 2014;
7 previously on the NACD Blue Ribbon Commission on the
8 Audit Committee and their Blue Ribbon Commission on Risk
9 Governance.

10 Prior to becoming the director of the CAQ she was
11 the regulatory and conflicts management executive for
12 Bank of America, and, most importantly perhaps, she was
13 deputy director of the Division of Investment Management
14 of the United States Securities and Exchange
15 Commission -- a long and distinguished career in
16 financial services regulation.

17 Gaylen Hansen -- audit partner and director of
18 quality assurance at EKS&H in Denver, Colorado, chairman-
19 elect of the National Association of State Boards of
20 Accountancy, NASBA. He's responsible for his firm's
21 policies and procedures, a member of the standard
22 advisory group of the PCAOB and the AICPA's Professional

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1 Ethics Executive Committee.

2 He serves internationally on IFAC's Consultative
3 Advisory Group, both the IAASB and the IESBA, both of
4 those being the international audit bodies that we deal
5 with frequently. A panelist on the IFRS roundtable,
6 Colorado State Board of Accountancy member, U.S. Treasury
7 Department Advisory Committee. On the auditing
8 profession there's not much that Gaylen Hansen hasn't
9 been able to do for the audit profession over the last
10 decades.

11 W. David Rook, partner-in-charge, Firm Assurance
12 and Advisory Services at Weaver and Tidwell, LLP, a
13 certified public accountant in Texas. As the firm's
14 partner-in-charge he has overall responsibility for their
15 audit and advisory services at their seven offices
16 throughout Texas.

17 Fifteen years of auditing experience in public
18 company accountancy, a member of the AICPA, Texas Society
19 of Certified Public Accountants, and the IPA of --
20 Independent Petroleum Association.

21 He has been appointed by the presiding officer of
22 the Texas State Board of Public Accountancy as a member

1 of the Technical Standards Review Committee and Peer
2 Review Committee. And he received a bachelor of
3 administration from Stephen F. Austin, magna cum laude.

4 Welcome to all of you and thank you. Cindy, you
5 want to kick us off?

6 MS. FORNELLI: I'd be pleased to do that. So
7 thank you, Chairman Doty and members of the Board and
8 PCAOB staff. I do appreciate the opportunity to
9 participate in the PCAOB's third public meeting on
10 auditor independence, objectivity, and skepticism.

11 You mentioned my career at the SEC. I suppose
12 once a regulator some of that gets baked into you and so
13 I'm going to give a disclaimer of my own and say that my
14 remarks today represent my observations and those of the
15 CAQ, but not necessarily those of any specific firm,
16 individual, or CAQ governing board member.

17 You have my written comments which I submitted
18 and those focus on the development since the March public
19 meeting at which I had the pleasure to attend and
20 participate in. So I would like to just summarize a few
21 points that I outlined in my written statement.

22 Our system of financial reporting is often

1 described as a four-legged stool with preparers,
2 auditors, audit committees, and regulators as the four
3 legs. It's also described as a canoe with four rowers.

4 Regardless of the analogy used we all have the
5 same objectives -- strong, fair markets in which
6 investors have confidence to invest. And with respect
7 to auditors in this system their leg of the stool is to
8 provide quality audits and do so independently,
9 objectively, and with the appropriate level of
10 skepticism.

11 I would like to address the notion that has been
12 raised somewhat during the day today that auditors
13 perhaps are not on the side of investors. I would note
14 that auditors do have investors' interests at heart.

15 And as just a few examples of that I point to the
16 recent fair value debates where the profession fought to
17 maintain fair valuation and also fought for the sanctity
18 of independent accounting and auditor standards setting,
19 the profession's opposition to 404 exemptions for smaller
20 public companies, and to investor confidence surveys
21 where investors say that the party they most trust to
22 look after their interests are auditors.

1 The timing of the Board's review on auditor
2 independence, objectivity, and skepticism coincides with
3 the tenth anniversary of the Sarbanes-Oxley Act, which
4 forms the backbone in the United States of the unique and
5 highly effective system of investor protection, as we've
6 heard a number of panelists say today.

7 The profession has respected and fully embraced
8 the requirements and the spirit of Sarbanes-Oxley and is
9 committed to ongoing efforts to enhance audit quality and
10 independence, objectivity, and skepticism.

11 The work of the CAQ is an example of how the
12 firms have strived to contributed collectively to the
13 development of audit and financial reporting policy and
14 the enhancement of corporate governance in a positive and
15 substantive manner.

16 Each of us with a role to play in the overall
17 system of investor protection has an obligation to
18 continually endeavor to enhance the attributes that
19 sustain audit quality and to continuously improve our
20 respective roles and responsibilities.

21 First and foremost, the firms themselves are
22 responsible for establishing and maintaining a system of

1 internal quality control that fosters these attributes.
2 Firms must use the information they receive from PCAOB
3 inspections, their own internal inspections, peer
4 reviews, and other inputs to understand the root causes
5 and respond appropriately to any deficiencies in
6 particular audits or quality control systems.

7 In addition, firms must not only teach and
8 reinforcement the skills related to the technical aspects
9 of evolving standards but they also must inculcate in
10 their auditors the importance of fusing their work with
11 independence, objectivity, and skepticism. This requires
12 a firm culture that pays explicit homage to these values
13 and supports their conscious application through
14 training, tools, and monitoring.

15 As for audit committees, the CAQ supports efforts
16 to strengthen their oversight role, particularly as it
17 relates to assessing the auditor's performance during the
18 audit and formalizing its views before making a
19 recommendation on auditor retention.

20 We also support the efforts of the audit
21 committee community to find better ways to communicate
22 to shareholders information about the annual evaluation

1 of the auditor. The assessment tool released earlier
2 this week by the audit committee community and supported
3 by the CAQ addresses both of these issues. And as you
4 heard Ken Daly say earlier today this work is ongoing.

5 Also as we've heard throughout the day, the PCAOB
6 also can assist in improvements to audit quality and
7 auditor independence, objectivity, and skepticism. We,
8 too, encourage the PCAOB to utilize the wealth of
9 inspection information gathered each year to provide
10 guidance on how auditors can continue to improve audit
11 quality in areas that are representing the greatest
12 challenges to auditors and are of the greatest concerns
13 to the PCAOB.

14 With respect to the firms, there are a couple of
15 specific initiatives and developments I would like to
16 quickly mention that build on many of the constructive
17 ideas that have emerged from the ongoing public dialogue
18 started by the PCAOB.

