NOTICE: This is an unofficial transcript of the Public Company Accounting Oversight Board's October 18, 2012 Public Meeting on Auditor Independence and Audit Firm Rotation.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION

PCAOB RULEMAKING DOCKET MATTER
NO. 37

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PUBLIC MEETING

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THURSDAY,
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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PANELISTS:

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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

W. DAVID ROOK, Partner-in-Charge, Firm Assurance and Advisory Services, Weaver and Tidwell, LLP

GREGORY W. SMITH, Interim Executive Director, Public Employees' Retirement Association of Colorado

DAN M. SLACK, CEO, Fire & Police Pension Association of Colorado

SCOTT WHISENANT, Associate Professor of Accounting, University of Kansas School of Business

STEPHEN A. ZEFF, Herbert S. Autrey Professor of Accounting, Jones Graduate School of Business, Rice University

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P R O C E E D I N G S

8:30 a.m.

MR. DOTY: Good morning, everyone. Welcome to the Public Company Accounting Oversight Board's third public meeting on the board's concept release on ways to enhance auditor independence. We are holding this in the Shell Amphitheater of the McNair Building of the Jones Graduate School of Business at Rice University. And I want to thank Rice University and Dean Glick for providing this venue for this meeting.

We've assembled an August set of panelists today to assist the board in an in-depth examination of an issue that continues to trouble many of the most thoughtful supporters of the audit profession, the subtle and not-so-subtle influences on the auditor's mind-set and the implications of that for the integrity of the audit.

Enhancing auditor independence was one of the main goals of the Sarbanes-Oxley Act of 2002. We have one of the draftsmen of that Act sitting to my left on the panel. In the weeks and months leading up to the enactment of Sarbanes-Oxley, Congress considered requiring audit firm rotation to improve auditor independence but the final statute, as enacted, stepped back. Instead, it provided for partner rotation on public company audits. In addition, it asked for further study of firm rotation.

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

Since then, the financial crisis of 2008 has caused us as a nation to reflect on how dependent our financial system is on high-quality, unbiased, credible audits. It has prompted us to look again at auditor independence, objectivity, and professional skepticism, and to ask whether features of our financial system have allowed companies to become too close to their auditors, and to consider whether there are ways we can improve the reliability and the usefulness of audit reports to the public.

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

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

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

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

As noted in the concept release, the PCAOB inspectors continue to find what is to me an unacceptable level of deficient audits. In addition, inspectors continue to find troubling suggestions of firms showing willingness to put management's short-term interest ahead of investors.

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

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

We have the benefit of the record of our first two meetings, however, and although today's panelists have been invited to provide views on any of the issues raised in the board's concept release, they have also been asked to comment specifically on certain themes, issues, and suggestions from the prior public meetings.

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

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

Jeanette Franzel?

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

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

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

I believe that we need concerted and sustained action from the full range of parties who have responsibility for these issues, including those responsible for accounting education, audit firm recruitment and training, audit firm culture and tone at the top, audit committee and board oversight, as well as the PCAOB inspection process and other regulatory activities. It is paramount, of course, that all of the parties with responsibility throughout the process keep the interests of investors front and center.

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

I believe investors will be well served if the various organizations and groups charged with protecting investors and the public interest and the integrity of the US capital markets work together effectively to achieve these goals. The bottom line is we need to come up with a package of solutions that will be solid and effective in protecting investors and the public interest through independent high-quality financial audits. We also need to carefully consider and analyze the potential costs and benefits of various actions, as well as the risks associated with unintended consequences.

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

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

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

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

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

So some of the things we've done recently including our standard on audit committee communications, AS16, as well as the release we put out to help auditors and audit committees -- I have a framework for discussion about our inspection findings that I think will be very helpful and we've received positive feedback, and I'm interested in doing even more to help audit committees achieve their goals and enhance audit quality.

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

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

We really couldn't do what we're required to do here and what the statute requires of us without help from people like you who are coming here today. We understand that you're busy; we understand that this takes time out of your normal work and normal life to give us our thoughts. And for that we are profoundly grateful. So thank you.

MR. DOTY: Steven Harris.

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

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

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

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

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

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

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

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

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

These roundtables are an excellent opportunity for the board to create a thorough and lasting hearing record before taking any action to explore each of the recommendations brought to our attention. They allow us to very carefully consider the intended and unintended consequences of each recommended course of action including importantly their potential costs and benefits.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Now, to some causes of professional skepticism among auditors which the board has been finding. If one can judge by the textbooks which are used in universities throughout the United States, the way in which accounting is taught in American universities and college effectively is a massive indoctrination or memorization of Generally Accepted Accounting Principles, teaching to the CPA examination.

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

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

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

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

MR. FERGUSON: Could we just do it by telephone line?

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

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

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

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

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

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

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

This kind of teaching does not stimulate students' intellectual curiosity about the problems that gave rise to the standards and the political lobbying that may have diluted the quality of the standards. A good example is the distinction between available for sale and trading securities in Statement 115 of the FASB in 1993. Seldom is it mentioned that this unholy compromise was driven by intense lobbying by the banking industry, or why the lobbying occurred, which helps us understand that this was not really the preference by the FASB and perhaps is going to be changed very soon, but it's still with us today in US GAAP.

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

But nothing is said in the textbooks about these attempts and nor why they have failed. They have failed because the Securities and Exchange Commission, especially the staff of the Securities and Exchange Commission, is very conservative and every time these have been raised, the SEC's accounting staff has opposed them. This has not been true in other countries.

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

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

Prior to the 1980s, audit firm partners would give speeches, and write articles and even books, expressing their views on controversial accounting issues. But not today. The profession is bland and partners are uninterested in stimulating a dialogue on how best to solve the pressing problems of the day. There is no incentive to speak out publicly as partners and firms seek to avoid offending clients.

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

Thank you very much.

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

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

MR. ZEFF: That's fine with me.

MR. DOTY: I've just introduced Karen Nelson, a distinguished professor here at Rice. She is joined by Professor Mark Nelson, the Landew Professor of Accounting at Cornell University's Johnson Graduate School of Management.

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

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

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

Scott Whisenant, Associate Professor, a Fred Ball professor, a fellow at the University of Kansas where he is director of doctoral program in the accounting department. He has a PhD in accounting from the University of Oklahoma, has previously been a member of the faculty of Georgetown, MIT, and the University of Houston.

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

Welcome, Scott.

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

Karen?

MS. NELSON: Good morning, and thank you very much for allowing me to speak with you this morning. It's an honor to be with you here today. I start my remarks maybe following on a little bit of the historical perspective of my colleague Steve Zeff earlier in noting that it's interesting that although concerns about conflicts of interest in auditing and other professions seem commonplace today, the term and, indeed, the concept itself, has a relatively short history, first appearing in law dictionaries and codes of ethics only beginning in the 1970s.

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

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

So what can be done about conflicts of interest? I believe there are three categories of responses that are typically proposed. The first is to fundamentally redefine the underlying relationship to remove that conflict. For example, a judge with financial or other conflicts in a case before her court may recuse herself in favor of another judge with no such conflicts. Short of a radical overhaul of the existing auditor-client relationship, including, but not limited to, the client-payer model, we must accept that this is probably not a possible solution to completely eliminate the auditor's inherent conflict of interest.

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

However, research casts doubt on the effectiveness of conflicts of interest disclosures. The simple fact is that people do not discount the judgment of advisors with misaligned incentives as much as they should, even when those conflicts of interest are disclosed, and I should also note that this is particularly the case for small investors.

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

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

A research experiment comparing these four regimes shows that auditors are significantly more likely to issue a report biased in favor of the client in the regime with neither a mandatory retention nor rotation, in other words, the model currently employed in practice, relative to each of the other three regimes.

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

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

The evidence suggests that audit fees decreased following the introduction of mandatory tendering, but that fees were secondary to audit quality considerations in the decision to either retain the incumbent or appoint a successor. If the incumbent did participate in the tender, however, there was a high probability of retention. Although these findings are difficult to generalize and should be interpreted with caution, there is nothing to suggest here that mandatory tendering would impair audit quality or auditor independence.

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

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

In closing, I'd like to comment on two additional issues inherent in managing conflicts of interest. The first is the cost-benefit tradeoff of various proposed solutions. If these were easy to quantify, then the solution would be much more straightforward and we would likely not be here today. Compounding the problem is that the costs of mandatory audit firm rotation are concentrated while the benefits are diffuse.

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

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

The first line of defense in this situation is a strong and capable audit committee. By all accounts, audit committees have improved in the post-SOX era but more could and should be done to strengthen their role. Research shows that all too often management still plays a dominant role in overseeing the audit function. Moreover, criteria for qualifying as a financial expert do not ensure the level of knowledge and experience necessary to provide adequate oversight.

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

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

MR. DOTY: Thank you.

And Mark Nelson, please proceed.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

So, overall, the model and the extant research, I think, highlight multiple ways that mandatory rotation could increase or decrease auditors' professional skepticism. Under a very short rotation period, I think it's likely that the costs associated with obtaining and setting up new clients would dominate the benefits and under a longer rotation period, the costs are spread over more years, but the benefits of rotation are reduced. And so, on balance, I don't see a persuasive case for mandatory firm rotation increasing auditors' professional skepticism over the life of the engagement.

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

And also, second guessing by a successor auditor may be a low-probability event, rather than a sure thing, reducing that benefit. So, on balance, I don't see mandatory re-tendering is likely to improve professional skepticism, and there are circumstances in which in which it might be counterproductive.

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

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

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

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

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

In our study we also vary whether the audit managers are under pressure to design a particularly efficient audit. Similar to prior research, our results indicate that auditors plan significantly fewer hours when under high efficiency pressure. These results suggest that increasing efficiency pressure, as might occur with more frequent competitive bidding that could accompany mandatory firm rotation, might reduce planned audit effort and thus potentially reduce professional skepticism.

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

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

MR. DOTY: Thank you.

Scott.

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

I'd like to start by saying that in my 30 years in the accounting profession as a student, an auditor, and now an academic, I believe the intensity of the discussions about independence, objectivity and professional skepticism is well justified given the importance of the topic to our profession and to the efficient functioning of our capital markets. The issue before the Board today, and in Brussels, is one that clearly represents a structural shift and warrants careful consideration of the cost as well as the benefits.

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

In my research for that portfolio on auditor independence for BNA and my other professional experiences, an overriding theme for auditor independence rules is clear. The rules serve two related public policy goals. First, the rules are intended to minimize the possibility that external factors will influence an auditor's judgments while performing financial statement attestation functions. Second, the rules are intended to promote investor confidence in the financial statements of public companies.

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

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

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

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

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

Ann Vanstraelen's 2000 study is one of the exceptions to this. She investigates the impact of renewable long-term audit mandates on audit quality. The results of her study suggest that long-term auditor-client relationships significantly increase the likelihood of an unqualified opinion; that is, they lower audit quality except when the long-term audit mandate is in its last year. It appears, as one of my colleagues said last week in an audit symposium, that in this final year the auditors finally drop the hammer down on their clients. She concludes that the findings could be in favor of mandatory auditor rotation to maintain the value of an audit to external users.

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

Using available data from these countries, we investigate the debonding effect of a rotation policy, that is, the enhancement of audit quality in those countries. A comparison of all years with available data pre-adoption to those post-adoption yields some very interesting results, in our opinion.

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

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

The results highlight the importance, particularly to audit market regulators, of considering ways to mitigate the erosion of audit quality during the transition to new auditors under rotation rules, for example, the use of detailed handover files between predecessor and successor audit firms or two-auditor involvement in years of initial audits, that is, the "four eyes" concepts.

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

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

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

To summarize briefly though, Steven Zeff, I think, has given us something of a keynote. He has said, essentially, something must change in the United States in conduct in the board room, in conduct in the governance structure, at the risk of the US becoming an outlier, that we, in fact, may be behind the rest of the world in a governance structure that people can have confidence in, unless some things change.

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

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

Professor Nelson has pointed us to experimental data, in both cases with and without rotation, and with rotation and retention, and has raised some interesting questions that sound -- that go to rest in a subject that Professor Hu is going to get into later which is what are the risks to us if we do nothing in the face of what we know is going to be a rapidly changing commercial and complex environment.

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

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

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

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

Our former GAO member, Jeanette Franzel.

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

Professor Zeff, I was especially intrigued by your statements that the United States might be an outlier in terms of corporate governance and that might be really driving some of the incentives, and I'd be interested in hearing more from you about that.

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

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

How can the education and training of professionals really give them the framework and the basis for thinking critically and making professional judgments and using skepticism in these types of cases because oftentimes auditors are faced by a point of view being presented to them and this is something brand new. And so I'd be very curious to hear from all of your views on how education and training could be changed throughout the entire career of accountants and auditors.

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

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

And, Scott, the lower audit quality during transitions, this must be also related to knowledge so I'd love to hear all of your perspectives on education and training and, Steve, also the statement about the US being an outlier.

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

Professor Zeff?

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

I don't know what movement or what momentum there is in this country or, indeed, what legislative or regulatory organ can do anything about it. Obviously, Congress can; possibly the SEC can. I believe that the New York Stock Exchange and NASDAQ requirements or rules do not indicate a preference here. I could be wrong; I haven't studied them in depth.

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

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

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

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

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

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

MR. NELSON: If I could respond both to the education question and then also to the framing question that you posed -- first off, I'm a textbook author so I'm public enemy number one on this to some extent, and I can tell you that when you're writing an intermediate accounting textbook you face this balancing act because you want it to be comprehensive and you want it be rigorous and you do worry that the people who are consuming this book have to be able to pass the CPA exam but more broadly have to be cognizant of GAAP.

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

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

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

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

In terms of the framing aspect of the research that I was talking about, my main concern here is that when you're dealing with complex estimates -- there's a paper by Griffith, Hammersley and Kadous that look at PCAOB inspection reports in '08 and '09, and they identify sort of two-thirds of these involving estimates broadly defined. I think, is that reasonable to say that it's roughly in that category?

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

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

And then time pressure kicks in and you have people that are struggling to get the work done in the field and the thing that I'm worried that they give short shrift to is critically evaluating the assumptions that underlie those estimates. So that's something -- and our research is holding constant a mandatory rotation regime or a non-mandatory rotation regime, and it's getting at saying if you're focusing people instead on why this might be wrong and if you're trying to shore up the guidelines and the standards and the practices that they're using, to try to be pushing people to be critically evaluating that, that might address a lot of the things that you guys are concerned about.

Does that help?

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

And it was at that point, in my mind-set, as an instructor that I can recall that that was the first moment that I truly understood what we're trying to teach the accounting students, and I've vowed ever since then to make sure that I focus on what we're trying to do as opposed to what we need to do. And I think that's critical for us in our classrooms to really teach from the perspective of how do we provide critical thinking for the students and help them foster critical thinking, and not just teach them rules.

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

The other point that you mentioned, and I think it's a good one, and it's one that -- we struggle often with definitions in our profession about what is audit quality and it's a difficult question to answer. As difficult to answer is what is audit cost. In my mind I tend to align myself with something Andy Bailey said in San Francisco, that the cost of an audit is not the cost that we pay in audit fees; it is the cost of failure. And that cost of failure is quite substantial as many in Houston know from corporate failures such as Enron.

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

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

MR. DOTY: That's very interesting.

Jay, do you have questions for the panelists?

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

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

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

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

MR. DOTY: This is called a jump ball.

(Laughter.)

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

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

So I think part of it, this notion of a fresh look, starts at the very most junior level in the firm with any sort of audit is the notion of maybe not start with last year's files. Think about -- take a mind-set of this is a new client; this isn't a client that we've had for ten, 15, 20, 30, 50 years. This is a client that we don't have any prior audit papers on. This is a client that we need to think of from a fresh view internally so that we don't fall into that trap of opening up the audit papers from the past year.

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

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

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

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

Getting back to the idea of auditing estimates, this Griffith, Hammersley, Kadous working paper -- they interview auditors, audit partners, in addition to looking at PCAOB inspections and they find a real emphasis on auditing the client's process as opposed to developing independent expectations so a circumstance where you're moving people in the direction of a fresh look in the sense of saying don't be focusing on corroborating management's assertions but, as much as possible, coming up with your own independent estimate, I think, is a really helpful way to get as much of that as you can. That's about all I have to share for you on that one.

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

And I heard someone from Enron -- I brought them in my class recently and we asked him some questions about what happened. And I got the sense from him -- similar experience that I had when I was 26 years old when I went in for an eye exam and I walked out with glasses, not knowing that I needed the glasses. But when I walked outside and had this contraption on my head, I could see trees and read signs.

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

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

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

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

And the second thing is we are faced with and shown evidence, for example, of where audits change hands, fees go down -- the great concern that when fees go down inevitably audit quality will suffer. And secondly that the evidence from our inspections is that in the case -- and this is in the context of voluntary rotation, not mandatory rotation, but voluntary, where auditors do change. And there's a lot of that that happens. We tend to find more audit failures in the early years after an audit change than later.

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

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

MR. WHISENANT: Yes, I cited at least a study where we attempted to control for that. Let me back up by saying that we have a selection-bias problem in the US in that when we study auditor changes those tend to be associated with either some type of misalignment, that Karen's looked at in her research, or a problem that the auditor knows about and the audit firm is no longer willing to accept that level of liability or that level of client risk anymore.

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

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

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

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

I worry about the unintended consequences aspect of this that relates to the idea of when there is change, fees are lowered and therefore likely audit quality might suffer. And the thought experiment that we have to do because we don't have the data is what happens in the US when you're having so many changes happen, and what are firms competing on, and if it's, to some extent, fees, how that translates into efficiency pressure which my work and other work suggests translates into deficiencies in audits. And I think that's a real concern.

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

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

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

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

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

So I think there is a sense that when presented with a pool of vast new clients there wasn't a reluctance on the part of the auditors to bring on new clients as we're hearing under a mandatory rotation situation. They were very happy to bring on those new clients at that point in time.

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

And so some of the question about fee reductions, I think, as well, is done in a voluntary environment where to get the new clients as a voluntary switch you do need to make a fee reduction. I have some questions as to whether we would continue to see that fee discounting if we move to a mandatory regime where there there's always going to be available clients coming onto the market and that the fees at that point won't need to be as discounted as we see in a voluntary market. So, again, there, I would caution about extrapolating too much from the voluntary-change literature into what we might observe in a mandatory-audit-rotation environment.

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

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

MR. HARRIS: Mark, you mentioned in your statement other changes in audit standards and practice beside mandatory firm rotation potentially could improve professional skepticism. Because we're creating a record here, what are the three or four specific recommendations that you would leave with us in terms of improving, objectivity, independence, professional skepticism? And at this point, I resist the temptation to talk about corporate governance because that's largely within the purview of the SEC, but there is a common theme with respect to the independence of independent audit committees. For example, going back to a statement by Rod Hills, he agrees with, I think, a couple of you and some other panelists that we're going to hear from later on today that the key to enhancing the independence of external auditors is take substantial action to better ensure the independence of audit committees. But I don't want to go there, I don't want to go to cover corporate governance because that's not within the PCAOB.

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

MR. NELSON: Thanks for the question, Steve.

A few possibilities here. The first is and I know you do this to some extent now, but I don't know how much to mine your inspection data, to really focus in on for each deficiency you identify, ask not only what the remediation approach would be for the firm but also say what sort of guidance could you give for potentially a change in standard could you make that would yield an outcome that you would prefer to what you saw. And I was talking from the perspective of auditing estimates, is it possible that you want to give best practices guidance or even effect standards in a way that moves auditors' approaches to something that you wish you were seeing when you're seeing so many problems in a particular area. And I think mining your inspection data to think about that is really useful.

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

The second then -- and I'm going to talk about communication with audit committees -- I know also that you provide audit committees with some best practices information and some information from inspections but it's at a pretty high level. So could you drill down to a level where you're providing pretty explicit ideas about the ways that auditors should be approaching these high risk areas and require audit committees to require their auditors to be very explicit about how they're doing that.

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

And then the final thing is when you've got these areas that are really clear that you're seeing repeated deficiencies on, I think very clearly signaling to the firms that that's going to show up in inspections and there are going to be very clear problems, penalties for the firms, up to and including required rotation of firm off a client. If those problems are not being rectified, I think that would be very reasonable. That would be a rotation for cause as opposed to rotation generally.

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

And I've read some of these and I'd have to say 50 percent of them are boilerplate, but the other 50 percent I found to be quite informative. And so the 40 model, I think, is one that certainly needs to change, and you guys have addressed this, the SEC has thought about this, so I don't think that this or my other suggestion is going to be that profound, but the Treasury came up with a proposal a few years ago about audit quality, and I don't think many of us in this room could even agree on what audit quality is, but getting more insights into the audit production function I think would help investors.

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

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

MS. NELSON: I guess I would echo some of the comments of my colleagues here. One point I would start with is if mandatory audit firm rotation is taken off of the table for looking at other options -- which I believe is kind of where your question is going, what else can we do -- I think the next best solution might be the mandatory re-tendering in the sense that at that point it's a less blunt instrument, you're not making everyone rotate, whether cause is there or not, but the notion that at least at that point there's a rigorous, careful look at what we've been doing, at what the auditor has been doing, at the audit committee, rather than just assuming that everything is fine and continuing to move forward.

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

I would also reiterate one of the issues if you're thinking of a less blunt instrument is mandatory rotation only when cause has been shown as a result of a PCAOB inspection and that significant deficiencies have been identified, at that point triggering a forced rotation for that particular client-auditor pair rather than for the entire marketplace. But again, I see both of those as nibbling around the edges of the problem rather than tackling the main problem on its face.

MR. DOTY: Professor Zeff.

