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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION

PCAOB RULEMAKING DOCKET MATTER
NO. 37

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PUBLIC MEETING

+ + + + +

THURSDAY
JUNE 28, 2012

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The Public Meeting convened at the Hilton San Francisco Financial District, 750 Kearny Street, San Francisco, California, at 8:00 a.m., Jim Doty, PCAOB Chairman, presiding.

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WILLIAM D. CVENGROS, Trustee and Independent Director, Janus Funds

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KENNETH A. GOLDMAN, Senior Vice President and Chief Financial Officer, Fortinet, Inc.

CONRAD HEWITT, Director, Bank of the West; former Chief Accountant, US Securities Exchange Commission

BONNIE HILL, Co-Founder, Icon Blue, Inc.; President, B. Hill Enterprises LLC; Director, The Home Depot, Inc., Yum! Brands, Inc, AK Steel Corporation and California Water Services Group

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

2 (8:18 a.m.)

3 CHAIRMAN DOTY: Well, welcome, everybody, to the
4 Public Company Accounting Oversight Board's second public
5 meeting on the Board's Concept Release on ways to enhance
6 auditor independence. A couple of logistical matters.
7 Our practice here has been to take a break occasionally,
8 and I have the intention of providing for 10 or 15-minute
9 breaks before the third and fifth panel this morning, and
10 again, at appropriate intervals, the same intervals this
11 afternoon. So we will have breaks. Our methodology has
12 been to move through the statements of panelists and then
13 to open the floor for questions and engagement by the
14 Board. And we will begin the session this morning with
15 some brief opening statements by Board members that will
16 lend a little context to where we are in this process.

17 It's the second meeting on our Concept Release,
18 but it's the first meeting that the PCAOB is held on the
19 west coast of this type. This meeting will give us the
20 opportunity to benefit from important perspectives with
21 investors, financial statement preparers, academicians,
22 and firm professionals and regulators who participate in

1 our financial markets. We have venture capitalists,
2 audit committee chairs and CFOs on today's panels, and
3 we're eager to hear from all of them.

4 The Concept Release that we issued last August
5 was intended to begin the discussion of auditor
6 independence and the factors that can jeopardize the
7 fundamental investor protection -- that fundamental
8 investor protection of auditor independence. This round-
9 table is the next step in that journey.

10 The PCAOB benefits from the diverse range of
11 views that have been gathered through the comment
12 letters, the round-tables and the public discussions.
13 And this public meeting is an extension of that
14 interaction. We are honored today to have the
15 participation of former SEC Chairman, Harold Williams.
16 We're going to benefit from the wisdom that he has
17 accumulated over a long and distinguished career
18 protecting investors and promoting strong public
19 disclosure.

20 We're also deeply grateful for the time spent by
21 the many other speakers who are scheduled here today, in
22 preparing and participating -- preparing for and

1 participating in this open meeting. We have had
2 statements submitted by the Black Economic Council, the
3 NACD, the National Association of Corporate Directors,
4 has a strong interest in this program and in this
5 outreach. And while we have not been able to include
6 everyone on the panel today in the space of the day, we
7 look forward to doing so in the future.

8 I would not predict the outcome of the debate,
9 but I expect that we will all benefit from a robust
10 debate on approaches to improving independence,
11 objectivity and professional skepticism. Most of all,
12 I want to thank the dedicated PCAOB staff, many of whom
13 you see before you, and whose efforts have made this
14 meeting possible, our Office of the Chief Auditor, our
15 General Counsel's Office, and the entire staff who are
16 around the premises today. And we are, as always,
17 grateful for the participation of the Securities and
18 Exchange Commission, and the Deputy Chief Accountant,
19 Brian Croteau.

20 With that, I'd like to turn this over to my
21 colleagues for a statement. Board Member Ferguson?
22 Thank you.

1 MEMBER FERGUSON: I just want to say how much we
2 appreciate your coming here and taking time out of your
3 busy schedules to help us with this. These are difficult
4 and complex issues that we're considering. And the more
5 widely we consult, and the more -- the greater the
6 breadth of views we hear, the more we are informed in
7 terms of both thinking about them and taking action, if
8 that's appropriate. So I simply want to say thank you
9 very much for coming here.

10 CHAIRMAN DOTY: Mr. Hanson?

11 MEMBER HANSON: I also want to thank all the
12 panelists and say good morning to all of you. We heard
13 good discussion in March from a wide variety of
14 constituents and certainly no consensus, but lots of good
15 debate we had there, and good viewpoints.

16 I'm very interested to hear the viewpoints of all
17 the panelists on things, in addition to mandatory firm
18 rotation. The thing that we seem to hear the most about
19 is the references to audit committees and what audit
20 committees could and should be doing to discharge their
21 responsibilities under Sarbanes-Oxley Act. And we've
22 heard some -- from some very prominent audit committee

1 members about the things they are doing. And I'm looking
2 very much forward it hearing from some prominent audit
3 committee members today as well.

4 One of the things that is a common theme coming
5 from, from a wide variety of constituents is what more
6 we could do at the PCAOB to provide audit committees more
7 information about what we do and what we see broadly, as
8 well as on individual audits that we inspect. And we've
9 had some firm representatives advocate that -- that being
10 able to provide audit committees the direct information
11 about what we saw in the audit of the company that
12 they're responsible for would be helpful. We've had many
13 audit committee members say that. Some of the folks here
14 today have included that in their statement.

15 And even in Chairman Doty's recent testimony
16 before Congress, Congressman Waters asked specifically
17 if that's something that would need legislation, and
18 something that we would advocate. And so I personally
19 think that we should have more discussion on that to see
20 if it is something that would be of a benefit to the
21 audit committee to help them discharge their
22 responsibility so that we can raise the level of all

1 audit committees to what we observe as some of the best
2 practices.

3 So with that, I will turn it over to Mr. Harris.

4 MEMBER HARRIS: Well, thank you, Jay. Thank you,
5 Mr. Chairman. And in my opinion, there is no more
6 important issue confronting the Board than ensuring the
7 independence, objectivity and professional skepticism of
8 auditors as they conduct their audits. Both our own
9 PCAOB inspection reports and those of many of our
10 international counterparts recognize that more must be
11 done in this area. Whether the answer is mandatory
12 rotation, re-tendering, greater transparency of audit
13 tenure, as Jay indicated, enhanced independent audit
14 committees, or any of the other recommendations that
15 resulted from our first round-table discussion, or any
16 of those that may be offered today, I believe that all
17 alternatives must be thoroughly considered to further
18 shareholder trust in the quality of the audit.

19 I believe that the public policy-making process
20 is best serve by hearing from all interested parties in
21 open deliberative processes such as we are conducting
22 today. And while some of the recommendations we have

1 heard so far are within the SEC's jurisdiction, not ours,
2 I believe the record we are creating may serve as a
3 potentially valuable tool for their consideration as
4 well. I join my colleagues here in looking forward to
5 an illuminating and robust discussion of the many
6 implications of our Concept Release on auditor
7 independence. Thank you, Mr. Chairman.

8 CHAIRMAN DOTY: Board Member Franzel?

9 MEMBER FRANZEL: I also want to thank all the
10 panelists and the staff and their constituencies for
11 taking the time and effort to come here today to discuss
12 this important topic.

13 Obviously, auditor independence, objectivity and
14 professional skepticism is a very complex topic. And the
15 more feedback and input we can get from a wide variety
16 of stakeholders, the better off all of us will be. The
17 challenge before all of us is to find the appropriate
18 path forward to achieve the needed improvements and audit
19 independence and audit quality. And this is part of that
20 process.

21 Through extensive input and feedback we've
22 received to date, many people have expressed support for

1 the Board's efforts in this area of enhancing auditor
2 independence, objectivity and professional skepticism.
3 And we've also heard through some of other projects broad
4 support for the audit itself, and the value that the
5 audit provides. And so the task before us is to really
6 continue to find ways to maintain the relevance and
7 reliability of those audits.

8 It is troubling that our inspections do continue
9 to find a significant amount of findings. And we
10 continue to work on that in conjunction with these other
11 efforts. But coming up with a solution is not going to
12 be easy or simple, and we must look at all alternatives.

13 Like Jay, I'm very interested in exploring the
14 audit committee's role and how audit committees can be
15 made more effective in the three-legged stool model that
16 has often been discussed with regard to reliable
17 financial reporting. The feedback that we've gotten is
18 that when audit committees work properly, they're very
19 effective, but that all audit committees are not created
20 equal. And so people often talk of best practices. I'm
21 interested in consistent practices to help ensure auditor
22 independence and objectivity and professional skepticism.

1 But achieving this will be difficult because this
2 really goes beyond the PCAOB. But I believe that it is
3 our responsibility to explore these issues, because the
4 audit committee provides part of an ecosystem for a good
5 reliable audit. So again, I want to thank all of the
6 panelists who are here today, and I look forward to
7 hearing your input.

8 CHAIRMAN DOTY: Thank you, Jeanette. Our panels
9 begin today with the statement and the opportunity to
10 speak with the former Chairman of the United States
11 Securities and Exchange Commission, Harold M. Williams.
12 And as he comes to the table, I will try to synopsise
13 what are the highlights of a long and very distinguished
14 career.

15 We have one of the giants and one of the giant
16 thinkers in the area of financial securities regulation
17 here. He is the President of Emeritus of the J. Paul
18 Getty Trust, a charitable trust devoted to the arts and
19 humanities. He was the chief executive officer and
20 president from May of '81 until January of '98. And
21 under that leadership, the programs of the trust were
22 established, and the Getty Center in Los Angeles was

1 created.

2 He was council to the Law Firm of Skadden, Arps,
3 Slate, Meagher & Flom. He was chairman of the United
4 States Securities and Exchange Commission, nominated in
5 '77 by President Carter.

6 During his tenure he received considerable
7 attention for his views advocating the necessity of
8 accountable conduct by the business community,
9 particularly of boards of directors and the accounting
10 profession. He was the dean and professor of management
11 in the Graduate School of Management in the University
12 of California, Los Angeles, his alma mater. He is a
13 Harvard Law graduate. He is a veteran of the Korean War,
14 where he received a bronze star.

15 He is one of the most admired members of the
16 Securities Bar. I can testify firsthand that we're
17 deeply honored to have you here. Please proceed,
18 Chairman Williams.

19 You have to press your mic.

20 MR. WILLIAMS: There we go. I'm sorry. I'll
21 just repeat. I'm delighted to be here. Thank you for
22 the opportunity to comment on the Public Company

1 Oversight Board's Concept Release on Auditor Independence
2 and Audit Firm Rotation and its efforts to enhance the
3 independence objectivity of professional skepticism of
4 external auditors, and to express my personal view as to
5 whether a decision to require the regular rotation of
6 auditors would significantly further those efforts is
7 desirable.

8 I want to begin by expressing my respect and
9 appreciation for the outstanding work of the PCAOB. A
10 tribute to its committed and thoughtful leadership, its
11 outstanding board members, and a superb staff. You're
12 making a significant difference towards assuring auditor
13 independence and audit quality.

14 I'm impressed by the volume and quality of the
15 responses you've received to your Concept Release.
16 Rather than offering a comprehensive statement, I will
17 focus my comments as a response to specific recurring
18 arguments and will be happy to expand on them as you
19 wish.

20 I recognize that many audit committees have been
21 much more active and proactive in their discharging their
22 responsibilities under Sarbanes-Oxley. Certainly, both

1 the written and oral testimony before this body pays high
2 tribute. I do not believe, however, that the audit
3 committee is capable of addressing the issues of lack of
4 professional skepticism by its lack of independence
5 addressed by the Concept Release.

6 In reviewing the audit failures identified by the
7 Board in its Concept Release, I'm left with the question,
8 "Would a diligent -- vigilant audit committee discharging
9 its responsibilities under Sarbanes-Oxley have discovered
10 the lack of skepticism, bias, and lack of independence
11 identified in the PCAOB audits?" And my belief is no,
12 not likely, not systemically.

13 If the relationship between management and
14 managers is harmonious, let alone cozy, how is the audit
15 committee to effectively probe behind it? What questions
16 could it ask? What consultants could it employ to get
17 behind the harmonious responses you would receive from
18 the management and the auditor that would have surfaced
19 the conditions and failures identified in the Board
20 audits? Now, if there are instances where the audit
21 committee has been successful in this regard, it would
22 be instructive if they could be made public.

1 How else to address the problem head on and not
2 just at the margin? Short of or as part of making
3 mandatory rotation effective, I recommend the Board be
4 empowered to publicly release the results of its
5 investigations and proceedings and direct rotation of
6 auditors where the investigation finds the absence of
7 independence, objectivity and professional skepticism.

8 Rotation could also be called for on other audits
9 involving one or more of the same senior audit committee
10 members. Of course, action against the partner in charge
11 of the audit committee would have a meaningful impact.
12 Rotation might also be called for in industries which
13 appear to have a higher incidence of failure. The Board
14 might consider responding to an audit committee request
15 for an inspection, but be careful about being overwhelmed
16 by requests.

17 I also recommend that the Board be enabled to
18 re-examine what constitutes audit-related consulting, and
19 define it more narrowly than the SEC has done.

20 Now, I support mandatory rotation, but I'm not
21 saying whether it will produce the desired results. We
22 start by addressing recurrent concerns raised about

1 mandatory rotations. There may be but not necessarily
2 would be costs associated with the rotation. I believe
3 the concern is exaggerated. And to the extent that there
4 are costs, I believe they would be justified.

5 I do not believe that the quality of the audit
6 needs to deteriorate for the first year or two of the new
7 auditor's work. And the concern that audit quality might
8 deteriorate in the last several years of the departing
9 auditor's engagement casts serious doubt on confidence
10 in the professionalism, and suggests a more serious
11 problem that I trust is not warranted. To what extent
12 have these concerns manifest themselves in voluntary
13 rotations? And for reasons I've already stated, I do not
14 believe that such a requirement would reduce the
15 authority and the role of audit committees.

16 Now, the uncertainty about whether mandatory
17 rotation would produce the desired result is due to the
18 international oligopoly of the big four accounting firms.
19 Auditing is a profession run as a business. As a
20 business, oligopolies generally, recognizing they're very
21 comfortable in secure straits, are not inclined to rock
22 the boat in relation to each other. Status quo, rather

1 than competition, is the name of the game.

2 Would the auditing business, behave any
3 differently? What would it take for an auditor coming
4 in to embarrass the one it's replacing. Certainly public
5 policy would not look favorably at anything that
6 jeopardizes the existence or even the reputation of one
7 of the big four. On the other hand, mandatory rotation,
8 would, I believe, provide incentive to middle-sized firms
9 to develop their capabilities to serve larger clients.
10 This, in turn, if successful, would enlarge and
11 destabilize the oligopoly. If mandatory rotation is
12 undertaken, I recommend that it begin on a limited basis
13 so that the Board and the firms could learn from the
14 experience.

15 I close with a caution to the profession, that
16 what underlies this entire inquiry is the concern of many
17 that its basic product, the reason that it has a
18 statutory mandate is suspect. If the profession doesn't
19 see a problem, and/or cannot be proactive in effectively
20 addressing it, then perhaps the business model of the
21 client-auditor relationship has to be changed.

22 And I'll be happy to respond to questions.

1 CHAIRMAN DOTY: Thank you, Chairman Williams.
2 Board Member Franzel.

3 MEMBER FRANZEL: Thank you, Chairman. Mr.
4 Williams, I would like to highlight a very insightful
5 comment that you made. And I think it is something that
6 we need to all focus on. And that is your caution to the
7 profession that what underlies this entire inquiry is the
8 concern of many that its basic product is suspect. And
9 I think that lends just a tremendous amount of insight
10 into the complexity of the problems that we're trying to
11 solve, and of course, at PCAOB we're doing a tremendous
12 amount of work on the inspection side also trying to get
13 at this.

14 But it really illustrates that we need to look at
15 all the parties involved, and the responsibilities that
16 each party needs to take. And if those parties don't
17 take appropriate responsibility, then what would the
18 consequences be. So I just wanted to highlight that
19 statement.

20 I'd like to ask you for a little more elaboration
21 on another statement that you made. And that is, if
22 mandatory rotation is undertaken, you recommend that it

1 begin on a limited basis. And what do you envision by
2 that?

3 MR. WILLIAMS: Well, I'm not quite sure. I guess
4 if I had to venture forth today, I think I'd start with
5 other than the big four and, and either -- I don't know
6 how the limited basis might be designed, but it could be
7 by, by industries that are of particular sensitivity.
8 It could be by size. Yes, I'd have to give it more
9 thought to come up with a more specific recommendation.

10 CHAIRMAN DOTY: We do pilot programs. I think
11 you're suggesting probably a pilot program that's focused
12 on, I presume, firms.

13

14 MR. WILLIAMS: Yes.

15 CHAIRMAN DOTY: Board Member Harris, you want to
16 pick up the ball? We're going to go down the line and
17 come back.

18 MEMBER HARRIS: Well, I wanted to focus on the
19 same sentence that, that Jeanette did. And that is if
20 the profession doesn't see a problem and/or cannot be
21 proactive in effectively addressing it, then perhaps the
22 business model of the client-auditor relationship has to

1 be changed. And a number of people have asked, you know,
2 why are we doing this and what is the problem? And they
3 want empirical evidence.

4 So I'd like for you to spell out for us, to the
5 extent that you can, what you see as the problem, and how
6 you think the profession can be proactive in terms of
7 addressing it?

8 MR. WILLIAMS: Well, I think the best definition
9 of the problem, or the best example of the problem, is
10 the audit results of PCAOB. And it -- and every -- part
11 of my sense on this, and it comes directly from personal
12 experience, is that to some extent, I think the firms
13 audited -- the problem presented by the PCAOB audit is
14 dealt with at the national office in response to and in
15 contact with, and in relation with the report that's
16 issued by the Board.

17 From the outside, I was somewhat skeptical about
18 what the internal consequences of the audit are within
19 the firm itself. When I talk to auditors or firms who
20 have been audited, I don't really sense that they feel
21 much consequence to the audit. So I would start by
22 really trying to understand. I mean, that may be unfair,

1 but I'd start by trying to understand what happens
2 systemically, culturally within the firm to respond to
3 the audit.

4 My sense is that more needs to be done, that the
5 auditor himself or herself doesn't really know what the
6 problems were and what conduct on the part of that
7 auditor ought to be to assure that it doesn't happen.

8 CHAIRMAN DOTY: Board Member Ferguson? Lewis?

9 MEMBER FERGUSON: Yes. I also want to ask you
10 questions. We all seemed to have been focused on your
11 statement about the fact that the profession itself does
12 not seem to perceive that there's a problem here, and
13 that that may come from the oligopolistic structure of
14 this industry, that there is -- oligopolies are
15 notoriously resistant to change and conservative in their
16 behavior, because they have only things to lose. I
17 sometimes think of the accounting profession views this
18 particular issue of the rotation as a storm to be
19 weathered rather than an opportunity to examine
20 themselves closer.

21 But I want to ask you a specific question about
22 that. To what extent does this conservatism, aside from

1 the oligopolistic structure in the profession, come from
2 the fact that the basic payment model of the audit is
3 that the client pays for the audit? So that there's an
4 inherent reluctance in the final analysis, I think, to
5 do anything that is likely to upset the client too much,
6 the person who's paying the bills. And particularly when
7 the tenure of these audits are very, very long.

8 And if you look at them in a financial sense,
9 this stream of revenue is, particularly for large
10 clients, is effectively an annuity that could be
11 capitalized by the market; billions -- potentially
12 billions of dollars. To what extent is that payment
13 model reinforce the conservatism on both the client and
14 the auditor's part?

15 MR. WILLIAMS: Well, I think it does. I think it
16 does substantially. The accounting firm presents itself
17 if there is competition -- if that word fits here -- for
18 a client on the basis of, is basically on the basis of
19 service. It doesn't present itself -- it has a detached
20 professional, and the very nature of the relationship
21 becomes one of essentially keeping the clients satisfied.

22 From the firm's standpoint, they want a long-term

1 relationship. It's very understandable. I'd expect
2 that. There's the partner in charge, his progress within
3 the firm will depend upon how well you satisfy the
4 client. If he loses a client, it doesn't do him much
5 positive good within the firm. In fact, it may seriously
6 disrupt his career.

7 From the client's standpoint, the client is
8 focused on many cases on short-term issues, of
9 maintaining earnings growth, of -- of keeping the market
10 happy, and oftentimes of personal, short-term financial
11 incentives are a part of management. All the forces at
12 work suggest a desire for a harmonious relationship that
13 is not built on any -- on the kind of skepticism,
14 detachment -- you know, nobody wants to be the skunk at
15 the picnic. And so it goes on. And it's all very
16 understandable.