19 First, open, two-way communication between the
20 auditor and audit committee is crucial, and improving
21 this process fosters quality audits. To this end there
22 are three projects to note. First, on October 24 the CAQ

1 is hosting a public free webcast on communications with
2 audit committees. The webcast will help educate auditors
3 and audit committee members about the requirements of AS
4 16 and discuss leading practices in the area of audit
5 committee communications.

6 Second, in response to the PCAOB's August 1
7 inspections released, the CAQ has developed and issued
8 a practice aid that encourages proactive auditor
9 communications with audit committees regarding inspection
10 findings and the steps the firms are taking to improve
11 its system of quality control. This topic also will be
12 discussed at next week's webcast.

13 Third is the series of skepticism webinars that
14 Ken Daly mentioned earlier that were designed -- or that
15 are designed to enhance the ability of those with a role
16 in the financial reporting process to develop and
17 maintain an environment and mindset that promotes
18 skepticism.

19 These webinars, along with the white paper that
20 will follow, will address some of the challenges with
21 exercising skepticism that we heard from some of the
22 behavioral economists and behavioral psychologists that

1 you had earlier on in your panel.

2 I appreciate the opportunity to be part of the
3 PCAOB's examination of ideas to enhance auditor
4 independence, objectivity, and skepticism. Again, I
5 believe the profession is strongly aligned with the PCAOB
6 and the audit committee community in the objective of
7 furthering these critical attributes. And we are
8 committed to working with you and other stakeholders to
9 see this through. Thank you.

10 MR. HANSEN: Thank you, Chairman Doty. It's a
11 privilege to be here. And thank you for inviting me to
12 participate in what I think is a very important dialogue
13 that we've had here today. I had the opportunity to
14 attend the Washington meeting and I would say that the
15 quality of these -- each one of them seems to improve.
16 So we're at the end of the day here. Someone said that
17 we were batting cleanup. I said, I feel more like it was
18 when I was ten years ago and I was invited to play right
19 field and bat ninth.

20 I -- let me -- I thought I would share with you
21 a little bit about my background -- my employment
22 background. I've been an auditor almost 40 years. I

1 started right out of college with one of the big eight
2 firms and then actually ended up working for another one
3 later on -- a regional firm -- and was actually self-
4 employed at one point as an auditor. I thought if I got
5 any smaller I'd be the invisible man.

6 But I am currently with a large firm in Colorado.
7 We'd be considered a small firm except for the fact in
8 our market area we're the largest firm in Colorado --
9 really in the Rocky Mountain area with quite a number of
10 professionals. It's my responsibility to be the quality
11 control partner of the firm.

12 I don't have any direct client responsibilities
13 any more with the exception of being a concurring
14 reviewer and EQR reviewer, which I take very seriously
15 and allows me to keep my thumb on the pulse of the firm
16 and what's going on.

17 I'd also like to share with you a little bit
18 about NASBA, since you had mentioned it -- of my
19 involvement with it. NASBA's mission is to enhance the
20 effectiveness of licensing authorities of CPAs and their
21 firms in the U.S. and its territories. Boards of
22 Accountancy take seriously their responsibilities to

1 protect the public interest. They understand the
2 importance of the public confidence and the importance
3 of reliable capital markets. And in that spirit now on
4 behalf of NASBA I wish to convey our appreciation for
5 this opportunity to express some thoughts on
6 independence, objectivity, and professional skepticism.

7 And with that I'm going to depart from my written
8 statement because you already have that. I wanted to go
9 back to my employment. My very first -- and I should
10 move back for a minute. I would also say that despite
11 the fact that I have an opinion on these things there is
12 no consensus like Greg Smith within my firm. I have
13 partners that disagree with my position and they're also
14 individuals within NASBA. So we don't have a uniform
15 position on what I'm going to be discussing today.

16 My first job right out of school -- big eight
17 firm, Southern California. After all the training and
18 everything was said and done my -- the first job I was
19 assigned to was in southern California on a very large
20 utility. At that time it was the seventh largest utility
21 in the world.

22 On my first day I checked in and got my

1 securities card. They gave me a key. I noticed that we
2 had our own offices that key would get me into. We were
3 listed in the phone directory. Went down to the
4 cafeteria to have lunch and no one could tell the
5 difference between who the auditors were and who the
6 employees were. So I felt right at home. That was going
7 to be my home for six months out of the year for the next
8 number of years. Nothing necessarily wrong with any of
9 those things individually.

10 But I wanted to share an experience that I had at
11 the end of that day as I sat down with the audit senior.
12 The audit senior gave me a little bit of background of
13 the firm's history with this particular client --
14 informed me that it was a very important client of the
15 firm, that they had been a client for over 50 years. And
16 his parting words to me as I left that day has sort of
17 haunted me throughout my career. He said, Hansen, don't
18 screw it up.

19 And I tried not to screw it up over the course of
20 my career, and everyone -- when I convey to them and they
21 say, Well, everybody has this anecdotal, you know -- it's
22 just anecdotal, Gaylen. Don't worry too much about that

1 because we've had all these SOX protections that have
2 kicked in, there's audit committees that have more
3 authority now, partner rotation, and so forth. But I'll
4 tell you I would bet you anything that those same sorts
5 of conversations can take place today -- and they are
6 taking place today.

7 In my written statement I'd like to share
8 something with you that I had written about audit
9 committees. While SOX has resulted in a significant net
10 improvement of the audit management, and unfortunately
11 not the audit committee, typically still drive the
12 auditor hire-or-fire decision, at least more so with
13 smaller issuers.

14 In some respects these audit committees have very
15 little real involvement in auditor oversight other than
16 a briefing before the audit begins and again prior to
17 filing. Often, these meetings are merely quick
18 conference calls and usually includes significant
19 management participation. In many cases the focus
20 continues to be driven primarily by a desire to control
21 or reduce fees instead of improve audit quality.

22 In summary, in many instances audit committees

1 continue to exist solely as an alter-ego of management.
2 The role of the audit committee still needs to be
3 strengthened and especially to remove the management --
4 remove management from the hire-or-fire decision.

5 After a few years in L.A. I was transferred by my
6 firm in Denver. And in Denver I worked on much smaller
7 engagements -- worked with venture capitalists. These
8 are the high tech startups up in the Boulder area. It
9 was interesting whenever I was at firm meetings -- and
10 you know how you sit down a lunch and you're on those --
11 in those round tables and you kind of go around and
12 introduce yourself.