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

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

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

But I do think we've made some progress in this direction. SAS-99, for instance, now AU-316, at least began to change that to some degree in statements such as do not assume that management is honest and has integrity, and so assume that there's bias and things of that nature, to get the auditor in their brainstorming to think that yes, this management that I've been associated with for 10, 20 or 30 years could be dishonest.

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

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

And then one other specific question, either for you or anybody else, if you want to add to this, as a standard-setter, I can tell you that rulemaking in our current U.S. environment is a multi-year process, and we have many standards on our standard-setting agenda that we want to get to but it's a very lengthy process to rewrite standards and to change the tone of them in the context in which you're talking about. Do you have any ideas how we could get the auditor to think that way by doing something else before we get around to rewriting so many of the standards that we have on our agenda?

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

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

In general, when we're thinking about this from sort of a judgment, decision-making standpoint, the concern would be that once you start someone down an alley of thinking about reasonableness rather than unreasonableness, that pretty strong forces for confirmation bias kick in, and particularly under time pressure people might not think about the converse as much. So the basic idea is that moving people down a line where even though if you ask them what the standards right next to each other, do these differ, they'll tell you no, that would have me do the same thing.

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

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

Another question, though, is whether you would move from where you are right now to something more along the lines of a presumptive doubt or even almost a forensic view of some of these procedures. So in other words, it wouldn't be a reframing but it would be going back through and identifying circumstances where professional skepticism was being described as sort of a suspension of disbelief kind of thing and saying, no, we're really looking for circumstances where we want the auditor to have a heightened view that management's assertion is incorrect, conditional on the evidence available to the auditor.

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

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

So it's trying to give auditors a tool for thinking about how you implement the standards, sort of how the SEC has with different statements that they've made where they're saying we're not changing GAAP, we're helping you understand our interpretation of GAAP. Maybe you can do some things along those lines.

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

Now, we know that these decisions by us are grave decisions, there is gravamen about this because they affect careers, but it is a fair assessment of what your approach is to say that you think that let us suppose rule proposals became impossible because, as Stephen Zeff says, we could not meet the challenge of showing the benefits. If that were the case we actually found, are you suggesting then we should go in the direction of heightening the sensitivity of our own inspection process to where we do not see presumptive doubt and reporting that?

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

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

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

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

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

MS. NELSON: I would add, I think, the question was what could be done in the interim, given sometimes the long lead time to any standard changes, should they occur, and I'll go back to our earlier discussion on education, that this is something that if we can get them young and tackle it at that point, whether it be at the undergraduate level or even continuing education. We had a lot of talk about textbooks and other materials and how that forms people's views as they go through the educational system, there's also a lot of educational materials that are put out by the firms that are used by faculty and other sources, and to the extent that educational materials can be provided to faculty, we're always looking for good educational materials to use in the classroom that would maybe bring out some of these thought processes, the PCAOB's view on, and helping educators provide those supplemental materials to textbooks and to other information provided by firms and other sources, I think that would be something that would be very useful.

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

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

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

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

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

Did you have one more question?

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

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

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

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

In the latter part of the 19th Century, many of them went around the world and created professions, including in the United States. Arthur Young himself was from Scotland, although, in fact, in his case he was a lawyer and not an accountant. And so an awful lot of the early accountants and chartered accountants in Canada and the United States did come from Scotland and they still have a very strong profession. And so I don't know how much this would have contributed to it because they already are on a very high plane, as I would see it.

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

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

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

Brian, yes.

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

I just had one question for any of the panelists, but I think Mark, in particular, mentioned a couple of times the importance of mining inspection data, and I guess Scott and Karen, as you think about choices as to what should be done from a policy perspective relative to improving quality, I'm wondering to what extent you've given thought to the public information that's available relative to inspection results and identifying the varying problems that exist that might be the underlying basis and the root cause of those inspection findings, and in fact, whether you believe it's a necessary precursor to go through that analysis and actually have more information relative to the root causes of inspection data in making the policy decisions that we're talking about today.

Thank you.

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

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

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

MR. WHISENANT: Brian, I would add to that that in many contexts we need to protect the confidentiality of the data, whether it's the tax preparer or the public company that's providing the data, but there are ways to work around that so that we can get to that issues. Karen and I do very similar research and we are often challenged by the level of aggregation of the data that we get, as well as looking at deficiency reports that we can't tie back to the underlying financial statements. So they look good in general, we can talk about them specifically, but it's very difficult for us to then analyze and ask really interesting research questions.

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

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

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

The only other thing I would mention is actually with respect to a comment that Chairman Doty made, and that was with this client-pays model. The more that I think about it that I think we focus on the payment aspect of it, and there's been proposals, the insurance proposal and so forth, where is the money coming from, it's the payments that's causing the problem. The more I think of it, it's not, per se, the payment, it's that the client hires and fires, that's where it's really the problem, the incentive is coming from. And so to continue to call it a client-pays model I think maybe is diverting our attention from the true underlying cause of the incentive problem.

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

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

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

(Whereupon, a brief recess was taken.)

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

From a research standpoint, he's best known for his articles on law and economics of modern capital markets, financial innovation, and corporate governance. His latest article, June of this year, suggests that the SEC's disclosure paradigm, in place since the Depression, is increasingly undermined by innovation in financial theory and practice and offers ways forward. A series of articles offered the first systematic analysis of debt and equity decoupling and coined terms that have come into worldwide use such as empty creditor and empty voter.

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

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

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

Professor Hu.

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

There's a joke that made the rounds in the old Soviet Union. The CIA, FBI and KGB each had declared their agency to be the best crime fighting unit in the world. At long last, a contest was structured to determine who really was the best. A hare was released into each of three forests, after which each of the best and brightest of each agency was set to prove their mettle. The CIA recruited various animal informants throughout the forest. All the plants, streams and minerals were interrogated. After months of search and analysis, the CIA declared the forest, in fact, contains no hare. The FBI spent two weeks crisscrossing the forest. Having turned up noting at all, the FBI agents burned the whole forest to the ground, all animal life, the hare included, goes up in flame. The FBI issues a highly publicized report trumpeting their success. The KGB was much more efficient. A mere two hours after the start of the contest, triumphant KGB agents, the whole search team, emerged from the forest. They drag out a large bear beaten to an inch of its life, howling at the top of its lungs: Yes, yes, I'm the hare, a hare I tell you.

(General laughter.)

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

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

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

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

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

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

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

In broad outline, this future exemplary performance approach would work as follows. As a general matter, there will be a fixed rotation period of some type, some length, let's pretend ten years, however, the existing accounting firm could seek a waiver from the PCAOB. And what's the overarching standard that the PCAOB might want to use in terms of deciding whether to grant such a waiver? Well, the standard is who would have a greater likelihood of delivering truly exemplary performance over the next ten years.

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

So that the PCAOB could consider the quality of the existing accounting firm's past performance, and one possibility is not only to consider the past performance with respect to this particular company, the current company, but in fact, in terms of its performance across various companies that it has audited, including small companies, that this kind of system -- in fact, when you think about incentives, this kind of system may lead to all kinds of benefits where smaller companies, who otherwise might feel neglected, that these accounting firms want to show boy, they are exemplary or close to exemplary all the way through.

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

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

But past performance is only one aspect in terms of this approach. That is, we also want to take advantage, for instance, of the unique information the existing outside accounting firm may have in terms of assessing the likelihood of future exemplary performance. The existing accounting firm really does have special information as to the particulars of that particular company, of what might be involved in terms of the learning curve in terms of bringing new people in. We should benefit from that. In terms of its decision-making, this is valuable information.

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

This is a relative issue, not an absolute issue in terms of exemplary performance. That is, the existing accounting firm may only have done a B-plus job on the usual inflated grade curve, B-plus job, but if that existing accounting firm can show that despite one's hopes for some new accounting firm coming in, swooping in and delivering exemplary performance, maybe this existing accounting firm can show that even if you bring this new person with all the attendant costs and so forth, learning curve and so forth, you'll still end up with a B-plus performance, hey, maybe you should be satisfied with B-plus performance and keep the same person, keep the same accounting firm.

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

In terms of possible effects, this, again, avoids a blunt mechanistic approach that ignores totally information that's relevant to a particular case, and that we don't fall into the trap of the grass is always greener on the other side of the fence, that somehow the new accounting firm will get everything right. That's not realistic. This offers, perhaps, more of an apples to apples comparison and some more reasoned information-driven, fine-tuned approach.

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

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

Lots of big caveats, lots of open questions: you know, how long should a term be, what data should be looked at, to what extent should the various inspection reports, the efficiency analysis play a role. And there are lots of costs. Frankly, this may tax the resources of the PCAOB. Making a determination whether or not to give a waiver has huge consequences for an accounting firm. Will the PCAOB have resources, the necessary sheer manpower and specialized expertise to make these judgments, and keeping in mind that inevitably people will be concerned about the centralization of power in the PCAOB, that people may be very concerned about the centralization of power in terms of PCAOB forcing or not forcing, in effect, rotation.

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

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

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

The article's main thesis is that this

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

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

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

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

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

In a sense I first offered these ideas in February at a symposium that Chairman Doty was kind enough to come to, the article was in final stages of editing in mid May of this year when the JPMorgan Chase chief investment office, also known as the London Whale problems, derivatives problems starting emerging. So I managed to quickly add a section to the article dealing with JPMorgan Chase, and I used this JPMORGAN Chase chief investment office, these derivatives issues to illustrate, in fact, these very themes that I had been arguing. Which points out that academics have a conflict of interest -- right? -- we profit from disaster. But anyway, so I used the JPMORGAN thing to illustrate some of these kinds of roadblocks to good depictions, and also to illustrate some of the potential solutions.

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

Such pure information can, theoretically, be more granular, more accurate than the intermediary's depiction and free from possible intermediary biases and misunderstandings. However, at the same time, this intermediation will also leave investors bereft of an intermediary's efforts to analyze and distill the object reality and incorporate their resulting very valuable insights in the intermediary's depiction.

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

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

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

So thank you very much.

MR. DOTY: Well, first, the practice here for me to turn to my Board members, but while I allow them to gather their thoughts on what you've just said, I would explain or I would say that I found the article terrifying, absolutely terrifying, and it relates to some issues that Phil Wiedemeier, who is in the audience here, and others have brought up with us from time to time, and they bear directly on the Board and its mission. In addition to containing some statements by Judge Landes and by Joe Kennedy about how they never found the accounting profession on the right side of the investor issues, we'll put that in the historical footnote area.

You note in the JPMORGAN London Whale, you see four areas of slippage between what the company understood or could have understood and what happened. You note slippage between the intended mathematical concept and the contract provisions of the derivatives, slippage between the contract provisions of the derivatives and the computer program, the computer's depiction of reality as effective reality, slippage between the prospectus selling the securities and both the contractual provisions and the computer program -- that's the prospectus depiction versus true reality theory -- and then slippages in the mapping of the prospectus depiction of the reality and the true reality.

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

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

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

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

With that, I think I will shut up and tell Board members and staff why I was worried about this, why Henry's theory I find to be a threatening theory in the way that Descartes and some of the early philosophers were threatening, and let people chime in. Does anybody want to chime in?

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

But in terms of the analysis, in terms of the distilling of information, what is it that our Office of Research and Analysis ought to be researching, analyzing, mining, whatever. So whatever thoughts you have of that, maybe when you're in Washington at some point, you can meet with Greg Jonas. I think it's essential that we look at that. So thank you very much.

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

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

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

MR. HU: Board Member Ferguson, I agree totally with you, we don't want to have a situation where we have to throw anybody out. That's precisely the motivation, if you will, for this kind of hybrid or halfway approach. And I'm just as concerned in terms of the notion of the need for proper safeguards, and you can well imagine here you have -- you could characterize a Stalinist system, one central body determining who gets to be auditor and I'm as concerned about that, that's why I raised the issue.

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

And in terms of the procedural safeguards, perhaps one of the things that can happen is some kind of limited public greater disclosure but perhaps not the whole thing, limited public disclosure so that there would be greater opportunities for, in effect, challenges to the deficiency analysis, public challenges and public discussion and so forth. But I agree with you fully that this is one of the fundamental problems with this approach but it does offer something that currently is not being used.

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

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

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

MR. HANSON: Right. And the context that we don't go looking for things that are done right, we only go looking for problems and we have a very sophisticated screening mechanism looking through the issuers to say where do we think the problems are, and we match that up with the data we know about the firm and the office and the individual partners, so we go in looking for problems and we're very good at finding that hare. And so we don't, within any given engagement and for any one of the major firms, we maybe only look at 5 percent of their audits in a year and we don't look at the whole engagement, we don't go looking for what did they do right.

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

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

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

I'm sorry, the second question relates to?

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

MR. HU: Right. I am leaning -- that's why I was thinking about throwing out the idea, perhaps you actually care about its overall performance across a lot of engagements. Because , number one, if you simply zoom in on a couple of firms, a couple of company audits as being subject of the special rotation system, if you will, that accounting firm may, to some extent, neglect in terms of be rather loose in terms of how it approaches audits of smaller companies or companies not subject to it. And so that you might want a system where, in fact, you look across engagements simply because you want that firm to have quality control across companies, so that there is some incidental benefits to this beyond that particular company.

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

MR. DOTY: Other questions?

MS. FRANZEL: You've presented us with some very intriguing and insightful comments. With regard to your comments about the banks, the very large banks that might be too big to fail, too complex to depict and too complex to exist, I have to question how they can possibly be auditable, and I think that's something we all need to come to terms with and it's going to take a long time to figure that out.

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

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

MR. HU: Quality control at the GAO.

MS. FRANZEL: Exactly. And I think we would want to work through some of those issues here too, you know, what is the role of each of the parties, including the PCAOB, in a system where firms would be measured prior to this type of system being put in place.

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

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

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

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

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

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

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

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

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

Michelle Edkins. Managing director at Blackrock and global head of the corporate governance and responsible investment team for 20 specialists based in five key regions internationally. Responsible for her team's engagement and proxy voting activities in relation to the companies in which Blackrock invests on behalf of the clients, and she is on the firm's government relations steering committee. Active participant in public corporate governance debate. Regularly speaks and writes. Chairman of the board of governors of the International Corporate Governance Network. An economist by training, Michelle has also worked in the UK in a number of governance-related roles and in government roles in her native New Zealand.

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

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

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

Robert, start us off.

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

What I'd like to do today is comment and make suggestions that the Sarbanes-Oxley Act actually offers audit committees, and particularly audit committee chairs, significantly more opportunity than I think is generally understood to mitigate the concerns regarding lack of professional skepticism, independence, and auditor- management coziness.

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

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

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

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

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

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

What are my general expectations as a board member? That I'm provided adequate access to information, it comes in a timely manner, and there's sufficient detail to allow thoughtful analysis and adequate to provide the opportunity to develop an informed point of view. Part of that process is reaching out in a very proactive way, whether it be to management, consultants or the external auditors, to satisfy what's required to reach the judgments that have to be rendered. I have to be comfortable in the end that I understand the issue and have an informed point of view. In 2011, Allied had over 50 board meetings, so it just goes to show a monthly board meeting typically in a high stress situation is far from enough.

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

So how do I approach these responsibilities? I proactively work to have a good and very open relationship with the finance staff, the internal auditors, the external auditors, and yes, the chief risk officer. I try to create a tone that instills trust and confidence, that all the individuals that are involved in the financial reporting process have full access to the committee, I create the expectation they're expected to proactively come forward, and also that there will be a constant dialogue and it will be much more than just the formal meetings.

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

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

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

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

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

A couple of observations. I'm reading from

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

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

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

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

In my view this criteria is necessary but not sufficient for a chair of an audit committee. A couple of recommendations. The audit committee process, in effect, the audit committee chair should be held to a higher bar for qualifications to serve as chair of an audit committee. I think we need criteria that relate to judgment, maturity and experience, and also substantial experience with process of setting accounting standards, implementing accounting standards and financial disclosures is important to provide the leadership for the process. Frankly, I would also add an additional educational requirement for audit committee chairs over and above those for audit committee members.

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

I'd like to read from the testimony of John

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

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

So what do I worry about? The first thing I worry about may be something that you would turn over to the FASB rather than deal with the PCAOB, but it's sufficiently important that I did want to mention it. I worry as accounting becomes more complex and subtle that we begin to lose the linkage between corporate earnings and corporate operations; what's actually going on in the business. As I indicated earlier, the day after I finished the restatement at Fannie Mae I stepped down. Why did I do that? I felt I was ultimately qualified to drive the process to do the restatement, but in looking at the restatements, I didn't feel I had the ability to see the same level of linkage between the operating results and what the accounting statements were saying, and I felt someone who had substantially more experience as a CFO in financial services could better serve at that point than I could, so I stepped down.

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

There's another item which is new to me, and I've just been made aware of and I'd share it with you, and it may be something that you actually understand better than I, but I found in an engagement letter from external auditors, there's the concept of offshoring where they can actually move a portion of the audit work offshore. I guess it may turn out that all this is fine and okay, but I guess I want to understand the level of professionalism, the training, the security, the controls around the work that actually moves outside the United States for companies based in the U.S.

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

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

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

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

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

MR. DOTY: Thanks, Bob.

Ken.

MR. DALY: I, too, would like to express my sincere appreciation to the Board allowing me to speak today regarding the Board's concept release on auditor independence and audit firm rotation. As you're aware, I have provided a written version of this commentary.

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

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

NACD has concluded the following three things: One, the corporate director community shares the PCAOB's views that external auditor independence, objectivity and skepticism are critical objectives to pursue. Two, mandatory audit firm rotation is not seen as an effective way to achieve that objective. Three, audit committees can and will take a lead in the oversight of achieving auditor independence, objectivity and skepticism.

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

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

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

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

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

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

There's some important features of this tool: one, it is scalable; two, it specifically includes and evaluation of the auditor's independence, objectivity and skepticism; and three, it encourages audit committees to advise shareholders that they've conducted the evaluation of the auditor, as well as the process and scope of the evaluation. It has been vetted by the NACD's national Audit Committee Chair Advisory Council and our national board of directors, all corporate directors themselves.

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

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

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

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

A third component of effective oversight, let's take a look at director education and awareness along with improved disclosures. Our coalition of leading organizations currently making the auditor assessment tool more broadly available throughout the United States boardrooms will also educate the audit committee community about effective use of the tool. We convene advisory councils of audit committee chairs and institutional investors annually to examine how committees can do a better job of communicating the rigor of oversight to shareholders. On November 1, our Audit Committee Chair Advisory Council will meet specifically to examine enhancements to audit committee disclosure.

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

This is just one of the tools we're developing in collaboration with the Financial Executives International, the Institute of Internal Auditors, the Center for Audit Quality, to aid in the detection and deterrence of fraud. NACD promotes the sharing of leading practices between corporate directors and we continue to educate on a wide range of audit committee responsibilities: oversight of the auditors' performance, financial reporting and a need to employ a healthy dose of skepticism in their work.

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

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

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

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

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

Thank you.

MR. DOTY: Thank you, Ken.

Michelle.

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

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

I think you're probably aware Blackrock is a major investor in public companies, both from the equity side and the debt side, so this is clearly a very material issue for us. Another aspect of our investment strategy that informs our thinking is that we make a significant number of investments through index strategies, so our clients are basically locked in investors over the long term. And a number of the issues that come up in accounting and auditing are long-term issues over the period that they play out, so this is, again, clearly quite material.

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

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

Our corporate governance program is an investment function. We see it as part of our fiduciary duty to monitor the companies that we invest in, in relation to how they are protecting and enhancing the value of our clients' assets, and so we have our own policies for how we do that which reflect market standards. They're applied pragmatically, and the key point which builds a little bit on what Ken has just said, the onus is on companies to explain and justify the approach that they are taking to their governance.

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

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

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

When we talk about engagement, what we're really talking about is talking to boards and management about how well they're running the company and our focus is on the board because that's the link between the shareholders and management. One of the most powerful sanctions that a shareholder has if they think the board is not working in shareholder interests is to vote against the reelection of directors.

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

The other aspect of that is an improvement in disclosures or communication, and another observation I would have, as someone who's only really been close to the U.S. governance system for a year or so, is that too many of the documents that are issued by companies around governance are more a disclosure or regulatory reporting type of document than a communication document. And I think a lot can be done there in terms of improving shareholder understanding about the approach a board is taking, demonstrating board oversight of management, how the board members are fulfilling their responsibilities to shareholders and to the company, and explaining company-specific situations. Because we are very clear as an investor that governance has to be looked at on a case-by-case basis, there isn't a single approach that would apply to everybody, but companies have to explain why the approach they are taking is in the interest of the investors.

When all of this is applied to the audit committee, our focus is definitely on the independence of those members and on the expertise. I think there's a lot that can be done to improve both at the level of the appointment. So independence of thought is very difficult to assess if you're not inside the boardroom, but that is basically what we're talking about when we're talking about independence. There are a number of different criteria that are a proxy for what independence is, but what we're really looking for is demonstrated independence of thought. And we think that improving the appointment process and ensuring that it is a formal process and that the board explains the process that was undertaken to appoint new directors, that the biographical notes of directors are more fulsome than they are right now. I don't know how many of you have the joy of reading proxy statements, but an awful of them look a lot alike.

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

We also think that board evaluation should become a formal part of the annual board process, and whether that's done externally or internally is very much up to the company, but as part of that succession planning so that you are sure that you always have board members who are willing and able to become audit committee members should a gap arise. And in addition to the sort of board evaluation, the succession planning, periodic refreshment of the board, so the regular but periodic introduction of new board members.

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

Another thing that we're quite keen to see but it's, again, incredibly difficult to assess from the outside, is that auditor skepticism, which is clearly your focus, is matched by audit committee skepticism so that they trust that the process has been a good one but that they verify that. And from our perspective, that's having a sense that probing questions have been asked by the audit committee members, probably under the leadership and guidance of the chairman -- because, you know, I think that is how you have effective boards, good leadership by chairmen and chairmen of subcommittees -- and that those probing questions are asked of the auditor and of management so that the audit committee can marry up the versions of the stories that they get.