17 And part of that is, obviously is, the payment
18 model. It's hard to visualize a different model. I mean
19 certainly at the extremes I have, you know, federal
20 auditors come in, would certainly change the
21 relationship. But it creates a whole new set of problems
22 that we don't have to presumably deal with today. But

1 it -- and to expect the audit committee -- and I'm in
2 favor of strong audit committees. I think audit
3 committees are doing much more and a better job today,
4 on the basis of Sarbanes-Oxley, than they've done before.

5 But their ability -- they don't normally -- they
6 don't have the ability, generally speaking, to intercede
7 and become the referee between the accounting firm and
8 the client.

9 CHAIRMAN DOTY: Board Member Hanson?

10 MEMBER HANSON: One of the benefits I personally
11 get from these events like this, is the ability to hear
12 from folks like you that are -- that have a long history
13 of, of experiences. And we all learn from, from our past
14 experience and our history. And I know from my personal
15 reflections in my almost year and a half now of being on
16 the board, that my views tend to change over time. And
17 I think it -- I'd personally like to think I'm learning
18 from experience and it shapes my view.

19 I'm sort of just curious about how your views
20 might have changed over time on this topic, and
21 especially since the package of the Sarbanes-Oxley Act
22 10 years ago now, next month, and what you maybe observed

1 in conduct or any interactions with auditors, audit
2 committees, companies more recently that -- since the
3 reforms of Sarbanes-Oxley have been under way.

4 MR. WILLIAMS: Well, my experience is that audit
5 -- and from what I've heard, audit committees are taking
6 their -- by and large they're taking their work more
7 seriously. But going to an executive session between the
8 auditor and the committee, if the auditor asked the
9 committee, you know, "How things are going?" "How are
10 they going? Fine." "Do you have any real problems?"
11 "No." "No big disagreements?" "No." Then what?

12 I mean, that's why I say that's the one area
13 where I don't think the audit committee has the
14 capability to probe effectively. Now I've been, in my
15 days, as the commission we had the predecessor of this
16 effort. There was the Metcalf committee and so forth.
17 And we of the Public Oversight Board. And this, in a
18 sense, as I look at it, is a very constructive outgrowth
19 of what was then an effort for the industry, for the
20 industry itself to regulate itself. So I think the PCAOB
21 is a major step forward.

22 And where I come down basically is, that the

1 extent that progress is going to be made, it's going to
2 be made by you, and how strongly, how much authority you
3 have, and how you can resist the pressures as you exert
4 -- have to exert more authority to resist the pressures
5 if you're doing your own audit. Because I think it's
6 your audits and the exposure that they get, and the
7 pressure that they bring to bear are the most
8 constructive force towards the end you're trying to
9 achieve.

10 CHAIRMAN DOTY: Chairman Williams, your views
11 about the limits of audit committees and some audit
12 committees particularly are shared by one John C. Bogle,
13 founder of the Vanguard, of course. And so there are a
14 number of people who have what Jay calls the long view
15 of this, who are concerned about some inherent limits on
16 the ability of audit committees, no matter how much we
17 do, to deal with the fundamental problem of management's
18 control. And there would be other panelists who shed
19 light from different angles on that.

20 Your written testimony really goes to the jugular
21 vein of this subject, when you raised what Jeanette
22 points to as the statutory mandate. And you also pull

1 apart some of the complexities of audit independence --
2 of firm rotation as an independence issue when you say
3 there are different segments, different industries that
4 have different risks.

5 We do risk-based analysis in our selection of
6 inspection. One of the things we hear is that, if
7 anything, is that perhaps the pressure to kowtow to
8 management and its interpretation of the business and the
9 facts, is stronger in the area of voluntary tenders, and
10 stronger in the younger corporations, and in the
11 corporations that are perhaps not the majors. So you're
12 directing us to a segment of the industry, and perhaps
13 the combination of younger companies with more ambitious
14 auditing, marketing programs behind them. That's a
15 fascinating idea.

16 And it's one that is especially fascinating out
17 here in California where we have so many young companies
18 and so many young audit firms. And so it makes us focus
19 on the complexity of doing something about this.

20 What would you think of some kind of a rule that
21 invoked some form of rotation, some form of requirement
22 of preserving independence through rotation if there is

1 a build up, an accretion of factors that seem to be
2 dangerous, that seem to be red flags such as frequent
3 changes in auditors, such as recruiting from the
4 accounting firm to the financial reporting area? Is that
5 the kind of thing that we should pursue in terms of
6 looking for areas where our regulatory difference could
7 be invoked?

8 MR. WILLIAMS: Well, I think those would be
9 certainly constructive areas in which to look. What I
10 have not done, or given any real serious thought to, is
11 whether there are -- there probably are a series of, or
12 a number of, of red flags that would create a kind of a
13 litmus test, that would suggest that they be priority
14 areas for at least deeper examination, if not, you know
15 -- at least a presumption that rotation is a rebuttable
16 presumption; perhaps that rotation is in order.

17 CHAIRMAN DOTY: So there's -- there should be
18 certain -- we could think of certain things that would
19 invoke a show-cause type hearing?

20 MR. WILLIAMS: Yes, exactly.

21 CHAIRMAN DOTY: Well, we are on schedule.

22 MR. WILLIAMS: Okay.

1 CHAIRMAN DOTY: You have got --

2 MEMBER HARRIS: Can we have --

3 CHAIRMAN DOTY: What?

4 MEMBER HARRIS: Can we have more?

5 CHAIRMAN DOTY: You want one more round? We've
6 got a minute.

7 MEMBER HARRIS: We've got less than a minute.

8 Let me just follow-up on what I think that Jay
9 raised in terms of the evolution of one's thinking over
10 the years. And you were extremely helpful when you were
11 -- the first panel that testified 10 years ago on
12 Sarbanes-Oxley. And we have the former chairman of the
13 SEC, and they did a terrific job in terms of laying the
14 foundation.

15 But at that time -- and let me ask a two-prong
16 question. You indicated that, "I would urge the
17 commission to consider a requirement that a public
18 company retain its auditor for a fixed term with no right
19 to terminate. This could be for five years, or perhaps
20 the biblical seven. After that fixed term, the
21 corporation will be required to change auditors. As a
22 consequence of such a requirement, the auditor would be

1 assured of the assignment, and therefore would not be
2 threatened with the loss of the client, and could
3 exercise truly independent judgment."

4 And of course we didn't go that route. But I'm
5 wondering whether or not you still share your previous
6 views on that subject?

7 And then second of all, I can't resist the
8 temptation. You talk about the oligopoly in terms of
9 your prepared statement. And I'm wondering whether you
10 have any views in terms of how we promote competition
11 within the profession.

12 MR. WILLIAMS: Well, that is a two-prong
13 question. I think there's something to be said for if
14 we go to a fixed term, I think it should be a secured
15 term. And so I still stand by that part of what I was
16 expressing at the Sarbanes-Oxley testimony. If we're
17 going to have independence, I think we ought to assure
18 the auditor that they're there regardless of whether
19 management likes them or not.

20 And your second question?

21 MEMBER HARRIS: How to promote competition within
22 the profession.

1 MR. WILLIAMS: Oh, well, I think mandatory
2 rotation would promote competition. Short of mandatory
3 rotation, I don't have a ready answer. With the benefit
4 of hindsight, I just -- I think the merger of the
5 accounting firms, given their statutory mandate, was
6 against public policy. I don't know that anybody even
7 raised that question at the time.

8 But I don't know how they -- at this point, I
9 think efforts should be made to -- I don't know what it
10 would take to encourage a Grant Thornton, for example,
11 to decide it wanted to be part of the big five.

12 MEMBER HARRIS: Well, you're definitely not alone
13 in that, but I couldn't resist asking the question.
14 Because everybody is in favor of competition, but nobody
15 seems to be coming up with too many --

16 MR. WILLIAMS: Yes.

17 MEMBER HARRIS: -- options in terms of
18 alternatives.

19 MR. WILLIAMS: You might ask Grant Thornton to
20 see what they have to say.

21 CHAIRMAN DOTY: Steve is right that we have a
22 couple of minutes. Are there other questions from other

1 board members that you want to chip in?

2 Thank you for getting us off.

3 MR. WILLIAMS: Thanks a lot, Chairman.

4 CHAIRMAN DOTY: Marty? Our chief auditor, Martin
5 Baumann. Yes?

6 MR. BAUMANN: I also wanted to probe. Everybody
7 probed on something in your statements. And they were
8 profound, so I thought I would probe a little deeper on
9 one also. And I think you've raised a very interesting
10 point with your statement that you did not believe that
11 audit committees are capable of addressing the issues of
12 a lack of professional skepticism and bias.

13 We heard -- we received many letters in the
14 comment process from audit committee members, and we
15 heard quite a bit from audit committee members at our
16 first hearing. And by and large they felt that the
17 decision of changing auditors should be left in their
18 hands. And they talked about their ability to select
19 auditors and evaluate the quality of the auditors that
20 they hired.

21 But I think you've raised a very interesting
22 point here, which we really -- which addresses another

1 point that came up from testimony from one of the
2 professors about unconscious bias that takes place in the
3 audit, in the client kind of pay -- the auditor pay
4 model. And so the audit committee can evaluate a lot of
5 things, as you've suggested. But can they evaluate
6 whether or not the auditor is lacking in skepticism or
7 is lacking in bias. And I think that's an area for
8 further pursuit on our part in terms of questioning of
9 audit committee members.

10 We understand you can question -- evaluate their
11 quality. But how can you get at this issue where so many
12 have raised about unconscious bias that takes place in
13 this area? So I don't know if you have anything further
14 to add on that in terms of additional research that might
15 be helpful in that area, but I think you've raised a good
16 point, which raises a question about the statement made
17 by so many audit committee members, that we're the ones
18 that are best suited to do this, to make this evaluation.

19 MR. WILLIAMS: Well, I don't know that I have
20 anything specific to add, other than to say I wish, you
21 know, if an audit committee's been successful in this
22 regard, let them come forward and tell us how to do it,

1 because we can learn from it. I don't think you're going
2 it find any examples.

3 MR. BAUMANN: Thank you.

4 MR. WILLIAMS: Thank you.

5 CHAIRMAN DOTY: We will move on to the next
6 panel.

7 Chairman Williams, thank you again for doing
8 this. This was above and beyond.

9 The next panel includes three distinguished
10 commenters on this area, academicians.

11 Andrew Bailey. Andy Bailey is Professor Emeritus
12 at the University of Illinois Urbana-Champaign. He is
13 the former Deputy Chief Accountant of the United States
14 Securities and Exchange Commission. He has spent three
15 years in an academic career, recently serving as director
16 of internal client services at Grant Thornton. He was
17 the SEC's representative responsible for the oversight
18 of the PCAOB when we were created, and he has spent a
19 significant amount of time on independence issues. Past
20 president of the American Accounting Association, which
21 is an important body for us.

22 Jim Cox, Brainerd Currie Professor of Law at Duke

1 University. Taught in the Universities of San Francisco,
2 Stanford, and the University of California Hastings
3 before he came to Duke. Has been active in the affairs
4 of the NASC, the NYSC, the standing committees of this
5 body, the standing advisory group of the Public Company
6 Accounting Oversight Board, and a prolific publisher in
7 many areas of financial reporting.

8 Maureen McNichols, the Mariner S. Eccles
9 Professor of Public and Private Management Graduate
10 School of Business, Stanford University, Affiliated
11 Faculty of Rock Center for Corporate Governance. We
12 welcome her. She is a director and a member of the audit
13 and compensation committees of companies in this area.
14 She has a Ph.D. in accounting from the University of
15 California, Los Angeles. A former student of Harold
16 Williams. We welcome her.

17 With that, our process will be to move through
18 the panel, and then we'll have questions. Andy, do you
19 want to start us off?

20 MR BAILEY: Thank you for inviting me. These
21 conversations remind me of my time at the SEC, and almost
22 make me wish I was there again, because there's so many

1 issues involved here, very hard to deal with. Asking me
2 to speak for five minutes is a real risk, but I'll try.

3 Independence, skepticism and objectivity are
4 without doubt, in my opinion, the most important topics
5 that the PCAOB can address. No matter how good the
6 operating standards are, no matter how well they are
7 adhered to, they really don't make much difference if the
8 auditor is not independent.

9 A cultural evolution of the accounting profession
10 to the business of accounting began in the '70s; reached
11 its apparent peak in the '90s when the public accounting
12 firms became the largest retail consulting organizations
13 in the world, and the audit became only one product in
14 a multi-product line.

15 The management emphasis of the business model
16 fails to give primacy to the idea that the investor is
17 the audit client, and any management-related benefits a
18 byproduct. Audits are a public good.

19 Throughout this transition, the leadership of the
20 firms believe they could manage any independence
21 conflicts arising out of the management-client service
22 business model. I believe they consistently underrate

1 the impact of the culture they have created.

2 SOX put a temporary hold on the dominance of the
3 management-client service model with a forced refocus on
4 the audit for third-party investors. Unfortunately, I
5 believe the paying management-client service model is
6 reasserting itself.

7 Today the management-client service model is
8 tightly coupled with an industry that shares the market
9 among a small number of participants, an oligopoly, where
10 company audits are held for long periods, in some cases
11 for so long as to appear to be in perpetuity, and when
12 the client-auditor changes that do occur, they are traded
13 within a small tight-knit group of four firms that are
14 now too big to fail.

15 I am not the first to note that this kind of
16 combination might not bode well for the investor.
17 Therefore, independence proposals that may, as a
18 byproduct, initiate discussions about further structural
19 changes in the profession -- in the business, should be
20 given extra points. And I think we may be discussing one
21 of these proposals today.

22 But first, a few comments on issues that arise

1 every time any kind of significant proposal for making
2 independence changes come up; I'll make a few comments.

3 Cost. Now, as I said, audits are a public good.
4 Everybody here knows that. Therefore, cost should not
5 be measured solely, or even primarily by the fee paid for
6 the specific audit of a specific company, but rather in
7 the likely cost that will be imposed on investors by
8 large and small audit failures. And yet even when you
9 look at a specific company, in most cases, audits are
10 cheap. It's really not a cost matter, in my opinion.

11 Management pays. A payment scheme where the
12 professional is paid, not by the client, but by the
13 management of the company under audit, introduces
14 independence problems, no question. I am not aware of
15 a good alternative. And I'd be happy to comment on the
16 insurance model that gets proposed on a regular basis,
17 if you'd like to ask.

18 And so all I think all it really means is that we
19 have to be more vigilant, not less on the independence
20 issue.

21 Expertise, that is, the auditor's expertise, and
22 transition issues come up. No doubt, firms have

1 developed specialties and have shared the market based
2 on these specialties. Nevertheless, I find it
3 interesting that we will entertain the idea that firms
4 as large and talent-laden as those in question, and that
5 pride themselves on advising managements on complex
6 strategic and operational issues cannot develop the
7 necessary methods to manage the required transitions and
8 operations, and the expertise to do virtually any audit.

9 More research. More studies. Pilot programs.
10 As an academic, I am always sympathetic to more research.
11 However, as with many decisions positing future
12 behaviors, research today has its limits. Waiting for
13 more research and studies, including pilot programs
14 fraught with their own independence issues will not
15 likely provide the comfort we seek. It will certainly
16 mean taking no substantive action now or in the near
17 future.

18 Now, the proposals. Tendering with a refutable
19 presumption of firm rotation. Put most simply, I do not
20 believe this proposal will work, whatever its appeal, as
21 a compromise position. The implementation will require
22 rule making -- and we heard a little bit of that here --

1 concerning the criteria in which the rotation can be
2 refuted.

3 This process will be an invitation for delay,
4 dilution, and ultimately litigation, in my opinion. Both
5 the audit firms and management will have a common
6 incentive to lobby this matter. And failing in this
7 effort, they will have a strong incentive to make common
8 cause as each rotation cycle appears.

9 Mandatory firm rotation. This is simpler and
10 more difficult to avoid. And I like the simpler solution
11 sometimes. I will not repeat the pros and cons of
12 mandatory rotation here. There are plusses and minuses,
13 no doubt. I believe that mandatory rotation firms can
14 stand on its own as a means of enhancing auditor
15 independence, skepticism and objectivity.

16 The implementation of mandatory rotation will
17 have to be staged. I do not think it should be pilot
18 studies. I think it should be laid out so that everybody
19 understands how this is going to unfold and when they
20 will be likely impacted. Otherwise, I don't think that's
21 going to work either.

22 In my opinion, it will be staged, and it will

1 give us time to work on the problems, and I think it will
2 be worth the effort.

3 Now the proposal has the distinct advantage of
4 being a significant break with a past, where we tinker
5 with the existing independence rule structure with little
6 success, other than to emphasize the rules game itself.
7 More importantly, and here I do step off the cliff that
8 some people have already stepped off of.

9 I sense that mandatory firm rotation may initiate
10 a discussion by the various stakeholders about more
11 fundamental changes to the structure of the auditing
12 business and possibly a return of the professional
13 auditor. This seems possible to me if we think not only
14 about auditor incentives, but also about management's
15 participation in this partnership.

16 A management that knows the joint auditor/manager
17 and dominance have limited life may rethink its
18 relationship to the audit, the auditor and their
19 consultants. I must admit I only have a sense of this
20 and not a complete story to tell at this point.

21 However, one thing is clear to me, and that is
22 that management must be convinced that failure to protect

1 their current auditor and future auditor's independence
2 will incur costs for them and that their responsibility
3 for those costs will be transparent in the marketplace.

4 CHAIRMAN DOTY: And I'll thank you, Andy. Thank
5 you. Jim Cox.

6 MR. COX: Well, I feel a little bit like déjà vu
7 all over again. My first professional career started
8 about five blocks away from here when there was eight
9 major accounting firms. I worked for then Haskins &
10 Sells. A lot of things have changed since then. In the
11 auditing profession, because of the Supreme Court rulings
12 about free speech, et cetera, let them engage in a lot
13 of competition again, a process which led to a
14 acceleration. A lot of other practices now characterize
15 the industry as being oligopolistic. I've written about
16 this. And while they don't compete necessarily on price,
17 they do compete upon quality or lack of quality of
18 services, and that is an ongoing concern.

19 One of the developments that was pointed out is
20 almost 10 years ago, we did enact and create this body
21 with Sarbanes-Oxley, and now we have a better roadmap
22 about what some of the problems are with public

1 accounting. That comes about by the inspection reports
2 and by the enforcement actions. And, unfortunately, it's
3 a trail that has a consistent theme, and it's what's been
4 hit here earlier, and that is the lack of professional
5 skepticism seems to lie behind every one of these cases.

6 I mean, you have a federal -- a February
7 Enforcement Action in the Medisys case, which I think is
8 symptomatic of what I see in so many of the inspection
9 reports that are carried out, as well as the enforcement
10 actions, and that is a complete breakdown in our
11 professional skepticism.

12 And moving beyond that, the facts of that case,
13 and a parade of other -- a parade of horrors, I would
14 think, if you look at the empirical evidence, there's a
15 lot of evidence out there that we don't have the
16 professional skepticism we have. There's a -- you know,
17 again, the papers -- I'm talking about the more recent
18 ones, but there's a paper on SSRN right now by Carson,
19 et al., that looks at, for example, the failure of the
20 audit opinion within 12 months of a bankruptcy to give
21 a qualification. And what we find, that in the good
22 years, that they fail in about 53 to 55 percent of cases.

1 And when you have a jarring situation in the economy,
2 such as existed in 2002 and 2003, they miss it about --
3 otherwise there's a rapid change in the liquidity of the
4 firms because of external events, you find that they're
5 missing about three-quarters of the time.

6 So, you know, it's something that explains why
7 we, the auditors for public companies are consistently
8 are getting it wrong more than half the time, and within
9 12 months of a bankruptcy. And then you can trail out
10 from that what was happening in the credit default swaps,
11 which are doing a little bit better, than probably the
12 auditor's qualifications. You know, this raises
13 questions about whether the audit opinion is probably
14 irrelevant if we can pick it up in the credit defaults
15 market, and not pick it up in the letter. But at the
16 same time, you think that these could be tracking in the
17 same direction.

18 You know, related to that as well, as the
19 disquiet is fed by, you know, constant data points being
20 put out by audit analytics in which we find, for example,
21 at 30 percent of the large public companies have had the
22 same auditor for 25 years, which means that we're not

1 talking about an engagement that's serving the public
2 interest, we're talking about a financial annuity, which
3 is the nature of the relationship. And it goes back to
4 our questions that Chairman Williams was talking about,
5 about the lack of independence that flows from this.