13 And whenever I introduced myself I would describe
14 the types of companies that I worked on but I never named
15 any of them. Some of the other individuals that worked
16 on the blue chips -- when you got around them -- to them
17 their chests sorts of puffed out and I work on so-and-so
18 company that everyone has heard of, and, boy, it's
19 tattooed right across my forehead -- and weren't they so
20 much more important than I was in the firm.

21 What they were talking about was the crown jewels
22 of the firm, and they were referred to as our clients.

1 I always could cringe when I read a proposal that talks
2 about our clients almost sort of in a possessive sort of
3 way. And that brings us back to the conversation that
4 occurred earlier -- who is our client.

5 I would submit to you -- I don't agree that it's
6 the audit committee. That might be our boss, at least
7 somebody that can whack us with their arm. But the
8 extended boss is really the investors. And NASBA, in
9 fact, has a little broader view than that. It's anyone
10 who uses or relies on financial statements, and that
11 could be the Government, it could be -- it could be
12 anybody that picks them up. But the important thing is
13 that that's who our responsibility's really with.

14 So we have this important reporting project
15 that's going on, both at the PCAOB and with other
16 regulators around the world. It's interesting is that
17 going through these paragraphs making these important
18 changes and focusing on that that they haven't really
19 spent any time on the salutation where it's addressed to
20 the Board of Directors and the Shareholders. And maybe
21 it should be addressed to the Public.

22 But certainly the standards should at some point

1 define who the client is. If this group doesn't
2 necessarily agree on the client it seems like we have a
3 little bit of work to do.

4 Just a couple of quick things because I know
5 we're out of time here. Board member Harris asked about
6 oaths and swearing in ceremonies. There's a number of
7 states where we do that when people become CPAs -- I'll
8 mention a few of them -- Louisiana, New Mexico, Rhode
9 Island, Texas. And actually we did have a member of the
10 PCAOB -- a Board member attend one of the ceremonies in
11 Maryland. Many of the states have affirmations that they
12 sign too, Steve.

13 Let's see. And then one other thing I think is
14 a problem -- is transitions with some discussions about
15 handoffs. I have something in my written testimony --
16 not testimony -- my written statement. But just wrapping
17 up, I'm still haunted about that statement. I ought to
18 find that senior some day and ask him what he meant by
19 Hansen, don't screw it up. Thank you for the opportunity
20 to present today.

21 MR. DOTY: Thank you. David Rook.

22 MR. ROOK: Thank you. On behalf of Weaver and

1 Tidwell, I'm pleased to have the opportunity to
2 participate in this panel and to present Weaver's views
3 on the PCAOB's Concept Release on Auditor Independence
4 and Audit Firm Rotation.

5 Some history on our firm -- over the past 62
6 years Weaver has become the largest public accounting
7 firm headquartered in the state of Texas with
8 approximately 450 team members located in seven offices
9 throughout the state of Texas. We consistently rank in
10 the top 50 accounting firms in the U.S. as reported by
11 Accounting Today and Inside Public Accounting Report --
12 currently 38th in the country.

13 We offer audit, tax, and advisory services to a
14 diversified client base operating in a variety of
15 industries. Our clients include both privately-held and
16 publicly-traded companies, as well as government
17 entities, typically headquartered in or around the state
18 of Texas, some with national and international
19 operations. And we've provided public -- we've provided
20 services to publicly-traded companies for over 40 years.

21 Our views on auditor independence is that we do
22 agree that independence, objectivity, and professional

1 skepticism are critical to the viability of the auditing
2 as a profession and provide the foundations for a high-
3 quality audit.

4 We also agree with the Board's assessment that
5 the reforms in Sarbanes-Oxley have made a significant,
6 positive difference in the quality of public company
7 auditing. These reforms include many measures intended
8 to improve the auditor's independence and objectivity,
9 including audit committee oversight of the process,
10 limitations on non-audit services, audit partner rotation
11 requirements, and creation of the PCAOB.

12 Since the enactment of Sarbanes-Oxley there have
13 been regulatory and other developments that have improved
14 audit quality such as adoption of PCAOB auditing
15 standards and the development of the PCAOB inspection
16 process. We believe these efforts and the Board's
17 ongoing standard setting agenda will continue to improve
18 audit quality.

19 While we support the Board's ongoing efforts to
20 improve independence, objectivity, and audit quality we
21 do not believe that mandatory audit firm rotation is a
22 concept that will work and, if enacted, could raise

1 significant risks and result in unintended consequences.

2 We have always believed that the danger of a
3 failed audit is greater when the auditor does not fully
4 understand the client's business than from the auditor
5 being too familiar with the client's business.

6 In some of the statements that we were asked to
7 review in participating the reference to the financial
8 crisis of 2008 and 2009 was brought up. And in that
9 process certain individuals made comments that mandatory
10 audit firm rotation may solve that particular crisis.
11 And in our view that was more of a competency issue, not
12 more understanding the client's business or the -- of
13 the financial instruments than familiarity risk.

14 And we agree with the General Accounting Office's
15 2003 conclusion which said in part, Mandatory audit firm
16 rotation may not be the most efficient way to enhance
17 auditor independence and audit quality considering the
18 additional financial costs and the loss of institutional
19 knowledge of a public company's previous auditor of
20 record.

21 And then specifically on auditor independence,
22 independence, objectivity, and professional skepticism

1 are fundamental to audit quality. Our reputation and our
2 people are our most important assets at Weaver. We
3 strive for audit quality in all that we do and
4 continually challenge our staff to regularly employ a
5 health level of skepticism in performing our
6 responsibilities.

7 And at Weaver we believe we practice what we
8 preach. An example of that is in May of 2012 we
9 implemented mandatory independence training for all firm
10 staff of four hours, and we've seen the benefits of that
11 in the past few months.

12 As stated in the Concept Release, PCAOB
13 inspectors have continued to identify significant
14 deficiencies related to complex financial instruments,
15 inappropriate use of substantive analytical procedures,
16 reliance on entity level controls without adequate
17 evaluation of whether those actually function as
18 effective controls and several other issues.

19 Whether the root causes of these deficiencies
20 relate to a lack of professional skepticism or some other
21 factors such as a lack of experience of the team members,
22 lack of technical competence, or a lack of training on

1 the part of the auditor is difficult to determine.

2 And we believe that additional study of these
3 root causes should be done before such a drastic measure
4 as mandatory firm -- audit firm rotation is mandated.
5 And as noted in the Concept Release a preliminary
6 analysis of the inspection results appears to show no
7 correlation between audit tenure and the number of
8 comments of the PCAOB inspection reports. Thank you for
9 allowing us to participate.