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

And when it comes to sort of assessing the audit firm, I think there are a number of things that we would like to be sure that audit committees were checking, and it is around the continuing training that the audit firm offers its staff and its senior partners, how mentoring systems work, so how knowledge transfer and experience is shared within the company. The culture around staff professionalism, so this idea that it isn't just about following rules, it is about having professional judgment and exercising that judgment.

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

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

I think when it comes to the audit committee members themselves and their continuing development, one of the, I think, quite encouraging changes that we have seen in the U.S. is more informal interaction between board members around specific issues, so around what the audit committee should be doing, what is its responsibilities, how does it implement those. I know a number of initiatives, NACD being one of the market leaders, but also smaller groups, like the tapestry networks, where they in private have these quite open discussions about sharing best practice, and I think that helps improve the professionalism of the directors.

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

When it comes to the reporting to shareholders or sharing information with shareholders, I think there's a lot more that could be included in audit committee reports. And one thing would be having more detailed terms of reference provided in public domains, either on the website or in the annual report, but detailed ones, not very sort of plain, boilerplate ones. Discussion in the audit committee report about the level of non-audit services compared to audit and the fees on both, and why that is appropriate. The areas of focus of the audit committee during the year, any special projects undertaken, any policy changes that were approved by the committee, and the policy on either rotation or re-tendering and why that approach is in the best interest of shareholders and how that determination was taken. And also, justifying the retention of the current auditor where there have been material misstatements or control issues disclosed.

Another aspect that may, I think, be something quite novel is making the audit committee chairman available to meet with shareholders on request. And I don't imagine that that would be picked up very often because shareholders, in principle, do believe the board is doing a good job and working in their interests, but where there are concerns, our view is these are much better expressed by the shareholders directly to the board members in private rather than waiting for the whole thing to blow up in public. That's a much better way of protecting the value of the company.

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

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

Thank you.

MR. DOTY: Thank you, Michelle.

Larry.

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

I'll try to give you perspectives today from my experience as an academic for many, many years, 35 years, but also in practice, serving on audit committees and now chairing an audit committee. I was asked to address three fundamental questions here today. Can the audit committee enhance the professional skepticism and independence of the external auditor. Can the audit committee evaluate the independence and professional skepticism of the external auditor. And third, maybe I wasn't asked this but I added it, are there other observations that I might have from my experience as being an audit committee member that the PCAOB might want to consider.

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

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

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

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

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

I have a number of other recommendations related to enhancing auditor independence, and I'll just state in passing that in my paper I included a couple of studies that we performed on professional skepticism, and certainly what it shows is that if we do routine functions time after time after time, we become less skeptical. What we have to do is to understand that these procedures can never be repetitious, they have to be unique. And one of the things I find when I talk to my students when they come back from their internships is that many of the firms do not do as good enough job as I'd like to see in making sure they understand the uniqueness of that client, they understand its business, as opposed to do a bank reconciliation, or something like that.

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

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

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

Four, I encourage proactive discussion of controversial accounting issues. Most of these issues don't arise overnight. We know in our company three or four really big issues right now. I want to see if they're consulting with their national office. I encourage that as long as we're involved and as long as management is involved. As I said before, I want to know their assessment of the economics of the situation.

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

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

I was asked to comment on previous recommendations that the audit committee perform an assessment of the external auditor on a periodic basis, such as every five years, and report the criteria as well as the evaluation in a public report. I do not support that recommendation for various reasons. One, potential liability. Two, I think it confuses oversight with assurance, and I worry about that. I also worry that the criteria could be a checklist approach. Like the example this morning, signing the oath in Scotland, it kind of reminded me of when you download software, you click the box -- I don't like that. What I think is that the evaluation of the independence of the audit firm is continuous, it comes with every decision every day.

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

Number two, I think there is a bit of divergence between the PCAOB inspectors and auditors -- and I'm sure you believe that's true as well -- regarding the direct testing that needs to be performed. I'm not going to take sides on this issue, but I would suggest that there might be some value in having hearings on this issue to determine if there is some sort of an expectations gap. My personal experience is that there is.

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

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

Thank you very much.

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

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

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

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

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

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

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

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

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

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

MR. HARRIS: Absolutely.

MR. DOTY: It's been a terrific panel. You've contributed terrific testimony and documentation that will go in the record. As you've made use of the prior testimony that was given in the earlier hearings, this will be of the same utility going forward and it will be very important. Thank you all. We'll see you in the quadrangle.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The findings also revealed insufficient

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

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

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

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

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

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

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

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

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

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

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

We consider that mandatory audit firm rotations entails many advantages such as, for example, of course, eliminating the threats to independence and reinforcing professional skepticism. It addresses the shortcomings of the partner rotation scenario, it avoids repetition of existing errors, and of course, it would create more competition in the market because in the European Union we have a problem of a very, very concentrated markets for the audit of, in particular, public interest audit entities.

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

Of course, we also need to look into the downside of the proposed measure which is mainly the issue of the cost. Of course, mandatory rotation would entail limited increase in costs for the audited entity, but that costs will be diminish over time with the standardization of the process of mandatory rotation. We consider in our impact assessment that the tendering cost for a public interest entity would range from about 7,000 euros to 45,000 euros per year on a nine-year basis. And we do believe that the increased costs by far outweighs -- how should I say, the improved quality by far outweighs the increased in terms of costs.

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

What are public interest entities? Listed companies, credit institutions, insurance undertakings, payment and electronic money institutions, investment firms or alternative investment firms, UCITs, central securities depositories and central counterparties. So you see, financial institutions and listed companies.

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

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

We propose measures in order to enhance the transparency. We propose a more detailed audit report and this is based on the best practice of the German long form reports. We propose an additional audit report to the audit committee, we propose strengthening the role of the audit committee because we consider that the audit committee is very important. But I would say, if I might refer to the debate this morning, we do not consider that the audit committee is the clients or the only client of the audit firm. We look further beyond and we consider that we need to protect the investor first.

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

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

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

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

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

Jeannette, do you want to start?

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

I'd like to just ask about next steps. You've got the draft directive and the draft regulation on audits of public interest entities. What is the timing and the next steps for some of these proposals becoming final and then implemented? And then my second question is I'd like a little more information about the European Quality Certificate. So first, the next steps and the timing, and then secondly, if you could explain a little bit more about the European Quality Certificate and what that means.

MS. BERGER: Yes, thank you.

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

And on the issue of mandatory rotation we already do see some very good support, both in the Council and in the European Parliament. Now both in the Council and in the European Parliament there is support regarding the principle of mandatory rotation but there are still discussions regarding how the mandatory rotation should operate, and in particular the period of mandatory rotation. We have proposed six years in case of solo audits and nine years in case of joint audits. We see some proposing maybe ten years, and of course, we will see what will the final outcome.

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

MR. HARRIS: Could you discuss a little bit your consultation process, and particularly with respect to your outreach to investors. We hear all the time from various groups here that the investors don't speak with any kind of a unified voice, they're scattered all over the lot. Who have you outreached to in terms of your investor stakeholders and to what extent are they unified in terms of two or three or four or five themes, or one or two, or any.

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

In addition to that, we organized a conference in February 2011, yet again to speak with our stakeholders, and afterwards we have what is done an impact assessment, so we have had to test all the measures we proposed in the European Union to estimate the costs and to estimate the benefits, and it's only on that basis that we have been able to table the proposal.

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

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

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

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

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

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

MS. BERGER: Yes.

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

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

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

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

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

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

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

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

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

And in your slide 3 you referenced the number of inspections, the percentage of material findings, and it appears like it's been over 500 inspections in France, Germany and the UK, and just wondering if you could share with us what you've done, or if anybody has done something to analyze those inspection findings to see how much is related to professional skepticism and how that translates to whether mandatory rotation would help or hurt.

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

We also have organized some exchanges between the oversight bodies and the regulators, notably within the Council, and we organized some presentations of audit inspection findings between the supervisors and the regulators in order to allow the exchanges and to discuss what are the best possible solutions to propose remedies to the problems or the shortcomings which were observed within these inspection findings. And I should like to say that it's interesting to note that the problem seems to be the same everywhere, and that's why we believe that not only do we need to have one serious and far reaching solution and a consistent remedy in the European Union, but of course, for us, for the European Union it is very important to look at the potential developments in the United States.

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

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

MR. DOTY: You mentioned the USS letter which is the University Superannuation Scheme, it's the British retirement scheme, and it appears from that letter that the time is sort of moving out beyond five or six years. Can you give us any insight on how the five- or six-year term factors in your thinking now? Is that something that you can see extending, perhaps, to 10-15 years, based on what the USS and others are saying as a predictive matter?

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

Now, we see emerging more and more proposals, both coming from member states, from some stakeholders and in the European Parliament whereby mandatory rotation would be based on the period of ten years, but we also see some proposals, notably in the European Parliament, to base mandatory rotation around the system of internal key audit partner rotation, because in the European Union the key audit partner shall rotate after seven years. So for example now an MEP in the European Parliament proposes to have mandatory re-tendering after seven years, we have a first period of seven years, then we would have mandatory re-tendering after seven years, and that would make 14 years, but after these 14 years that would be enough, that would be the end of it, and there should be mandatory rotation.

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

MR. DOTY: And would the mandatory partner rotation at seven years suspend for a ten-year or a 14-year term, or would it continue to operate? Would you still have mandatory engagement partner rotation with the ultimate term?

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

MR. DOTY: Yes, Michael.

MR. GURBUTT: Thanks, Jim.

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

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

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

Of course, we also follow what are the different reforms which are taken in the member states and we work in cooperation with the Financial Reporting Council, so of course, we are following the proposals and the system of five plus five and mandatory tendering and re-tendering on the basis of a metric-explained basis. In the view of the European Commission, this might not be sufficient in order to solve the problems, to solve the issues.

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

MS. BERGER: Thank you very much.

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

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

Welcome to both of you. Thank you.

Erik, do you wish to kick us off?

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

One of the lessons that I'd like to focus on is something you've already heard several times in this roundtable and in previous roundtables, and that is that the issuer-pays model creates perverse incentives for auditors to compromise their independence, objectivity, and professional skepticism. These perverse incentives are powerful, persistent, and pervasive.

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

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

So I'll return to the particular risk of market booms and bubbles on compliance and auditor independence later on when I talk about potential lessons that the Board might apply.

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

But let me bring up one potential wrinkle -- and that is that you could build in shareholder control of auditor selection into a mandatory audit rotation rule. And it could work as follows. You could require mandatory audit rotation but have a shareholder opt out. So each year in which an auditor is required -- or would otherwise be required to rotate out you can give shareholders the vote to decide whether they actually want that to occur or not. And if they affirmatively vote not to have auditor rotation you could basically allow shareholders to opt out of any regime. And I think that that might mitigate some of the negative effects that previous commentators have talked about with respect to this rule.

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

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

There's several problems with this. Even if you think the audit committees have the sufficient capabilities -- I'm sorry -- sufficient incentives to protect shareholders and to police -- to select and supervise auditors the audit committees are still at a disadvantage. They still need to rely on auditors to provide the audit committees with information. And the auditors' judgments are going to happen on a daily, day-to-day basis in the bowels of the issuer organization.

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

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

And I note as an educator that this is a statement against interest, and I think that that's probably a rarity for a public forum. But it's a statement against interest because every time we have a wave of corporate scandals in the United States business schools and law schools come out of the woodwork with new course work on ethics, professional responsibility and we even get grants and donations to beef up our ethics program.

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

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

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

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

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

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

Let me talk a minute about a few alternatives that the Board could consider to mandatory audit rotation. One I think the Board should consider using a power that likely would not need any additional statutory authority -- and that is to simply make a recommendation publicly and selectively to select issuers you should change your audit firm -- you should rotate it.

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

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

Finally, I would urge you to consider perhaps in a separate rule-making initiative ways to improve the disclosure in the auditors' letters that accompany financial statements. Right now auditors' letters are very -- have very little informational content. They're either a qualified opinion or they're a clean opinion. I think that we could redesign the disclosures that auditors make to make a -- to give investors a much richer sense of the quality of the audit and the independence of the auditor.

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

I think you could disclose data about the relationship between the audit firm and the issuer. So it would be incredibly helpful for investors to understand the total compensation that audit firms have received from the issuer, either in the last year or over the life of a relationship. It would also I think be extremely valuable for investors to know to what extent are there personnel at the issuer who used to work for the audit firm. Finally, I think that the audit letters could include information about the past performance of the audit firm, including the number of restatements that -- on financial statements that that firm audited.

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

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

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

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

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

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

Another study asked physicians essentially the same thing -- does this affect your judgment. Well, the first thing they asked them was does it affect the judgment of other physicians, and they said, Yes -- 61 percent of them said, Yes, that probably affects the prescribing conduct of other physicians, but only 16 percent would admit that it affected themselves.

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

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

So if, for example, I'm a Romney guy and I'm leafing through my newspaper in the morning and I'm heading towards the sports page and I run across a headline that indicates to me they're going to say good things about Romney I'm quite likely to stop and read that article. But if I can tell from the headline it's going to say bad things about my guy Romney I'm probably just going to keep on going because I don't need to be told that I'm wrong about stuff.

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

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

They went back six months later and asked them what they remembered about the document and the people who supported the death penalty remembered the arguments in the article that supported the death penalty. The people who opposed the death penalty remember the facts that were on the other side. And so, as I say, the -- this is a very pervasive bias and it affects all the judgments that we make.

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

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

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

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

But the bigger problem, of course, is the unconscious bias that Erik mentioned -- the fact that, again, which information we go after and look at, how we process that information, and even how we remember that information is affected by the self-serving bias. Pursuant to the confirmation bias, if an auditor knows that the client wants a particular point of view the auditor's likely to go out and look for information that supports that point of view and process the information consistent with that viewpoint. As long as the client pays the fee and as long as the client decides who the auditor, that's going to be a problem.

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

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

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

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

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

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

It is your scholarship as a behavioral scientist that convinces you that this must be true -- that the -- and, in other words, what you're telling us is that, in fact, without regard to how many restatements occur or when they occur or what kind of audit quality failures occur, the two of you believe that there simply is a strong basis for worrying about what we will call the client-pay model, but which I think Karen Nelson identified is really who engages in which area -- goes to it.

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

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

Thoughts on whether that -- whether there's things that we can do within the current system to help audit committees with their responsibilities and their roles and give them more information, or if that's not going to get us very far.

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

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

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

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

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

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

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

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

MR. GERDING: I think that that depends largely on the amount of information the large institutional shareholders have. And there I would go back to one of the first alternative proposals I have. If the Board makes selective recommendations for your -- that an issuer should change an auditor. If it's selective -- it's short -- I think that that would carry a lot of weight with institutional shareholders who might be concerned that maybe there's something that we need to look into. Maybe there's something that we need to address with the audit committee. And that that might have an effect on the actual voting of shareholders.

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

MR. GERDING: I believe so. I could look into the matter more if you find it helpful. I believe you could. The Board does have a -- the Board can speak for itself. It's not disclosing any information that's prohibited by the Sarbanes-Oxley Act. And I don't think that a recommendation that a issuer change auditors would be viewed as a penalty or trigger additional due process concerns. But if you are intrigued enough by the proposal I will be happy to submit further comments to show my analysis on that.

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

MR. GERDING: Okay.

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

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

Getting back to, you know, Jay's fundamental question which I was going to actually ask Natalie about, you know, earlier on, in defining what is the problem, I mean, you've indicated there are powerful, pervasive, persistent incentives. But what's the positive impact on the marketplace should we act versus doing nothing?

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

No one issuer has the incentive to signal on its own by firing an auditor. And if they actually do rotate an auditor I think under the current regime that actually sends a very negative signal if an issuer decides to change auditors. So part of what you're doing is creating a structure where it's no longer seen as a negative information signal to change auditors.

MR. PRENTICE: I would agree. I don't think anybody thinks that we need less independence. I don't think anybody thinks we need less information or less reliable information.

Our stock market thrives on accurate, reliable information. Investors have to -- will pay a premium for that sort of thing. And anything we can do to make the audit more reliable has got to be a plus for the market.

MS. FRANZEL: I want to thank both of you for your comments and for really the multi-pronged approach that you've taken to this.

As a career auditor I find the behavioral issues fascinating. And, of course, I was at GAO so we were not in a client-paying model. And we used to think a lot about objectivity and professional skepticism, and our work was always subjected to the public scrutiny as well.

I'm wondering if there are some discipline decision-making frameworks that we could maybe use in the professional skepticism context of audits to maybe help auditors from getting off track and letting that personal bias take over -- you know, sort of an additional safeguard or something that could be really used in the university programs and then again by the firms -- again, a way to help auditors get through the decision-making process without defaulting so quickly to personal bias.

MR. PRENTICE: One of the things I try to do in the accounting ethics classes that I teach is have the students fully informed of the self-serving bias among others. And I give them all the examples that I talked about with you and several more so that at the very least they can guard against it to the extent that they can.

But it is a very tricky one. It's devilishly difficult to completely defeat even if you are looking out for it because the human mind has an incredible ability to rationalize and we can always find ways that, oh, this is okay.

Just an example that pops into my head -- lots of people, you know, are worried about child labor in Asia, and so they'll tell themselves they don't want to buy goods made by child labor in Asia. But if you show them something they really want and then they find out it's made by child labor in Asia all of a sudden they think child labor in Asia is a much less significant problem than it was before.

It's the human ability to rationalize. And because it is -- that is such a great ability that we have we need structural mechanisms to keep conflicts of interest at a minimum because when they're there it's very difficult for humans to free themselves of these influences completely.

MR. GERDING: I agree. There is a lot of literature out there by behavioral economists that try to make the jump from describing the problem to prescribing solutions. And I think it's extremely difficult to de-bias individuals.

There's a lot of literature that builds off of Professor Kahneman's work that talks about developing nudges or changing default rules to encourage to try and counteract biases to act in a certain way. There's also ways in which information can be framed or made more salient, to put it colloquially, scare people out of their pants into acting in a certain way.

That still being said, a lot of these proposals frankly don't necessarily convince me that they're going to effectively de-bias. So I think one of the problems with behavioral economics is it doesn't necessarily lead to powerful policy prescriptions of ways around these very deep, very fundamental neurologically hard-wired problems.

MR. FERGUSON: This goes back to Professor Kahneman and at least in his book *Thinking Fast and Slow*, one of the points he makes is that these fast thinking, these biases are, in fact -- as you said, you called them neurologically hard wired. But they are extraordinarily useful survival mechanisms that we have to have, that we cannot function without them.

Applying that insight to the structure of the audit today, which is a -- particularly of a large complex audit which is done on a fixed-cost basis with a highly pyramided structure -- people doing work and doing lots and lots of routine tasks. Does the very structure of the way this business is done, in fact, reinforce those biases?

MR. PRENTICE: I think the reinforcement comes just right back to who's paying and who's choosing, because I think that's where the primary incentive is for the accountants; that's the main thing that they have to worry about.

And so if you were exposed to something and the first thing that pops into your mind is, Oh, I don't want to lose this client, that's immediately going to affect the judgment you make and how you perceive the information that you're given. And what Professor

Kahneman's work shows in -- to a great extent is that when we -- we oftentimes make a judgment just like that about, Okay, my guy won this debate or this fact supports my guy or this fact supports the position that my audit client wants to take.

Once you've made that decision automatically, then the rational part of your brain that kicks in and starts thinking about stuff is really just rationalizing the decision that your quick-start mind -- what does he call it? -- stage 1 -- phase 1 -- that it is already made.

MS. FRANZEL: I'd like to follow up. Taking that point -- so let's just say that there is a new structure put in place. Let's just say there is mandatory audit firm rotation. But everybody still has this self-serving bias, so wouldn't everybody automatically adjust all these biases to benefit under the new system and wouldn't we have a whole new set of problems?

MR. PRENTICE: I would just say again you've got the self-serving bias pulling you one way, but you've got a lot of other things pulling you the other way -- your professional responsibility, the Code of Professional

Ethics, the potential for liability, the embarrassment that if you screw up something shows up in the newspapers, et cetera. All auditor rotation does it seems to me is put one more structural feature in that side of the scale to try to overcome the self-serving bias.

MR. GERDING: Yes, let me reiterate something that Professor Prentice said a minute ago. It's not just that you're behaviorally biased. It's the fact -- and there's quite a bit of accounting literature on this -- it's the fact that you combine the behavioral bias with the incentives created by the issuer pays model.

So the incentive of who's paying combined with behavioral bias is going to trigger -- or cause a biases to flip in the direction of confirming what you're being told by who's controlling the purse strings.

It's certainly possible that there might be behavioral biases to please shareholders if shareholders were controlling the selection of auditors, but I guess in that particular scenario shareholders would want a mix of different things. They would want more information, but they would also not want auditors to necessarily waste time or open up issues that are not materially important. So I think fixing the incentive problem goes a long way to fixing the bias problem as well.

MR. PRENTICE: Just I think in one of my written submissions I talk about a study that was done where auditors were construing sort of a vague rule, and they would construe it in exactly the way their client wanted it construed unless their client was in financial trouble.

If the client was in financial trouble and there was a good chance it would go under and, therefore, it would increase a chance that the auditor would be sued all of a sudden they got a little backbone and they said, No, we're not going to construe it that way.

That shows how incentives can flip the self-serving bias. And, again, I think that if you mandatory auditor rotation it puts one more thing in the right side of the scales.

MR. DOTY: Fascinating, terrific, scintillating. You've done for us just what we needed to have done. Thank you.

MR. PRENTICE: Our pleasure.