6 You know, there's a -- there's a study, again, on
7 SSRN, and there's a lot of studies out there. If you
8 find one, you can, in fact, get all the rest, by Brooks,
9 et al., in 2012, and find that the audit quality starts
10 deteriorating by various metrics, you know, a rise in the
11 number of questionable accruals, et cetera, about the
12 12-year mark.

13 You know, again, if -- you know, the numbers, I
14 believe, speak for themselves, that there's a good deal
15 of brief concern for whether we have the right structure
16 today for assuring professional detachment and
17 independence on the part of the accountant.

18 Now, we do live, as we're all aware, particularly
19 those who reside within the Beltway, in a political
20 climate. And so it may be that what we heard Chairman
21 Williams saying, I think is some very good wisdom, and
22 that is that sometimes in a contemporary, legal political

1 climate, one can think about steps toward where the
2 ultimate goal are, and the suggestions were pilot
3 programs, et cetera.

4 I, too, do empirical work. I, too, like doing
5 that. Maybe it gets me a raise. Fortunately I have
6 tenure, I don't have to worry about that anymore. But
7 nonetheless, it is a way of building, moving forward.

8 But short of those concerns, let me just suggest
9 that there's some other ways out there. And that is --
10 and I think we're talking about two -- killing two birds
11 with one stone here with we're talking about auditor
12 independence and moving in that direction. One is the
13 question about trying to ratchet up professional
14 independence. But it also goes back to the initial point
15 that, again, others have mentioned, and that is that this
16 is an industry that's not structured very well.

17 I mean, there's an oligopoly at the top. And so,
18 you know, our fellow regulators across the pond in Europe
19 are thinking about this not just in terms of professional
20 skepticism, but also thinking about what the long-term
21 approach is to introducing more competition. Okay? So
22 we thought about this as not only as an industry-

1 structured question, but also a professional competence
2 question. I think they would -- the vectors would point
3 the same way, and that is that you'd like to be able to
4 see the jobs turn over a little bit more often.

5 So there's several approaches here. In just the
6 remaining time I have, I can list them. One, we can do
7 nothing. I don't think that that's the answer. I don't
8 think that's in the industry's profession interest, and
9 I certainly don't think that's in the interest of the
10 PCAOB, we can't do anything.

11 One is that the opposite extreme is to mandate
12 some firm rotation. And that has the benefit of
13 everybody understanding what the deal is and when it's
14 going to happen, and it's a very clear message. And I
15 would support that, but for my concerns about what the
16 sort of geopolitical environment is. Okay?

17 So what are some of the half measures there that
18 work? And, you know, without endorsing any one of these,
19 I would just suggest that, one would be the approach
20 where there would be a requirement that after X number
21 of years -- and we can all sit down and wonder what the
22 X is -- that the firm has to put the client has to put

1 the audit up for a bid. And included in the bidders
2 would be the former auditor, and then have a mandatory
3 disclosure obligation about why, if it turns out that the
4 company, the reporting company, chose to select the
5 former auditor, have some explanation about that.

6 And anyone can think about a variety of
7 explanations, but at least it raises a consciousness and
8 makes that process visible and gives other firms an
9 opportunity to step in and compete for the bid.

10 Another idea would be something that would -- it
11 could be totally within the control of PCAOB, and that
12 is that -- and you may be doing this because you were
13 pointing out, Chairman Doty, that on risk assessments and
14 carrying out your inspections, that one of the heuristics
15 that would be used is to link the audit tenure. And so
16 when you carry out your inspections, not only will you
17 be looking at targeting those firms that had a long-term
18 historical relationship with the client that they're
19 auditing, but should you find questions about
20 professional judgment, then the sanction or remedy that
21 could be imposed would be rotation. Okay. Think of this
22 as a remedy to a problem that has been identified through

1 the independent process of an inspection. Okay?

2 The other thing that also could be within the
3 control of the PCAOB without having to perhaps have to
4 worry about what the scope of its authority would be that
5 maybe some of the others of them have, and that would be
6 the question about tinkering with the audit opinion
7 letter. That, you know, should the audit opinion letter
8 be fairly clear of saying, we've been auditing this firm
9 for a hundred years.

10 You may think that that's absurd. There are
11 eight companies, public companies in America who've had
12 the same auditor for a hundred years. Surprising that
13 we have eight companies in America that are still in
14 existence over a hundred years, but nonetheless, the same
15 auditor for that period of time. So one can think about
16 that.

17 So those are some halfway measures. But the
18 important thing is that this is an important journey, and
19 one well worth taking. And I'm sure investor groups will
20 support you right down the road. Thank you.

21 CHAIRMAN DOTY: Thank you, Professor Cox.

22 Maureen McNichols.

1 MS. McNICHOLS: Chairman Doty, commissioners and
2 members of the PCAOB staff and the SEC, it is a great
3 honor to speak with you this morning.

4 I joined the accounting group at Stanford in 1984
5 and have taught a number of courses on financial
6 reporting, financial statement analysis, and investing
7 over the past 28 years. My students and I have studied
8 the financial reporting issues at many well-known
9 companies including Sunbeam, Waste Management, Enron,
10 IBM, WorldCom, Halliburton, AIG, Tyco, CIT and Fannie
11 Mae.

12 I also developed an elective for our students
13 entitled "Understanding Cheating," which draws on the
14 literatures in accounting, economics, sociology,
15 psychology and education to understand the factors that
16 contribute to cheating and corruption. My research
17 focuses on the role of accounting and providing
18 information to investors in capital markets.

19 My own research and the work of many others in
20 accounting establishes that informative financial
21 statements are crucial to the allocation of capital in
22 our economy. Substantial research establishes that

1 investors are informed by financial statements, and that
2 stock prices respond significantly to earnings
3 announcements.

4 My dissertation documents that financial
5 statements play a distinctive role in causing less
6 favorable information to be disclosed on a timely basis.
7 This is in contrast to the aggregate of competing sources
8 of information such as management's voluntary disclosures
9 and financial analysts.

10 In subsequent work, I and my co-authors, as well
11 as many other researchers have examined the causes and
12 consequences of earnings management. This research
13 documents that investors experience significant losses
14 when firms announce earnings restatements or other
15 financial reporting quality issues. Furthermore, the
16 evidence suggests that incentives to manage earnings are
17 substantial, and that in addition to investor losses,
18 firms that manipulate to increase their earnings often
19 over-invest in their own businesses, increasing investor
20 losses.

21 In other research, my co-authors and I find that
22 the ability to predict bankruptcy is impaired when firms

1 manipulate earnings. These findings indicate that the
2 benefits of high-quality financial statements are
3 substantial, immeasurable. These findings also indicate
4 that the potential to manipulate earnings is greatest
5 where judgment is greatest.

6 I teach my students that financial statements
7 reflect three elements: fundamental information about
8 firms, measurement error, and discretion. The greater
9 the potential measurement error, the greater is the
10 judgment required, and consequently the greater the
11 potential for managers to exercise discretion over the
12 measures and disclosures in financial reports.

13 We are at a point in our history where
14 unprecedented levels of judgment about values enter our
15 financial statements and, consequently, there is
16 unprecedented potential for management's unintentional
17 and intentional biases to influence financial statements.

18 Furthermore, the level of judgment and discretion
19 in financial reporting can only be expected to increase
20 as businesses evolve and engage in ever more complex
21 transactions and contractual arrangements as businesses
22 expand their global reach, and as accounting standards

1 converge globally.

2 While Sarbanes-Oxley has brought substantial
3 reforms and improvements to the reporting process, it is
4 clear from the PCAOB's reviews, and from the financial
5 crisis, that audit quality is not what it needs to be.
6 Furthermore, the financial crisis makes clear that the
7 interconnected nature of corporations and financial
8 institutions has increased the potential harm from audit
9 failure by orders of magnitude.

10 Entering into this ever more challenging
11 environment are the auditors. SOX requires that the
12 auditor maintain independence and mental attitude in all
13 matters relating to the audit. And this is crucial to
14 permitting financial statements to fairly present the
15 results of operations in the financial status of firms.

16 The classic model of corporate governance is that
17 shareholders appoint the board of directors who appoints
18 management who hires employees and manages the firm. The
19 independent directors on the audit committee appoint the
20 auditor who acts on behalf of investors. In this model,
21 investors are the principals in a cascade of principal
22 agent relationships.

1 While the financial statements are the assertions
2 of management, and the audit committee bears a key
3 responsibility to assess the reasonableness of critical
4 accounting processes and judgment, auditors have access
5 to information and the responsibility to assess
6 materiality that may determine whether an issue comes to
7 the Board or the audit committee.

8 Thus, even in a world where audit committees are
9 fully aligned with investors' interests, lack of
10 independence in the auditor can degrade the quality of
11 financial statements. In companies where directors are
12 less than fully independent or are not fully diligent,
13 the auditor's role is even more critical. However, when
14 a firm hires its auditor, it is hard for the auditor to
15 be truly independent.

16 One has only to look at the common language
17 describing this relationship to see this. Audit firms
18 speak of the companies they audit as their clients. When
19 you look at the websites of public accounting firms, you
20 see language that describes how their purpose is provide
21 value to their clients and to build relationships, to
22 help clients solve complex business problems and enhance

1 their ability to build value.

2 I believe public accounting firms were created to
3 serve a different client, the investing public. There
4 is substantial academic research on the effect of
5 conflicts of interest in many domains, and the findings
6 are very consistent.

7 One example of this research studies whether
8 equity research analyst reports are affected by
9 investment banking and other types of relationships. The
10 findings indicate that affiliated analysts issue more
11 favorable recommendations than unaffiliated analysts.

12 The findings on scientific research are similar,
13 and indicate when scientists consult a company, their
14 research results are more favorable to those companies.

15 Research conducted by Max Bazerman and his
16 colleagues provides strong evidence that in many cases
17 these biases may be unintentional rather than
18 intentional.

19 The Sarbanes-Oxley reforms have been fully
20 implemented, and substantial concern remains regarding
21 the ability of auditors to remain appropriately skeptical
22 of company assertions. I believe the lack of skepticism

1 results from the structure of the client-payer model, and
2 it is now time to pursue alternatives to the current
3 model where the company being audited hires its auditor.
4 I therefore support developing a plan that provides a
5 form of term limit or mandatory rotations for auditors.

6 Some may argue that research in accounting calls
7 the arguments on the benefits of rotation into question,
8 documenting a positive relation between earnings quality
9 and auditor tenure. I would be reluctant to draw
10 inferences about the effect of mandatory rotation from
11 this research for several reasons.

12 First, it is hard to control for the
13 circumstances that lead to the early years of the audit.
14 The early years could arise because the company is newly
15 public, or because it recently chose to switch auditors.
16 And for either reason, its earnings quality could be
17 lower than for firms with greater auditor tenure.
18 Second, it is harder to separate longer auditor tenure
19 from survivor bias in the firm, in the company.

20 Third, the findings could reflect the fact that
21 earnings quality contributes to auditor tenure, rather
22 than the reverse. Lastly, these studies cannot capture

1 the counterfactual at issue, how auditors perform audits
2 when they are not concerned with maintaining the revenue
3 stream provided by the firm they are auditing, and when
4 they know their work will be reviewed by a successor
5 auditor.

6 So, to conclude, I believe a form of auditor
7 rotation is in the best interest of the investing public,
8 as it would strengthen an auditor's ability to
9 independently assess the reasonableness of management's
10 measures and methods. This has the potential to improve
11 the quality of audits and to decrease the frequency and
12 magnitude of manipulation and errors in financial
13 statements.

14 The structure of the PCAOB gives you unique
15 opportunity to work with the auditing profession to meet
16 the needs of its clients, the investing public.

17 I thank you for taking on a very challenging
18 issue on behalf of the investing public, and for allowing
19 you to speak me -- allowing me to speak with you today.

20 CHAIRMAN DOTY: Thank you. There are several
21 board members leaning forward on the edge of their chair.
22 Mr. Hanson.

1 MEMBER HANSON: Thank you. There were very
2 insightful comments.

3 And I want to -- I want to come back to a point
4 I made in my opening remarks about audit committees. And
5 Professor McNichols, you mentioned audit committees
6 briefly. But I'm reflecting on Chairman Williams'
7 comments and his statement that we talked about that he
8 does not believe that even the most vigilant audit
9 committees can do their jobs in terms of assessing the
10 professional skepticism of the auditor.

11 And later today, we're going to have some of the
12 most prominent audit committee Chairs here in America
13 sitting here asserting that they do have that ability.
14 So I'm curious to see your thoughts as to -- each of you,
15 your thoughts as to whether even the best audit committee
16 members and Chairs, which we will have some of them
17 sitting here today, can do their job of assessing the
18 auditor's independence and skepticism.

19 CHAIRMAN DOTY: Andrew, you want to start the
20 process?

21 MR. BAILEY: Yes. It's hard for me to know
22 whether an individual on an audit committee will be able

1 to do that. I don't think that the structure of the
2 audit committees gives me great comfort that that will
3 be something that can be done on a regular basis.

4 One of the things I note is that there's very
5 little consequence to failure for the audit committee
6 members. In fact, along this whole chain of things, one
7 of the things that's missing in many cases is a
8 consequence, a known consequence. When you fail, this
9 will happen.

10 Audit committees are very close to management.
11 I've been to some of the ODX meetings, for example. I
12 think they try hard. But their view is still that
13 they're there to assist management. And so I don't have
14 a lot of confidence that the audit committees will be
15 able to do that job on any kind of consistent basis.
16 Some will do well, some will not.

17 CHAIRMAN DOTY: Jim?

18 MR. COX: Yes, I think the audit committee
19 suffers from some of the same illnesses that boards
20 generally have; that is that they're bounded by time and
21 they're bounded by information.

22 They know the company. They spend more time out.

1 They have a task that's more specific than the board,
2 generally. But at the same time, the meetings are --
3 there's a time, there's a plane you have to catch. And
4 at the same time, many of these audit failures are down
5 in the weeds. And unless you know how to answer the
6 questions or how you interpret matters, what's being said
7 by the auditor reporting to the audit committee, you may
8 not be, as an audit committee member, able to follow the
9 -- you know, follow the questions along far enough to
10 find out where the problems are.

11 And then added to what Andrew was saying, there
12 continues to be a cultural issue about who serves on
13 boards. And that is, you know, a little bit of the
14 "there but for the grace of God go I" deference to the
15 management team.

16 So it's, you know, audit committees are doing a
17 better job today than they were 10 years ago, and a
18 better job than they were 25 years ago, but I think
19 they're still dependent on the lynch pin, which is the
20 outside auditor.

21 CHAIRMAN DOTY: Professor McNichols.

22 MS. McNICHOLS: Okay. I agree Andy and, and

1 Jim's comments. I think that a diligent audit committee,
2 the very best audit committee in the world is not a
3 substitute for an independent accountant, an independent
4 auditor.

5 I think for the audit committee to fully grasp
6 the potential biases of auditor, they have to have the
7 information that the auditor had. And they certainly can
8 see the extent to which the auditor probes management on
9 their judgments. That's certainly something that's
10 important to look for.

11 But to the extent you don't know everything the
12 auditor saw, I think the audit committee's really not in
13 a position to fully understand whether the auditor's
14 judgments have been unintentionally or intentionally
15 biased.

16 I think consistency is the key here. On some
17 boards, things can work very, very well, but you can't
18 assure that with purely strengthening the audit
19 committee.

20 CHAIRMAN DOTY: Mr. Ferguson.

21 MEMBER FERGUSON: Professor McNichols, you made
22 a statement that I found intriguing, and I think I got

1 it down correctly. And I would like to you elaborate on
2 it, if you would.

3 You said earnings quality contributes to auditor
4 tenure rather than the reverse. Did I quote you
5 correctly on that?

6 MS. McNICHOLS: Right.

7 MEMBER FERGUSON: What does that mean, and how
8 does that impact the way we should be thinking about
9 auditor tenure?

10 MS. McNICHOLS: Well, I think the notion is that
11 an auditor may stay with a client that has good earnings
12 quality longer than a client that has poor earnings
13 quality. And so the auditor has a higher probability of
14 quitting a client that's really troubled. And that means
15 they go into the pool of starting over, and they're in
16 the early years of the sample where you're looking at the
17 quality of the earnings. So that was really, I think --

18 MEMBER FERGUSON: Is that the auditor's decision,
19 or is that a question of auditor -- an auditor risk
20 assessment that an auditor assesses the risk of an audit
21 where a client has poor-earnings quality as high, but
22 from a liability standpoint?

1 MS. McNICHOLS: Well --

2 MEMBER FERGUSON: Is that what the concern is?

3 MS. McNICHOLS: It could be the auditor chooses
4 to walk away. It could be the company goes away. In
5 most of these studies, the company, you know, doesn't
6 have to survive forever, it just has to survive a certain
7 number of years.

8 And so, you know, a company that doesn't survive
9 also could drop out of the sample. So for either reason.

10 CHAIRMAN DOTY: Steve?

11 MEMBER HARRIS: Well, I'm struck by the fact that
12 auditors are not encouraged and sought after to serve on
13 independent audit committees. I think that auditors know
14 an awful lot about what goes on in an organization, and
15 I'm struck by the fact that CEOs are encouraged to serve
16 on independent audit committees instead of auditors.

17 So when we talk about the independence of the
18 audit committee, I'm wondering how independent they truly
19 are if they don't have auditors on the audit committee.

20 I have two questions. One, following up on
21 Chairman Williams' testimony, if you were head of a --
22 one of the firms listening to this hearing today, how

1 would you suggest they be proactive in terms of
2 addressing the problems that you've articulated?

3 And then, second of all -- because time is
4 limited I can't resist the temptation to ask multi
5 questions at one point. With respect to the client,
6 who's the primary client? I'd be interested in your --
7 all of your views in terms of who you view as the primary
8 client of the auditor when management pays the bill. I
9 mean, if management's paying the bill, how can management
10 not be the priority client? But we've all indicated that
11 you -- some of you have indicated you believe the
12 investor is the primary client. So if you could take
13 those two on, I'd appreciate it.

14 CHAIRMAN DOTY: Andy, do you want to begin?
15 Andy, do you want to begin?

16 MR. BAILEY: Let's do client first. We, as I
17 have always understood this, and I've been -- I actually
18 ran into people during my time at the SEC who argued
19 contrary, but my understanding of this has always been
20 that we got a monopoly on this activity, in the interest
21 of the investor, third-party uses the market. And they
22 are the client.

1 The payment scheme is an artifact that we seem to
2 not be able to avoid. Somebody's got to come up with the
3 money. All of the proposals that I have encountered
4 about coming up with the funding to pay, have
5 consequences that are almost, from our selfish
6 professional point of view, at least, worst for us. So
7 if we have a single-party pay, like the government, or
8 an agency, in effect, they become the arbitraries of
9 auditing. I mean, we basically eliminate ourselves as
10 a profession, become a GAO public audits, if you like.

11 The insurance model's been proposed. Josh Roman
12 has -- a very intelligent guy, but he and I just don't
13 agree. All I think that that does is it shifts the
14 nature of the payment scheme. You now have an insurance
15 company, for example, that likes to take premiums,
16 probably isn't going to like to pay out the benefits, and
17 they hire the auditor in a private contract. And so we
18 even lose that relationship that we would have had
19 earlier.

20 So I don't know how to deal with the price
21 problem, except to recognize that it's there, that it's
22 an unusual sort of relationship that the client doesn't

1 actually pay you, somebody else does.

2 As to proactive, I'd be happy if they'd just stop
3 being completely negative on virtually any change that
4 might impact the way in which they do business. I mean,
5 that would be a help.

6 I, right now -- basically, by the way, and this
7 is maybe relevant -- I'm not sure that in this oligopoly,
8 in a strange sense, that they do compete on quality. I
9 think what they actually compete on is the price of the
10 audit, and we drive that way down, because they don't
11 perceive that as value added to them. And it's all made
12 up in some way or another on the other services that are
13 offered in a variety of ways, across -- not across a
14 single client, but across the profession.

15 So proactive, it can be very hard for them to be
16 proactive, because all of this has implications for how
17 they're organized, how they do business and how much
18 money they're going to make. I'd just be happy if they'd
19 be a little less negative.

20 CHAIRMAN DOTY: Jim?

21 MR. COX: Yes, what I meant is, they don't
22 compete on quality. They don't. I think there's a fair

1 amount of reason to support that.

2 On the client, I thought that one of the great
3 innovations of SOX was making sure that the audit
4 committee is the client and it represents the
5 stakeholders of the company, which will be all in the
6 reporting area, I believe all the financial statement
7 users.