10 MR. DOTY: Well, thank you. Jeannette?

11 MS. FRANZEL: I'd like to talk a little bit about
12 root cause analysis and professional skepticism because
13 in our inspection findings we find a lot of things that
14 are labeled as professional skepticism -- and it's a big
15 bucket.

16 And what we really need is some good root cause
17 analysis from the firms on this. And given what we've
18 heard about bias I guess maybe I'm understanding why it's
19 hard for the firms in some cases to do these root causes
20 analyses.

21 But I'm going to oversimplify a little bit. But,
22 you know, we find examples where maybe an entire audit

1 area isn't even audited, you know, so clearly the
2 auditor's not using professional skepticism there in
3 auditing that.

4 We might find a case that -- or just kind of
5 going along the spectrum where the auditor takes what
6 management hands them and puts them in the files and
7 that, you know, serves as the audit work. And that's a
8 skepticism problem.

9 We may find a case moving down the spectrum where
10 the auditor did steps one, two, and three but not four,
11 you know, in terms of trying to challenge and verify that
12 information, et cetera.

13 And so what -- and several people today have
14 called for root cause analysis of linkage -- you know,
15 is this linked to tenure. Well, we need some good root
16 cause analysis. We do attempt to do some of that
17 ourselves here, but, really, these are very complicated
18 situations where the firms really need to go and retrace
19 the steps of that audit team to decide what went wrong
20 here and how can it be prevented in the future.

21 So I'd just like each of you to talk about root
22 causes analysis -- you know, Cindy, maybe any initiatives

1 you have with the firms on that with the CAQ. And then,
2 Gaylen and David, whatever works in your firms for doing
3 root cause analysis because this is complicated.

4 MS. FORNELLI: I'll go first. I think that
5 you're exactly right. Root cause analysis being done
6 both by the PCAOB and the firms is critical to getting
7 not only at issues around independence, objectivity, and
8 skepticism that can negatively impact audit quality but
9 other attributes that negatively impact audit quality.

10 So I think that a number of firms -- certainly
11 the CAQ governing firms, as well as a number of our
12 members, have started implementing root cause analyses
13 within their firms. We haven't yet in initiated a
14 project where we will try to collect that data at the CAQ
15 and look toward that, but at a lunch conversation that
16 we had today informally out on the lovely Rice quad --
17 and congratulations on 100 years -- we had a discussion
18 at the luncheon table about that very project. So that
19 will be something that I will take back to look at.

20 But I think that is a key to this, getting down
21 to it. You mentioned the behavioral discussions that we
22 heard today. I too found those very, very fascinating.

1 And part of what we did when we did these skepticism
2 webinars was actually look at that and look at what are
3 the decisions that -- what's the framework that can help
4 people make decisions so that they can overcome their
5 natural biases. And then what are the tendencies -- what
6 are those bias tendencies that people tend to have.

7 And so I think training and education on that
8 also can help so that you have this decision framework
9 where people look -- try to combat or mitigate those
10 inherent biases as well as then the tendencies to bias.

11 MR. HANSEN: I absolutely believe that the
12 discussions we've had about root cause at the SAG
13 meetings is really -- have been productive. And I
14 brought that back to my firm and we have had discussions
15 about that.

16 It's easier to talk about it; it's much harder to
17 do. And, you know, more work needs to be done on it.
18 In our firm we just simply -- we demand quality. I mean,
19 that's -- there's no ifs, ands, or buts about it. And
20 if a person isn't willing to go there then we have to
21 have other discussions.

22 Now, as a state board member, when I was a

1 regulator -- and I've been off the state board for a
2 couple of years -- these are the things that keep you up
3 at night worrying about whether or not the balance of
4 fairness is there, whether or not you're going to take
5 somebody's license and ability to make a living away from
6 them. So I've been down that road and I know the heavy
7 weight that -- much heavier weight that you folks deal
8 with.

9 There's some people that you're not going to be
10 able to remediate. There's that you just have to come
11 to grips with that. And in this root cause analysis part
12 of it is you have to be able to build an environment of
13 trust because it's sort of like fraud in financial
14 reporting. If -- you have a difficult time cutting
15 through to what really happened unless you have an
16 environment of trust and you can walk through, Jeannette,
17 like you talked about, and take those tracing steps of
18 what really went wrong in order to help someone --
19 they're not going to tell you where they went unless
20 there's that environment of trust.

21 So I think those are some of the things that we
22 work on in our firm and we're going to -- we're not even

1 anywhere near where we need to be on this and I don't as
2 a profession we are. But I think you're going down the
3 right road.

4 MR. ROOK: I would agree with that. Our firm --
5 our leadership team does try to set the right tone at the
6 top. Quality is paramount. If you ask every accounting
7 firm in the country and they were before you they would
8 probably also say quality's paramount to their firm.

9 We do practice what we preach. We have the
10 partner in charge of assurance and advisory separated
11 from our quality and risk management function. That
12 particular partner in charge reports directly to our
13 executive committee, which is independent of the CEO and
14 myself. So I think that's an important aspect of
15 ensuring quality.

16 From a root cause analysis we go through internal
17 inspections annually, including our peer review every
18 three years and then the PCAOB inspection.

19 Annually we still cover issuer audits through our
20 internal inspection process. We look to what issues, if
21 any, are identified in those audits. And then the
22 quality risk management partner, myself, and each of

1 those engagement partners sit down and they go through
2 what went wrong in that particular audit, what the
3 findings were, was it a competency issue, was it a
4 staffing issue, was it a training issue. So I think we
5 do those things well.

6 And I do agree with Gaylen. I think that the
7 profession could do a better job analyzing the root cause
8 analysis -- but that's what we do at our firm.

9 MR. HARRIS: First of all, Gaylen, thank you for
10 the update with respect to the states on the
11 certification -- or the affirmation, and, Cindy, to the
12 extent that the CAQ could consider whether that's an idea
13 worth pursuing on an incremental list as well in certain
14 areas -- not in others. But I think that may be one
15 where we could make a difference.

16 MS. FORNELLI: Yes. I have to say throughout my
17 career I've had to do such attestations and
18 certifications. And, you're right, it does make you stop
19 and pause and think about what it is that you're signing.
20 And so it's definitely we will take back.