MR. DOTY: Oh, Michael. Sorry. Quickie. Make it fast.

MR. GURBUTT: If I could just get one last question in quickly if that's okay. And I sure want to address Professor Prentice a question on his 2007 paper on ethical decision-making. And I think one of the things that you've highlighted which is explored in that paper is the self-serving bias.

But there's also other biases which you discussed in that. And I want to name three of them. One is obedience to authority. And I want to get your remarks on whether or not there's any relation there to the pyramidal structure that Lew referenced with respect to the way audit firms staff their engagements.

And then two others which you mentioned are over-optimism and over-confidence. And I'm interested in your remarks as to whether or not there's any tension there between the concept of professional skepticism and the auditing standards.

MR. PRENTICE: On obedience to authority, yes. The pyramidal structure I think would definitely be impacted there. We all are hard wired to want to please authority. When we grow up we want to please our parents, we want to please our teachers, we want to please the cop on the beat, and we're all used to that.

And even when we're adults we like to please authority. I realize that every time I walk into my dean's office. And that definitely affects the judgments that people make -- people down the rung on the audit team and it often affects us unconsciously.

Sometimes we realize we're being asked to do something we're uncomfortable with and we knuckle under because we don't have the courage to stand up to our superior. But oftentimes we are so focused on pleasing our superior it seems like, you know, a good thing to do that we're normally rewarded for we don't even realize that we're doing something that later we think, you know, oops, I think why didn't I see that.

Sorry, Michael. I didn't understand your second question about over-optimism and over-confidence.

MR. GURBUTT: Well, I was just wondering whether or not there's any tension there between the requirements in the auditing standards to apply professional skepticism -- and maybe there's not -- and those concepts of over-confidence and over-optimism.

MR. PRENTICE: Well, most people think they're better than average drivers -- like 80 percent of people think they're better than average drivers. They did a study of college professors -- 94 percent said they were better than average classroom teachers, which means the other 6 percent must really suck.

And a very high percentage of auditors think they are better than average auditors. And so if you're just confident you're a better than average auditor then you may well make decisions without adequate reflection or adequate research and that over-confidence I do think can lead you to not be as skeptical as you should be.

MR. GERDING: Can I make one additional point on the pyramid structure point? In my experience -- as I mentioned at the beginning, I worked with both forensic accountants and auditors. And I saw just anecdotally a pretty big difference in I think the way that they approached problems.

Auditors had a responsibility for a lot of different pieces of financial statements, whereas forensic accountants when they interviewed in a potential enforcement matter -- when they went in and interviewed they had very targeted questions and it was much more focused and they could get right at the heart of potential problems.

So one potential policy wrinkle that this could be is if you're concerned about the cost of mandatory audit rotation one perhaps lower cost alternative would be to selectively require or selectively have shareholders have the right to bring in a forensic accountant if the Board finds sufficient problems.

And that would allow for a very targeted attack on particular accounting issues that I think would really deal with what's really a structural problem between being responsible in this pyramid for the entire financial statements and going really at the most critical difficult issues.

MR. DOTY: We're going to have to leave it there. Thank you both. It's been terrific.

MR. PRENTICE: Thank you.

MR. DOTY: The next panel we have money coming to the table. We have Dan Slack, Chief Executive Officer of the Fire & Police Pension Association of Colorado since December 2008. He served as the executive director of the State University's Retirement System of Illinois. He's a member of the standing advisory group of the Public Company Accounting Oversight Board and holds two degrees from the University of Illinois and has been the assistant attorney general for the State of Illinois and held a number of other very responsible positions.

Greg Smith joined the Public Employees' Retirement Association of Colorado as general counsel in 2002. He was promoted to chief operating officer. In addition to that role he's been named interim executive director and he guides PERA's involvement and corporate governance. He's also a former president for the executive board for the National Association of Public Pension Attorneys, is a member of the Board of Directors for the Council of Institutional Investors. So Dan -- or Greg rather has enormous credibility here as an investor.

Both of you are here at some expense and some travel. We thank you and please proceed. Dan, do you want to begin?

MR. SLACK: I thank you, Chairman Doty, members of the Board. Thanks for the opportunity to speak on this incredibly important area of auditor independence, objectivity, and professional skepticism.

As Chairman Doty mentioned, I'm the CEO of the Fire & Police Pension Association of Colorado, which provides retirement and disability benefits to police officers and firefighters in Colorado throughout the state. We invest their contributions and their employers' contributions in the capital markets here in the U.S. and around the world. Integrity of the capital markets and reliable and audited financial reporting is of great importance to us because of that.

First I'd like to start off with a comment on my small personal experiences with auditor independence. And I've had sort of experience I want to relate to you in two different regimes. So heads up -- on the first one there's self-serving bias coming into play -- just to sort of get that right out on the table here.

So my experience at Fire & Police Pension Association. Like the private sector we pick our own auditor. I came in -- my Board of Directors does -- I don't, the Board does. But I came in as the CEO about four years ago. We had had our own audit firm -- the same audit firm at the time -- for about 13 years. There had been no problems. There had been no deficiencies, no issues, with respect to the quality of the auditing work that had been done.

But we wanted a review, and I wanted a review and determination by the Board -- you know, should we rotate, should we keep our same auditor. We did an RFP, we chose a new firm, we paid a little more, but cost was really not the primary consideration that we were looking at there.

And we took great comfort -- or I personally took great comfort from having a new set of eyes looking at the organization, even though I will concede that there was staff time involved in bringing the new auditing firm up to speed on our organization and the issues and the processes around it. But I felt that it was a worthwhile process to go through and I was very pleased that we ended up making the rotation.

And then the second experience that I have had is I would caption that do you really want independence. And I would take the model that was in place at my former employer, State University's Retirement System of Illinois. Our auditor rotated every five years, whether we liked it or not. Our auditor was chosen by the State Auditor General, not by my Board of Trustees, not by the management.

Talk about independent. When the audit firm walked in the door it was quite clear they didn't view us as the client in any form. We were the auditee. And that's a huge difference in tone, attitude, frame of mind -- you name it. There was no question about their independence -- you could feel it.

It sort of reminds me of -- I think it was Justice Potter Stewart who made the famous remark about pornography -- I know it when I see it. This was sort of like independence -- you knew it when you felt it.

So I think that if we truly want independence we have to somehow move away from the issuer pays model and that sort of, you know, builds upon what the prior panelists said. But I want to talk about maybe what are more implementable options and more incremental approaches that can be taken because I would say that I am probably more of an incrementalist by nature.

So I want to commend the PCAOB on its recent release to audit committees regarding the inspection process that came out I think earlier this fall or late summer. I think that that's an initiative that meshes well with many of the comments that have been made by prior speakers to you at these various hearings. I also think that the recent release by the Center for Audit Quality of their auditor assessment tools is another step in the right direction. So I think those are all very positive things.

After I submitted my written statement to you and I was looking at it again in preparation for today's meeting I became concerned that it might imply that I'm opposed to mandatory audit rotation -- or auditor rotation. And I'm not really opposed to mandatory auditor rotation, I just think that it's not quite the time there yet and I think that there are some interim steps that might need to be taken first.

And so as I mention in my written statement I'm in favor -- I was struck by the proposal as put forth by Robert Pozen to have the mandatory re-tender or mandatory RFP after a term of years. I think that that serves a number of purposes that would be of value and would be a good interim step.

I think if it's accompanied by a requirement that there be articulated reasons for the retention or non-retention -- I guess if it's a non-retention that's not as important, but if it's a retention of the auditor articulate reasons, not just boilerplate, about why there was value in retaining the audit relationship. I think that could be of value.

I also think that it could help clarify in the auditing situations where there's been a decades-long retention of the auditing firm by the company -- that it could help clarify that really, hey, it's the audit committee now that is making the decision on retention not management and so clarify that hire decision.

I think that it could be helpful to have further restrictions on the provision of non-audit services. I think it's, one, just in terms of independence and objectivity and then, two, in terms of perhaps clearing the brush a bit for the conflicts that might exist if some form or auditor rotation is implemented where the Big Four firms might be so intertwined with the provision of audit and non-audit services to the large multi-national companies that effectively there is no alternative. So a trimming back of non-audit services perhaps even further than what was mandated by Sarbanes-Oxley could be in order.

I think -- I would say my written statement suggests other incremental steps that might be considered. But I'll stop right here and just say thank you for the opportunity to state my views and I look forward to answering any questions that any of you may have.

MR. DOTY: The other items you've directed us to will be included in your written statement, which will be a part of the record.

MR. SLACK: That is correct.

MR. SMITH: Thank you, members of the panel and Board. I appreciate the opportunity to address you. I'm Greg Smith from the Colorado Public Employees' Retirement Association. I am here, I think, because we run the money. And in Colorado PERA we manage about $40 billion on behalf of 495,000 current or public -- current or former public employees and servants.

As a result of that we consider ourselves to be the consumers of financial reporting. And we consume a lot of them and we manage 60 percent of our assets internally. We don't rely on Wall Street; we do it at home. We do it with our own professionals and we rely extensively on financial reports.

We view auditors as our eyes and ears inside the corporation. We don't have the access, the ability, the tools to go into each company and assess their true financial condition. So the accuracy of our eyes and our ears and their reporting to us are critical. We have no other means of obtaining the information that they're responsible for harvesting for us.

I want to comment for a moment about the previous panel and the discussion about bias and internal bias. And I agree with every bit of what was talked about except that I'm not sure any of it matters because whether they're biased or they're not biased or whether we could train auditors to control that bias I'm not sure matters because what I think really matters is the perception of bias. And if people think the bias is there, whether it's there or not, whether the professional is above that or not, it's going to deter and detract from the quality of the audit in terms of how it's perceived by the consumer of those audits.

In my role -- and I'm going to focus most of my initial talk about some things that the Policies Committee has done for the Council of Institutional Investors. The Council of Institutional Investors is a nonprofit organization made up of corporate pension plans, labor pension plans, and public pension plans in excess of $3 trillion in management.

We are very strong advocates for long-term shareholder rights and we think that the issue of auditor rotation and auditor independence, objectivity, and professional skepticism are critical and something we've since done significant time on.

I chair the Policies Committee, and that makes me responsible for developing new potential policies for the Council to adopt through its membership. And since 2011 we have been debating the issue of mandatory rotation of audit firm.

Despite that lengthy period of time and despite the many different angles we have looked at we have not reached consensus among that group as to what the right solution is. We do think we've made some progress and we've done some analysis that I intend to pass on to you. But I do have to say at the outset that the fact that this debate has gone on for 30 years -- it certainly started in the eighties sometime -- makes it a pretty daunting task and one I admire the Board for taking on.

When we started looking at this issue -- and I'm going to bring a little bit of the lawyer's mindset to this -- I can't purge that from my genetic makeup here. One of the things we started looking at was what if we do want auditor rotation -- what if that is what we think is the best solution to serve long-term shareholders? What does mean we have to do?

And I think the conclusion -- or the answer to that question colors the entire process because our conclusion -- or our answer to that question was, Well, we need to figure out how we could possibly get it passed. And in order to get it passed in the post-DC circuit ruling on access regime we need to find cost benefit analysis that supports mandatory rotation if that's where we want to head.

And I don't mean to say that we're going in looking for that. We go into that analysis seeing whether that analysis truly support rotation. But I think it's an important concept to consider -- that we've got to be able to prove the value of that rotation in order to ultimately have it be successful in a rulemaking effort, whether before this body or elsewhere.

So we started trying to decide, well, how can we tackle that issue. And one of the areas that we went to was looking at is there really supportive evidence that cost will increase if there's auditor rotation. As we know, in the United States it's all voluntary rotation. There is no mandated regime to go and examine of any significance that would give us very much guidance.

But what we did was we went back to 2004 and we looked at 85 companies -- well, we looked at all of the companies greater than $2.5 billion in capitalization that had changed auditors since 2004. In looking at those we looked at the two years preceding the change in auditor and the two years after the change in auditor to detect whether there had been an increase in cost associated with conducting the audit. We excluded those that made the change more recently than two years ago.

And the result of working our way through that sample was that we had 85 companies that met that criteria that we looked at. In some instances you had a situation where the company was a split audit responsibility for a given year because there was an overlap between the two firms when there was a change. In those instances we excluded that year of change and looked at the two years preceding and the two years after the year of change.

We don't claim this to be a scientific study -- let me put that out on the front end. All of us could sit here and poke holes in out we did this -- whether we backed out inflation, whether we examined the precise nature of the scope of the audit. A variety of variables are out there. But we wanted to see in a nonscientific cut where we wound up.

And what we found was that in that 85 firms 50 firms experienced an increase in audit cost over the subsequent two years and 35 companies experienced a decrease. The median increase was 59.4 percent and the median decrease was 22.4 percent. And when we put it all together the net change in audit cost was 18.4 percent. That's a two-year figure and doesn't consider the fact that there would be some presumed escalation in the cost of audit with or without a rotation.

We then looked at the concept of these companies that had had a split where they had two auditors in a given year and looked at the fact that that may well be an indicator that it wasn't a desired transition and that it may have been something that was forced or needed as a result of some event within the company.

So we excluded those split cases where we were looking at really a five-year term instead of the four-year term. And when we did that we found that we were down to 61 companies. 33 companies experienced an increase in their cost, 28 experienced a decrease in their cost, and the net overall change was an increase of 3.4 percent for the cost of the audit.

As a consumer of the audited financials certainly that didn't strike us as a material alteration in the cost of obtaining the audit. It's those numbers that are critical. And the ability of us to rely on those numbers -- our analysts to know that the number they're looking at are, in fact, reliable is critical.

Within -- one more cut that I want to cover quickly for you, and that was total fees, not just audit fees. Preceding numbers were based on just audit fees and not total payments to the audit firms.

Looking at the 85 companies again and looking at total expenses to the audit firms, 44 percent experienced an increase, 41 -- I'm sorry -- 44 companies experienced an increase, 41 companies experienced a decrease. The net total change in cost was a plus 3.3 percent over that examination.

Again, we went one more step and excluded those split companies out of the 85 taking us back to the 61. And in that instance it actually flipped the results. We had 29 who had an increase in their cost, 32 with a decrease in their cost, with the total net being a decrease of 1.8 percent.

We don't, as I say, claim this to be the gospel in terms of whether a firm would charge more or less in a rotation regime, but we certainly think it's relevant evidence to consider when trying to do the cost benefit analysis that we're going to face in the event we pursue mandatory rotation.

I'd also make the point that -- and it's certainly my opinion and not that of the Council -- but it appears that if there was a regime of known rotation where the companies knew and the audit firms knew that every periodic -- whether it's five years or ten years -- there was going to be that rotation I would certainly think that there would be a development of a professional expectation among the firms that that handoff would be done in an appropriate manner -- that they would do things in a way that wouldn't intentionally drive up costs on each other.

They might try that once or twice, but when they figured out the other guy was doing it to them too I suspect it would have a chilling effect on that practice and I think you would find that that handoff and that ability to accomplish that transition at the same or lower cost would prevail.

With that I'm going to stop and take your questions. There are certainly many things that we think would be important. I guess I should cover a few other things that the Policies Committee it looking at.

The current Council position and policy that's in place calls for a competitive bidding process for auditors every five years. The Policies Committee is looking at whether or not to enhance that and identify specific triggering events that should require a rotation or perhaps that would require a comply-or-explain type of an approach. And in comply-or-explain we have looked at a variety of different triggers that would require the company to provide an explanation to the shareholders in the event they didn't go forward with rotation or, in fact, did retain the existing audit firm.

And those continue to be a subject of debate, but they include things similar to what I've heard earlier today. The presence of some former partners from the audit firm that are now employees of the company, the actual time of tenure for that company -- I'm sorry -- for the audit firm. And we even talked about the one which relates to a significant financial restatement. And in the event of a significant financial restatement should that trigger an automatic rotation or should it trigger a compliant -- or explain if you're going to retain that audit firm.

And there was quite a bit of debate about whether that would have a chilling effect on that firm coming forward and being honest in terms of its assessment of its prior work or whether that would motivate people to hide perhaps what should be a financial restatement. So that one remains in debate.

But we think that triggering events and the looking at triggering events, and thereby when those events occur enhancing the disclosure to shareholders would aid shareholders in gaining confidence in the financial reports generated by our corporations. So I'll stop there and welcome your questions.

DR. DOTY: Well, thank you both. You've given us a lot to chew on. Steve, do you want to comment?

MR. HARRIS: With respect to the competitive bidding process how do you envision that working? In reality in these tough economic times why wouldn't the lowest bid almost always be accepted? I mean, how do you envision the competitive bidding process working?

MR. SMITH: Well, I think any of -- any large company in governmental or private we engage in a lot of competitive bidding processes. And I think it would need to be approached in a way that had a lot of transparency to it.

One problem that I see with it -- and I'm not saying it's all perfect -- but one problem I see is that you would have to be clear and it would have to be a legitimate competitive bidding process. So often what we find ourselves in is, oh, we're going to do an RFP but nobody really believes we're looking to change and, therefore, nobody really comes forward with a legitimate bid, and therefore, it's kind of a meaningless process.

We would have to break that mold. We would have to make it clear that we're truly putting this out for bid -- the company's truly putting it out for bid and truly looking for legitimate response. And on top of that there would have to be an increased transparency about the process.

I want to know what the range of bids were. I don't need to know the name of every bidder that made a particular bid, but I want to know how big that spread was as a consumer of the financial reports. I want to know what their analysis was that took them to the conclusion that they reached.

Is it always going to be a low bidder? I hope not because I don't think that's healthy. I don't think that's everybody's conclusion that your -- I don't hire my doctors that way and I'm not going to hire my accountant that way.

But there's other things that have to come into play, and that's part of the explain process. The boilerplate type of an approach of, well, we believe this is in the best interest of management or best interest of the shareholders and, therefore, we didn't change -- that's not what we're looking for. We're looking for a real analysis and a real description of the decision-making process from that bidding process. And I think that package is what we need and not just let's do a bid every five years.

MR. FERGUSON: Yes, I have a couple of questions. First, in your own organizations -- I know you mentioned, Dan, that when you came in you basically had a rotation. Do you rotate your auditors in either of your home institutions? I know many, many public pension firms to.

MR. SMITH: I do -- Colorado PERA. Not only do we experience a rotation but we don't retain our own auditors. We don't select our own auditors. We get to pay the bill and we're happy to pay the bill because we like to know our numbers are right. But the State Auditor under the supervision of the Legislative Audit Committee makes the selection of our auditor, defines the scope of the audit, and does have a four-year rotation policy on its contracting with outside firms for that service.

MR. FERGUSON: And has that worked reasonably well for you?

MR. SMITH: It's worked very well for us. I will acknowledge that the first year's not the easy year. There's a lot of learning to be done -- takes a little bit more of our staff time during that year to bring them up to understanding how we do things and have done them historically. But the cost differentials have been nominal.

MR. SLACK: And for us we have a little different format even though we're in the same state. We -- my Board of Directors does pick the auditor upon recommendation of the audit committee of my Board. As I said, we sort of instituted some new processes and the expectation is that every five years we'll be going out to bid. Will we change auditors or retain I don't know, but the expectation is that every five years we'll go out to bid.

MR. FERGUSON: My second question has to do with the very interesting results of your Policy Committee study on cost, which shows that, you know, kind of you net it down the cost of auditor rotation appears to be pretty nominal. And I think that's consistent with studies elsewhere around the world that auditor rotation does not necessarily raise the cost of the audit fee.

But the objection -- one of the big objections is not so much that the audit fee will go up but that auditor rotation is very costly to the client in terms of management having to bring the auditor up to date. It takes more people, it takes more time, takes more management involvement with a new auditor. And the issuers don't like that. That's a lot of the objection. Do you have views on that?

MR. SMITH: Well, I'll take a run at it. As an entity that buys and sells stock I think we would pay a premium for a company whose financials we're confident in. And when we look at financial reports and we have skepticism about their accuracy that results in a discount in their valuation of that company. And I think companies would be well served by demonstrating themselves to go the extra mile to give us comfort that their numbers are correct.

MR. SLACK: Yes. And I think that there is -- there has been -- from my personal experience there is that initial run up of management time, company time in a new relationship with an auditor. That -- I think it cannot be avoided. I would concur with Greg's comments though that I think it's a cost that's worth bearing in appropriate circumstances.

MR. HANSON: I want to follow up on something that you just said for my first question, then I've got a second question too. And that was about confidence in the numbers -- that you're willing to pay more for a company that you have confidence in the numbers.

In your mix of how you make investment decisions today is auditor tenure one of the things that you include in that mix of -- total mix of information when you decide how much you're going to pay for your particular investment and whether you're going to make it at all? And if it in that mix how? So that's my first question.

Second question is I want to explore just a little bit more about the purpose of mandatory re-tendering. Because as I think about it -- and three things come to mind. You've already mentioned one, which is fees. A second purpose I can see is to demonstrate -- I'll use a really simple way to say this -- who wears the pants in the relationship -- that it's the audit committee. And then the third thing is the threat of someone second guessing the decisions that the auditors made.

There might be a bunch more reasons for re-tendering, and if there are more than that that you weigh heavily I'd like to hear that. But of those three things that I mentioned which ones do you weigh the most in terms of the value of re-tendering, and are there ways to accomplish that without re-tendering? So my two long-winded questions.

MR. SLACK: So on the first question -- I hope I can remember your questions but -- and please correct me if I don't get them answered. So our process is a little bit different than that followed by Colorado PERA. We sort of manage the managers at our organization. So we are not buying Coke, selling Pepsi, or vice versa. But, you know, we talk to our managers though. I mentioned in my written statement that a lot of our equities are passively managed.