8 And so, unfortunately, I think audit committees
9 haven't fully gotten that message. I don't know totally
10 why that is. Maybe it's cultural, everybody was talking
11 about earlier. But the client -- the client, for the
12 auditor, is the audit firm -- I mean, the audit
13 committee. And the audit committee represents the broad
14 range of stakeholders, even broader than probably
15 corporate law would probably think about, but the
16 obligations of the directors are in that regard.

17 I thought -- and I think that that's a good
18 model, I just -- it's not totally clear to me outside of
19 the cultural, why it's not working better than it is.

20 And then how can various people be proactive? I
21 actually think it's time for leadership within the
22 accounting profession, for individuals, not just outside

1 the big four, but the big four themselves, to understand
2 that this is kind of their last go ahead, quite frankly.

3 You know, history's a long time, and if the
4 current SOX PCAOB model doesn't work, the next one that
5 comes down the road is going to be a lot less appealing
6 to them. It's going to be, as Andrew was pointing out
7 -- you're going to be working for the federal government.
8 And I found that pleasant. I'm not sure all auditors are
9 going to find that that pleasant. So it's time for the
10 industry to step up and understand that they can survive
11 and do very well in this industry by enhancing their own
12 professional independence.

13 CHAIRMAN DOTY: Maureen?

14 MS. McNICHOLS: I'll talk about what audit firms
15 can do first. I think there the culture of the firm is
16 critical. And in terms of, of enforcing a culture that
17 motivates auditors others rewards auditors to do the
18 right thing, I think I would like to see something like
19 grand rounds, where they talk about, you know, cases that
20 have been handled well and poorly, and recognize sort of
21 what the values of the firm are in those instances, and
22 have, you know, pretty candid discussions with their key

1 people about -- about the values that they really want
2 to enforce in the partnership in the firm.

3 In terms of the question of who's the client, I
4 think of its client as the investing public. I think
5 that is the point of the audit. And while the engagement
6 is with -- through the audit committee, not all audit
7 committees are perfectly aligned with the investing
8 public. And so I think the mindset should be that that
9 is who they're there to serve.

10 In terms of payments, I think who pays is less of
11 an issue than who makes the decision to hire and fire,
12 and who structures the engagement and what limits there
13 are associated with that. And that's why I think
14 mandatory rotation can have value in terms of aligning
15 auditors' incentives with investors.

16 CHAIRMAN DOTY: Jeanette Franzel?

17 MEMBER FRANZEL: You've all made reference to the
18 client-payer model being flawed. And we've heard that
19 reference from many others as well.

20 But there seems to be an acceptance that any
21 other model, just -- we can't really realistically look
22 at that. So given that we've got a model that people

1 believe is flawed, and you all have made references to
2 structural changes that might be needed because of that,
3 the inherent bias in that model, and we also talked about
4 mandatory audit firm rotation and your views on that, I'd
5 be curious in hearing any other structural changes that
6 you think could or should be implemented, and what order
7 of priority would you really place these in.

8 And then, Professor McNichols, I was also going
9 to ask a question, really the one right after what Lew
10 asked, and that is: You were talking about survivor bias
11 in the firms, so I would just like to hear a little bit
12 more about that as well.

13 MS. McNICHOLS: Okay. I could start off with
14 survivor bias in the firm. I mean, the notion there is
15 that a firm doesn't live a hundred years unless it
16 actually has a good business. It has -- it may not, you
17 know, have a perfect business over time, it has ups and
18 downs, but you have to have a strong business to last a
19 long time.

20 And so when you're looking at data and trying to
21 understand whether auditor tenure -- auditors, I think
22 are learning over time, I think the idea is, you know,

1 do auditors do a better job on their audits early in the
2 engagement versus later, or, obviously the -- you know,
3 the argument for many is it's when they do a poor job
4 there's greater audit risk early in the engagement
5 because they don't know the firm as well.

6 When you're looking at samples of data relating
7 earnings quality, for example, and auditor tenure,
8 there's other variables that enter into that relationship
9 that would have to be controlled out before you could
10 really understand whether there's higher or lower
11 earnings quality at the beginning of the engagement
12 versus later on, and what role the auditor actually
13 played in achieving that, if at all.

14 So, when you have a firm that lasts a long time
15 because it has very high-quality earnings, and an auditor
16 that stayed with that firm, it doesn't necessarily mean
17 that the auditor was doing a good job in controlling the
18 firm's incentives to manage their earnings. They
19 happened to be aligned with a very good firm in terms of
20 a profitable, healthy company, healthy business. And so,
21 you tend to see that higher earnings quality and auditor
22 tenure could go together because of that.

1 So on the structural issues, I think you were
2 thinking about structural issues vis-à-vis the
3 relationship with -- with the client?

4 MEMBER FRANZEL: Just any other particular
5 structural issues that you all might have in mind, or
6 adjustment that could or should be made to the current
7 model.

8 MS. McNICHOLS: I guess I could comment on one
9 direction that I see, vis-à-vis audit committees. And
10 that is in terms of compensation committees and audit
11 committees.

12 I mean, one thing I see from the research on
13 earnings management, as of course it's tied to management
14 incentives, and when you have an audit committee that is
15 not fully informed of all of the compensation
16 arrangements and fully understanding of how exactly
17 you're measuring the numbers that are going to determine
18 bonuses and awards and so forth, then they don't quite
19 know what to look for. And so things have to be very
20 clear in terms of what's included and what's not
21 included, and different kinds of targets.

22 And so one structural recommendation I would make

1 is that there always be someone on, you know, the audit
2 committee and the compensation committee jointly. And
3 some boards, I think, actually have those meetings held
4 at the same time, and so they're completely different
5 compositions.

6 CHAIRMAN DOTY: Andy?

7 MR. BAILEY: Yes. One thing about this
8 conversation is that we're talking about mandatory
9 rotation or tendering, and this really can be a multi
10 track. It's not necessarily that we do only this and not
11 something else.

12 And so, for example, the conversation down here,
13 we might pursue figuring out how to make audit committees
14 more effective, add consequences. There have been
15 proposals that we have further limits of services that
16 these firms can provide. There's no reason that can't
17 be part of the conversation. Because I do think,
18 fundamentally, this is in part a problem of a conflict
19 of interest on these other services, where we really
20 don't care that they perform them in a non-independent
21 way. It's for the company that pays them.

22 On a first preference basis, you know, dangerous,

1 I would like to see -- I would have liked to have seen
2 the Arthur Andersen option as an audit-only firm allowed
3 to run for a while. I think there is -- and I think the
4 firms can make -- and the people in these firms can make
5 plenty of money. I mean, in an audit-only firm. And I
6 don't mean very narrowly defined, but make it the 60s
7 firm, whatever you'd like, and get rid of a large
8 fraction of the consulting. These are the largest
9 consulting firms in the world. They can stand alone.
10 They don't need, I think, to have the audit.

11 Now, how are you going to get there? I have no
12 clue. I do think that putting in mandatory rotation is
13 likely to put a lot of pressure on the companies that are
14 being audited, particularly if there's a consequence to
15 their failure to predict that auditor and future
16 auditor's independence. A real consequence may cause
17 them to begin to rethink this.

18 I mean, the GAO had a round-table in which the
19 issue of splitting up the firms came up. Nobody really
20 wanted to talk about it, but it came up. And it is
21 technically feasible to do that. It's going to be very
22 costly, but this might actually begin putting some

1 pressure on the other side of the partnership to think
2 about what it would mean to strip off the auditor, thus
3 eliminating at least that particular part of the
4 conflict, or influencing these firms to grow other
5 consulting firms.

6 I don't know what the real answer is, I kind of
7 -- my first preference, if I were given that authority,
8 would be that I'd split these firms up.

9 CHAIRMAN DOTY: Jim, do you have a comment on
10 structure?

11 MR. COX: Yes. I, you know, still continue to be
12 bothered by the fact that the auditors do perform an
13 awful lot of consulting services outside the prohibited
14 list of SOX. And one of them is tax area. I think the
15 political realities there, again, are formidable.

16 The issue I would really have there is wanting to
17 know whether it could be some means of forcing audit
18 committees to make a detached, or as detached a judgment
19 as possible about whether it's possible to continue to
20 have the auditor perform the tax services, but
21 nevertheless have somebody else do the audit. Which is
22 something, by the way, we're doing at Duke.

1 We decided filing 529 tax returns with various
2 authorities around the world, that it just doesn't make
3 sense to bring in somebody else new, but we are putting
4 the audit up for bid this year. And we will be making
5 a change there. That's all public knowledge.

6 So, I think greater transparency in -- somewhere,
7 even in the audit opinion order, about how much revenue
8 the auditors have from doing the audit services may have
9 some chastening effect.

10 CHAIRMAN DOTY: We may have a time for a second
11 round here. But what I find extraordinary about the
12 panel is we've got -- with Andy Bailey, we have someone
13 who is deputy chief accountant, spent a very significant
14 amount of time looking at auditor independence and
15 thinking about the principles that either undermine it
16 or guided it. And what I take away from Andy, the cost
17 is not the fee, but the failure.

18 I mean, the interesting thing here is that it
19 should be a profitable business but for the kind of audit
20 failure that results in stupendous litigation, the
21 Parmalat-type situation. Stage predictability and
22 thinking about this issue comes through strong in your

1 -- strongly in your statement.

2 With Jim Cox, you're suggesting that there is a
3 range of change that could be addressed, concluding or
4 coming to rest in a disclosure issue that if you retain,
5 you must explain that you -- and this is of course where
6 the FRC seems to be headed on tenure cycle in London.

7 And then -- and then from Professor McNichols,
8 the idea that we should be mistrustful of the current --
9 of the authoritativeness of the current literature to
10 simply dispel in the investigation of this.

11 I mean, I think that the three of you have the
12 advantage of having actually read and exhausted the
13 academic literature, which many of the people reacting
14 to this subject have not. And I take it that Maureen is
15 cautioning us that the models that have been structured
16 really are undermined by the terms, the tenure changes,
17 and some of the other dynamics that go into auditor
18 rotation studies, or the relationship of the auditor, the
19 audit committee and the company.

20 What should we be looking at, though? Where, if
21 there is additional work that we should do to focus on
22 what is pragmatic and what is likely to preserve and to

1 foster an independent audit profession and not move us
2 to a government operation or to something that is an
3 unattainable, such as an insurance model?

4 Where should we be putting our investigation?
5 Any thoughts on that? Since research is your business,
6 as you've said, where do we need to do more research?

7 MR. BAILEY: As an academic, this is blasphemy,
8 but, you know, all the research that's been done, there
9 is -- you can find one that supports the idea. It will
10 be narrowly done and narrowly performed. And you'll find
11 one that is suggestive of failure of independence. And
12 then a jump might be -- a leap might be made to auditor
13 rotation or handling the audit committees in a different
14 way. And we will continue to do that sort of thing.

15 And we're not bad at it. I mean, it's
16 interesting work, and -- but I just have this feeling on
17 this one that it's never going to resolve. You're never
18 going to get the kind of comforts you would like to have
19 that. You're moving, on mandatory auditor rotation, for
20 example, is going to resolve the problem. In fact, of
21 course it will not resolve the problem; it will change
22 the rules of the game. But I think it's a rule changer

1 that might be much more difficult to deal with than the
2 tinkering we've done in the past. And that tinkering,
3 by the way, I don't mean to minimize it, it's important.

4 So I'm not sure that, despite my background, that
5 I would suggest that you wait around a long time
6 commissioning studies, commissioning trials and more
7 research. We're much better as academics, frankly, of
8 taking the change in the environment and testing what the
9 character of that change was.

10 MR. COX: Well, you know there's always two
11 responses to any empirical research. People say I knew
12 that, or that can't be right. And it's a little like
13 what Andrew is saying here is, one brick doesn't build
14 a house. And it takes a long time. And as somebody who
15 does empirical work, I understand how long this is.

16 I actually think that, getting ready for this, I
17 was surprised how much literature there is already out
18 there. And it also made me start thinking about the
19 following, and that this is a problem largely of large
20 reporting companies; less of a problem, I think, of small
21 companies. And the reason I'm saying that is that there
22 there's a fair amount, what I'll -- just out of the

1 corner of my eye -- a fair amount of changes of
2 accounting firms each year of public reporting companies
3 which tend to be more allocated to the smaller firms.

4 So although smaller firms have weaker reporting
5 systems, and that's where you're going to find more of
6 a problem, you may be starting at the top where there's
7 less concern that the audit costs are really -- have a
8 disproportionate impact on earnings. Maybe that's where
9 you would start off.

10 So, again -- so I'm agreeing with Andrew that
11 maybe just looking at the field of research right now and
12 then get your priors and then reaching a policy judgment,
13 is probably enough. I don't know if there needs to be
14 a lot more research and then figuring out how you can
15 roll this out in a sellable fashion.

16 CHAIRMAN DOTY: Do you have a parting ---

17 MR. BAILEY: You know, this business of large
18 firms/small firms, I was one of the advocates that said
19 that IAS -- AS-2 and 5 should be applied to the non-
20 accelerated filers.

21 If our interest is in protecting the markets,
22 okay, then it's the large firms and the large clients,

1 because small failures don't really impact the market
2 much. If your interest is in protecting the investor,
3 you've got a kind of a different kind of moral problem
4 to deal with. So on a roll-out basis, however, starting
5 big and working down in terms of the markets would be the
6 way to go.

7 CHAIRMAN DOTY: Maureen?

8 MS. McNICHOLS: Yes, I concur with Andrew and
9 Jim's comments. I think that you have the evidence you
10 need to move ahead in terms of mandatory auditor
11 rotation. I think -- I think the data are clear that
12 structure contributes to unintentional and intentional
13 biases that are very, very harmful to the economy. I
14 think starting with sensitive companies and large
15 companies where the benefits are the greatest, and where
16 basically the companies are too big for audits to fail.
17 And so I agree with sort of a starting position with
18 perhaps the largest companies.

19 I think the other thing that's possible for the
20 boards to do is exploit what you have learned as much as
21 possible from all of your investigations. Perhaps it's
22 some kind of collaboration with academics. Maybe you

1 were already doing some of that. I'm sure that many
2 academics over the years have had, you know, tremendous
3 interest in pursuing questions relating to audits, and
4 are unable to access data through the firms. And so I
5 think there's great potential to contribute to how to do
6 better audits going forward.

7 But, vis-à-vis the decision before you today, I
8 think the research is already there.

9 CHAIRMAN DOTY: If we're going it have a break,
10 we should take it soon. Brian? Yes, go, sorry.

11 MR. CROTEAU: Thank you, and good morning.

12 I just have a follow-up for Professor Cox. And
13 it relates to -- I think you've asserted that perhaps an
14 option would be to look to mandatory re-tendering, with
15 an option of retaining the current auditor.

16 And you've also asserted that you don't believe
17 that firms today are competing on quality. And I just
18 wonder, some have suggested under that type of a model
19 firms would spend more time marketing, more time thinking
20 about what they need to do to appease their client.

21 And I just wonder how you think about that in the
22 context of the re-tendering option, and whether that

1 actually would drive increased quality, or whether that
2 actually could create additional incentives that could
3 cause us to focus more on, in fact, cost rather than
4 quality?

5 MR. COX: I think it's very -- that's an
6 excellent question. And unfortunately I don't have an
7 excellent answer.

8 The answer I'll provide is along the following
9 line. It's very difficult to communicate on quality and
10 differences in quality when you're talking about
11 professional services of going forward. And so I think
12 that the real benefits wouldn't be in the sharp process
13 that we normally see of making consumer choice on certain
14 decisions.

15 What I would think might come about would be,
16 hopefully -- and again, I'm less than certain about this
17 -- that by opening it up and having the competition, that
18 that changes somehow the dynamics and the culture within
19 the board, okay. And because when the institutions and
20 others see that the decision's coming up, maybe they'll
21 be reaching out.

22 And we are finding, you know -- that's where

1 really accelerating change is occurring, is the
2 robustness in which a wide range of financial
3 institutions are now communicating their views to
4 individual directors. And I think that's where the
5 change would occur. So I don't think it's the same thing
6 where having GM and Ford go against each other, we're
7 talking about product quality.

8 I think it's what happens in the boardroom in
9 terms of being an awareness that this decision's going
10 to happen. You have these different choices. Maybe
11 you'll change the culture. Again, emphasis on the maybe.

12 CHAIRMAN DOTY: Our chief auditor, Marty Baumann,
13 has a quick parting question.

14 MR. BAUMANN: Thanks. I want to follow up, too,
15 Professor Cox, on something you said. But I'd be
16 interested in the views of others.

17 You said, plus there's cultural issues of who
18 serves on the boards getting to the fact of are they
19 capable of digging into the complex accounting and
20 auditing issues, and are they independent audit
21 committees, et cetera.

22 We also heard from Chairman Williams about can

1 audit committees really dig into some of the issues, do
2 they have the ability to dig into some of the
3 unintentional, you know, the bias that's there, and do
4 they really have the capability to get behind that.

5 I don't have the statistics. I'm going to get
6 them. I don't have the statistics of how many companies,
7 as large as 500 or a thousand, have experienced auditors
8 serving on them. I don't know if you do have that,
9 because you pointed out the cultural issue.

10 I do observe that when a company has problems,
11 when it's had restatements, it's now -- the company's in
12 a financial crisis, there are difficulties, experienced
13 auditors do get appointed to the boards and audit
14 committees ultimately, and that's interesting to see that
15 happen after the fact. But I will get the statistics on
16 what percentage of very large companies have experienced
17 auditors serving on them.

18 Would it make a difference, in your minds, that
19 if audit committees did have very experienced auditors,
20 former auditors serving on the committee in terms of this
21 entire process of governance and/or the way in which
22 audit committee auditor interaction and independence

1 might work?

2 MR. COX: I think the answer to that is yes. And
3 I think that one of the reasons that makes me say yes is
4 the following.

5 If you look at the two -- I think I'm using the
6 appropriate titles -- the two COSO reports where you
7 looked at SEC enforcement actions for one decade, which
8 was leading up pretty much to the Enron collapse, and
9 then looked at the more recent one, that, as I recall,
10 the data there, we found a really substantial change that
11 the variable that leapt out at you at the '79 through '89
12 enforcement actions, was the absence of an audit
13 committee or experienced personnel on audit committees.
14 That was the variable that leapt out and said that's what
15 matches up with financial frauds.

16 And then we looked at other variables that --
17 other than the -- the audit committees were good, and
18 they weren't a variable that was leaping out in quality.
19 So, you know, my own feeling is that, private staffing
20 isn't necessarily going to be the issue with the audit
21 committee, meaning who's on there or isn't there.

22 There was a question that Board Member Harris was

1 suggesting, why do we have existing auditors on these
2 committees or more. I actually think it's still a
3 problem that's for the board, and that is that they're
4 time bound and they're information bound. And they --
5 you're still seeing things through several filters that
6 prevents them from being as engaged as perhaps we would
7 like to see engage the.

8 CHAIRMAN DOTY: Andy?

9 MR. BAILEY: As a practice problem with only four
10 firms, we're not talking about being able to put active
11 auditors on these audit committees, because that will
12 conflict them out promptly unless they're rotated off
13 within some specified period of time on a mandatory
14 rotation. But, in general, the answer would be --

15 MR. BAUMANN: There are plenty of retired --

16 MR. BAILEY: Yes, that's what I was going to say.

17 MR. BAUMANN: Right. I know of one.

18 MR. COX: And as many as you can guess who have
19 distanced themselves from their firms, it can hardly do
20 any harm. I mean, they would actually know something
21 about the financial issues and about the auditing issues,
22 and the information flow is going to get better.

1 CHAIRMAN DOTY: It can't hurt.

2 MEMBER HARRIS: Yes. And I was focused just on
3 retired auditors --

4 MR. COX: Yes.

5 MEMBER HARRIS: -- who retired at a very early
6 age, try and get on audit committees, they go to
7 headhunters, and they find out, no, no, we don't want
8 you, we want CEOs. It seems to me that an independent
9 audit committee ought to have its fair share of retired
10 auditors or others on an independent audit committee.

11 CHAIRMAN DOTY: We're going to have to leave it
12 there if we're going to have a break. I'm always
13 reluctant to have closure and pose closure on board
14 members or staff. But thank you, all three of you. We
15 will resume.

16 And let's resume at 10 past 10:00 to get the next
17 panel going. We'll give ourselves a 10-minute break,
18 because we're on schedule.

19 (Whereupon, the above-entitled matter went off
20 the record at 10:01 a.m. and resumed at 10:14 a.m.)