21 MR. HARRIS: Well, we have to do at the PCAOB and
22 it certainly focused my mind the second time around. You

1 also mentioned, you know, disseminating expanded
2 transparency report in the October 15 -- and Natalie
3 Berger mentioned that as well. What are some of the
4 ideas that you are considering in terms of an expanded
5 transparency report on the part of the firms?

6 MS. FORNELLI: Well, I think it would be -- in
7 fact, I think some of the largest firms already do a form
8 of a transparency report. We had considered whether or
9 not it should be a standardized transparency report,
10 which does have the benefit of comparability amongst the
11 various firms.

12 But I also think that the firms should think
13 about how they want to describe their systems of internal
14 controls. And that, to me, is the key as an investor
15 that I want to know: what are firms' quality control
16 systems.

17 So allowing them to do that in a way that gets
18 that information out there as opposed to having it in a
19 standardized form I think is probably a better way to go.
20 But I think there should be certain components in there.
21 And so we're very supportive of that idea.

22 We're also very supportive, of course, though of

1 the audit committee having a lot of transparency about
2 how they go about doing their annual assessment. And
3 another point -- and I guess this is one of the benefits,
4 or the harms perhaps, of battling cleanup is that there
5 are a lot of ideas that were explored today that I'd like
6 to touch on.

7 But I think that, you know, having more
8 transparency out there is beneficial. And I think we
9 should all work on doing that. So certainly in the audit
10 committee community I think that's important as well as
11 the auditors themselves.

12 MR. HARRIS: Because that was front and center
13 among the May recommendations and the ACAP
14 recommendations. And obviously these firms are
15 extraordinarily important and I think the more
16 transparency that they give for all parties and interests
17 probably the better off we are.

18 MS. FORNELLI: Well, and I would be remiss not to
19 mention also the auditors' reporting initiative that you
20 have underway. I think that's also a very critical,
21 important, and timely issue. And so we were pleased to
22 participate in that and provide information about what

1 that might look like based on the concept release.

2 So Marty and his team and the Board is to be
3 commended for that as well. And I think that's also a
4 form of transparency -- having more robust disclosures
5 in the auditors' report as well.

6 MR. HARRIS: And then, finally, Gaylen, you
7 mentioned the need to strengthen audit committees. But
8 aside from removing management from the hiring, which is
9 something that Rod Hills is very aggressively supported
10 in the past and he -- from my perspective he's kind of
11 the father of the independent audit committee. How would
12 you recommend that we make independent audit committees
13 more independent?

14 MR. HANSEN: Well, how do you make -- it's --
15 they need to have some distance from the CEO -- from
16 management. And, you know, whoever's choosing the Board
17 members -- whoever has that authority -- it's got to be
18 folks that are a bit further removed. And I think this
19 actually happens in the larger companies. It's the
20 smaller ones that just don't really have a lot of board
21 members to begin with, and they're handpicked by those
22 that are running the company. I think that's where you

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1 have to start.

2 But I think also their skills and the quality the
3 individuals need to be upgraded significantly. I don't
4 see any reason why someone with an audit -- stronger
5 financial reporting background shouldn't be on the audit
6 committee.

7 MS. FORNELLI: May I add to that, if I could? As
8 you well know, in Sarbanes-Oxley it allows for -- if not
9 I would say perhaps even encourages -- audit committees
10 to get expertise if they don't have that expertise. And
11 that is something that in our discussions with the audit
12 committee community that we have very much stressed --
13 that if they don't have the requisite experience, be it
14 financial expert or an auditing and accounting expert on
15 the audit committee that they can under Sarbanes-Oxley
16 get that. And so we would encourage more use of that
17 provision in Sarbanes-Oxley.

18 MR. FERGUSON: Yes. I want to go back to a
19 concept that's been raised earlier today -- or at various
20 times in these meetings -- the concepts of what's called
21 economic bonding. And economic bonding refers to what
22 you talked about, Gaylen, which is if you want to

1 capitalize the value of the long-term relationship with
2 a client, particularly a large client that could have
3 millions or tens of millions or hundreds of millions of
4 dollars of audit firms, and this asset -- this could be
5 an asset worth gigantic amounts of money -- hundreds of
6 millions, billions of dollars.

7 If we're not naive isn't that really the mother
8 of all root causes? I mean, isn't that the 800-pound
9 gorilla that sits in the room with the auditor who really
10 wants to be skeptical and says, Am I going to be the guy
11 who is going to threaten this revenue stream.

12 And as long as that exists are we really
13 whistling in the wind here about thinking that we can
14 make major and significant improvements in audit quality
15 that are sustainable?

16 MS. FORNELLI: Well, I would posit that under a
17 system of mandatory rotation you might still have that
18 incentive. Presumably even if you're rotating every
19 five, ten, 25 years you're being paid for the work that
20 you're doing. And if it's a large, multinational
21 corporation that's going to be a large fee.

22 And so I don't know that the economic incentive

1 is what necessarily leads to a perceived lack of
2 independence, objectivity, and skepticism or a real lack
3 of independence, objectivity, and skepticism. I think
4 perhaps it's more along the lines of the behavioral
5 issues -- is this unconscious tendency to trust in these
6 built-in biases.

7 And so I do think based on my career at Bank of
8 America when I was charged with developing the bank-wide
9 conflicts of interest program -- you know, there are
10 several ways -- and one of the panelists today talked
11 about that.

12 There are several ways to get rid of an inherent
13 conflict of interest, and I think that the issuer pay
14 model presents one of those inherent conflicts of
15 interest. So you can either eliminate it and -- I
16 haven't heard a good alternative to eliminating the
17 issuer pay model, and I think it's been studied for many
18 decades, or you can mitigate it.

19 And I would argue that Sarbanes-Oxley put in many
20 systemic mitigants to that, but we all have to do a
21 better job of also combating this erosion -- potential
22 erosion of independence, objectivity, and skepticism.

1 It's one of continuous improvements. You know, we're
2 never going to get it 100 percent right because we're
3 always going to have to improve, improve, improve. But
4 I personally don't think it's the economic incentive.

5 MR. FERGUSON: What if you coupled mandatory
6 rotation with mandatory retention so that you knew you
7 had this client for a particular period of years and
8 that's all you could have it for. But you would not be
9 removed. The client couldn't remove you so the fear of
10 being fired would be gone.