But, you know, audited financial statements are of interest whether you're equities, fixed income -- whatever sort of investing that you're doing. And I'm not aware that -- no one has told me, Oh, gee, we look at auditor tenure specifically and give, you know, a checkmark in a box against that. I think it just goes more to the issue of, you know, is there independence there, is there a feeling that they can rely upon the audit financials. So I think it's just really part of a bigger picture I guess.

And then your second question about, you know, what would be the value of mandatory re-tendering and are there alternatives -- I think as far as the value I would weight heavier on the who-wears-the-pants argument. I think that it's -- that the establishing the responsibility of the audit committee that's clearly been, you know, granted to them through the changes made by Sarbanes-Oxley -- I think that that's of real value.

I think that an explication, as Greg commented about, of the rationale for if there is a mandatory re-tendering and yet a retention of the firm -- not just boilerplate that says it was in the best interest of shareholders, but more just, you know, we looked at this issue and that issue and we weighed it and we came out that this was the best thing to do is to retain the auditing firm. I think that's what we would see of value.

MR. SMITH: The issue of tenure I would agree with Dan. I can't say that even my internal management professionals coming to me and say, Well, this company's had the same auditor for ten years so I think I'm going to downgrade it in terms of my reliance on it. It's a bigger picture. It's one piece in a bigger puzzle than that.

But I can say that we've certainly had members of our staff and our Board raise concerns about companies where it's a perpetual relationship. And those concerns are ones that are brought forward and ones that result in increased skepticism about the reliability of those financials.

I would also agree with Dan about -- I weigh towards the who-wears-the-pants version of the priority and the reason for the rotation. But I might look at it a little bit different. To me the audit committee -- one of their last concerns perhaps in the equation should be what is management going to be put through. Because they don't work for management. They work for me. They work for the shareholder. They're supposed to be my boss in the boardroom. I've got my eyes and my ears that are the auditors and I've got my boss -- and that's the directors and those that sit on the audit committee are responsible for making sure that my eyes and ears are getting the right job done.

And is that an inconvenience to management? Well, then management better make it more convenient for themselves, because I need the ears and the eyes to go get that job done, and I need the boss in the boardroom to be my directors. And if I got majority vote -- and I won't go too deep into other corporate governance issues, but if I knew those audit committee members were really working for me and they weren't beholden to management I'd be a lot more comfortable with their decision about who the auditor is.

MR. DOTY: Let's cut to Jeanette's question and then we'll go to Marty.

MS. FRANZEL: I think all my questions have been addressed. I thank you for your very candid answers. Dan, I think we've been quoting you, people have been quoting you all day on your statement that mandatory audit firm rotation is too blunt an instrument.

MR. SLACK: Yes.

MR. FRANZEL: But I appreciate hearing the various incremental steps and other steps and really how you're thinking through these issues. So thank you for coming today and I'll go ahead and defer to Marty.

MR. BAUMANN: Thank you, Jeanette. I wanted to talk -- ask a question a little bit about the mandatory re-tendering, which is -- again, has not been in play for very much. The U.K. has just put that in play for the FTSE 350. So I guess that has some -- doesn't have a lot of history behind it either.

If you consider the issue that we're trying to tackle here -- at least the concept at least, raise the problems that we saw in inspections of lack of professional skepticism and that's why we're raising this issue among other reasons.

And in an ongoing relationship there's some economic bonding that takes place between -- in the relationship, unconscious biases we hear about, and a little bit I don't want to lose this client on my watch. But I just wonder about your reaction -- how is the auditor going to react when he or she knows that the relationship's going to be up for tender in the next year or two? Might those biases to please the client be greater or do you think they'd be lesser?

Further, some academic studies that I've looked at have shown that in selection of auditors management plays a key role in helping the audit committee get through that -- get through all of the documents and giving their views on the auditors. Again, would the auditor again be more likely to be saying, Gee, I want to please the -- please management in the last couple of years before this re-tendering takes place and have just an opposite effect of improving audit quality but exacerbating the problem.

MR. SLACK: I'll take a shot at that first perhaps. I think that the potential unintended consequence of mandatory re-tendering that you just mentioned -- I think those are real potential consequences. I don't think that there is a perfect answer to this issue of how do you increase what, you know, everyone is looking for -- independence, skepticism, objectivity.

So, yes, could you have that? I could see that you could, but I also think that there is sort of a countervailing issue of if there's a mandatory re-tendering that's going to take place if I'm the incumbent I might feel pretty good that I've got a good shot at retaining that contract. But there's always the chance that I'm not going to.

And I think that that would also bear into the process as well. And I think it would perhaps lead more towards, you know, making that everything -- all the Ts were crossed, all the Is were dotted in case I'm not retained. And so I think that that might countervail the tendency to want to try and please management to get through the re-tendering process.

MR. SMITH: And I would think that if -- if what we were doing was going to this -- and really permanently going to it -- that the long-term nature of an accounting firm's business is going to drive them to do it right. And the community in which they function and that they educate each other and they bring their junior accountants up through the regime is going to change into a world where they know there's going to be turnover, where they know there's going to be maybe not mandatory rotation but movement as a result of business forces different changes in management's view, different desires to accomplish different things, changes in business models.

But they're going to always be in line for the next one or the other one that just rotated away from one. And it doesn't allow them to say, Well, I'm going to do a biased job or I'm going to change how I do business because I might be able to hold this client that way when that shoots them down in terms of their marketability potentially to others when they get discovered for doing that.

I think it's -- if you look at a very short period of time I can see that problem. If you look over a ten-year period of that kind of regime I think it regulates itself very well and controls those tendencies very well.

MR. DOTY: We're at a break. You have one quickie?

MR. HARRIS: You can answer it quickly. But you both raised the issue of the audit report in your written and prepared remarks. And, Greg, you said that the auditor's report as it currently exists does not fully meet the goals of investors. Could you very briefly comment on what more you might be looking for in the audit report and why you don't think it currently meets the needs of investors?

MR. SMITH: I think it doesn't currently give us the information that would help us make judgments about that bias and whether the bias is coming into play. I'm not sure I'm in a position to really specify -- you know, I agree with the signature on the audit -- let's have some accountability, let's know who owns it, let's ascertain whether there's a history of discovery of frauds, what's the average experience level for the people on the audit staff, how much rotation, how much -- how many hours are they putting into each level of the analysts within that audit -- particularly how much time is the partner spending versus how many low-level people are spending on it.

Those kinds of things I think would be helpful. There's other probably better qualified, like my 55 investment professionals that are looking at them and telling me whether they think it's getting the job done for them or not than I am to get better specifics for you. But that's a few of them.

MR. SLACK: If I could quickly respond to that as well, I mean, you know, one of the things that -- when our money managers come into our office or maybe prospective ones I tell them, I serve on this thing called the standing advisory group of the PCAOB.

So I want to ask you while we're, you know, talking about your investment philosophy, et cetera, et cetera, let's talk about financial statements. And -- you know, and what I come away with in those conversations is probably that more information is better than less information. And so that's sort of where I'm coming out.

And so could there be -- I know we've talked about at standing advisory group meetings of things like auditors' discussion and analysis that might, you know, talk about areas of judgment, areas of inquiry, areas of disagreement -- not disagreement or discussion with management. All that to the extent that that could be elucidated I think that would be helpful to the investment process.

MR. SMITH: If I could just -- one more point on that is more access to your inspection reports I think would go a long way -- more access, whether it's the audit committee or to the investor. There's a lot of good information there. More than I -- more good information even that I get to see I'm sure is there. And I think more timely and increased access to that would be very helpful.

MR. DOTY: This has been one of the most concrete, specific, and useful sessions we've had in the entire time we've been doing this. So we thank you.

You've brought great preparation to it and you gave us a wonderful bit of information to chew on. Thank you both.

Let's take a break and let's reconvene here promptly at 3:45.

(Whereupon, a short recess was taken.)

MR. DOTY: Well, I was explaining to our guests as the Board assembled how critical it is to have preparers on this panel -- how important to the integrity of this process it is to hear from people that are with us now.

Cory Bleuer, Vice President, Controller, and Chief Accounting Officer for BMC Software, one of the world's largest independent global public software and cloud solutions companies since 2006. Previously VP and Controller of EMC Corporation's Captiva Software group. Following that acquisition of Captiva he was EMC's corporate vice president and controller.

Bleuer served with -- also with HNC Software and has a long, distinguished career in public accountancy. He was an experienced audit manager with Price Waterhouse Coopers, holding bachelor of science degrees and B.A. --

business administration accounting concentration from Indiana.

Dan Cancelmi, Chief Financial Officer of Tenet Healthcare Corporation, in charge of the finance, accounting, investors relations, and related function. Previously Tenet's senior vice president and controller, principle accounting officer. Joined Tenet after serving as CFO of Hahnemann University Hospital in Philadelphia. Began his career with Price Waterhouse Coopers where he worked for more than nine years in various positions in Pittsburgh and New York City, including the company's national accounting and SEC unit. A bachelor of science degree from Duquesne and a certified public accountant, of course.

Patrick Mulva, three years in the Air Force, joined ExxonMobil Corporation in `76 as a financial analyst at the Baton Rouge, Louisiana, refinery. A variety of financial positions in upstream and downstream operations. He is now vice president and controller. He's been there since July 1, 2004. Chairman of the American Petroleum Institute's Finance Committee. Member of the Financial Executives International, its committee on corporate reporting. Member of the Financial Accounting Standards Advisory Council. A bachelor's degree in business administration from the University of Notre Dame, MBA from the University of Texas at San Antonio.

Welcome, gentlemen. Thank you for being here. And please begin. Cory, will you start us off?

MR. BLEUER: Thank you. Members of the Board and observers, on behalf of BMC Software thank you for the opportunity to present our views on auditor independence and audit firm rotation.

As noted, my name is Cory Bleuer and I currently serve as BMC's V.P., Controller, and Chief Accounting Officer, a role that I've held for just over six years.

BMC Software is noted as one of the world's largest independent public software companies operating globally through approximately 75 legal entities and branches worldwide. BMC operates in a specialized industry where the application of accounting standards requires experience industry skill sets, both by preparing companies and their auditing firms.

BMC supports the Board's continued efforts to maximize auditor independence and audit quality. However, we believe there are more effective ways to accomplish this goal than through mandatory firm rotation. At the core we believe that independent audit committees are in the best position to reinforce auditor independence through their critical oversight role and that mandatory rotation could, in fact, actually weaken the effectiveness of this core responsibility.

At BMC our audit committee takes this oversight responsibility very seriously as evidenced by the rigor of regular interactions between our audit committee and our audit firm.

An example that I will highlight is the process undertaken by BMC's audit committee during our audit firm's last mandatory partner rotation cycle. Our audit committee took the opportunity to perform a critical review of the entire firm relationship during which the committee set the criteria for partner candidates and team structure, interviewed multiple partner candidates, and also reviewed the capabilities of two other global accounting firms.

This process resulted in the engagement of our --

or, excuse me -- re-engagement of our audit firm under a realigned team structure that included new primary and independent review partners each based in separate practice regions and neither previously associated with the BMC engagement. This process was very rigorous, but in the end a strong example of effective audit committee oversight.

In addition to the risk of diluting corporate audit committee oversight we believe the mandatory rotation would also have other negative ramifications. First we believe that required rotation would, in fact, decrease audit quality. Auditors must develop and maintain a thorough understanding of industry and company specific business practices in order to deliver quality audits. In our review mandatory rotation would reduce audit quality during transition periods and preclude an audit firm from maximizing critical company knowledge over time.

These concerns would be particularly heightened for large multinationals. Complex global companies require audit firms with substantive global presence and industry knowledge. And, admittedly, few firms have this global reach and presence today.

While we recognize that audit firm changes do and should occur today these instances are more conducive to effective transition efforts, both by companies and audit firms under the guidance of audit committee oversight.

In contrast, we don't believe that it would be feasible for thousands of public companies and a limited number of qualified firms to regularly engage and mobilize resources in mass scale without harming audit quality.

Secondly, mandatory rotation would increase audit cost and create other practical constraints on companies. Increased audit firm engagement costs would in our view need to be passed on to companies via higher fees which would be detrimental to companies and their investors. Some estimates that we have seen suggest that first-year audit costs alone could increase by at least 20 percent.

Mandatory rotation would also regularly distract company management, personnel, and audit committees, which could also harm critical financial oversight by these core groups.

Because of independence requirements mandatory rotation would also limit a company's agility to engage other audit firms to provide non-audit services which could create issues for many companies like us. By way of example, several of the largest global accounting firms could not currently serve as BMC's independent auditor because of independence conflicts today.

Mandatory rotation would also create issues for multinationals like us that routinely engage their integrated auditors to serve as statutory auditors at the subsidiary level. Mandatory rotation would necessitate changing integrated and statutory auditors concurrently which would create inefficiencies, incremental cost, expanded audit risk, et cetera, and in some cases may not be possible or practicable to accomplish at all.

In lieu of mandatory rotation I'll now offer several recommendations that we have to strengthen audit independence and audit quality. At the core we believe that U.S. regulators should take the lead to support and strengthen the role of corporate audit committees and demonstrate that the U.S. believes there to be a greater and broader benefit to strengthening this type of governance than in taking risky and costly approaches like mandatory rotation.

Building on this view the Board should work with appropriate parties and explore options aimed at improving audit committee best practices regarding independence matters recognizing that optimal audit committee practices may not today exist within all public company environments. We believe that strong, educated audit committees will make appropriate decisions holistically, including changing auditors if and when necessary to protect independence.

The Board should also consider sharing inspection results for a particular company's audit directly with that company's audit committee recognizing that statute change may be required here. Again, this is to better enable audit committees to perform the oversight role that I'm discussing.

Lastly, we are supportive of having audit committees report additional information to shareholders related to audit firm independence measures. To highlight an approach taken by us I would note that one of our shareholders recently submitted a proposal regarding a form of audit firm independence report for inclusion in our annual proxy with the goal of providing insight into audit committee efforts to protect auditor independence.

While we didn't support the shareholder's proposal as submitted, after constructive dialogue with the shareholder we enhanced the disclosure in our most recent proxy to describe processes taken by our audit committee to protect auditor independence. This shareholder viewed BMC's dialogue and openness to increased transparency on this important topic in a very positive light and withdrew its proposal.

While this is just an example of an approach taken by us the Board may wish to further explore reporting options such as this which I know you are presently. And we think there are options there that may make sense. That concludes my opening remarks. Thank you.

MR. DOTY: Thank you. Dan? Dan Cancelmi.

MR. CANCELMI: Thank you, Chairman Doty. On behalf of Tenet Healthcare Corporation I want to thank the Board for inviting me to participate in this important discussion and everyone for taking time out of their busy schedules to provide their feedback today.

I'm pleased to have this forum to provide my company's perspective on the concept of mandatory audit rotation and measures that can be taken to enhance auditor independence, objectivity, and professional skepticism. I truly appreciate the opportunity to discuss the benefits and concerns of mandatory rotation.

In our comment letter to the Board we provided several key points for consideration as the concept is debated by the Board. I would like to provide a brief overview of those points.

First and foremost we believe the creation of the Board by Congress to provide oversight of registered public accounting firms has been extremely beneficial in restoring trust in the financial statements of public companies. We fully support the Board's oversight role.

However, we believe the enactment of mandatory rotation could create adverse perceptions regarding the need of the Board's future oversight role. Having previously been an auditor with a large international firm and also most recently as a member of management intimately involved with the external audit process I can't emphasize enough the importance and benefits of the Board's periodic reviews of external audits.

I have observed firsthand how serious our external auditors take into consideration the Board's findings and immediately implement changes to improve its audit processes as a result of Board findings.

Second, we believe the current five-year rotation requirement of lead audit partners captures substantially all the benefits of mandatory audit firm rotation in a cost effective manner, including the important attribute of a fresh set of skeptical eyes.

My company's lead partner just rotated off after five years of service. I can assure you the rotation of the lead partner after five years is essentially equivalent to changing audit firms. When the lead audit partner rotates off management needs to review and seek concurrence for each critical area of accounting judgment with the new partner as well as having to provide background information on all aspects of the company's business, which is tantamount to the process that occurs when a company changes auditors.

Many stakeholders have questioned whether audit failures would be minimized if mandatory rotation was required. We don't believe there are conclusive findings or evidence to support this theory. Rather, it appears that most audit failures occur due to intentional or unintentional negligence by auditors and management and/or lack of compliance with existing laws, rules, and regulations.

Instead of mandatory rotation we believe continued robust inspections by the Board will hold individuals and their firms accountable for improper actions and are a greater deterrent than mandatory rotation.

Also, if mandatory rotation is ultimately enacted in the maximum time period a firm would audit a public company's too short we believe the incentive for firms to fully invest in client service and audit quality could be diminished.

Given the fact that there are only four large international auditing firms one possible unintended consequence of mandatory rotation is the creation of financial benefits to the four large firms' business models. Under mandatory rotation we believe there's a strong likelihood that companies will select the four firms in sequential order.

Another possible unintended consequence of sequentially rotating firms could be a perception for outside parties to suggest the auditing business should be nationalized -- or is nationalized as the private sector would be compelled to change auditors every so many years with little choice of firms which could lead to higher audit fees as the firms would have less incentive to invest in a long-term business relationship.

I do want to point out that after deliberate consideration my company decided to change auditors in 2007 after many years with the same firm. It made sense for a company to change auditors at that point in time after our audit committee carefully considered the pros and cons of such a change.

However, there are various inefficiencies on a change of auditors and we do not believe it would be in the best interest of various stakeholders if such a change was imposed every so many years. Although there are numerous benefits of mandatory rotation we believe the cost and possible unintended consequences of mandatory rotation outweigh the potential benefits. As a result we believe mandatory rotation is unnecessary.

Again, we believe the Board is adequately structured and equipped to provide appropriate oversight of the auditing profession. Thank you.

MR. DOTY: Thank you. Patrick Mulva.

MR. MULVA: Chairman Doty and Board members, thank you very much for the opportunity to participate in today's meeting to comment on the Concept Release on Auditor Independence and Audit Firm Rotation. We appreciate the Board's efforts to reach out to stakeholders on such a very important issue.

We all agree that auditor independence plays a key role in the audit process, which includes forming an opinion as to whether company's financial statements are fairly presented. Independent audits of companies' financial statements provide investors with a level of trust that is vital to our financial markets.

Investor trust has also been buoyed by the PCAOB's oversight responsibilities of the registered audit firms. We recognize that this oversight role has improved the objectivity and independence of audits performed on all public companies.

Despite these observed improvements, however, the Board has continued to find deficiencies during the inspections. The Board has concluded that the cause of these deficiencies may be related to a lack of professional skepticism and objectivity.

On this finding, we respectfully are very concerned that the Board has not provided sufficient and substantive evidence to support this theory. The one specific suggestion in the Board's concept release to address the apparent weaknesses in audit quality is to implement mandatory auditor firm rotation.

As communicated through similar forums and comment letters submitted to the PCAOB, views on mandatory auditor rotation basically fall into two groups. Those in one camp believe that a long-term relationship between auditor and the company results in an erosion of auditor independence.

On the other hand, those opposed to mandatory auditor rotation state that such a change is not supported by empirical evidence and believe that audit quality would actually decline following a change, particularly during the first several years as the new firm builds up its knowledge and understanding of the company's policies, practices, procedures, and fundamental control systems. I'd like to note that mandatory auditor rotation has been met with virtually universal rejection by Board audit committees, including ExxonMobil's, as the proposal diminishes the audit committee's role in hiring, assessing, and firing audit firms.

If you don't happen to recall my letter specifically, I won't keep you in suspense. I simply don't see that a cause has been made to require mandatory auditor rotation. The Board has not demonstrated the audit deficiencies are directly related to the lack of auditor independence. Unless that case is made, the Board's suggested cure could prove far worse than the perceived ailment.

Mandatory rotation would represent a significant process change. Our experience tells us that a change in any process carries with it inherently greater risk of error. We do not believe a speculative marginal increase in objectivity would be worth the combined risks posed by unseating an experienced auditor and replacing it with a new auditor possessing absolutely no institutional knowledge.

Equally concerning is the exposure to risk that the Board audit committee would face due to the smaller number of audit firms that would have the global organization and the technical staff to effectively audit large, highly integrated, multinational companies such as ExxonMobil. Suggestions by some to have multiple audit firms conduct audits would simply syndicate the risk and eliminate clear lines of accountability for audits given the likely coordination, communication, and consistency issues that undoubtedly would exist in this sharing.

At this point, to suggest such a structural change is premature and risks severely diminishing the significant audit process enhancements that have been made in the relatively brief existence by the PCAOB. Over the last ten years, the PCAOB has continued to strengthen its inspection and investigative efforts, and comments received from these reviews have resulted in constructive, meaningful changes to audit procedures.

Additionally, the PCAOB has various enforcement tools which are effective at further improving audit quality. The ongoing use of these tools should continue to drive future audit quality improvements.

Within audit firms enhanced quality assurance programs necessitated by the PCAOB have provided a level of consistency and have been an important factor in promoting independence.

In addition, the five-year rotation of the engagement partner and the systematic rotation of a portion of the staff each year provides a change in personnel and new perspective and objectivity, without incurring the risks associated with a wholesale, mandatory change to a new audit firm.

In short, I believe the Board already has broad powers to effect positive change and sustained improvement through the various tools at your disposal today, which is evident from the success achieved in these years. I recommend that these tools continue to be used to the full extent possible before mandatory auditor rotation be considered again.

Many suggestions have been made to enhance or strengthen various components with the current process and framework, and I support the following: more transparency of the inspection results, stronger disciplinary action, more communications with the audit committee, and better auditor training.

The Board should give careful and deliberate consideration to these available policy tools, identify those that can be implemented effectively, and then assess their effectiveness prior to revisiting such a drastic and potentially counterproductive approach as mandatory rotation.