21 CHAIRMAN DOTY: Welcome. This is a panel of
22 entrepreneurs who have actually founded and run

1 businesses. Charlie Drott is an independent consultant,
2 operated your own professional services company based on
3 Novato, California since 1982, providing investigative
4 CPA services, expert witnesses, primarily relative to
5 audit failures and accounting fraud for law firms, law
6 enforcement agencies. Mr. Drott was appointed to and
7 served a full term as a member of the California Board
8 of Accountancy serving as chair of the board's
9 enforcement program oversight committee. He's been chair
10 of a peer review task force, a member of the committee
11 on professional conduct, and has practiced with two of
12 the major public accounting firms.

13 Brian Fox is the founder of confirmation.com, the
14 holder of two patents granted on electronic audit
15 confirmation, which he used as the foundation for the
16 company that's now used by all of the top 10 banks, the
17 Federal Reserve, more than 8,000 accounting firms, by
18 more than 45,000 individual accountants and 106
19 companies. Prior to founding Capital Confirmation, Mr.
20 Fox was in Dallas as an auditor for Ernst & Young and
21 mergers and acquisitions for PricewaterhouseCoopers, a
22 four-time winner of the accounting profession's Top 40

1 under 40 CPA and accounting, and Entrepreneur of the
2 Year, and on the board of the -- the advisory board of
3 several businesses and services and mentor to
4 entrepreneurs in 500 Military Entrepreneurship Program
5 in Nashville. Welcome to you.

6 Steve Thomas, a founding partner of Thomas,
7 Alexander & Forrester. Prior to that with Sullivan &
8 Cromwell for six years. A law clerk for the Honorable
9 Ralph Winter, one of the -- certainly one of the most
10 foremost judicial minds in corporate governance law in
11 the United States, in securities law. Mr. Thomas
12 represents businesses as defendants. And what's unusual
13 about your practice, I think, Mr. Thomas, is you have a
14 lot of knowledge and insight into what we're inquiring
15 into here, which are audit failures and corporate crises,
16 but you have an active defense practice.

17 So welcome to all of you. You bring an insight
18 and you bring a point of view that we badly need in this
19 discussion. Charlie, we'll begin with you.

20 MR. DROTT: Thank you, Chairman Doty, members of
21 the Board and PCAOB staff, for inviting me here today to
22 express my views on auditor independence, mandatory audit

1 firm rotation, professional skepticism and objectivity.

2 During my work as a forensic auditor, I have
3 investigated over 50 audit failures, many of which were
4 large public companies. In many of these matters, I also
5 testified as an expert witness in litigation relative to
6 the audit failure issues, as well as fraudulent financial
7 reporting.

8 I have concluded that the primary reasons for the
9 majority of these failures were compromised auditor
10 independence and lack of professional skepticism. And
11 also, I wanted to say that true auditor independence, in
12 my view, is never going to be achieved until the auditors
13 are hired and paid by an entity independent of the audit
14 client.

15 So that then asks the question, what can be done
16 in the meantime? Well, until that day comes when
17 auditors are hired and paid by an independent entity, a
18 viable step forward, in my view, is enhancing auditor
19 independence and skepticism by mandatory audit firm
20 rotation, which I fully support.

21 Mandatory rotation has several benefits. One, it
22 establishes a limit on the continuous stream of audit

1 fees. This will significantly free the auditor from
2 pressure by clients to accept improper financial
3 reporting. It would also have the benefit of a new and
4 fresh evaluation of a client's financial reporting and
5 internal controls. It would eliminate long-term cozy
6 improper relationships between the auditor and its
7 client. And it would eliminate further influences on the
8 audit firm's decisions when many of the audit firm's
9 partners, managers and staff have accepted positions with
10 the client.

11 One way in which I thought that mandatory audit
12 firm rotation could be structured, and this is just one
13 of many ways it could be structured, is to have a 10-year
14 rotation period. And I would not want to see more than
15 10 years, but a 10-year rotation period directly linked
16 to the PCAOB's inspection program.

17 If inspectors encounter an audit failure for the
18 first time during the 10 years regarding a specific
19 client of the audit firm, I recommend the PCAOB require
20 a total audit team rotation. But if it happens a second
21 time with the same client within the 10-year rotation
22 period, then automatic rotation as the client's auditors

1 would occur.

2 Critics of the mandatory audit firm rotation make
3 two major points. One is that there's a possible lack
4 of audit quality and knowledge of the client in the early
5 years of an engagement. And secondly, additional costs
6 of changing auditors. Well, I believe just the opposite
7 is true regarding lack of knowledge in the early years
8 of the engagement. Audit quality, in my view, tends to
9 suffer the longer the relationship exists because the
10 auditor becomes too cozy with the client, can become
11 complacent, and protects the audit income stream as a top
12 priority.

13 Also, in a new audit engagement, the new auditors
14 expend considerable resources in evaluating the
15 accounting treatment of high-risk audit areas, the
16 accounting systems and internal controls.

17 And also the argument that auditors lack
18 knowledge of the client in a new audit, to me doesn't
19 make a lot of sense. Because in order for the auditors
20 to give an unqualified audit opinion, they have to fully
21 understand the client's operations, accounting systems
22 and controls.

1 As far as additional costs of a new audit, this
2 generally occurs only in the first year, or perhaps the
3 first two years in the new engagement. Audit firms, in
4 many cases, will have -- or I should say, the client in
5 many cases will not have any additional costs because of
6 competitive bidding.

7 And also, clients and auditors need to understand
8 that short-term additional audit costs, if any, are far
9 less than the costs of litigation if the client's
10 financial reporting is misleading and not caught by a
11 complacent long-term auditor, who is not on his toes like
12 a new auditor would be with new eyes focused on the
13 client's financial reporting.

14 And I would suggest also staggering these
15 rotations over a period of time at each firm to avoid too
16 much disruption at any one firm. I have heard a lot of
17 people say that emphasis should be given on the large
18 firms, and I tend to agree with that. But I would add
19 to it that special emphasis should be placed on large
20 clients with high-risk audit issues, and even some
21 smaller clients with high-risk audit issues.

22 Finally, regarding auditor skepticism and

1 objectivity, the lack of auditor skepticism and
2 objectivity were significant factors in virtually all of
3 the audit failures which I investigated. The most common
4 results of the lack of professional skepticism were
5 excessive reliance on management representations without
6 obtaining adequate corroboration with persuasive audit
7 evidence, and allowing improper financial reporting of
8 a client.

9 This was particularly evident in long-term client
10 relationships with high-risk audit areas that required
11 critical management estimates and judgments. More
12 emphasis needs to be placed on professional skepticism
13 by the audit staff and audit team reviewers, to ensure
14 that this situation is corrected through emphasizing
15 professional skepticism during audit planning and
16 execution, partner reviews and staff training.

17 This concludes my opening remarks, and I am happy
18 to answer any questions you have. And I thank you very
19 much.

20 CHAIRMAN DOTY: Thank you. Brian Fox.

21 MR. FOX: Thank you, Chairman Doty, board members
22 and staff, for inviting me here to speak today.

1 Given the high volume of comment letters and the
2 amount of rhetoric devoted to this subject over the last
3 few months, it is apparent that the subject of audit firm
4 rotation is an extremely polarizing topic. With my time,
5 I'd like to present a point of view that I believe has
6 been overlooked during the discussions and deliberations
7 on these topics.

8 Think like a fraudster. I'd like to ask the
9 Board to consider any current standards or proposed
10 standards from the viewpoint of a fraudster. The PCAOB
11 was created because of fraud and the billions of dollars
12 of resulting investor losses. I believe that it is
13 imperative to look at any PCAOB standards and proposed
14 changes through the lens of a fraudster.

15 So in this case, what would a fraudster say about
16 audit firm rotation? The answer's obvious. A fraudster
17 would be wholeheartedly against it. You see, a fraudster
18 has already fooled their auditor. That is what has
19 allowed them to be getting away with fraud already.

20 Results from the Association of Certified Fraud
21 Examiners show that frauds usually take place for
22 multiple years before they are discovered, which is far

1 too late for investors who have already invested in the
2 company. In fact, if I were a fraudster, I wouldn't have
3 just written one letter opposing audit firm rotation, I
4 would have written four using different letterhead with
5 logos that I had taken off the internet.

6 As I see it, there are four sets of parties
7 commenting on audit firm rotation. External auditors,
8 honest issuers, fraudster issuers and the investors.
9 Each of the first three parties is adamantly opposed to
10 firm rotation, and understandably so. Collectively, they
11 are also doing their best to convincing investors to take
12 the same position.

13 Let's look at the positions of each of the first
14 three groups. External auditors claim that higher costs
15 and lower-quality audits will result in the first few
16 years after firm change. But we've heard testimony from
17 companies like TIAA-CREF whose actual experience showed
18 lower cost in what they perceived as heightened audit
19 quality due to new thinking by the auditors.

20 Honest issuers also don't want to change audit
21 firms. Change always creates a heightened level of
22 anxiety, and changing external audit firms is no

1 exception. Companies note that the new auditors will
2 likely ask different questions, look in new areas, view
3 things from a different point of view, and poke and prod
4 new territory which the prior firm did not, which is
5 exactly the point. People are creatures of habit and
6 like what's familiar to them.

7 However fraudster issuers also rely on that
8 familiarity, and also oppose audit firm rotation.
9 Fraudsters try their best to befriend the auditors,
10 because for them to pull off their fraud successfully,
11 they have to know where the auditors are going to look,
12 what audit procedures they're going to perform, how
13 they're going to do their inventory counts, and how
14 they're going to perform the confirmation process.
15 Without this knowledge, the fraudster can never fool the
16 auditors into signing off on the audit report. Being
17 forced to hire a new audit firm is unthinkable for a
18 fraudster, because it creates a heightened level of
19 uncertainty for them, which produces a more likely chance
20 that the fraud will be uncovered.

21 A recent look at short sellers, like companies
22 like Muddy Waters illustrates that as a profession, we

1 may be missing the forest for trees, as was the case with
2 Sino-Forest and any others. We need to look at how and
3 why external auditors with much greater insight and
4 access to the company, management and detailed financial
5 information can miss frauds that short sellers are able
6 to identify using just publicly available information.

7 As for audit firm concentration, while we have
8 gone from the big eight to the big four, I think that if
9 mandatory firm rotation is put into practice, that the
10 current concentration of just four big firms will become
11 less of an issue, because market needs will create a
12 market reaction to meet the needs in the marketplace.

13 Required rebidding of the audit will not stop
14 fraud, and will also fall short of the PCAOB's primary
15 objective of protecting the investor. Would the
16 executives of a company who are committing fraud which
17 personally benefits them to the tune of millions of
18 dollars actually switch firms because the audit fee is
19 a million or two lower? It's impractical to assume so.
20 In fact, even the offer of a free audit to the fraudster
21 would be turned down because of the risk of being found
22 out by the new auditors is too great.

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1 Similarly, requiring periodic affirmative vote on
2 the audit firm, or having a clause that allows the
3 company to forego changing auditors if they simply
4 document the reasons why they aren't changing, won't stop
5 or deter fraud either. A fraudulent company will keep
6 their auditors indefinitely using every plausible reason
7 why, because it's in their own personal best interest not
8 to change firms.

9 Sharing inspection reports with boards and audit
10 committees is a great idea, and will certainly serve to
11 enhance the audit quality of honest companies. However,
12 for a fraudster it doesn't matter how bad his or her
13 auditors are. Unless the fraudster is forced to do so,
14 they will never change firms.

15 While there is much debate about what we
16 shouldn't do, it is obvious that what we are currently
17 doing isn't stopping fraud. We have enough facts, and
18 it is time to take action. When an audit firm feels it
19 can be fired an any point, there's an inherent conflict
20 of interest that exists, at least at some level. In
21 order to fully remove that conflict of interest, the
22 PCAOB should consider requiring multi-year contracts with

1 pre-determined lengths and fees.

2 I believe it is also time to reconsider an audit
3 rating scale for companies, similar to the debt-rating
4 scales that companies receive. What actually exists
5 today is a pass/fail model which gives no leeway to the
6 auditors to provide better, more accurate information to
7 the public.

8 An alternative to mandatory audit firm rotation
9 would be a requirement to allow the shareholders to
10 determine when to change audit firms. So that minority
11 shareholders aren't held hostage by groups of large
12 voting blocks, I propose a decreasing scale of
13 shareholder approval needed to change audit firms.

14 Another alternative to audit firm rotation would
15 be to limit any single team member from working on the
16 same client for more than a certain number of years.

17 I want to thank the Board for allowing me to
18 speak at this public panel and ask the Board to spend
19 part of its deliberations thinking like a fraudster.
20 Doing so will provide the Board with an interesting
21 perspective on any proposed changes or current standards
22 that I believe will allow you to see the world as the

1 fraudster sees it, which should provide some clarity as
2 to the direction the Board should go with its proposed
3 changes.

4 I believe in the value that our profession
5 provides. And I believe it can also be strengthened.
6 And on a purely personal note, I'd like to see more
7 fraudsters go to jail and more families stop losing a
8 significant part of their life savings. Thank you.

9 CHAIRMAN DOTY: Thank you. Steve Thomas.

10 MR. THOMAS: I've been struck today between the
11 difference of the reality that's been discussed here and
12 the reality that I hear every day coming out of the
13 mouths of the actual auditors for the big firm.

14 Today, almost everyone here assumes that the
15 audits have a public role, that auditors have a public
16 duty, and that auditor's job is to actually find fraud.
17 That is not what the auditors that actually go out and
18 do the audits think. At least that's not what they tell
19 people when they're not in front of you.

20 Over and over and over again the big firms deny
21 that the public is any sort of a client of theirs, deny
22 that they have any public duty, and deny that it's their

1 job to detect fraud. This isn't an isolated instance,
2 it's in virtually every case I have representing
3 businesses as plaintiffs and defendants.

4 I've given some examples in the handouts that
5 I've provided to the Board. We asked auditors what does
6 the P stand for in certified public accountant? They
7 never know. In the first page you see for a big four
8 audit partner who had been at the firm doing audits for
9 over 15 or 20 years. He said, "Why is public inserted
10 between certified and accountant? I don't know that
11 there's any definition in the accounting literature
12 related to public. So I don't know that public has any
13 particular meaning today."

14 So I asked him, "So as of today, you don't know
15 what public means in that phrase, right?" And he
16 answered, "I don't know." If you look at ET 53, which
17 is the ethical rule governing accountants, which also is
18 always news to the auditors that we speak to, and I've
19 attached it to the back, there's actually a definition
20 of what public is.

21 So the statement by a long-time audit partner at
22 a big four firm, "I don't know what public means," well,

1 it's defined in their own ethical rules. The accounting
2 profession's public consists of clients, credit granters,
3 governments, employers, investors, the business and
4 financial community, and others who rely on the
5 objectivity and integrity of certified public accountants
6 to maintain the orderly functioning of commerce. That's
7 what the rules say. But they don't know it.

8 And to show you that it's not isolated, I put in
9 -- from another big four firm -- I asked him, "Do you
10 understand that you have a responsibility to the public?"
11 And he said, "I'm not sure I understand what you mean by
12 any responsibility to the public; I mean, I always viewed
13 myself as being responsible to myself, and that would
14 just protect me." And I asked him, "Well do you owe a
15 duty to the public?" And he said "No, I owe a duty to
16 perform my audits with GAAS, that's good." And I said,
17 "Well who do you owe that duty to?" And he said, "I
18 think my firm and myself are it."

19 Auditor rotation is a good idea, but it's like
20 hitting a lion with a fly swatter. The problem is not
21 that we need to change from one great big auditing firm
22 to another. That's just bringing in someone else who

1 doesn't have the incentive to act in the public interest.

2 Because, in fact, what was asked earlier, I think
3 by Board Member Harris is who is the client. Well, you
4 know, the United States Supreme Court addressed that
5 years ago, in 1984, about who allegiance was owed to.
6 And the United States Supreme Court said that by
7 certifying the public reports that collectively depict
8 a corporation's financial status, the independent auditor
9 assumes a public responsibility transcending any
10 employment relationship with the client. The supreme
11 court went on to say that the auditor owes ultimate
12 allegiance to the corporation's creditors and
13 stockholders, as well as the investing public.

14 That's what the rules should be, and maybe people
15 in this room assume. But it's not what the auditors who
16 are actually doing audits assume. And that's because
17 they don't have an incentive to act in the public
18 interest. Their incentive is to act in their own
19 financial interest. So any change that is going to be
20 made is going to give -- real change is going to be a
21 change that effects those incentives.

22 I would propose things that change the

1 incentives. Audit rotation is good. But you can't just
2 put another fox in the hen house. The first thing I
3 would propose is that when the PCAOB does your
4 investigations and you find audit failure, and it is
5 linked in any way to the failure to audit management
6 representations, to the failure to carry out SAS 99, or
7 the failure for professional skepticism, then the audit
8 firm automatically foregoes its audit fees.

9 Those fees are paid to the government. They're
10 disgorged. Why? Because the audit is a public good.
11 Something that will actually give an incentive to the
12 auditors to do a job that serves the public.

13 The second thing I would suggest is, if we're
14 talking about public companies and the Public Company
15 Accounting Oversight Board, your work should be public.
16 The work of the PCAOB should be public. So each audit
17 opinion that we see all look the same, right? They all
18 look the same when they sign off. There's nothing behind
19 it to tell you what happened. But where there's audit
20 failure, the public, the investors and companies who are
21 going to hire that accounting firm in the future deserve
22 to know. They deserve to know the details of the

1 investigation, and there shouldn't be something that's
2 kept secret for years until, you know, one of the big
3 four just refuses to make any change, if you say, "You
4 ultimately have to disclose it."

5 The third thing I would suggest is that we have
6 to involve management to change the incentives, and
7 specifically audit committees. The big issue is that,
8 just as audit rotation tries to address, that auditors
9 and management get too cozy. We see it in our cases all
10 the time.

11 I have a case now where everyone agrees that the
12 financial statements were materially misstated for seven,
13 eight years. Same auditor signed off every year. And
14 what happened? By the end, half of management were
15 former auditors at the bigger accounting firm that was
16 doing the audit. So they were just talking to their
17 colleagues back and forth. So audit rotation addresses
18 that. But, in fact, the audit committee must be
19 involved.

20 Therefore, if there's an issue about management
21 representations, meaning that the accounting firm is
22 relying on management representations, those must be

1 disclosed in writing to the audit committee, and as part
2 of the audit opinion, and that disclosure should say what
3 the auditor did to actually test management's
4 representations. That written disclosure will make
5 accountability easier, easier for the Board, and easier
6 for investors.

7 And, finally, if these aren't able to address the
8 fundamental problem that we have, then I propose public
9 audits of public companies. This system, as of now,
10 doesn't work. The auditors themselves don't accept their
11 responsibility. Audit failure, you find all the time;
12 I see it every day.

13 Public audits of public companies take the firms
14 and their conflicts of interest out of equation. That
15 would be a greatly increased role for the PCAOB, but it
16 could be where we're headed. Because as I've listened
17 today, I'm not sure anyone is confident that the lack of
18 incentive for the accounting firms to act in the public
19 interest is being addressed. Thank you.

20 CHAIRMAN DOTY: Thank you. Lewis Ferguson?

21 MEMBER FERGUSON: Yes, I must say this. I
22 thought the points that all of you made were intriguing

1 here. But I'd like to ask a kind of funny question that
2 goes to the nature of the way audits are conducted today.

3 And I think you, Steve Thomas, pointed it out
4 when you said -- or maybe you did, I can't remember who
5 said that -- you know, auditors basically say that their
6 job is not to find fraud, that's not what they do, that
7 that's a different thing, that's a forensic audit and
8 they're not doing forensic audits, they're not looking
9 for fraud.

10 What if -- and I happen to know that one firm not
11 in the United States is actually experimenting with this,
12 that something that was built into the audit -- and this
13 doesn't -- this does not solve the systemic problems, but
14 it might solve some of the problems in the way audits
15 occur -- what if part of what the auditor did was to take
16 -- you might pick a different area each year, but to
17 bring forensic auditors in and say we will look at a
18 particular part of this audit the way a forensic auditor
19 will do?

20 That we will essentially do a forensic audit of
21 a particular part of the company's operations, starting
22 with the assumption that something's wrong here, not that

1 something's right, but bring a different presumption.

2 It could even be done by a different firm. But even with

3 the firm, because oftentimes the forensic sections of

4 these big firms are separate parts of the firm. Would

5 that help? Would that help to make these -- to basically

6 put management more -- sort of make management more

7 concerned about the nature of the audit, about what's

8 going on?

9 Would it help find frauds? Would it be more --

10 would it make the auditor think more like a fraudster

11 himself to try to find audits? What do you think about

12 it?