11 MS. FORNELLI: Well, I worry about that too. I
12 think that also has a set of biases and potential
13 problems if you can't be removed. I prefer a rigorous
14 annual evaluation where the audit committee is annually
15 assessing the auditor's performance and making a
16 determination that the auditor should be retained or
17 replaced. And perhaps as importantly, if not more
18 importantly, is explaining to the marketplace and to
19 shareholders that they've done that assessment and what
20 their findings are.

21 MR. HENSEN: If I might say, I agree with some of
22 what Cindy says, but basically you're preaching to the

1 choir with me. I buy into the notion that there's -- as
2 long as that economic link is there there's a problem.
3 And I essentially favor mandatory rotation.

4 On the removal I'm not as energetic about that.
5 I worry about, as I said in my response -- my written
6 response. Complacency -- I do believe that there's a
7 fair amount of visibility to this and firms can just
8 suffer through it for a couple of years, and it's not a
9 big a deal.

10 So I don't know that that's going to be a
11 deterrent. I am more aligned with the notion of rotation
12 at some level. I go back to what Chairman Levitt said
13 at your first meeting -- your first conference. You
14 know, after 50 or 100 years this just does not --
15 something about this just doesn't feel right. And that's
16 what bothered me way back when, 40 years ago. It just
17 didn't feel right.

18 MR. ROOK: I think what's lost, either in the
19 profession or in the this discussion, is just
20 accountability and holding the firms accountable for
21 doing a quality job.

22 And I don't think that mandatory audit rotation

1 solves that particular issue of do your job -- do what
2 you're hired to do which is an obligation to the
3 investment public.

4 And I don't know that especially not being able
5 to fire -- I mean, coming from an audit partner
6 background if you told me I had an engagement for ten
7 years as a firm but I couldn't get fired from that I
8 don't -- I think you take -- you somewhat undermine the
9 audit committee and what their job and what they're
10 accountable to -- their organization and to the public
11 as well in that they no longer can evaluate the audit
12 firm on an annual basis or every three years or every
13 five years or whatever their policies are to determine
14 if that particular firm's doing a very good job or not.

15 And after two years if you're not serving that
16 client correctly the audit committee should be able to
17 remove you from that position whereas -- I mean, and I
18 think the alternative is the same. If you are doing a
19 very good job -- if it's after five years or ten years
20 or 15 years if the firm is serving that company well they
21 should be able to continue to serve that company well
22 based on the decision of the audit committee.

1 I would go back and speak -- I mean, our firm
2 audits much smaller issuers than an ExxonMobil or a BMC
3 Software or Tenet that was up here earlier. And I think
4 Gaylen spoke to -- there's a difference between the small
5 issuers that we see as a firm and the Fortune 100 or 200
6 companies in the U.S.

7 And most of the smaller issuers -- they may not
8 even have an audit committee. And I think that's where
9 some of some of the skepticism comes in where management,
10 because they don't have an audit committee or the only
11 CEO of a company that has a \$20 million market cap is
12 serving as the audit committee and they're doing the
13 hiring and firing of the auditor. And I think those --
14 that's a different pressure point than your Fortune 100
15 or 200 companies.

16 MR. HANSON: Gaylen, when you said the phrase
17 Hansen, don't screw it up, well, I hear that every single
18 day, usually when I get out of bed in the morning and it
19 continues throughout the day from these guys. So I know
20 those words.

21 I've got a couple of questions around mandatory
22 re-tendering. And I'm going to give you each a couple --

1 some very specific questions around that. And I get the
2 sense from many of the comments that people have made
3 that mandatory re-tendering might be almost as blunt of
4 an instrument as I believe mandatory rotation is.

5 But I was trying to probe earlier with some of
6 the panelists about what's the benefit of mandatory
7 rotation. So I'd like your thoughts on that. And one
8 of the things I had posited that the panel was picked up
9 on was a benefit is my simple statement of demonstrating
10 who wears the pants in the relationship -- that it's the
11 audit committee.

12 And, Gaylen, I'm picking up on something you said
13 a few minutes ago in your statement about the smaller
14 companies -- that audit committees just maybe aren't
15 doing -- now, I want you to comment on whether mandatory
16 re-tendering would give them -- would teach them they
17 wear the pants anymore.

18 And a question that might be difficult for you to
19 answer publicly, but whether you think that in general
20 the smaller company audit committees aren't doing their
21 job. Is it because more they don't know and you don't
22 know what you don't know or they really don't care, which

1 is a very different issue.

2 But on the mandatory re-tendering the -- firms
3 compete on fees all the time, compete on service a lot,
4 but, really, how do firms compete on audit quality. So
5 I'd like each of your comments on how you compete on
6 quality. And if there's any other broader initiatives
7 going on in the profession around even defining what
8 quality is and how firms might compete on it. So I've
9 given each a little bit of an assignment.

10 MR. HANSEN: It's hard to show somebody, you
11 know, what you do when they -- they're not looking in
12 your file and they're not spending time with you during
13 the day and they meet several times a year at the start
14 and the end.

15 So I think that's very difficult to demonstrate
16 to an audit committee. I think it's going to be word of
17 mouth and it's going to be trust and basically the
18 community getting to know you. Now, that's a real
19 handicap for smaller firms, and that's why we're shut out
20 a lot of times. I mention that in my written statement
21 as well.

22 And your earlier question about who wears the

1 pants and the tendering, I've never really been a big,
2 big fan of the RFP process and sort of a rotation mode
3 like this that we're talking about. Oftentimes I've seen
4 it just as a tool to sort of reaffirm the decision that
5 somebody already has made. And then my firm ends up
6 spending a ton of time putting together a proposal -- a
7 lot of resources, time, and energy go into it. And then
8 you find out your hometowned -- you know, that, you know,
9 they just replaced whoever was there earlier.

10 So I think there would be a lot of game playing
11 with tendering -- that it -- concerns that some of my
12 colleagues have is that people end up spending so much
13 time focused on marketing, and that isn't a productive
14 exercise.

15 I wouldn't close the door to it. As I said in my
16 statement I think perhaps maybe there's a hybrid
17 approach -- perhaps it's rotation as well as periodic re-
18 tendering. I think that we need to see -- you know, see
19 how this is going to play out with some of the other
20 participants in other jurisdictions as well.

21 Because I think they're coming up with some good
22 ideas, particularly that -- I had mentioned in the

1 statement the Canadian approach. They just put out that
2 statement that talked about a more comprehensive review
3 where they bring in the auditors and the auditors have
4 to demonstrate how they've -- really have exercised
5 professional skepticism.