I appreciate the Board's willingness to listen to all sides of the issue and I thank you for the opportunity to speak to you today.

MR. DOTY: One of the problems we always have in these roundtables is to get the panel of preparers -- of chief financial officers -- to discard the ambiguity and the nuances and to tell us what they really think about mandatory firm rotation.

You have all -- each of you in one way or another have -- with gratification on our side of the table I must say have referred in one way or another, either explicitly or inferentially, to the things we are doing that are attempts to enhance the audit committee effectiveness.

We have Audit Standard Number 16 relating to communications with audit committees that's up before the Commission now, and Cory has mentioned that specifically. We've got a release out in August that encouraged auditors to be candid and forthright with audit committees about what their reports meant -- something I pick up your statements, Patrick Mulva.

I take it -- is it -- can I assume for the record that each of you in terms of what you know about auditor independence, skepticism, and objectivity, and your desire for an enhanced audit, you all believe that it's a good thing that Audit Standard 16 and the release on the information about audit inspection results -- these are positive and that you would support A.S. 16.

MR. MULVA: Chairman Doty, yes, we support that. We would encourage you to go further than that. We would encourage you to release the findings of all the investigation publicly. Obviously companies can't be named, and obviously firms can't be named. But if we want to increase the focus on objectivity and independence we think that providing that information in the public domain through the public accounting firms and then provide the opportunity to discuss with audit committees will even further enhance the progress that you've achieved in the last ten years.

MR. CANCELMI: I would agree with what Pat says about the release of the findings. It was one of the key elements that our audit committee brought up in terms of receiving the nature of the findings on a timely basis so they can evaluate the performance of the current external auditors knowing all the full set of facts and circumstances at that point in time.

MR. DOTY: Well, if we can truthfully represent that BMC Software, Tenet, and ExxonMobil all support A.S. 16 and greater transparency to our inspection results this is very helpful to us and we're very grateful. I would have to tell you that the Chamber of Commerce, the organization which purports at times to represent you, hasn't yet come around to that point of view, but I have hope they will. I have some expectation they will.

I've been doing this to give my fellow Board members time to develop their thoughts and -- Jay, do you want to pounce?

MR. HANSON: I tend to repeat myself a lot and so I'm going to ask myself a question that I asked earlier, which is what's the problem we're trying to solve. And I recently was in front of a group of preparers like yourself and I asked them a tongue-in-cheek question and I won't ask this question of you, but I'll tell you the question I asked, which is, It seems to me that part of the purpose of our exploring objectivity and skepticism is that we don't think auditors are being tough enough on you. And so my question when I had a whole bunch of you sitting in front of me was, Does it feel like auditors aren't being tough enough on you today, and, of course, I didn't expect anybody to really answer that question.

But my real question -- and I want to circle back to something that Larry Rittenberg mentioned earlier, which is around the fundamental competency of auditors. And it's interesting we're in an academic institution here and an institution with a mission to hopefully -- and the accounting program needs to educate accountants and auditors. And, Pat, I know that you had one of the thins in your statement about better auditor training. And maybe if you could just share with us some of the on-the-ground observations you see about the challenges and maybe some of your frustrations with the people that come to actually do the real work on the job.

Because we've heard a lot of questions about, Well, is it the partner that's not being skeptical or is worker bee not being skeptical. But, to me, competency has to underlie -- has to be there before you can have skepticism.

MR. MULVA: Thoughts on that? First I'd want to comment that particularly over the last ten years and as this issue's been addressed by the PCAOB I can only speak about one audit firm, that firm dealing with ExxonMobil -- is that they clearly have developed a very comprehensive educational process for their people. So we see very well trained, very competent auditors arriving on our account at all levels -- junior auditors, senior auditors.

I think though -- so I would say we've seen improvements. I think though that there's an opportunity to further improve where we are today. And what I would suggest is some level of testing within the audit firms with regard to independence and competency. We do a lot of testing in our company around competencies -- computer-based testing where you're asked a question and you get a score. And I think that that kind of focus in training would in particular raise the bar even further. I think it's been raised and people are much more knowledgeable.

But in the area of independence, particularly with new auditors, helping them understand what that means, and even some of the people that have been around a little bit longer -- help refresh them to what does that independence issue mean. And the focus of the kind of testing that could go on I think would be a continuing reminder to those people how important that is to them and is very important to us.

MR. CANCELMI: I'd like to point out, having been in this business for a number of years, both with an auditing firm as well as on the corporate side, there has been a profound change in the day-to-day involvement of the more senior people with the auditing firms. The day-to-day involvement of the partners on the account I think it's fair to say is much more extensive than it was 10, 15, 20 years ago.

So I can assure you the level of attention being paid to critical areas of accounting judgment in my opinion has stepped up over the past five, ten years. Our partners are very involved on a day-to-day basis with our organization evaluating accounting issues.

The other noticeable change from, say, 10, 15, 20 years ago is the involvement of the firm's national office in evaluating issues. If you go back two or three decades I think it was fair to say that you may have had one or two issues that during the course of an audit was raised with the national office. That is not the case any more. There are issues that are routinely raised to the firm's national office.

So in terms of addressing, you know, the competence of the field personnel I think it's very good and the involvement and the elevation of issues to senior people within the firm has improved dramatically.

MR. BLEUER: I would just add, first, one of the struggles that I personally have on this topic is that over the past, say, ten years I haven't evidenced the lack of this rigor that we're all talking about. Call that fortunate or unfortunate, I would add that even pre-Sarbanes-Oxley -- so go back ten years plus -- I experienced in roles like I have today very strenuous, tough, appropriate audits, if you will, from my audit firms. And I've worked with several of the Big Four global firms, by way of example.

So taking that into context I do struggle. And, admittedly to my knowledge, my current organization has not been a subject -- or my audit firm over my organization of a PCAOB examination or inspection. And so I haven't read the type 2 reports or the things that you're all seeing.

But from my experience over the last decade I just don't see it or sense it and would just echo the comments that each of the gentlemen to my left made on the teams, the competencies, the critical involvement of the partners, the senior managers, all the way down to staff. Even my organization -- comparing it to an Exxon, if you will, this is night and day in size, but that doesn't mean we don't have global complexity, accounting-specific, industry-specific issues.

And a corporation of my company's size sees and has as part of its audit team multiple partners. I mentioned in my remarks a regular and independent review partner effectively on two sides of the country -- different experienced skill sets. Multiple national review type partners touch issues at BMC or that my department deals with virtually quarterly -- more often than not twice or multiple times per quarter. And that's just pervasive.

And so it's difficult to conceptualize where some of these other problems are occurring because I see the independence, the objectivity, my team, my CFO -- everyone in the group does. And I just have a hard time evidencing the other things you're seeing. But I don't see the problems.

MR. DOTY: Jeanette Franzel, we got you late last time. Why don't you go this time?

MS. FRANZEL: I'm really following up here on Jay's question and I'm pleased to hear that you all have rigorous audits and I wouldn't have expected you to say that, gee, our auditors are going easy on us. But one thing -- you know, we see the problems, and what we really need to get a good handle on is, well, how do you know when things are going right -- what are your auditors doing right.

So where do you see those pressure points where -- you all take comfort I'm sure once the auditors are through and you've gotten a clean opinion. And so what is it about the process that really gives you comfort, both from the auditor's side as well as the audit committee's side because you all are also overseen by the audit committees and you see much of that process. So what is it that really gives you comfort that this is a rigorous process and there's also proper oversight from the audit committee?

MR. CANCELMI: One important attribute is the direct one-on-one routine communication that our auditors have with our audit committee without management presence. And it's not just executive session at the end of an audit committee meeting.

Routinely throughout the course of the year they are having routine dialogues, meetings with our audit committee discussing issues. In my role there would be times I would not even know that they were going to have that conversation. So it's totally independent of management.

And it's the external auditors going to audit committee saying, Here's what our issues are; this is what, you know, we're focusing our audit emphasis on -- you know, what concerns do you as an audit committee have. And in a totally independent dialogue without management being involved in that process.

MR. MULVA: I would say we're more comprehensive. That's where I get the comfort from management side. And, really, if I may, reach back to -- and why not rotate audit firms. These people have an in depth understanding of our operations, our massive systems that we run, the changes in our footprint, and they carry that knowledge and build on it every day.

So when they come to ask the question it doesn't have to be, well, what are you doing in Nigeria. It's a specific question about how we're handling certain controls issues, accounting issues in Nigeria with a depth of knowledge. Or when we've changed a system they've lived through that. And I think that -- to me, where I get the comfort is these are comprehensive looks at our business asking very, very good questions.

And then the next step is that -- again, not all that clear on what is shared in the private time with our audit committee, but our external audit meets with our audit committee privately at each meeting. But in the open part of that audit committee meeting where I am there it is clear there are comprehensive discussions that take place on critical accounting issues, control issues -- really, to me, gives that comfort.

And I think I can speak at least on behalf of our chairman of our Board or our committee from his comments that were made to you that holistic view that our auditor can bring to each issue provides them the comfort level that the company is getting a very good hard look by the independent auditor.

MR. BLEUER: I would just echo the comments made and my comments on the last question. The rigor -- the totality of the entire relationship is evident to me. Auditors aside, my organization and I would like to think and believe we maintain GAAP compliant financial accounting records and would disseminate the same to the public even without the audit firm.

I have a generally good perception of where my risk is, where my accounting risk -- financial statement risks are, and it's evident to me that the core focus is all over those risks. I would echo, too, the number of times that through regular or ad hoc meetings management is not present during executive sessions between audit committee members or the audit committee chair of BMC and our auditors. I would say it always exceeds once per quarter or your typical four per year.

It's just an ongoing rolling relationship. And it's a triangulation -- not all three points of the triangle in the same room, but once a quarter that makes me feel that there's total safeguard there.

MR. FERGUSON: You know, it's heartening to me to hear all three of you say that you think we've done a good job over the past ten years. But I think as Jeannette mentioned from what we see and having looked at inspection reports over ten years and parts of the reports that unfortunately because of the statutory constraints we really can't share with you and can't share with the public -- but I think we have a great concern that, in fact, there hasn't been enough improvement in that we keep seeing the same problems again and again and again and again.

And I cannot tell you how many times we've seen firms come and say, Oh, well, we'll do more education, we'll educate more, we'll train people more -- I think the point that we're highly skeptical of that.

And one of the interesting things that just happened this year is that the international group of audit regulators just completed a survey of inspection -- first time it's ever been done -- just completed a survey of the inspection results of 40 countries around the world by the independent regulators. And they found virtually uniform findings about the world in audit failures, in internal -- auditing of internal control and auditing of estimates and auditing of compliance with the independence rules, and in auditing fair value calculations.

So this is where the pressure comes from on the regulators. And it's happening around the world. I mean, you heard Natalie Berger here talking about what's happening in the European Union earlier. It's happening in Asia as well. I mean, auditor rotation is under active consideration in China, for example. It's already been imposed for financial institutions.

I'm not sure that's the right answer, but regulators are faced with the problems that these are persistent problems. So let me ask you -- that's a long speech as a predicate for my question -- sorry to bore you with that. But some people have considered alternatives to mandatory rotation because it's admittedly a blunt instrument -- mandatory re-tendering, for example. Periodically you have to re-tender the audit -- full-blown re-tender.

Another alternative, which the British have imposed at this point, is that you can retain the auditor periodically, but if you do retain then the audit committee in great detail must explain why it's retaining it. And it's not just that they're the best, but it's a full-blown long form, which is what do you think about proposals like that.

MR. CANCELMI: In terms of the re-tendering, I -- that process is very similar to a process a company goes through when they're looking acquiring a business or a company is looking at selling a business. It's a very extensive process -- due diligence process where data rooms are set up with thousands of documents and a wide variety of individuals that need to be involved in that process.

And if there's -- if the firms do not believe there's a strong likelihood that there will be a change the process probably will not be as robust as it needs to be. And one might argue it's a process that we're just doing it to go through that process.

I would tell you that I think the inspection findings -- if there are repeat offenders, which it's individuals or firms, and that information is communicated in a timely manner and in a manner that most effectively puts it out in the open on that firm and on that individual I believe will have a greater impact than going through an RFP process every so many years.

I couldn't tell you -- when inspection findings are identified over, you know, the past several years I've heard -- as management I've heard these were the findings that the Board's team -- inspection teams have identified. We need to sit down with you, management, and we want to go through this, this, and that. And this is what we've typically done, but this is what we're going to have to do differently.

And I find it very effective. And the public disclosure of firms that -- or individuals that are not following the rules or repeat offenders -- if that continues there might be a need to have a mandatory change at that point in time, which would create a lot of pressure on firms, as well as companies.

Because, as a company, I can assure you that you do not want to be involved with an auditing firm that's been publicly embarrassed as deficient. You have your internal and external constituencies, and you as an organization do not necessarily want to be associated with a firm that doesn't have the appropriate quality.

MR. MULVA: I'm concerned, like Dan, that re-tendering would divert a lot of resources on both sides of the equation -- the company equation and on the audit firm equation around that whole process. And at the end of the day I'm not sure we got any better but we spent a lot of time.

So I go back to a couple of points that I made around, if not that then what. One of them that I commented upon was the overall regulatory environment and the disciplinary action that could be taken. In our view, when you look at the performance of any audit firm with the information that you have from the investigative work that you do and the testing that you do, I think that you can look at an audit firm and see if there are systemic issues in that audit firm and would encourage that if they are systemic to lay on to the audit firms actions that must be taken to address those systemic.

On the other hand, in some instances, the problems could be performance. They could be execution. There could be a particular auditor that's not doing their job. And I think that certain disciplinary actions should be put in place.

I think it's more teeth in it than spending time on re-tendering and whether or not we're going to get the job and all the rest. I would suggest the look at the disciplinary opportunity.

MR. FERGUSON: What about retaining but explain? After a period of time that if you're going the keep the auditor for more than ten years -- whatever it is -- that the audit committee on a regular basis has to explain in great detail why the particular firm is being retained.

MR. BLEUER: I would just comment on that -- and I touched upon it briefly in my remarks regarding a company-specific example. I wouldn't be against that speaking as a person separate from my organization that I'm representing. I would prefer that to mandatory or forced re-tendering or go out to bid situation.

Just to comment on the latter really brief, I would admittedly prefer -- and I think most corporate panelists would prefer -- a forced re-tendering to a forced rotation. I'll state that but I don't, as well as the fellow panelists here, think that that's the right answer.

I think it gives rise to practical constraints and concerns about whether there is really substance and that the corporations and the auditors are really getting into conversations that could likely give rise to change. I believe that audit committees in my example earlier do that occasionally. My situation just under two years ago within BMC was one in which, although without mandate, our audit committee through the partner rotation process effectively re-tendered with the involvement with two other local firms that played through the process.

I wouldn't -- to your question more specifically, again, I'd reiterate I wouldn't have any concern with stating a reasonable bound of information or the audit committee, if you will, through proxy or other reporting means as to the auditor relationship.

I commented on and was a little bit more fluid in the written comments I pre-submitted about the situation my company went through. It was brought to light as a result of a shareholder actually asking that we do a bit more.

But on principal on premise I think it would be hard as a comparison to force rotation to argue that reasonable -- not exhaustive, but reasonable information into the public -- or put into the public as to how an audit committee thinks through the independence issues and why it retains or doesn't retain or how often it gives what considerations to that process could not harm and could only aid the industry and shareholders who might have a concern. That's my opinion.

MR. MULVA: I think that there's always been --

I can only speak, of course, for one company and one audit committee -- that there's been a rigorous process of considering in the overall independence, but I think the bar was raised following Sarbanes-Oxley and the change in the rules from New York Stock Exchange.

And once those rules have been implemented or those guidelines are in place what I see on an ongoing basis, at least, again, within our audit committee, is the continuing discussion around are we getting an independent, comprehensive view of what's going on.

So I wouldn't want to tell you that we are looking at re-tendering because we're not. But what I would say is the objective of that is to answer the question does the audit committee really test the independence and the objectivity of the auditor. And I can only speak for one in saying that between the communication that goes on between the auditor and the audit committee and the audit committee's requirements and the charter of the audit committee, at least in our company, that I feel that that's being done.

So to then increase or change the -- what I would say I guess is the disclosure I look to the disclosure as saying that's the audit committee's job to ensure the independence and they disclose that in summary.

MR. HARRIS: Dan, you changed auditors --

MR. CANCELMI: Yes.

MR. HARRIS: -- and I'm curious as to your experience. First of all, why did you change auditors? And we hear that after you change auditors that first year is a tough year. Audit risks are going to incline, there's going to be a lot of difficult transition issues to deal with.

How did you make this transition? And if you were able to make it relatively easy what does that say about the arguments against either re-tendering or rotation? I mean, we hear these -- we hear the arguments that somehow or other switching auditors, for any reason, is going to be costly, difficult, risk is going to go up. So could you tell us a little bit about your experience and what happened in that first year?

MR. CANCELMI: Absolutely. As I mentioned in my remarks we -- you know, our company did change auditors five years ago. It is a -- it's a very comprehensive process that requires a significant amount of time, not only during the proposal stage because -- to be able to provide the information to the four firms, for them to make an appropriate assessment of this potential audit for them, again, it's somewhat similar to going through an acquisition or divestiture.

You need to pull together so much information and -- as well as a multitude of individuals within the company just to get at the stage of the RFP process where that firm can make an appropriate assessment of this potential audit. It -- just the RFP process takes a number of months in terms of gathering information, having the firms come in -- and they'll come in more than once and for a number of different days. But very, very, very time consuming. But we thought it was appropriate at that point in time for our organization.

After the audit firm is selected I think, as most people would realize, you know, the first year is certainly tougher than, you know, year three or four. Whether the firms would ever, you know, want to suggest that, you know, audit quality in the first year is any different then year four, you know, for malpractice reasons no one would want to suggest that.

But it's, you know, significant learning curve, very difficult. Management needs to be fully committed to it and across the organization. And you have to conclude it's in the best interest of the organization to do that.

To have that imposed on an organization every so many years, we just don't believe that's the best way to get at the problem. Again -- repeating myself -- but I believe the best way to get at this problem is if individuals continue to perform inadequate procedures, inadequate audits the threat of a mandatory change because of deficient audit practices I think would have a greater impact on this issue than going through a mandatory RFP process every so many years.

The other item that many individuals have suggested is having the individual audit partners be personally accountable with their names on the audit opinion. I think that's certainly an interesting idea. It would hold them personally accountable similar to management. The CEO, the CFO, the controller -- they're personally signing their names. So, you know, that's something I certainly would hope the Board would evaluate.

But I think those approaches get to this problem in a more effective manner than a mandatory re-tendering or re-proposal process every so many years.

MR. HARRIS: Following up on that, first of all, you'd do it again. Right? I mean, would you --

MR. CANCELMI: Yes.

MR. HARRIS: -- change your --

MR. CANCELMI: It was the right thing for our organization. Absolutely.

MR. HARRIS: If it's the right thing for your organization, based upon what you seem to be saying, there was a very significant problem with your prior auditor. And if that's the case why shouldn't the regulator be all over that auditor because presumably there's either a quality issue or there's a major substantive problem for you to change auditors.

MR. CANCELMI: Well, I just want to clarify it. I didn't indicate that there was a major quality problem with our former auditors. However, if we were associated with a firm that continued to have problems on a repeat basis for a long period of time and did not seem to want to change their practices and learn from their past mistakes I can assure you -- not speaking for our company's audit committee -- but I would assure you that they would have concerns with that.

And it goes back to a company not wanting to be associated with a firm that's not considered, you know, world class. You want to be associated with a firm that's world class.

MR. DOTY: This -- and the lingo that develops -- or the argot that that develops around an issue like this -- this is known as the default provision solution to rotation. In other words, in the event of a series of adverse findings by the PCAOB or other circumstances that add up a problem, combined with tenure or whatever factors might be deemed relevant, as a default the firm must rotate and the auditor is declared independent.

It raises a couple of interesting questions, one of which is the one that Jay Hanson raised earlier, and that is would it be -- is your approach limited to the engagement level and not the firm level? In other words, would you be dealing -- would you be suggesting that what we should do is be thinking about building into our enforcement process this as a remedy on an engagement level basis, not with respect to the firm as a whole.

And, if not, one would have to worry I think -- people would be concerned that a more general pronouncement might create a rush for the door in crowded theater. In other words, what we would not want to do is suggest that what we are saying about a particular engagement suggests that the firm's quality control as a whole is wrong. Can you comment on those? Those would be useful.

MR. MULVA: Chairman, I go back to the comment that I made. What I would suggest from PCAOB is looking at the performance of an audit firm at two levels and judging is it a systemic issue. In other words, are there processes in how their doing their training and the overall -- is that the issue or is it an execution issue -- or is the audit itself.

And so I would tend to say that judging from the work that's gone on in many audit firms you possibly are seeing -- have very few systemic issues and then it is execution. And then I would encourage specific actions taken at that level as opposed to painting the entire firm. There may be systemic issues and then the entire firm may need to be dealt with.

MR. DOTY: Exactly. Exactly. What you're saying is that this is the kitchen we live in -- that the PCAOB is in this kitchen -- that --

MR. MULVA: Right.

MR. DOTY: -- that's the heat in our kitchen -- that we, in fact, are charged with making determinations of whether there's a systemic problem in the firm, whether it's engagement problem in a particular office -- that that's what our enforcement and other powers are for. Do you think that -- if that's where we are do you think that it's important that when we find an enforcement problem or a systemic problem that we'll be able to make it public promptly as opposed to having it go through an extended appellate process? Would you want to know, for example, that we have found that your auditor has a systemic quality control problem of some sort?

MR. MULVA: The answer -- yes. And, in addition, timely from the standpoint that a lot of the information that we get and we see is two or three years previous.