13 MR. THOMAS: Well, I think yes, it would help.

14 But I think the problem is not so much the rules, as the

15 incentives. Right now SAS 99 requires that an auditor,

16 for revenue recognition, assume that something could be

17 wrong beyond professional skepticism. But we find the

18 firms don't -- often don't even point to SAS 99.

19 So I think there are already strong rules that

20 say that an auditor who is giving an opinion about

21 whether there is a material misstatement due to error or

22 fraud undisputedly had the obligation to find fraud, and

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1 SAS 99 takes the presumption beyond professional
2 skepticism, yet they still deny it.

3 So making the rules even more clear I think would
4 be helpful, but I think it's the incentive that is more
5 the issue than more rules, because the rules we have
6 already require it.

7 MR. FOX: You know that's a -- really, as I look
8 at it, the profession to some degree can't be blamed for
9 our history, right. I mean, it's hundreds of years that
10 we went out and essentially it wasn't until SAS 82 that
11 we admitted the word fraud in our standards, which was
12 updated in SAS 99.

13 And so it wasn't until recently that the majority
14 of our profession, as Steve said, refused to admit that
15 part of our responsibility was to find fraud and, yet we
16 were supposed to find material misstatement. Which, if
17 you look at a case like Parmalat, I'd say a \$4.9 billion
18 bank account balance that didn't exist, even though that
19 was fraud, it was certainly a material misstatement of
20 the balance sheet as well, so it should have been caught.

21 But as we look at it, SAS 99 does require you to
22 brainstorm, assume a revenue recognition risk. And yet

1 as I do presentations and speeches to two or three
2 hundred folks at a time, and I ask them, I said if that's
3 the case in order to audit revenue you'd have to look at
4 either cash receivables, because you either received it
5 or it's owed, how many people have altered the nature,
6 time and the extent of their confirmation procedures from
7 the time you were staff members, and not one person
8 raises their hand.

9 They're still looking at a small sample as they
10 possibly can, they're picking a few of the large items
11 to get that sample size down, you know, smaller. Because
12 we all played that game when we were staff, because it's
13 a painful process. And yet as you look at a fraud like
14 Satyam, it was a confirmation fraud, and yet the partner
15 and senior manager both lost their job and went to jail,
16 but we know for a fact that the senior manager and
17 partner weren't the ones to actually be doing the
18 confirmation procedures. And so we're not altering the
19 nature, time and extent of our procedures. So I do think
20 that would be beneficial.

21 And as Steve said, realigning the incentives. I
22 mean, if you went to the far extreme, what if you -- and

1 this is impractical to do, but what if you said any audit
2 team that actually catches the fraud, they get to split
3 the audit fee that year amongst them. Right? I mean,
4 that's impractical to say, but, but at least you see
5 where we're going. That would properly align their
6 incentives.

7 And so, you know, from our standpoint, we're
8 doing that as a company, think like a fraudster. We're
9 going to roll out a program somewhere to take a bite out
10 of crime like Crime Stoppers. We're going to give an
11 annual award of \$25,000 to staff auditors who actually
12 catch fraud. Because we do want to align their
13 incentives, make them -- make them think about fraud.

14 MR. DROTT: It's been around a long time that
15 auditors have clear responsibilities with respect to
16 dealing with possible fraud. It used to be illegal acts.
17 Your suggestion about bringing in a forensic team, I
18 think you said occasionally, not every year necessarily,
19 or was it every year?

20 MEMBER FERGUSON: I said every year.

21 MR. DROTT: Every year.

22 MEMBER FERGUSON: But in different areas.

1 MR. DROTT: Right.

2 MEMBER FERGUSON: And areas that would not be
3 known to the client.

4 MR. DROTT: I think some firms, to my knowledge,
5 are using that, but not systematically like you're
6 talking about, where you look at a different area each
7 different year. I don't know of any firm that's done
8 that. Perhaps there have, but I'm not aware of it.

9 It's not a bad idea, because forensic auditors
10 know more about how to look at and determine whether or
11 not there in fact has been fraud. And, yes, it's a good
12 idea, I think. It would have to be -- I think, go
13 through the standard setting process. It would have to
14 be part of a standard. And I think it certainly couldn't
15 hurt, let's put it that way. So I wouldn't be opposed
16 to seeing something like that, because I think it's
17 already being done on a much more limited basis.

18 CHAIRMAN DOTY: Steve Harris?

19 MEMBER HARRIS: Mr. Fox, I was struck by your --
20 your statement in the segment titled "Missing the forest
21 for the trees." I'd like you to answer your own
22 question. I'm a non-accountant and a non-auditor.

1 MR. FOX: Sure.

2 MEMBER HARRIS: But I asked the same question
3 myself, but I don't have the answer. And the question
4 that you pose is: Why do external auditors with much
5 greater insight and access to the company management and
6 detailed financial information miss frauds that short
7 sellers are able to identify using only publicly
8 available information? How can that be, and what do we
9 do to correct that?

10 MR. FOX: You know, some of the techniques that
11 we should look to employ as a profession of CPAs are some
12 of the fraud detection techniques. And it's some of the
13 analytical things that I don't think are taking place
14 today.

15 And so as an example, one of the things that
16 we've seen is where in one case one of the short sellers
17 went out and they looked at the gross margin analysis,
18 and they mapped the gross margin movement percentage to
19 the competition. And when they saw very little standard
20 deviation over a four-, five-, or six-year period, they
21 said that's -- that's statistically impossible that that
22 company, their gross margins are going to remain so

1 steady, and yet their competition is going to move up and
2 down with the market, and so they said something's going
3 on. They're playing with their earnings.

4 In another case with one of the Chinese companies
5 where they said hey we've got these television screens
6 that rotate advertising, well, instead of taking their
7 word for it, they actually sent out some folks and they
8 went and looked at how many television screens they had
9 hanging up in different places to rotate the advertising,
10 and what they found was that, in fact, those were just
11 regular cardboard advertisements without the ability to
12 rotate. And so based on the revenue model, they wouldn't
13 have the ability to have the advertising revenue because
14 they didn't have the rotational capability on the
15 advertising. So they shorted the stock and came out with
16 it.

17 It's those types of things that we've got to
18 think, you know, we have computers today, we don't need
19 to teach our students how to add columns of numbers any
20 longer. We need to teach them to think critically, you
21 know.

22 I'm a CPA in the State of Texas, and I have a

1 four-hour ethics requirement that I have to do every
2 year for CPE, which teaches me how big my signage can be,
3 and how I need to do my name if I had a CPA firm. And
4 yet there's no requirement for me to take any fraud
5 courses. There's very few fraud courses in the student
6 curriculum today. It's more of an after-ran thought.

7 So those are the types of things that we need to
8 begin to incorporate, because computers can do a lot of
9 the things that staff auditors used to be doing, adding
10 columns of numbers.

11 MEMBER HARRIS: But is that changing the
12 fundamental role of the auditor?

13 MR. FOX: I don't know if it's changing the
14 fundamental role if our role is to protect the public.
15 If our role is to catch -- in my opinion, to catch fraud
16 and also to catch those folks who are pushing the
17 envelope with their accounting assumptions, then it's
18 probably just changing the recognition of what our role
19 really is. Because, as we look at the frauds, whether
20 it's K-Mart or Satyam, Revco, Ahold, Olympus, from our
21 standpoint, those are all confirmation frauds that we
22 see, and that's what I've been studying for the last 12

1 years, and yet those should have been caught.

2 So I don't think that those are fundamentally
3 changing the nature of our role, I think we've got to
4 fundamentally think about how are we doing our audits,
5 and shouldn't those incorporate some fraud detection
6 techniques.

7 MEMBER HARRIS: Well, I think the profession's
8 got to look at more of their evolving role. Because what
9 I hear back from them is that that's not our role, and
10 we don't want to be financial analysts, we don't want to
11 look beyond yesterday's tables or yesterday's news; our
12 role is to essentially verify the accuracy of the
13 numbers.

14 MR. FOX: And, unfortunately, as a profession,
15 and I take great pride in the fact that I'm a CPA, we
16 keep losing in the court of law when we go in there and
17 we make those statements, because the public doesn't --
18 they hold us to the degree of the public watchdog, and
19 we've got to accept that role, move forward with it, and
20 just say that that is part of our role. Otherwise, we're
21 going to continue to lose the lawsuits in the courts of
22 law.

1 MR. THOMAS: Mr. Harris, what I see is something
2 a little different. I agree with what Brian is saying,
3 that there -- as times change, the evolving role of the
4 auditor changes. But what we see in these big frauds
5 time after time is, if the auditor would have just
6 followed GAAS, they would have found it. I mean, most
7 of the time, it's not even that close.

8 So, again, it's not so much that the rules are
9 wrong, GAAS is pretty good, and it makes a lot of sense.
10 And if the auditors would just follow it, they'd find the
11 fraud. What we find is they don't have the incentives
12 to do the work that GAAS requires. In fact, their
13 incentive is just the opposite, to hit the deadline with
14 management, keep management happy and get hired to do the
15 consulting work.

16 You know, and if they do rotate out, that's
17 great, because now we can be the consultants. So, we --
18 I haven't had a fraud case in the past -- I'm going to
19 say, six, seven years, and these are all sizeable fraud
20 cases where just following the rules of GAAS would not
21 have identified the fraud.

22 MR. DROTT: You know, one of the problems that

1 hasn't been discussed here is that in high-risk audit
2 issues, or high-risk audit areas, there's more obvious
3 risk by definition of material misstatement on the
4 financial statements. And what I find in all of these
5 audit failures, generally, is that junior-level people,
6 or let's say somebody below the rank of manager, is doing
7 most of the work. And they don't have the experience to
8 detect a fraud, what we call a management fraud, which
9 was perpetrated by, let's say, top management, because
10 top management is highly experienced, highly intelligent,
11 if I can use the term slick and devious, and these young
12 people don't have the experience to detect it.

13 CHAIRMAN DOTY: I'm going to turn this over to
14 Jeanette. But just to remind the audience and the panel,
15 that there's been a thought for some time that the PCAOB
16 should establish a fraud center or a fraud -- a center,
17 an institute that would examine it. It comes out of the
18 treasury advisory committee recommendations, and it still
19 lies behind the questions that both Lewis and Steve have
20 posed.

21 Jeanette?

22 MEMBER FRANZEL: I appreciate the viewpoints of

1 the panelists. And because of the viewpoints they're
2 coming in with, I'm going to ask for innovative ideas,
3 so that's your heads up.

4 We talked a lot about auditors not following
5 GAAS, and if they have, they could have found it, or
6 maybe just slightly more creative audit procedures, as
7 opposed to just the same old thing, and the incentives
8 within the firms.

9 What do you all, after having combed through some
10 frauds, many frauds, and, Mr. Fox, after you've taken the
11 opportunity to really improve audit procedures, what
12 other creative -- well in the auditing profession they
13 might be referred to as creative, but it might be just
14 a basic change -- what other sort of innovative changes
15 do you think we need to implement to the audit process
16 itself to get better results?

17 MR. DROTT: Shall I start? I'm not sure I'd call
18 this innovative, but it would be different, and that is
19 something I alluded to in my opening remarks, that one
20 of the biggest problems I see in these audit failures is
21 the over-reliance and the failure to challenge management
22 representations in high-risk audit areas. And that's an

1 invitation for overlooking fraud right there.

2 Because what happens is, and it's really
3 appalling, is that you have a high-risk audit area, and
4 let's say there's fraud -- has been fraud involved, and
5 I've seen this, and the audit team will get
6 representations from management that everything is okay,
7 or management will give them a spiel about how this works
8 and this and that, and that's it. There's no
9 corroboration with persuasive audit evidence as the
10 standards require.

11 MEMBER FRANZEL: And what do you think the cause
12 has been for that in the cases you've seen?

13 MR. DROTT: Lack of professional skepticism. I
14 think that a lot of these people have grown up in these
15 audit firms and they get -- again, it goes back to what
16 this whole purpose is -- they get too close to the
17 client. And I'll tell you, it's especially bad where
18 you've had a large group of the audit firm's people move
19 and become employed by the client, and there's a level
20 of trust there that shouldn't be there. Because that
21 level of trust is such that it's preventing the
22 application of appropriate audit procedures.

1 MR. FOX: As I see it, there's really two types
2 of audit failures, and I think we need to be clear about
3 which one we're talking about. The one that I've heard
4 a lot of folks talk about is really what I would call the
5 business risk or accounting assumption failures, where
6 we say that, you know, there weren't enough reserves,
7 where a company is taking a business risk and they're
8 kind of making a gamble with other folks' money, but if
9 the gamble pays off, they're heroes.

10 But, you know, maybe once we look back at like
11 2008, the risk was too big, we didn't have big enough
12 reserves, we should have reserved more. That's one kind
13 of failure. And some could call that a fraud. What I
14 look at as fraud are those folks who are intentionally
15 committing financial statement fraud in order to get
16 either loans or investment money from the market, and
17 then they take those dollars and abscond with them, and
18 that is their intent from day one. Where there is no
19 ability to actually see the company be successful. And
20 that's where we've seen a lot of the frauds.

21 And so, to that question, to your question,
22 Jeanette, the answer to me is this. We've got to go in

1 and perform audit procedures that the fraudsters don't
2 know we're going to perform. We've got to jump and move.
3 We've got to look in different areas, poke, prod and ask
4 questions. Do things differently than we've done before.
5 If we've just been doing things at year end with small
6 sample sizes, let's do them quarterly, let's do them
7 semiannually.

8 I was talking to a person who's wife is an
9 auditor in China, and one of the things -- she's a
10 partner. One of the things that she does is she actually
11 drove to the company, grabbed the treasurer of the
12 company in China, and said get in the car. Took away his
13 cell phone. Drove to the bank that she wanted to go to
14 and asked the person at the front desk to verify their
15 account statement. That's being unique. That's being
16 creative.

17 Now, that's expensive and we can't do that on
18 everything, but that's the kind of way that we need to
19 begin to think about how we're auditing and thinking like
20 a fraudster.

21 MR. THOMAS: I appreciate what Brian's saying,
22 and I think that's helpful. Although our experience is

1 that that's not the problem. I mean, I think now maybe
2 the second or third biggest fraud of all time that came
3 out at the same time of Madoff was the Petters fraud.

4 And Petters went on for 10 years as a \$3 billion
5 fraud up in Minnesota, and he was supposedly selling
6 electronics to Costco on a basis where he bought them
7 wholesale and then sold them for an up-tick. Well, it
8 turned out that for out of that nine or 10 years, he
9 never actually sold an electronic to Costco. And the way
10 to detect that fraud would have been to actually just
11 test the numbers and call up Costco.

12 You don't need something super sophisticated to
13 figure out that fraud, but it was signed off on by
14 auditors for nine or 10 years. So, again, I think that
15 may be helpful in some circumstances, and I think that
16 Brian's right about that. But most of the time, just
17 follow GAAS.

18 And what I proposed in my original remarks was
19 that there should be, for management representations
20 where most of these problems come from, we call it
21 auditing by conversation, is that when they speak to
22 management and get a representation, they should have to

1 detail to the audit committee, and in their audit
2 opinion, what they did to test out management's
3 representations.

4 Now to answer your question, what is more
5 creative than that, get rid of management
6 representations. You don't get to rely on what
7 management tells you. You have to audit it. Now, there
8 are very limited areas where there is not sufficient
9 evidence and management representations are the only way
10 to verify. And if that's the case, detail it in your
11 audit opinion and to the audit committee. But otherwise,
12 make it absolutely clear. It's not about a management
13 letter and later claim "Oh, we were lied to." No you
14 have to audit the numbers. And the creative way would
15 say get rid of management representations.

16 CHAIRMAN DOTY: This panel has been very
17 stimulating, and what you've done is stepped back a bit
18 from independence and skepticism, or at least from
19 independence and rotation, and you've said -- I think
20 you've given us as a take away, there's a skepticism
21 requirement to have an effective audit. It's got to
22 project down through the team, it cannot be just at the

1 top.

2 It's a challenge to get it. It's a challenge to
3 get the kind of thinking of creativity and of skepticism
4 that has got to exist throughout the team. That it's
5 expensive. But the firms must do it if they're to
6 preserve the model of an independent accounting
7 profession. These are big ideas. It resonates with some
8 of the things we were told in our March meetings.

9 Independence is a wonderful thing, but if you're
10 incompetent and not skeptical, you can think you're
11 independent and you cannot be a very effective auditor
12 and you will miss fraud. On the other hand, it may be
13 or it may not be that some form of predictability in
14 terms of the time you have the audit engagement, as Brian
15 says, would in fact tend to inject more caution, more
16 skepticism in the audit. That's another big issue that
17 we're going to hear a lot about.

18 But your contribution to this discussion is a
19 very valuable one. And we want to thank all of you. And
20 your written contributions, as well as what you've told
21 us today, are going to be in the record, and they're an
22 important part of the record. Thank you.

1 ALL: Thank you very much.

2 CHAIRMAN DOTY: We're going to go to the next
3 panel. The next panel, we're going to hear from audit
4 committee authorities.

5 Conrad Hewitt, director of Bank of the West,
6 former chief accountant of the United States Securities
7 and Exchange Commission. He joined the Bank of the West
8 board in 2009. He serves on its audit committee,
9 executive committee, and is chairman of the trust and
10 wealth management committee. He has many other such
11 important positions that he discharges. He was an Ernst
12 & Young partner for -- he was an Ernst & Young auditor
13 and partner for 33 years, managing partner for Hawai'i,
14 Pacific Northwest, Seattle and Northern California. He
15 became -- and this is something I confess I did not know
16 about Conrad Hewitt until I got this bio information --
17 he became the superintendent of banks of the State of
18 California. I should have known that. Formed the
19 Department of Financial Institutions in the State of
20 California, and became its first commissioner. Again,
21 a new fact, he was a captain in the U.S. Air Force at
22 Strategic Air Command Headquarters. So he brings a

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1 wealth of experience in addition to audit committees.

2 Bonnie Hill. Dr. Hill, 20 years experience in
3 corporate governance. She is the lead director of the
4 Home Depot Corporation, on the boards of Rand. She
5 serves on the PCAOB's Investor Advisory Group. She was
6 recognized by the NACD directorship as one of our most
7 influential persons in corporate governance in 2010 and
8 2011. She has a Doctorate of Education from the
9 University of California at Berkeley, and is on a number
10 of boards and audit committees.

11 Christopher Lynch, welcome. Mr. Lynch is the
12 chairman of the audit committee of AIG, an audit
13 committee member of Freddie Mac, and he is the non-
14 executive chair of the board of Freddie Mac. An
15 independent consultant, he provides a variety of service
16 to financial intermediaries. He held a variety of
17 positions at KPMG, including the national partner in
18 charge of financial services, chairman of KPMG, America's
19 Financial Services Leadership, and a fellow of the
20 Financial Accounting Standards Board. Chris Lynch brings
21 distinct, very distinct qualifications to this discussion
22 and we're happy to have him.

1 Steve West, chairman of the audit committee Cisco
2 Systems. A 30-year veteran of information technology,
3 and the founder of Emerging Company Partners, LLC, ECP.
4 He has held -- had a wide range of executive leadership
5 positions. He was the president and CEO of Hitachi Data
6 Systems, with responsibility of over 22 billion in
7 revenue. He served in a similar senior position at EDS
8 in Plano, Texas, COO of NCUBE in Portland, on the board
9 of a number of public and private companies, and is an
10 active member in the Audit Committee Leadership Network.

11 So we're honored, and we're conscious of the time
12 that we're getting here, and the attention from people
13 who have a lot in their day jobs.

14 Mr. Hewitt, please.

15 MR. HEWITT: Thank you, Mr. Chairman. Good
16 morning, everyone.

17 I am very pleased to be participating in a panel
18 of other distinguished panelists to discuss the PCAOB's
19 concept proposal on auditors' independence and mandatory
20 rotation of auditors. I'm also very pleased that the
21 PCAOB has brought this important discussion to the west
22 coast.

1 Based upon recent years, I do not recall any SEC
2 or PCAOB round-tables on the west coast. The west coast
3 is important because of the many public company
4 headquarters here, as well as the type of industries here
5 such as high tech and entertainment.

6 My comments are based on my 33 years in public
7 accounting, my four years as a regulator of financial
8 institutions, of being the Commissioner of Financial
9 Institutions for the State of California, chairman of
10 audit committees for six public companies and seven
11 private companies, and most recently three years ago as
12 Chief Accountant of the SEC.