6 It's the same sort of question like quality. How
7 do you demonstrate it? It's a tough one to do, but we're
8 going to have to think about it and we're going to have
9 to figure out ways of demonstrating it.

10 MR. ROOK: On mandatory re-tendering, we see this
11 somewhat in public sector arena where if a government
12 entity or a school district -- some of them have
13 mandatory rotation after five or seven years, but a lot
14 of them still -- do have a mandatory tendering process,
15 and it can be very frustrating from an auditor
16 perspective.

17 And do you spend a lot of resources on proposals
18 and really diving into their financial statements and
19 understanding their processes and their controls and do
20 they have risk with -- or issues with ICFR. And, I mean,
21 we could spend 100 or 200 hours looking at a potential
22 audit that may be a 1000 hour audit. And so it's a huge

1 investment.

2 And we've actually gotten to the -- and I'll
3 caveat that with saying public sector practice in the
4 state of Texas is a pretty large part of our business.
5 And we've gotten to the point where we'll actually pick
6 up the phone and call the purchasing agent or the
7 particular liaison and say, hey, is this legitimate --
8 are you happy with your auditor. And usually if the
9 answer is yes we'll decline to propose because just going
10 through the motions -- and we have other engagements or
11 proposals that we think are more substantive that we can
12 target.

13 On example of audit quality -- I mean, on
14 competing on quality I think you can compete on quality.
15 And our firm tries to do that in certain industries that
16 we have expertise, like oil and gas, being a Texas-based
17 firm. And I think it's reputation and branding and --
18 so I think you can compete on quality.

19 We do go through a process where we -- I mean, in
20 the proposal process we talk about how we audit. We use
21 the fact that we do require independence training
22 annually -- or every other year similar to ethics -- our

1 ethics requirement. So those are the ways that we
2 compete on quality.

3 MR. GURBUTT: Thank you, Chairman.

4 MR. DOTY: Cindy, were you going to say something
5 in response --

6 MS. FORNELLI: I was.

7 MR. GURBUTT: Oh, I'm sorry, Cindy.

8 MS. FORNELLI: That's okay. I was just going
9 to -- you mentioned, Jay, defining audit quality and some
10 of you I know have heard the story that I've talked about
11 that when I first came on to the Center for Audit Quality
12 my first task was to define audit quality and then
13 develop metrics to measure it. I actually got laughed
14 out of the room, and one person told me, Cindy, many
15 people much smarter and brighter than you have taken that
16 on and have failed, so good luck with that.

17 But, yet, we have not given that up and we do
18 currently have underway a project trying to at a
19 profession level -- not at a firm level or at an
20 individual partner level, but at a profession level,
21 trying to come up with metrics on how you would define
22 and then hopefully measure audit quality so that there

1 is a way to perhaps better compete on quality.

2 And the other thing I would say in response to
3 your questions, Jay, is that I do worry that with respect
4 to re-tendering -- we've heard a lot today about fees and
5 whether re-tendering or rotation would increase fees or
6 decrease fees. I worry more about the decrease of fees.
7 I think that there is currently a downward pressure on
8 fees and I worry about that. And so I would be concerned
9 that re-tendering could further accelerate that downward
10 pressure.

11 MR. GURBUTT: Well, I had a specific question for
12 Gaylen, but then I had a more general question for the
13 panel as a whole. David mentioned in some of his remarks
14 earlier some of the steps that his firm takes to
15 reinforce professional skepticism. So, Gaylen, I'd be
16 interested in your views on what your firm does in that
17 area and also anything that you think needs to be
18 improved in terms of audit firm culture or systems of
19 quality control potentially.

20 But then I have a question more generally for the
21 panel as a whole, and it relates to something that
22 Natalie brought up earlier on. And she quotes it the

1 investigation that the U.K. Competition Commission is
2 undertaking. And in one of their reports they recently
3 noted that those that have switched have not found the
4 process particularly burdensome or the cost particularly
5 high. Firms go to considerable efforts to ease the
6 process and to manage the risks involved.

7 So I'd be interested in your views as to steps
8 that audit firms take today to manage any potential risk
9 associated with new engagements and, again, anything that
10 needs to be improved in that area.

11 MR. HANSEN: Thanks, Michael. On the
12 professional skepticism in our firm, again -- and I keep
13 repeating the word trust, but a lot of this is
14 consultation and you have to be aware of that lone
15 auditor out there, that lone partner out there that's
16 operating in a silo.

17 Silos are dangerous in the auditing world.
18 It's -- this is a team thing. And if the firm is
19 structured so that individuals are going to get paid, and
20 if you look at the compensation models where -- that it
21 fosters their -- a situation where there's a linkage
22 where they can benefit by operating on their own, then

1 that's a problem.

2 So unlinking those silo opportunities and making
3 sure that there's teamwork going on and that there's
4 consultation that's going on, that there's mentoring and
5 coaching at not just the staff level but particularly at
6 the partner level -- I think that's really, really
7 critical because if you've got people going different
8 directions in their own interest then you could run into
9 some real problems -- my thoughts on it.

10 MS. FORNELLI: With respect to your question on
11 the management of the risks and changing the auditor, I
12 think firms do take that seriously and do try to manage
13 those risks. I think you also though need to look at the
14 risks and the costs that companies have to do to manage
15 those risks.

16 And we've heard about some of those costs. You
17 heard some of that from the CFO of Procter and Gamble.
18 I was stunned frankly by the number of people that are
19 on their engagement that audit their company -- the
20 various countries, the numbers of people. And so it
21 really made me pause and think about what the company
22 goes through as well.

1 The other thing I would say about that, too -- I
2 know we heard this morning from some of the academics
3 that the longer the tenure perhaps the more bias that
4 could creep into the system. But I also think that there
5 are academic studies here in the United States that talk
6 about the higher risks in the first couple of years in
7 a change of auditor. And so I would worry about that as
8 well.

9 And, again, it's one thing if it's a voluntary
10 decision that's being made by the audit committee based
11 on what the company's needs are at that time as opposed
12 to a systematic periodic rotation. So those would be
13 some of my concerns.

14 MR. ROOK: Steps that we take to address risk on
15 new engagements as a firm is -- and we start with what
16 we believe is a robust client acceptance process. In
17 that process an engagement -- or a prospect comes in and
18 we have an approval process to evaluate management, the
19 Board, the audit committee -- and this is both a
20 publicly-traded entity or a privately-held entity.