And so we would encourage a timeliness of those findings.

MR. DOTY: Well, those are profound comments and they go to changes -- they go -- if not structural, certainly significant changes in the current regime. My colleagues may have other issues. We're going to save a little bit of time. We have to thank you -- all three of you -- for a tremendous presentation and a very enlightening one. Thank you again.

MR. MULVA: Thank you, Chairman.

MR. CANCELMI: Thank you.

MR. DOTY: Now, Cynthia Fornelli, Executive Director for the Center of Audit Quality, will be coming to the rostrum. As Executive Director of the CAQ she's responsible for carrying out the mission and vision of the governing board comprised of eight leaders from public company audit firms, the American Institute of CPAs, and three independent public members.

Accounting Today has named Ms. Fornelli one of the top most -- 100 most influential people of 2012, the sixth consecutive year she's received that recognition. In 2011 she was honored for the third time by NAC Directorship magazine as one of the 100 most influential people on corporate governance and in the boardroom.

She currently serves as a member of the Financial Accounting Standards Advisory Council, responsible for advising the FASB on technical issues, project priorities and other matters, and the Securities Exchange Commission Historical Society's Board of Trustees class of 2014; previously on the NACD Blue Ribbon Commission on the Audit Committee and their Blue Ribbon Commission on Risk Governance.

Prior to becoming the director of the CAQ she was the regulatory and conflicts management executive for Bank of America, and, most importantly perhaps, she was deputy director of the Division of Investment Management of the United States Securities and Exchange Commission -- a long and distinguished career in financial services regulation.

Gaylen Hansen -- audit partner and director of quality assurance at EKS&H in Denver, Colorado, chairman-elect of the National Association of State Boards of Accountancy, NASBA. He's responsible for his firm's policies and procedures, a member of the standard advisory group of the PCAOB and the AICPA's Professional

Ethics Executive Committee.

He serves internationally on IFAC's Consultative Advisory Group, both the IAASB and the IESBA, both of those being the international audit bodies that we deal with frequently. A panelist on the IFRS roundtable, Colorado State Board of Accountancy member, U.S. Treasury Department Advisory Committee. On the auditing profession there's not much that Gaylen Hansen hasn't been able to do for the audit profession over the last decades.

W. David Rook, partner-in-charge, Firm Assurance and Advisory Services at Weaver and Tidwell, LLP, a certified public accountant in Texas. As the firm's partner-in-charge he has overall responsibility for their audit and advisory services at their seven offices throughout Texas.

Fifteen years of auditing experience in public company accountancy, a member of the AICPA, Texas Society of Certified Public Accountants, and the IPA of -- Independent Petroleum Association.

He has been appointed by the presiding officer of the Texas State Board of Public Accountancy as a member of the Technical Standards Review Committee and Peer Review Committee. And he received a bachelor of administration from Stephen F. Austin, magna cum laude.

Welcome to all of you and thank you. Cindy, you want to kick us off?

MS. FORNELLI: I'd be pleased to do that. So thank you, Chairman Doty and members of the Board and PCAOB staff. I do appreciate the opportunity to participate in the PCAOB's third public meeting on auditor independence, objectivity, and skepticism.

You mentioned my career at the SEC. I suppose once a regulator some of that gets baked into you and so I'm going to give a disclaimer of my own and say that my remarks today represent my observations and those of the CAQ, but not necessarily those of any specific firm, individual, or CAQ governing board member.

You have my written comments which I submitted and those focus on the development since the March public meeting at which I had the pleasure to attend and participate in. So I would like to just summarize a few points that I outlined in my written statement.

Our system of financial reporting is often described as a four-legged stool with preparers, auditors, audit committees, and regulators as the four legs. It's also described as a canoe with four rowers.

Regardless of the analogy used we all have the same objectives -- strong, fair markets in which investors have confidence to invest. And with respect to auditors in this system their leg of the stool is to provide quality audits and do so independently, objectively, and with the appropriate level of skepticism.

I would like to address the notion that has been raised somewhat during the day today that auditors perhaps are not on the side of investors. I would note that auditors do have investors' interests at heart.

And as just a few examples of that I point to the recent fair value debates where the profession fought to maintain fair valuation and also fought for the sanctity of independent accounting and auditor standards setting, the profession's opposition to 404 exemptions for smaller public companies, and to investor confidence surveys where investors say that the party they most trust to look after their interests are auditors.

The timing of the Board's review on auditor independence, objectivity, and skepticism coincides with the tenth anniversary of the Sarbanes-Oxley Act, which forms the backbone in the United States of the unique and highly effective system of investor protection, as we've heard a number of panelists say today.

The profession has respected and fully embraced the requirements and the spirit of Sarbanes-Oxley and is committed to ongoing efforts to enhance audit quality and independence, objectivity, and skepticism.

The work of the CAQ is an example of how the firms have strived to contributed collectively to the development of audit and financial reporting policy and the enhancement of corporate governance in a positive and substantive manner.

Each of us with a role to play in the overall system of investor protection has an obligation to continually endeavor to enhance the attributes that sustain audit quality and to continuously improve our respective roles and responsibilities.

First and foremost, the firms themselves are responsible for establishing and maintaining a system of internal quality control that fosters these attributes. Firms must use the information they receive from PCAOB inspections, their own internal inspections, peer reviews, and other inputs to understand the root causes and respond appropriately to any deficiencies in particular audits or quality control systems.

In addition, firms must not only teach and reinforcement the skills related to the technical aspects of evolving standards but they also must inculcate in their auditors the importance of fusing their work with independence, objectivity, and skepticism. This requires a firm culture that pays explicit homage to these values and supports their conscious application through training, tools, and monitoring.

As for audit committees, the CAQ supports efforts to strengthen their oversight role, particularly as it relates to assessing the auditor's performance during the audit and formalizing its views before making a recommendation on auditor retention.

We also support the efforts of the audit committee community to find better ways to communicate to shareholders information about the annual evaluation of the auditor. The assessment tool released earlier this week by the audit committee community and supported by the CAQ addresses both of these issues. And as you heard Ken Daly say earlier today this work is ongoing.

Also as we've heard throughout the day, the PCAOB also can assist in improvements to audit quality and auditor independence, objectivity, and skepticism. We, too, encourage the PCAOB to utilize the wealth of inspection information gathered each year to provide guidance on how auditors can continue to improve audit quality in areas that are representing the greatest challenges to auditors and are of the greatest concerns to the PCAOB.

With respect to the firms, there are a couple of specific initiatives and developments I would like to quickly mention that build on many of the constructive ideas that have emerged from the ongoing public dialogue started by the PCAOB.

First, open, two-way communication between the auditor and audit committee is crucial, and improving this process fosters quality audits. Tot his end there are three projects to note. First, on October 24 the CAQ is hosting a public free webcast on communications with audit committees. The webcast will help educate auditors and audit committee members about the requirements of AS 16 and discuss leading practices in the area of audit committee communications.

Second, in response to the PCAOB's August 1 inspections released, the CAQ has developed and issued a practice aid that encourages proactive auditor communications with audit committees regarding inspection findings and the steps the firms are taking to improve its system of quality control. This topic also will be discussed at next week's webcast.

Third is the series of skepticism webinars that Ken Daly mentioned earlier that were designed -- or that are designed to enhance the ability of those with a role in the financial reporting process to develop and maintain and environment and mindset that promotes skepticism.

These webinars, along with the white paper that will follow, will address some of the challenges with exercising skepticism that we heard from some of the behavioral economists and behavioral psychologists that you had earlier on in your panel.

I appreciate the opportunity to be part of the PCAOB's examination of ideas to enhance auditor independence, objectivity, and skepticism. Again, I believe the profession is strongly aligned with the PCAOB and the audit committee community in the objective of furthering these critical attributes. And we are committed to working with you and other stakeholders to see this through. Thank you.

MR. HANSEN: Thank you, Chairman Doty. It's a privilege to be here. And thank you for inviting me to participate in what I think is a very important dialogue that we've had here today. I had the opportunity to attend the Washington meeting and I would say that the quality of these -- each one of them seems to improve. So we're at the end of the day here. Someone said that we were batting cleanup. I said, I feel more like it was when I was ten years ago and I was invited to play right field and bat ninth.

I -- let me -- I thought I would share with you a little bit about my background -- my employment background. I've been an auditor almost 40 years. I started right out of college with one of the big eight firms and then actually ended up working for another one later on -- a regional firm -- and was actually self-employed at one point as an auditor. I thought if I got any smaller I'd be the invisible man.

But I am currently with a large firm in Colorado. We'd be considered a small firm except for the fact in our market area we're the largest firm in Colorado -- really in the Rocky Mountain area with quite a number of professionals. It's my responsibility to be the quality control partner of the firm.

I don't have any direct client responsibilities any more with the exception of being a concurring reviewer and EQR reviewer, which I take very seriously and allows me to keep my thumb on the pulse of the firm and what's going on.

I'd also like to share with you a little bit about NASBA, since you had mentioned it -- of my involvement with it. NASBA's mission is to enhance the effectiveness of licensing authorities of CPAs and their firms in the U.S. and its territories. Boards of Accountancy take seriously their responsibilities to protect the public interest. They understand the importance of the public confidence and the importance of reliable capital markets. And in that spirit now on behalf of NASBA I wish to convey our appreciation for this opportunity to express some thoughts on independence, objectivity, and professional skepticism.

And with that I'm going to depart from my written statement because you already have that. I wanted to go back to my employment. My very first -- and I should move back for a minute. I would also say that despite the fact that I have an opinion on these things there is no consensus like Greg Smith within my firm. I have partners that disagree with my position and they're also individuals within NASBA. So we don't have a uniform position on what I'm going to be discussing today.

My first job right out of school -- big eight firm, Southern California. After all the training and everything was said and done my -- the first job I was assigned to was in southern California on a very large utility. At that time it was the seventh largest utility in the world.

On my first day I checked in and got my

securities card. They gave me a key. I noticed that we had our own offices that key would get me into. We were listed in the phone directory. Went down to the cafeteria to have lunch and no one could tell the difference between who the auditors were and who the employees were. So I felt right at home. That was going to be my home for six months out of the year for the next number of years. Nothing necessarily wrong with any of those things individually.

But I wanted to share an experience that I had at the end of that day as I sat down with the audit senior. The audit senior gave me a little bit of background of the firm's history with this particular client -- informed me that it was a very important client of the firm, that they had been a client for over 50 years. And his parting words to me as I left that day has sort of haunted me throughout my career. He said, Hansen, don't screw it up.

And I tried not to screw it up over the course of my career, and everyone -- when I convey to them and they say, Well, everybody has this anecdotal, you know -- it's just anecdotal, Gaylen. Don't worry too much about that because we've had all these SOX protections that have kicked in, there's audit committees that have more authority now, partner rotation, and so forth. But I'll tell you I would bet you anything that those same sorts of conversations can take place today -- and they are taking place today.

In my written statement I'd like to share something with you that I had written about audit committees. While SOX has resulted in a significant net improvement of the audit management, and unfortunately not the audit committee, typically still drive the auditor hire-or-fire decision, at least more so with smaller issuers.

In some respects these audit committees have very little real involvement in auditor oversight other than a briefing before the audit begins and again prior to filing. Often, these meetings are merely quick conference calls and usually includes significant management participation. In many cases the focus continues to be driven primarily by a desire to control or reduce fees instead of improve audit quality.

In summary, in many instances audit committees continue to exist solely as an alter-ego of management. The role of the audit committee still needs to be strengthened and especially to remove the management -- remove management from the hire-or-fire decision.

After a few years in L.A. I was transferred by my firm in Denver. And in Denver I worked on much smaller engagements -- worked with venture capitalists. These are the high tech startups up in the Boulder area. It was interesting whenever I was at firm meetings -- and you know how you sit down a lunch and you're on those -- in those round tables and you kind of go around and introduce yourself.

And whenever I introduced myself I would describe the types of companies that I worked on but I never named any of them. Some of the other individuals that worked on the blue chips -- when you got around them -- to them their chests sorts of puffed out and I work on so-and-so company that everyone has heard of, and, boy, it's tattooed right across my forehead -- and weren't they so much more important than I was in the firm.

What they were talking about was the crown jewels of the firm, and they were referred to as our clients.

I always could cringe when I read a proposal that talks about our clients almost sort of in a possessive sort of way. And that brings us back to the conversation that occurred earlier -- who is our client.

I would submit to you -- I don't agree that it's the audit committee. That might be our boss, at least somebody that can whack us with their arm. But the extended boss is really the investors. And NASBA, in fact, has a little broader view than that. It's anyone who uses or relies on financial statements, and that could be the Government, it could be -- it could be anybody that picks them up. But the important thing is that that's who our responsibility's really with.

So we have this important reporting project that's going on, both at the PCAOB and with other regulators around the world. It's interesting is that going through these paragraphs making these important changes and focusing on that that they haven't really spent any time on the salutation where it's addressed to the Board of Directors and the Shareholders. And maybe it should be addressed to the Public.

But certainly the standards should at some point define who the client is. If this group doesn't necessarily agree on the client it seems like we have a little bit of work to do.

Just a couple of quick things because I know we're out of time here. Board member Harris asked about oaths and swearing in ceremonies. There's a number of states where we do that when people become CPAs -- I'll mention a few of them -- Louisiana, New Mexico, Rhode Island, Texas. And actually we did have a member of the PCAOB -- a Board member attend one of the ceremonies in Maryland. Many of the states have affirmations that they sign too, Steve.

Let's see. And then one other thing I think is a problem -- is transitions with some discussions about handoffs. I have something in my written testimony -- not testimony -- my written statement. But just wrapping up, I'm still haunted about that statement. I ought to find that senior some day and ask him what he meant by Hansen, don't screw it up. Thank you for the opportunity to present today.

MR. DOTY: Thank you. David Rook.

MR. ROOK: Thank you. On behalf of Weaver and

Tidwell, I'm pleased to have the opportunity to participate in this panel and to present Weaver's views on the PCAOB's Concept Release on Auditor Independence and Audit Firm Rotation.

Some history on our firm -- over the past 62 years Weaver has become the largest public accounting firm headquartered in the state of Texas with approximately 450 team members located in seven offices throughout the state of Texas. We consistently rank in the top 50 accounting firms in the U.S. as reported by Accounting Today and Inside Public Accounting Report -- currently 38th in the country.

We offer audit, tax, and advisory services to a diversified client base operating in a variety of industries. Our clients include both privately-held and publicly-traded companies, as well as government entities, typically headquartered in or around the state of Texas, some with national and international operations. And we've provided public -- we've provided services to publicly-traded companies for over 40 years.

Our views on auditor independence is that we do agree that independence, objectivity, and professional skepticism are critical to the viability of the auditing as a profession and provide the foundations for a high-quality audit.

We also agree with the Board's assessment that the reforms in Sarbanes-Oxley have made a significant, positive difference in the quality of public company auditing. These reforms include many measures intended to improve the auditor's independence and objectivity, including audit committee oversight of the process, limitations on non-audit services, audit partner rotation requirements, and creation of the PCAOB.

Since the enactment of Sarbanes-Oxley there have been regulatory and other developments that have improved audit quality such as adoption of PCAOB auditing standards and the development of the PCAOB inspection process. We believe these efforts and the Board's ongoing standard setting agenda will continue to improve audit quality.

While we support the Board's ongoing efforts to improve independence, objectivity, and audit quality we do not believe that mandatory audit firm rotation is a concept that will work and, if enacted, could raise significant risks and result in unintended consequences.

We have always believed that the danger of a failed audit is greater when the auditor does not fully understand the client's business than from the auditor being too familiar with the client's business.

In some of the statements that we were asked to review in participating the reference to the financial crisis of 2008 and 2009 was brought up. And in that process certain individuals made comments that mandatory audit firm rotation may solve that particular crisis. And in our view that was more of a competency issue, not more understanding the client's business or the -- of the financial instruments than familiarity risk.

And we agree with the General Accounting Office's 2003 conclusion which said in part, Mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality considering the additional financial costs and the loss of institutional knowledge of a public company's previous auditor of record.

And then specifically on auditor independence, independence, objectivity, and professional skepticism are fundamental to audit quality. Our reputation and our people are our most important assets at Weaver. We strive for audit quality in all that we do and continually challenge our staff to regularly employ a health level of skepticism in performing our responsibilities.

And at Weaver we believe we practice what we preach. An example of that is in May of 2012 we implemented mandatory independence training for all firm staff of four hours, and we've seen the benefits of that in the past few months.

As stated in the Concept Release, PCAOB inspectors have continued to identify significant deficiencies related to complex financial instruments, inappropriate use of substantive analytical procedures, reliance on entity level controls without adequate evaluation of whether those actually function as effective controls and several other issues.

Whether the root causes of these deficiencies relate to a lack of professional skepticism or some other factors such as a lack of experience of the team members, lack of technical competence, or a lack of training on the part of the auditor is difficult to determine.

And we believe that additional study of these root causes should be done before such a drastic measure as mandatory firm -- audit firm rotation is mandated. And as noted in the Concept Release a preliminary analysis of the inspection results appears to show no correlation between audit tenure and the number of comments of the PCAOB inspection reports. Thank you for allowing us to participate.

MR. DOTY: Well, thank you. Jeannette?

MS. FRANZEL: I'd like to talk a little bit about root cause analysis and professional skepticism because in our inspection findings we find a lot of things that are labeled as professional skepticism -- and it's a big bucket.

And what we really need is some good root cause analysis from the firms on this. And given what we've heard about bias I guess maybe I'm understanding why it's hard for the firms in some cases to do these root causes analyses.

But I'm going to oversimplify a little bit. But, you know, we find examples where maybe an entire audit area isn't even audited, you know, so clearly the auditor's not using professional skepticism there in auditing that.

We might find a case that -- or just kind of going along the spectrum where the auditor takes what management hands them and puts them in the files and that, you know, serves as the audit work. And that's a skepticism problem.

We may find a case moving down the spectrum where the auditor did steps one, two, and three but not four, you know, in terms of trying to challenge and verify that information, et cetera.

And so what -- and several people today have called for root cause analysis of linkage -- you know, is this linked to tenure. Well, we need some good root cause analysis. We do attempt to do some of that ourselves here, but, really, these are very complicated situations where the firms really need to go and retrace the steps of that audit team to decide what went wrong here and how can it be prevented in the future.

So I'd just like each of you to talk about root causes analysis -- you know, Cindy, maybe any initiatives you have with the firms on that with the CAQ. And then, Gaylen and David, whatever works in your firms for doing root cause analysis because this is complicated.

MS. FORNELLI: I'll go first. I think that you're exactly right. Root cause analysis being done both by the PCAOB and the firms is critical to getting not only at issues around independence, objectivity, and skepticism that can negatively impact audit quality but other attributes that negatively impact audit quality.

So I think that a number of firms -- certainly the CAQ governing firms, as well as a number of our members, have started implementing root cause analyses within their firms. We haven't yet in initiated a project where we will try to collect that data at the CAQ and look toward that, but at a lunch conversation that we had today informally out on the lovely Rice quad -- and congratulations on 100 years -- we had a discussion at the luncheon table about that very project. So that will be something that I will take back to look at.

But I think that is a key to this, getting down to it. You mentioned the behavioral discussions that we heard today. I too found those very, very fascinating.

And part of what we did when we did these skepticism webinars was actually look at that and look at what are the decisions that -- what's the framework that can help people make decisions so that they can overcome their natural biases. And then what are the tendencies -- what are those bias tendencies that people tend to have.

And so I think training and education on that also can help so that you have this decision framework where people look -- try to combat or mitigate those inherent biases as well as then the tendencies to bias.

MR. HANSEN: I absolutely believe that the discussions we've had about root cause at the SAG meetings is really -- have been productive. And I brought that back to my firm and we have had discussions about that.

It's easier to talk about it; it's much harder to do. And, you know, more work needs to be done on it. In our firm we just simply -- we demand quality. I mean, that's -- there's no ifs, ands, or buts about it. And if a person isn't willing to go there then we have to have other discussions.

Now, as a state board member, when I was a regulator -- and I've been off the state board for a couple of years -- these are the things that keep you up at night worrying about whether or not the balance of fairness is there, whether or not you're going to take somebody's license and ability to make a living away from them. So I've been down that road and I know the heavy weight that -- much heavier weight that you folks deal with.

There's some people that you're not going to be able to remediate. There's that you just have to come to grips with that. And in this root cause analysis part of it is you have to be able to build an environment of trust because it's sort of like fraud in financial reporting. If -- you have a difficult time cutting through to what really happened unless you have an environment of trust and you can walk through, Jeannette, like you talked about, and take those tracing steps of what really went wrong in order to help someone -- they're not going to tell you where they went unless there's that environment of trust.

So I think those are some of the things that we work on in our firm and we're going to -- we're not even anywhere near where we need to be on this and I don't as a profession we are. But I think you're going down the right road.

MR. ROOK: I would agree with that. Our firm -- our leadership team does try to set the right tone at the top. Quality is paramount. If you ask every accounting firm in the country and they were before you they would probably also say quality's paramount to their firm.

We do practice what we preach. We have the partner in charge of assurance and advisory separated from our quality and risk management function. That particular partner in charge reports directly to our executive committee, which is independent of the CEO and myself. So I think that's an important aspect of ensuring quality.

From a root cause analysis we go through internal inspections annually, including our peer review every three years and then the PCAOB inspection.

Annually we still cover issuer audits through our internal inspection process. We look to what issues, if any, are identified in those audits. And then the quality risk management partner, myself, and each of those engagement partners sit down and they go through what went wrong in that particular audit, what the findings were, was it a competency issue, was it a staffing issue, was it a training issue. So I think we do those things well.