13 I believe I've had much exposure and experience
14 concerning the auditors' independence, professional
15 judgment, skepticism, and as well as being an investor
16 for 40 years. Investors use financial statements as one,
17 just one of many factors before an investment decision
18 is made, so I view our subjects today from many different
19 experiences.

20 Regarding the auditor's independence, the auditor
21 has many different standards to adhere to. For example,
22 the 50 states, the AICPA, the SEC, the International

1 Ethics Standard Board, and now the PCAOB, are all
2 involved with the independence of an auditor. It's
3 almost impossible to comply with all the various
4 independent standards.

5 I am concerned about the multitude and
6 differences in independent standards in this fast-growing
7 global economy. As some of you know, I've been a very
8 vocal advocate of a single, high-quality international
9 accounting standard, as well as a single high-quality set
10 of international auditing standards. I believe the SEC
11 and PCAOB should consider promoting a single high-quality
12 set of independent standards to comply with, instead of
13 the multitude of standards that exist today.

14 Based upon my experiences of various audit
15 committees, I believe audit committees need to be more
16 involved with the auditors' independence. The PCAOB and
17 SEC need to focus more on audit committees to ensure the
18 independence of auditors without requiring mandatory
19 rotation of auditing firms. SOX gave audit committees
20 considerable power, responsibilities and authority over
21 auditing firms. And I believe that committees should
22 exercise more authority.

1 I am concerned that the SEC and PCAOB requiring
2 the mandatory rotation of auditors is maybe usurping the
3 intent and law of Congress providing that audit
4 committees have the power to hire and terminate external
5 auditors even without the company's board approval.

6 One problem that exists with audit committees is
7 the credentials and qualifications of the members of the
8 committees and a lack of continuing education
9 requirements for its members. The SEC could require that
10 proxy statements would indicate that audit committee
11 members would be required, say, to obtain four hours of
12 continuing education annually, and maybe increasing that
13 requirement to eight hours on an annual basis. And this
14 would be the same type disclosure which now exists in the
15 proxy statements for the attendance of board members at
16 the board of directors meetings.

17 The PCAOB and SEC should devise a set of
18 guidelines for audit committees to consider periodically
19 with respect to the independence of the audit firm. The
20 guidelines could be the foundation of the audit
21 committees to discuss and document all aspects of
22 independence with its auditors. And to me this would

1 create a greater focus on the independence and
2 transparency.

3 As chief accountant, I create a federal advisory
4 committee on improvements to financial reporting. The
5 committee debated several things, such as audit
6 compliance, the standards in the audit process. They
7 focused on materiality also, restatements and judgments
8 relating to accounting matters.

9 The PCAOB and SEC spends considerable time on
10 whether a professional judgment is properly made, and
11 it's a very important part of their responsibilities.
12 And generally regulators of all kinds respect judgments
13 if they are well-documented, unbiased and provide
14 evidence to support a conclusion. By creating an
15 environment in which all bodies understand a reasonable
16 judgment after the fact needs to be performed by the
17 PCAOB and the SEC. This environment would aid in the
18 independence of the auditor.

19 The Federal Advisory Committee recommended that
20 the SEC should issue a statement, a policy articulating
21 how it evaluates the reasonableness of accounting
22 judgments in making an evaluation. It also went on to

1 say the PCAOB should adopt a similar approach with
2 respect to auditing judgments.

3 Before leaving the SEC, my staff and I and the
4 Division of Corporation Finance and others within the SEC
5 developed such a policy, but it was never finalized. I
6 have that policy here today.

7 Lastly, I would like to comment on the mandatory
8 rotation of audit firms. I do not believe that the
9 policy would prevent accounting scandals and frauds such
10 as Enron, WorldCom, Sunbeam, AIG, Freddie Mac,
11 HealthSouth, Madoff and many others. There's never been
12 any evidence that a mandatory rotation of auditors would
13 have prevented these frauds, or even would improve the
14 quality of the audit. And please keep in mind that these
15 terrible events occurred over many years.

16 Many of these accounting scandals were due to
17 existing accounting standards which are based on rules
18 and not principles, and permitted abuses of GAAP. A
19 fraud is always difficult to detect and prevent, and a
20 mandatory change in auditors will not stop such frauds.

21 In summary, I implore this PCAOB to reexamine the
22 auditors' independence and mandatory rotation of

1 auditors. The solution to the problem is not simple.
2 The PCAOB should focus on strengthening the audit
3 committees, so that they can carry out their
4 responsibilities in auditing under SOX without making
5 mandatory rules and regulations.

6 Also the PCAOB should focus on its own reasonable
7 judgment internal policy, maybe can focus on the training
8 of auditing firm staff with respect to independence and
9 determining the root causes of past, current and future
10 independent cases, and providing more transparency to the
11 auditing firms, audit committees and investors concerning
12 independent problems. I believe the PCAOB inspection
13 process could identify, classify and determine solutions
14 and results concerning auditors' independence.

15 As alternatives to mandatory rotation, I
16 recommend -- I have six short recommendations here. One,
17 PCAOB and SEC need to require continuing education
18 requirements of all audit committee members with adequate
19 disclosure in the proxy statements similar to directors'
20 attendance at board meetings.

21 Two, that PCAOB and SEC need to develop and
22 implement a reasonable judgment policy for internal use,

1 and then require accounting firm professionals to have
2 a professional judgment policy.

3 Three, the audit staffs of accounting firms need
4 to have required annual training sessions in auditors'
5 independence, professional judgment and objectivity.

6 Four, the PCAOB and SEC need to develop
7 guidelines for audit committees concerning auditors'
8 independence, professional judgment and objectivity. And
9 periodically, these audit committees need to discuss and
10 document compliance with these guidelines.

11 Fifth, PCAOB needs to be more transparent with
12 accounting firms, investors and audit committees of the
13 problems found with independence and subsequent
14 remediation of the problems. Also root causes would be
15 very helpful, along with the best practices to reduce
16 independent problems.

17 And sixth, the SEC and PCAOB need to be the
18 leaders in promoting a single, global independent
19 standard.

20 If my recommendations are adopted, I believe the
21 auditors' independence will be enhanced for everyone.

22 SOX, SEC and the PCAOB have greatly improved the quality

1 of audits as evidenced by the great decline in the number
2 of restatements. Because of SOX, investors do have a
3 greater reliability on the financial statements than
4 existed 10 years ago.

5 And I thank you for allowing me to participate in
6 this important deliberation.

7 CHAIRMAN DOTY: Thank you, Conrad Hewitt. Bonnie
8 Hill.

9 MS. HILL: Thank you, Mr. Chairman, members of
10 the board. Thank you for the opportunity to share a few
11 thoughts on the important subject at hand.

12 By now you've heard practically every argument
13 that can be made either for or against mandatory
14 rotation, so I will simply focus my remarks on three
15 points that I consider important. The audit committee's
16 role and duty to shareholders, the audit committee's
17 relationship with independent auditors, and the cost
18 versus the benefit of mandatory auditor rotation.

19 And I begin with the premise that the members of
20 the board of directors are elected by shareholders, and
21 the audit committee is selected from that board. Since
22 the enactment of Sarbanes-Oxley, audit committees have

1 at least one financial expert on the board, on the
2 committee, and that is by choice. I know it isn't
3 required. But my experience is that is very beneficial
4 and that most boards do, in fact, look for a financial
5 expert, and that the remainder of the members be
6 financially literate.

7 The committee has the authority to retain outside
8 expertise whenever needed, and they do so. I also
9 believe in most instances we are looking at some very
10 competent individuals. And since the enactment of
11 Sarbanes-Oxley, my experience has been that audit
12 committee meetings have gone from two hours to four to
13 five hours, and the number of meetings has nearly doubled
14 in an effort to be thorough.

15 Audit committees are directly responsible, under
16 Sarbanes-Oxley, and related SEC and stock exchange rules
17 for overseeing the independent auditor. Audit committees
18 are also tasked with fiduciary responsibility to
19 shareholders and the oversight of the integrity of a
20 company's financial statements. It is the audit
21 committee that can better understand the needs and risks
22 faced on its company, and determine whether the cost of

1 rotation are outweighed by the need for a new team and
2 a fresh set of eyes.

3 If an audit committee determines that its company
4 needs a new audit firm after consideration of the
5 circumstances faced by that particular company, these
6 additional costs would be warranted. But it would not
7 be in the best interest of that company's shareholders
8 to whom the audit committee is responsible to incur those
9 costs when they are not warranted by any specific issues
10 or concern.

11 I've had the experience with two companies being
12 part of a decision to rotate the auditor. It was
13 recommended to the board by the audit committee. It was
14 the right thing to do, and it was in the best interest
15 of the company and its shareholders.

16 With regard to the relationship between the
17 auditor and the audit committee, the concerns about
18 independence, objectivity and professional skepticism are
19 good, they're interesting, and particularly since most
20 audit committees regularly evaluate the independent
21 auditor's performance. And clearly I'm dealing with my
22 experience and not, you know, everyone else's. But they

1 do that to ensure that they are both independent and
2 qualified.

3 An audit firm is not a person. It is a
4 collection of individuals with different skills and
5 characteristics. There are already regular changes to
6 the personnel performing an audit, whether due to rules
7 that require mandatory rotation of audit partners every
8 five or seven years, natural attrition that occurs with
9 any firm, or targeted rotation to address skill levels,
10 expertise and training needs of audit staff.

11 And then third, we look at the increased cost.
12 The cost of bringing a new audit firm on board is not
13 insignificant. It includes non-monetary costs of
14 significant management time and effort needed to educate
15 the new team. A 2011 study by Audit Analytics of audit
16 fees paid by companies Russell 3000 show that the highest
17 fees for companies with auditors were with those that had
18 a tenure of five years or less.

19 There is practical concern about whether audit
20 firms will be able to sufficiently staff their audit
21 teams with qualified personnel if each year they are
22 facing the logistical challenge of placing entirely new

1 teams with multiple clients in different locations
2 throughout the country and internationally.

3 For companies, this means a pass through of
4 relocation and hiring costs necessary to staff the audit.
5 Increased cost may also arise from other accounting firms
6 providing non-audit services. At any given time, there
7 may not be a qualified, independent alternative firm,
8 because many companies use other audit firms to provide
9 non-audit services that the independent auditor cannot
10 provide under applicable rules.

11 And as you know, to qualify as independent, an
12 accounting firm must wait until the completion of any
13 audit and professional engagement period, essentially the
14 period covered by the relevant financial statements in
15 which it performs certain non-audit services. And it
16 cannot audit any period in which it performed those
17 services.

18 To ensure an independent alternative, a company
19 would also have to consider rotating its non-audit
20 services, periodically ending engagements with other
21 firms far enough in advance to allow them to serve as the
22 independent audit firm. Many of these non-audit services

1 are for matters that cover an extended period of time,
2 such as an M&A transaction, tax matters, investigations
3 or consulting services where it is not practical or cost
4 effective to terminate an engagement before completion.

5 So in closing my remarks, I would give you a
6 specific example where there might be a shortage of
7 feasible alternatives.

8 As a \$70 billion company, the Home Depot, where
9 I serve as lead director, is effectively limited to using
10 one of the big four audit firms to ensure adequate
11 resources and global reach for our audit. KPMG is our
12 independent audit firm. We also used Deloitte & Touche
13 for tax planning strategies as we think they're best
14 suited for what we need. If we were required to rotate
15 audit firms and wanted to continue to use Deloitte &
16 Touche for tax planning strategies, they would be
17 precluded from being our independent auditor, thereby
18 reducing the field from four down to two.

19 They also currently audit our principal
20 competitor. So we would not be inclined to retain them
21 as our independent auditor for competitive reasons. If
22 I were faced with a situation in which we had to use them

1 as our audit firm, given the lack of alternatives, we'd
2 insist on a completely separate D&T team, and face
3 possible resource availability and allocation issues.

4 At various times, we also use
5 PricewaterhouseCoopers and Ernst & Young for internal
6 audit, tax, vendor compliance and consulting matters.
7 If forced to rotate firms, we would have to access and
8 reassign services in order to render one of the firms
9 independent and qualified to serve as our auditor. Being
10 limited to only two large firms that could serve as
11 auditors significantly decreases our leverage for
12 negotiating fees.

13 Even among the big four, we need to ensure that
14 the audit firm selected has sufficient retail experience,
15 and particularly with respect to the retail method of
16 inventory accounting, which is fairly unique to our
17 industry, and it has a significant impact on our
18 accounting, it's even less likely that a smaller boutique
19 firm has this expertise.

20 I won't go through the non-audit -- the non-
21 monetary costs, because I think you understand those.
22 You've heard enough. But like most companies, we've

1 leaned our staff down with our financial accounting
2 personnel fully engaged in supporting the business.
3 Large portions of time spent with a new audit team would
4 either force us to add staff who need to be trained, or
5 require our personnel to prioritize or delay tasks that
6 are critical. And so this is not just a one-year impact,
7 but can last for several years.

8 As I mentioned earlier, there's already routine
9 rotation occurring with the current independent auditors'
10 team, but without the disruption of losing the entire
11 team. And I won't go through all of that, because I know
12 time is short. But like many of those who have gone
13 before me, I applaud the PCAOB's desire to enhance
14 auditor independence, objectivity, and professional
15 skepticism. But I believe a proposal would undermine the
16 responsibilities and accountabilities of the audit
17 committee and would not improve the quality of the
18 independent financial statements enough to overcome the
19 down sides, which I believe you've heard a lot of
20 already.

21 And, so, I would encourage you -- I'm not going
22 to give you a way to do your job, I'm not even going to

1 give recommendations, because you've had enough of those,
2 but I would just say that when you look at the issues
3 that are involved, that you would consider a closer
4 relationship with audit committees and audit committee
5 chairs, and really an understanding of what happens in
6 the audit committee, as well as the boardroom as you
7 deliberate on this important issue. Thank you.

8 CHAIRMAN DOTY: Thank you. Christopher Lynch.

9 MR. LYNCH: Chairman Doty, members of the board,
10 and members of the staff, first thank you for your
11 service. I can tell -- assure you, over the last three
12 and a half years, spending a great deal of time in
13 Washington, the challenges, many challenges you face.
14 And so it's greatly appreciated.

15 Thank you for inviting me here today to comment
16 on the Concept Release and a topic that I think is
17 fundamental to all the capital market participants. The
18 vantage point I will share, I think is multifaceted, and
19 I hope brings a unique perspective.

20 During my career, I've been an audit partner, a
21 staff member of a standard setter, a technical partner
22 in our national office, a senior partner running an

1 industry practice, an audit committee chair, and a board
2 chair. And while the value I've derived from the
3 external auditors' role has varied depending upon the
4 seat that I occupied, I've always insisted that the
5 independence of the firm, its lead partner, and its
6 entire engagement team were critical to those
7 collaborations.

8 So let me start by affirming my complete support
9 that external auditors must be, in fact and appearance,
10 independent of the clients for which they issue their
11 audit reports. Some participants in this discussion cite
12 the declines in the recent board reports, inspection
13 reports, and the business failures from 2008 and the
14 financial crisis as anecdotal evidence that external
15 auditors are not meeting the marketplace's expectations,
16 and that tendering or mandatory auditor rotation will
17 address that shortcoming.

18 I don't see a meaningful correlation between
19 these variables, nor do I believe that mandatory auditor
20 rotation would achieve this objective. The Concept
21 Release establishes a premise that an audit firm with a
22 long client relationship, say greater than 10 or 15

1 years, may lose its independence, or that the engagement
2 team may be less capable of exercising professional
3 skepticism.

4 If you've ever served as an audit signing partner
5 in the Sarbanes-Oxley era, or been through the incredibly
6 comprehensive and rigorous examination process of the
7 PCAOB inspection, I don't think you could possibly have
8 that view. As a signing partner, you know you stand
9 alone and with your work papers, and that's it. As an
10 audit signing partner, it was irrelevant to me what the
11 positions of my predecessors were. It was irrelevant to
12 me what the position of my firm was. I was not going to
13 risk my reputation or that of my engagement team to
14 appease a client or fail to walk head on into a difficult
15 business judgment.

16 And since 2011, in the SEC's whistleblower
17 program, all types of issues are now being surfaced,
18 accounting, disclosure, third-party data, code of
19 conduct, ethics valuation, modeling, expenses, estimates,
20 and yes, even judgment. So in the last two years, I've
21 learned no department, no executive, no matter how high
22 nor how low in the organization can escape

1 whistleblowers. This is our new reality.

2 So considering the watchful eyes of a legion of
3 whistleblowers that can exist in internal audit,
4 accounting, policy, legal compliance, business, and yes,
5 even vendors, and yes, even our customers, it's pretty
6 hard to imagine an engagement partner who doesn't feel
7 the pressure that is out there right now to summon up the
8 courage to push back on any issue that they felt had not
9 been appropriately addressed by management.

10 The Concept Release also discusses one potential
11 benefit of mandatory auditor rotation, the fresh look.
12 But let's explore what is already occurring in practice.
13 The average tenure of a Fortune 500 CEO is seven years,
14 the CFO five years. The audit signing partner rotates
15 off the account in five years, the ancillary partner is
16 seven years.

17 Emerging best practices in the audit committee
18 and boardrooms is that audit committee chairs rotate out
19 of their positions after roughly some predetermined
20 number of years. An emerging number that's coming out
21 of this is five. And many other audit committee members
22 rotate off the committee on a staggered basis.

1 So in the end of a hypothetical five- or ten-year
2 mandatory auditor rotation period, the marketplace's
3 concern that external auditors have lost their
4 independence has already been remedied by the existing
5 market forces. There isn't a single key player left at
6 the table in this relationship that has not been
7 replaced.

8 But let's be clear, there are many opportunities
9 to improve auditor performance, and I'll identify three
10 broad categories of recommendations.

11 The first is performance contracts. They are
12 used to memorialize a totality of an enterprise's
13 collective expectations of the conduct of the audit
14 during the year. They are hard to put in place. They
15 are very time consuming to put in place. They require
16 rigorous negotiations, but they are an excellent tool to
17 then come back at the end of the year and objectively,
18 verifiably with clean documentation demonstrate to all
19 interested constituents the performance of that firm.

20 Second, clients need to be more involved in the
21 selection of the lead partner. Given the importance of
22 this role, most market participants expect that audit

1 committee chairs and the candidates have had qualitative
2 interactions beyond the one or two brief meetings that
3 typically occur before that appointment. My experience
4 also suggests that the transition time of these incoming
5 lead partners varies considerably depending upon the
6 size, complexity, and yes, profitability of the account.

7 And finally, in the area of governance, I see
8 several opportunities for improvement, and many of them
9 resist -- reside within the audit committee itself. We
10 need to strengthen our skills and our experiences,
11 because this role is very difficult. Given the
12 complexity today, we also need to question whether an
13 executive who ran a company 10 years ago or was
14 tangentially near a finance function somewhere in their
15 career is really qualified to be a financial expert
16 today.

17 We need to be more proactive. We have to reach
18 out as audit committee members to regulators, employees
19 and business units and support functions, and we need to
20 do that without senior management present. I've used
21 this technique where I try and have these one-on-one
22 sessions outside of the audit committee agenda because

1 it just doesn't lend itself. But we have a
2 responsibility to make sure that the information that's
3 coming to us has not been censored and has not been
4 filtered in any inappropriate way.

5 Next we need to insist that audit -- external
6 auditors are bringing their divisional partners and their
7 topical specialists into the room. They need to hear
8 firsthand the expectations of my committee, our board
9 members, as to candor, transparency and being forthright.
10 And they also need to know beyond the lead partner what
11 -- that they are accountable to every member of our audit
12 committee.

13 And with respect to tendering, I've had
14 experience at both of my boards, and I would say the
15 results are mixed. In one case, we spent approximately
16 a year because of a looming mandatory rotational
17 deadline, only to conclude that under the facts and
18 circumstances, it was a poor decision to even go forward
19 with it.

20 In the other instance, the board and our audit
21 committee charter had the provision that we would
22 consider once every five years whether an RFP is

1 appropriate or not for the external auditor.

2 So, in conclusion, I think that existing audit
3 committee charters and governance practices of public
4 registrants are sufficiently comprehensive to ensure
5 independence and objectivity is safeguarded. Thank you
6 very much for permitting me to participate in this
7 discussion.

8 CHAIRMAN DOTY: Thank you. Steven West.

9 MR. WEST: Thank you, Mr. Chairman and the board.
10 I very much appreciate the opportunity to participate on
11 this panel on behalf of the audit committee of Cisco
12 Systems, and discuss my views on auditor independence and
13 mandatory firm rotation.