21 And then the engagement partner's assigned really
22 at a partner in charge of a location level, and then

1 there's a review process in which myself and then the
2 partner -- ultimately the partner of our quality control
3 department ensures that that particular partner has the
4 experience, the industry knowledge, the background to
5 serve that client best for our firm.

6 And that's a very rigid process where -- and
7 there are multiple times annually where we change that
8 particular partner. That's how we mitigate risk really
9 from the top. It also -- there's a risk rating system
10 that we go through and assign risk one to five based on
11 different aspects -- complex accounting issues with the
12 client, the industry that particular client's in.

13 We will assign the engagement quality control
14 reviewer as well based on industry and risk, so that is
15 independent of the engagement partner. And that is also
16 a process that we go through on privately-held clients
17 where that process is independent of the engagement
18 partner. He or she cannot go select who's the EQCR.

19 And then depending on -- again, if it's an issuer
20 client we may require the senior on the engagement to
21 actually have a CPA license and not be in the process of
22 getting that license.

1 And then there are -- the final thing is there
2 are required consultations on new engagements to the
3 firm. And that can be various requirements there,
4 whether it's a purchase price acquisition -- I mean,
5 purchase price allocation would have to be reviewed and
6 various other matters depending on the client.

7 MR. HANSEN: Real quickly. Real quickly. And I
8 would probably echo most of what David has said there.
9 We do similar types of things. We do require on public
10 company audits independent third party investigation of,
11 you know, the background of the audit committee chair,
12 the CEO, and the CFO in all instances unless we really,
13 really know the firm that we're talking about and the
14 principals that are bringing them in. And we still fill
15 out the forms in those situations.

16 The other thing is it doesn't matter what partner
17 brings in a client into our firm. That isn't -- that is
18 not the engagement partner. That assignment is made by
19 our quality review people in the firm and the leadership
20 in the firm and not that -- the fact that someone brought
21 a client in doesn't default to it being their client.
22 This all goes back to the notion of not operating in a

1 silo.

2 And then I had mentioned in my written comments
3 on new engagements this handoff thing -- communications
4 between predecessors and successors. There's a real
5 problem there and I'm glad to see that on the PCAOB's
6 agenda. Hopefully we'll get a chance to talk about that
7 some other time.

8 MR. DOTY: One of the features of this process is
9 that as regulators we want to listen to everybody. We
10 hear a lot of different things. We heard very
11 stimulating and extremely fresh ideas today.

12 Part of that process though is that numerosity
13 isn't everything. We all started the day with an
14 allusion to the 600-plus comment letters and the
15 weight -- the tendency of those letters to grow around
16 certain ideas. And then as you go through the day you
17 hear certain ideas that have a kind of Occam's razor
18 simplicity about them.

19 One commenter points out, for example, that
20 actually there's a great deal of market impact --
21 negative market impact now if a company changes its
22 auditor. The change -- that would be eliminated if you

1 had an extended-term -- 10, 15 years with a handoff.

2 The auditor would gain tremendous leverage in
3 terms of fee negotiations because if the auditor resigned
4 in the middle of that engagement then that becomes a real
5 issue for the market. On the other hand, there's nothing
6 particularly dramatic about the auditor rotating off
7 after a period of years.

8 Issues about the handoff and the knowledge curve
9 occur in all of these. They're real issues as -- they're
10 cost issues. But the interesting thing about it is that
11 the knowledge curve and the distraction of management are
12 always seen as real costs, although those are really soft
13 costs. The soft benefits of having confidence in the
14 audit was reflected by one of our participants later in
15 the day, and those are often not as clearly tallied up.
16 So with handoff procedures and other approaches we've
17 heard a lot today about what could be done to ameliorate
18 some of the problems -- or some of the difficulties of
19 a form of rotation.

20 It doesn't get necessarily easier to sort through
21 all of these. But I think one of the things that we got
22 to today was a lot of data based testimony about what

1 people thought was the structural problem. It came to
2 rest in a behavioral comment that was made, and that is
3 that you've got to do something structurally. You've got
4 to manage conflict of interest.

5 It may be only one more aspect of trying to
6 manage a problem of who is the engaging entity and what
7 is the allegiance that the auditor owes to something
8 greater than the bargaining power of the engaging entity.

9 But it is a structural change. And there was
10 strong testimony today about the fact that if we wanted
11 to deal with conflict of interest we would have to be
12 prepared to consider structural change.

13 We wouldn't have to worry about conflict of
14 interest if we didn't have some of the problems that, in
15 fact, you, Gaylen, alluded to in the rather robust
16 discussions with NASBA. And you laid on the line some
17 of the current problems that undermine quality in the
18 audit, confidence in the quality of the audit. And these
19 were -- these are well publicized failures. So without
20 these we perhaps would not have to worry about the
21 conflict. But we do have to worry about the conflict
22 because persistently time and time again they keep coming

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1 back.

2 And, therefore, it seems to me that the things
3 that I take away from the day are that numerosity in the
4 comments is not going to determine -- or should not
5 determine this issue. We've got to get to more specific
6 and focused discussions about what the consequences
7 are -- what the unanticipated consequences might be,
8 what you do to address those, what, in fact, is required
9 to avoid having it become a blunt instrument.

10 And the question will be I think discussed for
11 some time as to whether, in fact, some form of rotation
12 is necessarily a blunt instrument. Can, in fact, some
13 form of change in the status of the auditor be tailored.
14 We heard this from some of the commentators later this
15 afternoon. And maybe that involves an opt out
16 provision -- something that is not solely within the
17 authority and the power of the PCAOB. I don't know.
18 Michael, do you have a last question?

19 MR. GURBUTT: No.

20 MR. DOTY: Comments -- other comments from Board
21 members?

22 (No response.)

1 MR. DOTY: David Rook, congratulations on
2 becoming the largest audit firm headquartered in Texas.
3 You've done very well by us, and you have brought to bear
4 a perspective that we talk about at the Board that we
5 need, which is a perspective other than the global
6 national firms.

7 Gaylen, I've said already what I'm saying about
8 your contribution, was that it was enormous. It has been
9 enormous over the years, and it becomes more critical as
10 we get into these discussions.

11 Cynthia, we are grateful for the support we get
12 from the CAQ and for the wisdom you all give us on the
13 issues that you comment on.

14 Thank you all. I think we're adjourned.

15 (Whereupon, at 5:51 p.m., the meeting was
16 concluded.)

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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: PCAOB Rulemaking Docket
Matter No. 37 Public Meeting

Before: PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Date: 10-18-12

Place: Houston, TX

was duly recorded and accurately transcribed under
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