And I do agree with Gaylen. I think that the profession could do a better job analyzing the root cause analysis -- but that's what we do at our firm.

MR. HARRIS: First of all, Gaylen, thank you for the update with respect to the states on the certification -- or the affirmation, and, Cindy, to the extent that the CAQ could consider whether that's an idea worth pursuing on an incremental list as well in certain areas -- not in others. But I think that may be one where we could make a difference.

MS. FORNELLI: Yes. I have to say throughout my career I've had to do such attestations and certifications. And, you're right, it does make you stop and pause and think about what it is that you're signing. And so it's definitely we will take back.

MR. HARRIS: Well, we have to do at the PCAOB and it certainly focused my mind the second time around. You also mentioned, you know, disseminating expanded transparency report in the October 15 -- and Natalie Berger mentioned that as well. What are some of the ideas that you are considering in terms of an expanded transparency report on the part of the firms?

MS. FORNELLI: Well, I think it would be -- in fact, I think some of the largest firms already do a form of a transparency report. We had considered whether or not it should be a standardized transparency report, which does have the benefit of comparability amongst the various firms.

But I also think that the firms should think about how they want to describe their systems of internal controls. And that, to me, is the key as an investor that I want to know: what are firms' quality control systems.

So allowing them to do that in a way that gets that information out there as opposed to having it in a standardized form I think is probably a better way to go. But I think there should be certain components in there. And so we're very supportive of that idea.

We're also very supportive, of course, though of the audit committee having a lot of transparency about how they go about doing their annual assessment. And another point -- and I guess this is one of the benefits, or the harms perhaps, of batting cleanup is that there are a lot of ideas that were explored today that I'd like to touch on.

But I think that, you know, having more transparency out there is beneficial. And I think we should all work on doing that. So certainly in the audit committee community I think that's important as well as the auditors themselves.

MR. HARRIS: Because that was front and center among the May recommendations and the ACAP recommendations. And obviously these firms are extraordinarily important and I think the more transparency that they give for all parties and interests probably the better off we are.

MS. FORNELLI: Well, and I would be remiss not to mention also the auditors' reporting initiative that you have underway. I think that's also a very critical, important, and timely issue. And so we were pleased to participate in that and provide information about what that might look like based on the concept release.

So Marty and his team and the Board is to be commended for that as well. And I think that's also a form of transparency -- having more robust disclosures in the auditors' report as well.

MR. HARRIS: And then, finally, Gaylen, you mentioned the need to strengthen audit committees. But aside from removing management from the hiring, which is something that Rod Hills is very aggressively supported in the past and he -- from my perspective he's kind of the father of the independent audit committee. How would you recommend that we make independent audit committees more independent?

MR. HANSEN: Well, how do you make -- it's -- they need to have some distance from the CEO -- from management. And, you know, whoever's choosing the Board members -- whoever has that authority -- it's got to be folks that are a bit further removed. And I think this actually happens in the larger companies. It's the smaller ones that just don't really have a lot of board members to begin with, and they're handpicked by those that are running the company. I think that's where you have to start.

But I think also their skills and the quality the individuals need to be upgraded significantly. I don't see any reason why someone with an audit -- stronger financial reporting background shouldn't be on the audit committee.

MS. FORNELLI: May I add to that, if I could? As you well know, in Sarbanes-Oxley it allows for -- if not I would say perhaps even encourages -- audit committees to get expertise if they don't have that expertise. And that is something that in our discussions with the audit committee community that we have very much stressed -- that if they don't have the requisite experience, be it financial expert or an auditing and accounting expert on the audit committee that they can under Sarbanes-Oxley get that. And so we would encourage more use of that provision in Sarbanes-Oxley.

MR. FERGUSON: Yes. I want to go back to a concept that's been raised earlier today -- or at various times in these meetings -- the concepts of what's called economic bonding. And economic bonding refers to what you talked about, Gaylen, which is if you want to capitalize the value of the long-term relationship with a client, particularly a large client that could have millions or tens of millions or hundreds of millions of dollars of audit firms, and this asset -- this could be an asset worth gigantic amounts of money -- hundreds of millions, billions of dollars.

If we're not naive isn't that really the mother of all root causes? I mean, isn't that the 800-pound gorilla that sits in the room with the auditor who really wants to be skeptical and says, Am I going to be the guy who is going to threaten this revenue stream.

And as long as that exists are we really whistling in the wind here about thinking that we can make major and significant improvements in audit quality that are sustainable?

MS. FORNELLI: Well, I would posit that under a system of mandatory rotation you might still have that incentive. Presumably even if you're rotating every five, ten, 25 years you're being paid for the work that you're doing. And if it's a large, multinational corporation that's going to be a large fee.

And so I don't know that the economic incentive is what necessarily leads to a perceived lack of independence, objectivity, and skepticism or a real lack of independence, objectivity, and skepticism. I think perhaps it's more along the lines of the behavioral issues -- is this unconscious tendency to trust in these built-in biases.

And so I do think based on my career at Bank of America when I was charged with developing the bank-wide conflicts of interest program -- you know, there are several ways -- and one of the panelists today talked about that.

There are several ways to get rid of an inherent conflict of interest, and I think that the issuer pay model presents one of those inherent conflicts of interest. So you can either eliminate it and -- I haven't heard a good alternative to eliminating the issuer pay model, and I think it's been studied for many decades, or you can mitigate it.

And I would argue that Sarbanes-Oxley put in many systemic mitigants to that, but we all have to do a better job of also combating this erosion -- potential erosion of independence, objectivity, and skepticism.

It's one of continuous improvements. You know, we're never going to get it 100 percent right because we're always going to have to improve, improve, improve. But I personally don't think it's the economic incentive.

MR. FERGUSON: What if you coupled mandatory rotation with mandatory retention so that you knew you had this client for a particular period of years and that's all you could have it for. But you would not be removed. The client couldn't remove you so the fear of being fired would be gone.

MS. FORNELLI: Well, I worry about that too. I think that also has a set of biases and potential problems if you can't be removed. I prefer a rigorous annual evaluation where the audit committee is annually assessing the auditor's performance and making a determination that the auditor should be retained or replaced. And perhaps as importantly, if not more importantly, is explaining to the marketplace and to shareholders that they've done that assessment and what their findings are.

MR. HENSEN: If I might say, I agree with some of what Cindy says, but basically you're preaching to the choir with me. I buy into the notion that there's -- as long as that economic link is there there's a problem. And I essentially favor mandatory rotation.

On the removal I'm not as energetic about that. I worry about, as I said in my response -- my written response. Complacency -- I do believe that there's a fair amount of visibility to this and firms can just suffer through it for a couple of years, and it's not a big a deal.

So I don't know that that's going to be a deterrent. I am more aligned with the notion of rotation at some level. I go back to what Chairman Levitt said at your first meeting -- your first conference. You know, after 50 or 100 years this just does not -- something about this just doesn't feel right. And that's what bothered me way back when, 40 years ago. It just didn't feel right.

MR. ROOK: I think what's lost, either in the profession or in the this discussion, is just accountability and holding the firms accountable for doing a quality job.

And I don't think that mandatory audit rotation solves that particular issue of do your job -- do what you're hired to do which is an obligation to the investment public.

And I don't know that especially not being able to fire -- I mean, coming from an audit partner background if you told me I had an engagement for ten years as a firm but I couldn't get fired from that I don't -- I think you take -- you somewhat undermine the audit committee and what their job and what they're accountable to -- their organization and to the public as well in that they no longer can evaluate the audit firm on an annual basis or every three years or every five years or whatever their policies are to determine if that particular firm's doing a very good job or not.

And after two years if you're not serving that client correctly the audit committee should be able to remove you from that position whereas -- I mean, and I think the alternative is the same. If you are doing a very good job -- if it's after five years or ten years or 15 years if the firm is serving that company well they should be able to continue to serve that company well based on the decision of the audit committee.

I would go back and speak -- I mean, our firm audits much smaller issuers than an ExxonMobil or a BMC Software or Tenet that was up here earlier. And I think Gaylen spoke to -- there's a difference between the small issuers that we see as a firm and the Fortune 100 or 200 companies in the U.S.

And most of the smaller issuers -- they may not even have an audit committee. And I think that's where some of some of the skepticism comes in where management, because they don't have an audit committee or the only CEO of a company that has a $20 million market cap is serving as the audit committee and they're doing the hiring and firing of the auditor. And I think those -- that's a different pressure point than your Fortune 100 or 200 companies.

MR. HANSON: Gaylen, when you said the phrase Hansen, don't screw it up, well, I hear that every single day, usually when I get out of bed in the morning and it continues throughout the day from these guys. So I know those words.

I've got a couple of questions around mandatory re-tendering. And I'm going to give you each a couple --

some very specific questions around that. And I get the sense from many of the comments that people have made that mandatory re-tendering might be almost as blunt of an instrument as I believe mandatory rotation is.

But I was trying to probe earlier with some of the panelists about what's the benefit of mandatory rotation. So I'd like your thoughts on that. And one of the things I had posited that the panel was picked up on was a benefit is my simple statement of demonstrating who wears the pants in the relationship -- that it's the audit committee.

And, Gaylen, I'm picking up on something you said a few minutes ago in your statement about the smaller companies -- that audit committees just maybe aren't doing -- now, I want you to comment on whether mandatory re-tendering would give them -- would teach them they wear the pants anymore.

And a question that might be difficult for you to answer publicly, but whether you think that in general the smaller company audit committees aren't doing their job. Is it because more they don't know and you don't know what you don't know or they really don't care, which is a very different issue.

But on the mandatory re-tendering the -- firms compete on fees all the time, compete on service a lot, but, really, how do firms compete on audit quality. So I'd like each of your comments on how you compete on quality. And if there's any other broader initiatives going on in the profession around even defining what quality is and how firms might compete on it. So I've given each a little bit of an assignment.

MR. HANSEN: It's hard to show somebody, you know, what you do when they -- they're not looking in your file and they're not spending time with you during the day and they meet several times a year at the start and the end.

So I think that's very difficult to demonstrate to an audit committee. I think it's going to be word of mouth and it's going to be trust and basically the community getting to know you. Now, that's a real handicap for smaller firms, and that's why we're shut out a lot of times. I mention that in my written statement as well.

And your earlier question about who wears the pants and the tendering, I've never really been a big, big fan of the RFP process and sort of a rotation mode like this that we're talking about. Oftentimes I've seen it just as a tool to sort of reaffirm the decision that somebody already has made. And then my firm ends up spending a ton of time putting together a proposal -- a lot of resources, time, and energy go into it. And then you find out your hometowned -- you know, that, you know, they just replaced whoever was there earlier.

So I think there would be a lot of game playing with tendering -- that it -- concerns that some of my colleagues have is that people end up spending so much time focused on marketing, and that isn't a productive exercise.

I wouldn't close the door to it. As I said in my statement I think perhaps maybe there's a hybrid approach -- perhaps it's rotation as well as periodic re-tendering. I think that we need to see -- you know, see how this is going to play out with some of the other participants in other jurisdictions as well.

Because I think they're coming up with some good ideas, particularly that -- I had mentioned in the statement the Canadian approach. They just put out that statement that talked about a more comprehensive review where they bring in the auditors and the auditors have to demonstrate how they've -- really have exercised professional skepticism.

It's the same sort of question like quality. How do you demonstrate it? It's a tough one to do, but we're going to have to think about it and we're going to have to figure out ways of demonstrating it.

MR. ROOK: On mandatory re-tendering, we see this somewhat in public sector arena where if a government entity or a school district -- some of them have mandatory rotation after five or seven years, but a lot of them still -- do have a mandatory tendering process, and it can be very frustrating from an auditor perspective.

And do you spend a lot of resources on proposals and really diving into their financial statements and understanding their processes and their controls and do they have risk with -- or issues with ICFR. And, I mean, we could spend 100 or 200 hours looking at a potential audit that may be a 1000 hour audit. And so it's a huge investment.

And we've actually gotten to the -- and I'll caveat that with saying public sector practice in the state of Texas is a pretty large part of our business. And we've gotten to the point where we'll actually pick up the phone and call the purchasing agent or the particular liaison and say, hey, is this legitimate -- are you happy with your auditor. And usually if the answer is yes we'll decline to propose because just going through the motions -- and we have other engagements or proposals that we think are more substantive that we can target.

On example of audit quality -- I mean, on competing on quality I think you can compete on quality. And our firm tries to do that in certain industries that we have expertise, like oil and gas, being a Texas-based firm. And I think it's reputation and branding and -- so I think you can compete on quality.

We do go through a process where we -- I mean, in the proposal process we talk about how we audit. We use the fact that we do require independence training annually -- or every other year similar to ethics -- our ethics requirement. So those are the ways that we compete on quality.

MR. GURBUTT: Thank you, Chairman.

MR. DOTY: Cindy, were you going to say something in response --

MS. FORNELLI: I was.

MR. GURBUTT: Oh, I'm sorry, Cindy.

MS. FORNELLI: That's okay. I was just going to -- you mentioned, Jay, defining audit quality and some of you I know have heard the story that I've talked about that when I first came on to the Center for Audit Quality my first task was to define audit quality and then develop metrics to measure it. I actually got laughed out of the room, and one person told me, Cindy, many people much smarter and brighter than you have taken that on and have failed, so good luck with that.

But, yet, we have not given that up and we do currently have underway a project trying to at a profession level -- not at a firm level or at an individual partner level, but at a profession level, trying to come up with metrics on how you would define and then hopefully measure audit quality so that there is a way to perhaps better compete on quality.

And the other thing I would say in response to your questions, Jay, is that I do worry that with respect to re-tendering -- we've heard a lot today about fees and whether re-tendering or rotation would increase fees or decrease fees. I worry more about the decrease of fees. I think that there is currently a downward pressure on fees and I worry about that. And so I would be concerned that re-tendering could further accelerate that downward pressure.

MR. GURBUTT: Well, I had a specific question for Gaylen, but then I had a more general question for the panel as a whole. David mentioned in some of his remarks earlier some of the steps that his firm takes to reinforce professional skepticism. So, Gaylen, I'd be interested in your views on what your firm does in that area and also anything that you think needs to be improved in terms of audit firm culture or systems of quality control potentially.

But then I have a question more generally for the panel as a whole, and it relates to something that Natalie brought up earlier on. And she quotes it the investigation that the U.K. Competition Commission is undertaking. And in one of their reports they recently noted that those that have switched have not found the process particularly burdensome or the cost particularly high. Firms go to considerable efforts to ease the process and to manage the risks involved.

So I'd be interested in your views as to steps that audit firms take today to manage any potential risk associated with new engagements and, again, anything that needs to be improved in that area.

MR. HANSEN: Thanks, Michael. On the professional skepticism in our firm, again -- and I keep repeating the word trust, but a lot of this is consultation and you have to be aware of that lone auditor out there, that lone partner out there that's operating in a silo.

Silos are dangerous in the auditing world. It's -- this is a team thing. And if the firm is structured so that individuals are going to get paid, and if you look at the compensation models where -- that it fosters their -- a situation where there's a linkage where they can benefit by operating on their own, then that's a problem.

So unlinking those silo opportunities and making sure that there's teamwork going on and that there's consultation that's going on, that there's mentoring and coaching at not just the staff level but particularly at the partner level -- I think that's really, really critical because if you've got people going different directions in their own interest then you could run into some real problems -- my thoughts on it.

MS. FORNELLI: With respect to your question on the management of the risks and changing the auditor, I think firms do take that seriously and do try to manage those risks. I think you also though need to look at the risks and the costs that companies have to do to manage those risks.

And we've heard about some of those costs. You heard some of that from the CFO of Procter and Gamble. I was stunned frankly by the number of people that are on their engagement that audit their company -- the various countries, the numbers of people. And so it really made me pause and think about what the company goes through as well.

The other thing I would say about that, too -- I know we heard this morning from some of the academics that the longer the tenure perhaps the more bias that could creep into the system. But I also think that there are academic studies here in the United States that talk about the higher risks in the first couple of years in a change of auditor. And so I would worry about that as well.

And, again, it's one thing if it's a voluntary decision that's being made by the audit committee based on what the company's needs are at that time as opposed to a systematic periodic rotation. So those would be some of my concerns.

MR. ROOK: Steps that we take to address risk on new engagements as a firm is -- and we start with what we believe is a robust client acceptance process. In that process an engagement -- or a prospect comes in and we have an approval process to evaluate management, the Board, the audit committee -- and this is both a publicly-traded entity or a privately-held entity.

And then the engagement partner's assigned really at a partner in charge of a location level, and then there's a review process in which myself and then the partner -- ultimately the partner of our quality control department ensures that that particular partner has the experience, the industry knowledge, the background to serve that client best for our firm.

And that's a very rigid process where -- and there are multiple times annually where we change that particular partner. That's how we mitigate risk really from the top. It also -- there's a risk rating system that we go through and assign risk one to five based on different aspects -- complex accounting issues with the client, the industry that particular client's in.

We will assign the engagement quality control reviewer as well based on industry and risk, so that is independent of the engagement partner. And that is also a process that we go through on privately-held clients where that process is independent of the engagement partner. He or she cannot go select who's the EQCR.

And then depending on -- again, if it's an issuer client we may require the senior on the engagement to actually have a CPA license and not be in the process of getting that license.

And then there are -- the final thing is there are required consultations on new engagements to the firm. And that can be various requirements there, whether it's a purchase price acquisition -- I mean, purchase price allocation would have to be reviewed and various other matters depending on the client.

MR. HANSEN: Real quickly. Real quickly. And I would probably echo most of what David has said there. We do similar types of things. We do require on public company audits independent third party investigation of, you know, the background of the audit committee chair, the CEO, and the CFO in all instances unless we really, really know the firm that we're talking about and the principals that are bringing them in. And we still fill out the forms in those situations.

The other thing is it doesn't matter what partner brings in a client into our firm. That isn't -- that is not the engagement partner. That assignment is made by our quality review people in the firm and the leadership in the firm and not that -- the fact that someone brought a client in doesn't default to it being their client. This all goes back to the notion of not operating in a silo.

And then I had mentioned in my written comments on new engagements this handoff thing -- communications between predecessors and successors. There's a real problem there and I'm glad to see that on the PCAOB's agenda. Hopefully we'll get a chance to talk about that some other time.

MR. DOTY: One of the features of this process is that as regulators we want to listen to everybody. We hear a lot of different things. We heard very stimulating and extremely fresh ideas today.

Part of that process though is that numerosity isn't everything. We all started the day with an allusion to the 600-plus comment letters and the weight -- the tendency of those letters to grow around certain ideas. And then as you go through the day you hear certain ideas that have a kind of Occam's razor simplicity about them.

One commenter points out, for example, that actually there's a great deal of market impact -- negative market impact now if a company changes its auditor. The change -- that would be eliminated if you had an extended-term -- 10, 15 years with a handoff.

The auditor would gain tremendous leverage in terms of fee negotiations because if the auditor resigned in the middle of that engagement then that becomes a real issue for the market. On the other hand, there's nothing particularly dramatic about the auditor rotating off after a period of years.

Issues about the handoff and the knowledge curve occur in all of these. They're real issues as -- they're cost issues. But the interesting thing about it is that the knowledge curve and the distraction of management are always seen as real costs, although those are really soft costs. The soft benefits of having confidence in the audit was reflected by one of our participants later in the day, and those are often not as clearly tallied up. So with handoff procedures and other approaches we've heard a lot today about what could be done to ameliorate some of the problems -- or some of the difficulties of a form of rotation.

It doesn't get necessarily easier to sort through all of these. But I think one of the things that we got to today was a lot of data based testimony about what people thought was the structural problem. It came to rest in a behavioral comment that was made, and that is that you've got to do something structurally. You've got to manage conflict of interest.

It may be only one more aspect of trying to manage a problem of who is the engaging entity and what is the allegiance that the auditor owes to something greater than the bargaining power of the engaging entity.

But it is a structural change. And there was strong testimony today about the fact that if we wanted to deal with conflict of interest we would have to be prepared to consider structural change.

We wouldn't have to worry about conflict of interest if we didn't have some of the problems that, in fact, you, Gaylen, alluded to in the rather robust discussions with NASBA. And you laid on the line some of the current problems that undermine quality in the audit, confidence in the quality of the audit. And these were -- these are well publicized failures. So without these we perhaps would not have to worry about the conflict. But we do have to worry about the conflict because persistently time and time again they keep coming back.

And, therefore, it seems to me that the things that I take away from the day are that numerosity in the comments is not going to determine -- or should not determine this issue. We've got to get to more specific and focused discussions about what the consequences are -- what the unanticipated consequences might be, what you do to address those, what, in fact, is required to avoid having it become a blunt instrument.

And the question will be I think discussed for some time as to whether, in fact, some form of rotation is necessarily a blunt instrument. Can, in fact, some form of change in the status of the auditor be tailored. We heard this from some of the commentators later this afternoon. And maybe that involves an opt out provision -- something that is not solely within the authority and the power of the PCAOB. I don't know. Michael, do you have a last question?

MR. GURBUTT: No.

MR. DOTY: Comments -- other comments from Board members?

(No response.)

MR. DOTY: David Rook, congratulations on becoming the largest audit firm headquartered in Texas. You've done very well by us, and you have brought to bear a perspective that we talk about at the Board that we need, which is a perspective other than the global national firms.

Gaylen, I've said already what I'm saying about your contribution, was that it was enormous. It has been enormous over the years, and it becomes more critical as we get into these discussions.

Cynthia, we are grateful for the support we get from the CAQ and for the wisdom you all give us on the issues that you comment on.

Thank you all. I think we're adjourned.

(Whereupon, at 5:51 p.m., the meeting was 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 my direction; further, that said transcript is a true and accurate record of the proceedings.

Neal R Gross

Court Reporter