14 The concept of auditor independence is not only
15 critical to the PCAOB and the auditing profession, but
16 is a cornerstone of the primary responsibilities of an
17 audit committee, and is important to the company's
18 investors and shareholders. The knowledge and experience
19 of an audit committee puts it in the best position to
20 evaluate the effectiveness of a company's independent
21 auditors.

22 Introducing mandatory audit firm rotations would

1 eliminate an audit committee's ability to select and
2 retain the best-suited audit firm based on a
3 comprehensive set of considerations that only the audit
4 committee is in the position to evaluate. In fact,
5 instituting a mandatory audit firm rotation rule will
6 have the effect of diminishing the committee's
7 responsibility for this critical oversight role, thereby
8 limiting its own effectiveness.

9 At Cisco, our audit committee sets expectations,
10 and we conduct ourselves in a manner that fosters an
11 open, challenging environment which supports healthy
12 skepticism and objectivity by our independent auditor.

13 Tenure actually allows us to nurture this type of
14 relationship, which I believe supports audit quality.
15 Our ongoing open discussions about risk, accounting and
16 auditing issues, as well as our review of the auditor's
17 audit scope and audit results facilitates our evaluation
18 of the audit firm's understanding of the company's
19 business, businesses and risks, the comprehensiveness of
20 their audit plan, their technical and other capabilities,
21 and their independence and objectivity, and their ability
22 to meet the company's changing needs on a global base.

1 It is primarily these considerations and not
2 tenure that we use to evaluate the effectiveness of the
3 audit firm. In large complex multinational companies
4 such as Cisco, it takes years to develop a sufficiently
5 deep level of knowledge of the company, which is required
6 to adequately perform a high-quality audit. As their
7 knowledge base continues to grow over time, the audit
8 firm builds a better foundation from which they can
9 assess and test the company's assertions.

10 It could be argued that while time builds this
11 knowledge base and leads to audit effectiveness, it also
12 creates a sense of familiarity that could lead to a loss
13 of independence. My view is that the requirements to
14 rotate the audit engagement partner every five years, as
15 instituted by the Sarbanes-Oxley Act effectively
16 addresses this risk, while providing the proper balance
17 of retaining the audit firm's cumulative knowledge of the
18 company's businesses, risk processes, and people, which
19 improves overall quality.

20 I believe sacrificing this relationship due to
21 length of service would be counterproductive to achieving
22 a high level of audit quality that audit committee

1 shareholders and the PCAOB expect.

2 In addition, many companies such as Cisco operate
3 in a complex multinational environment and use firms to
4 perform non-audit accounting-related service, which are
5 critical to its businesses. Mandatory audit firm
6 rotation will either limit the pool of available
7 alternative firms due to existing relationships for non-
8 audit services, or require companies to also rotate the
9 firms who provide the non-audit services, thereby
10 creating potential conflicts among service providers.

11 I do not believe it's in the best interest of
12 companies and their shareholders to burden them with the
13 negative impacts and the many unintended consequences of
14 mandatory audit firm rotation or retendering, especially
15 since there is no clear evidence that tenure diminishes
16 audit quality.

17 While I am supportive of -- while I am not
18 supportive of a one size fits all approach that would
19 result in making a change when the incumbent auditor is
20 providing a quality audit, I am supportive of any of the
21 alternatives that facilitate consistently higher
22 effectiveness of audit committees in evaluating

1 independent auditors. These alternatives could include
2 enhancing reporting of PCAOB inspections to audit
3 committees, to include key themes and root causes of
4 quality problems.

5 I would also suggest that enhanced quality
6 reports from the audit firms addressing quality controls,
7 quality issues and quality initiatives to improve and
8 remediate any quality concerns in that firm. These would
9 provide additional important information for audit
10 committees to consider when setting expectations,
11 challenging and evaluating the audit firm's capabilities,
12 independence, objectivity and skepticism on a regular
13 basis.

14 I think actions such as this would better address
15 the problem, as it enhances the audit committee's
16 governance role and ability to ensure auditor
17 independence.

18 Thank you again for inviting me to participate
19 here today and providing me with an opportunity to speak
20 with you on this topic.

21 CHAIRMAN DOTY: Thank you. Jeanette Franzel.

22 MEMBER FRANZEL: One of the things that we have

1 discussed in a whole lot of different contexts here is
2 the role of the audit committee, is it sufficient, is it
3 not, does it need to be reformed? -- et cetera -- and
4 we've heard from folks that when audit committees work
5 well, it really helps enhance the audit process, but that
6 there is inconsistency in practice out there.

7 And I would like to hear from the audit committee
8 members on this panel, and I guess you all are: What are
9 the specific things that you are doing as an audit
10 committee member that give you assurance?

11 And what are you asking your auditor to do to
12 give you assurance that the audit firm is in fact
13 independent and using an appropriate level of
14 professional skepticism, and that they are thoroughly
15 auditing material high-risk areas, especially areas
16 involving management judgments and management estimates?

17 MS. HILL: One of the things that I think is very
18 helpful in this is the executive sessions that audit
19 committees have with the auditors, and it's rather
20 interesting what you get out of those meetings when
21 management is not present and you ask directly about
22 various sundry items that you think really need to be

1 reviewed. So I highly advocate the executive sessions,
2 and I think they're very effective in helping the
3 committee get to the root of some issues directly with
4 the auditors.

5 MR. LYNCH: I'll share a couple, Jeanette. We
6 have quarterly reporting from the external auditor as to
7 any independence considerations that are occurring across
8 the globe, and the committee takes that every 90 days.

9 Another thing that I think is important is at
10 least once a year somewhere around the early stages of
11 the external auditor formulating their global audit plan,
12 I'll spend an entire day with their team, with no members
13 of management from the firm present, but only their lead
14 partners, their senior managers from around the globe,
15 so that they understand the expectations of our
16 committee. But more importantly, that I'm sensitized to
17 the unique views that are emerging from around the globe,
18 and the trajectory of where they see emerging risks.

19 And the third element I would state that I think
20 has been very helpful is, we've introduced the concept,
21 and I think most of the firms have been, but a heat map
22 of where they see the risk in the organization, the

1 volume, the potential magnitude for error. But most
2 importantly, not that they have a heat map, but that I
3 aligned that heat map with the risk assessments that
4 exist in my enterprise risk management function in the
5 company, my internal audit function, and my compliance
6 function.

7 MR. WEST: I would echo what my fellow panelists
8 here said. But I would also suggest that participating
9 with other audit committee members or audit committee
10 chairs in some type of a formal process or a network that
11 allows you to hear their issues, what they're seeing in
12 their part of the business, and then, you know, working
13 to merge that in with how you deal with your external
14 auditor in the programs.

15 MR. HEWITT: Okay, one of the things we do is ask
16 our external auditing firms about 404 and 404(b) or
17 404(a) under SOX, the evaluation of internal control
18 system by management and by the -- opined by the external
19 auditors as to the material weaknesses, significant
20 deficiencies, automation versus manual systems and those
21 types of important things. We do this in executive
22 session without our internal auditor there and

1 management, and it's very helpful.

2 CHAIRMAN DOTY: Steve Harris.

3 MEMBER HARRIS: Mr. Hewitt, I would like to
4 follow up on your third recommendation, which I think was
5 close to or exactly the same that Mr. Drott introduced
6 beforehand, which is required annual training sessions
7 in auditors independence, professional skepticism,
8 professional judgment and objectivity. And in our
9 inspection reports, in terms of remediation, we require
10 additional training in a number of different instances.

11 But could you add with some degree of specificity
12 on your recommendation? Because it's easy to say that
13 we ought to just have training. But how would you
14 conduct such training? What would you require with
15 respect to that training?

16 MR. HEWITT: Well, if I were the PCAOB, I would
17 provide -- I think it ought to be required of all -- of
18 your one thousand plus auditing firms that you inspect
19 that some kind of a training session be held so many
20 hours concerning these items of concern, the
21 independence, the objectivity, you know, professional
22 skepticism, and those types of judgments that they do.

1 And I don't know if I would do it at every level,
2 but I certainly would do it the first three or four years
3 to build the foundation so these auditors have the
4 attitude and the knowledge to be skeptical of a
5 management accounting matter. And I think you probably
6 need to provide some guidelines on what that training
7 should include. I would say, you know, it's a state of
8 mind on some of it and the attitude. But examples of
9 what has happened in the past, and it could be like a
10 case study in the training process.

11 And it would not be -- I'm talking about maybe,
12 you know -- the larger firms, I know they have annual
13 training sessions for all levels, and that adds to the
14 quality of the audit in my mind. It did in my situation.
15 And I think that the smaller firms really don't do this,
16 but you're also looking at who does most of the audits
17 of the Fortune 500 and so forth. It's 80 percent
18 probably done, I think, by the big four.

19 But those need to be implemented. And you
20 mentioned you do recommend training sessions, but maybe
21 it's spotty. But I'm talking about a broad requirement
22 of all auditing firms.

1 MEMBER HARRIS: Well, I guess my question really
2 is: Do you think it's the role of the PCAOB and the SEC
3 to establish guidelines for that training. So rather
4 than say we want training, do you think that we ought to
5 work on --

6 MR. HEWITT: That would not bother me.

7 MEMBER HARRIS: -- solving it all?

8 MR. HEWITT: I established the guidelines for
9 interpreted guidance on evaluations of internal controls
10 by management, and I think that helped management and the
11 external auditors. No, I think that would be good.

12 MEMBER HARRIS: And then -- my time's up -- but,
13 Ms. Hill, I just want to thank you for your participation
14 and your recommendations on the investor advisory group
15 of the PCAOB. We welcome all your recommendations, so
16 thank you.

17 MS. HILL: Thank you.

18 CHAIRMAN DOTY: Lewis Ferguson.

19 MEMBER FERGUSON: One of things a couple of you
20 mentioned was the fact that one of the problems with
21 mandatory auditor rotation is that, given the fact that
22 for any large company you're likely to have services of

1 various sorts performed by all of the big four, a number
2 of the big four, so that in any given -- if you were to
3 make a determination to rotate, you'd be very limited in
4 what your choices were.

5 And it strikes me that this is a problem with the
6 business models that the firms have chosen to undertake.
7 That if they've chosen, it's like a -- you know, a person
8 who comes to you and says well, you know, you really
9 can't change this model because I've put myself in such
10 a position that there really is no alternative. You give
11 the firms no alternative.

12 Does this argue for -- which is something that
13 the European community is concerned about -- does this
14 argue for our thinking about the possibility of audit-
15 only firms, that they could perform no services beyond
16 audits for their clients, and that these firms will be
17 limited to that? And therefore you would not be -- if
18 you did determine that you wanted to rotate, you would
19 not be limited by the independence rules? What do you
20 think of that? Or do you see these things creating a
21 problem?

22 MR. LYNCH: I guess one reaction. You're right,

1 particularly the big four of which I'm most familiar
2 with, do have -- offer a litany of services. But I would
3 say that when I look in totality at the global spend of
4 a company like AIG, there are a whole variety of -- a
5 long list of boutique firms that bring valuation skills,
6 modeling skills, actuarial skills, transformational
7 skills, project management skills, technology skills.

8 So I think the marketplace is actually actively
9 looking for diversification opportunities of their spend,
10 and I think increasingly audit committees are very
11 sensitive, and I think this is probably an emerging
12 practice that we're not looking at just the spend of the
13 external auditor, we're looking at the spend of all the
14 professional services firms, including investment banks
15 and legal, so that we know what our option is somewhere
16 down the road, if we were so inclined.

17 MS. HILL: I would agree with what my colleague
18 just said. I would -- I would say that yes, we probably
19 have gotten ourselves in a box. But many of us do use
20 other firms. I mean, we use other firms, small firms for
21 different activities that you have throughout the
22 company. But when you're dealing with things, you know,

1 such as mergers and acquisitions and share repurchase
2 and, you know, some major issue, you really are limited
3 by the capability of the firms that you use.

4 So if there is an opportunity, I think, to expand
5 the services group, sure, everybody would probably like
6 to see that. There was a time we weren't in a situation
7 with four. And I think most others can go back and
8 remember when there were eight, and then there were
9 seven, and so forth and so on. You know, heaven forbid
10 something happen to one of the four, and then we're
11 really stuck.

12 So, you know, I would say that there is a --
13 there are uses that are being made of smaller boutique
14 firms, but I would say that not on the major audits, and
15 I don't think we're close to being able to do that yet.

16 CHAIRMAN DOTY: Jay Hanson?

17 MEMBER HANSON: I was at an audit committee
18 conference last week put on by a practicing law
19 institute, and I was just struck by the discussion of
20 scope creep, or what the audit committee's responsibility
21 is today compared to what it was maybe originally
22 envisioned as, and here you're all smiling, and oh, amen.

1 And so I appreciate everything that you do.

2 And the opening panelists this morning, Chairman
3 Williams effectively raised the questions, gee, if there
4 are success stories around audit committees effectively
5 challenging their auditors on independence and
6 skepticism, bring it on, I'd like to hear them. And I
7 think I kind of heard you describing, at least
8 generically, the practices you do, and I appreciate that
9 you probably don't want to call out specifically, maybe
10 issues that you had with your audit firms. But if
11 there's any more on that that you want to comment, I
12 welcome that.

13 But my question is just something else. And that
14 is, in my opening comments I said that we've heard a
15 number of people suggest and advocate, and some of you
16 have touched on it, to enable us to tell you more.
17 Specifically, if we inspect the audit of Home Depot or
18 Bank of the West or AIG or Cisco, to be able to talk with
19 you directly about, "We came in and inspected the audit
20 and here's what we found," which we believe would
21 require legislation to enable us to do that.

22 And I'm scratching my head to think of the

1 downside of that, because personally I don't see any
2 downside, other than us figuring out how we would do it.
3 And so comments and supports or downsides that you would
4 see to effectively advocate that we should have some
5 legislation to enable us to speak to you more directly
6 about what we found on your audit.

7 MR. HEWITT: I'll speak to that, because I think
8 you bring up a very interesting subject of communications
9 from the PCAOB directly to the audit committees. Audit
10 committees that I have served on and observed as chief
11 accountant, very few of them get any feedback from their
12 external auditors as to what the inspection -- very
13 detailed, detailed findings were, and what the
14 remediation should be. So I think it would be a good
15 policy to do that.

16 The downside of it would be strictly legal of
17 some kind, to get a safe harbor situation, to permit that
18 communication with audit committees, I think it would
19 enhance the performance of the audit committees.

20 MS. HILL: I don't see any downside to having
21 that kind of interaction. I think back to the time when
22 it was considered a no-no, if you will, to have directors

1 talking with shareholders, with major investors, and now
2 there's a move afoot to have much more of that
3 engagement. Certainly understanding Reg FD, but really
4 having more engagement.

5 I think that without having that kind of
6 feedback, audit committees are oftentimes flying blind.
7 I mean, you know, you hear there's an inspection and
8 there's something wrong and you have no clue. And yet
9 -- and still you have an obligation to shareholders, you
10 have duties of care and loyalty and all those other
11 things, and in many ways your hands are tied because
12 you're not able to really exercise the judgment and the
13 oversight that you need.

14 MR. LYNCH: When I first came into my role at
15 AIG, the 2007 external auditor's report was being looked
16 at. And as I went through 2008, 2009, 2010, kind of
17 still waiting to hear on that process, and it would be
18 easy to quip that "Is reporting on that timeline really
19 relevant?"

20 But I do think, in fairness to the process, the
21 external auditor was very candid. They indicated that
22 there were a variety of shortcomings. They were very

1 forthright in saying, you know, we have to address these
2 deficiencies, they are real and we are on it. And that
3 has been incorporated and integrated into the current
4 audit scope and technique.

5 So on one hand, I could envision, since
6 effectively that regulator-regulatee relationship exists
7 with the external audit firm, it would seem to me there
8 may be a way that, with the firm's permission, for you
9 to participate in those debriefings, and that possibly
10 that would not require a legislative construct that might
11 be limiting for you.

12 But that feedback is terribly important. And
13 you're right, Mr. Hanson, I think we effectively had to
14 rely upon the firm's leadership and that lead partner to
15 convey accurately the results of your finding. Now once
16 it actually came out, I felt very comfortably that they
17 had relayed accurately what the nature of your findings
18 were.

19 MR. WEST: I would also agree with that. I think
20 it's terribly important for us as audit committee members
21 and chairs to get additional feedback from the PCAOB.
22 And definitely for the companies that we sit on the

1 boards of.

2 But I would also kind of go one step further.
3 If it was possible to somehow look at -- or I would like
4 to get feedback, in general, of what you saw from other
5 companies that are relatively our size, so that we could
6 then therefore be focused on possible issues with our
7 firm. So it's not just what our firm did, but maybe what
8 other companies that are relatively the size of Cisco,
9 you know, and what kind of things you saw. Not
10 necessarily by name, but in some generic form.

11 CHAIRMAN DOTY: Marty? Chief Auditor Baumann.

12 MR. BAUMANN: Thank you. I just wanted to follow
13 up on one point. And I know, Ms. Hill, you made the
14 point, but I think others have endorsed it, and my own
15 experience as an auditor, it was a common practice.

16 It goes to the question that Jeanette was asking
17 about, how do you as audit committee members get
18 comfortable that your auditors are independent and acting
19 with professional skepticism. And I'm talking about
20 independent in mental attitude, not the -- they're
21 complying to a variety of ownership rules and things like
22 that.

1 A point was made about the value of the executive
2 sessions. And I don't want to discourage executive
3 sessions by any means. But I was wondering if you could
4 be any more explicit in terms of what you think an audit
5 committee member gains in those executive sessions, and
6 how would an audit committee member do that in terms of
7 learning about the auditor's independence and skepticism?

8 I guess I'd be skeptical if an auditor said
9 something in an executive session that they were afraid
10 to say with management there. So I'm sort of wondering
11 what does a member learn that helps them in that regard,
12 in the executive session?

13 MS. HILL: I have a question that's a favorite
14 question of mine when meeting with the auditors in
15 executive sessions. And that is, if you were sitting in
16 my seat and you had just gone through the meeting that
17 we've had, is there something that you would see that you
18 think I should ask that hasn't been asked, and is there
19 something we haven't covered that you think should be
20 covered.

21 I think what happens, is that it's not that they
22 don't disclose when management is sitting there, because

1 they do when we look at the review say we've had a
2 difference of opinion here, and the auditor's in the room
3 during this time, the internal auditors, or management,
4 and they'll say but we have resolved it.

5 Sometimes the committee wants to dig deeper on
6 that, and the time is not always there in the meetings
7 themselves. There is an opportunity to ask questions
8 that may not have come up during the course of the
9 meeting, and you can do that in executive session as
10 well. I think it's one of the reasons that executive
11 sessions are required for independent directors when the
12 CEO or management is not present.

13 It gives you an opportunity to reflect on things
14 that you've heard that you may not have asked about, or
15 may not have even crossed your mind that you can deal
16 with after the fact. It doesn't mean you might not call
17 the management team back in and say hey, this came up and
18 we need to hear from you, we need to know, you know, more
19 about -- we need more color on what you had to say about
20 this particular issue.

21 So it really does just give a little bit of
22 additional opportunity for things that just don't cross

1 over in the course of the regular meetings.

2 MR. HEWITT: One of the things I ask the external
3 auditors in executive session, I want to know about the
4 quality of our accounting financial treasury personnel.
5 Are they making proper judgments on the subjective
6 estimates that are in many in the accounting financial
7 reports. And that gives me some idea.

8 And they're usually pretty straightforward with
9 it, and say, "Hey, this person's -- you need to add
10 another assistant controller because of the complexity
11 and the growth of the company and so forth." So that's
12 one example that I do all the time.

13 MR. WEST: I think the executive sessions are
14 important, and we gain a lot of benefit from that. But
15 I also think there's significant opportunity to be
16 engaged with the audit partners or any of the audit team
17 outside of those meetings and pick up the phone and call
18 and set up some time to speak with them about what issues
19 they're seeing, and not just make it on the meetings.
20 And I think you get a lot more value from your partner
21 in understanding what their issues are. Thank you.

22 MR. LYNCH: I would just say, Marty, in quick

1 response, in a way, if I hear something during an
2 executive session, I feel like I haven't done my job.
3 I am probing, reaching, challenging transactions,
4 judgments, go live dates, I want to hear from them. And
5 I -- you know, right or wrong, we all play devil's
6 advocate a little bit. We challenge management. You
7 better be the one to bring it to me first. And I
8 challenge the external auditors, you better be the one
9 to bring it to me first.

10 Somebody's pretty quick with a phone call, and
11 there's usually not a delta of more than five or 10
12 minutes in between those calls. So I think both methods
13 -- both sides get the message the expectations are high.

14 MS. HILL: I would agree. But I would tell you
15 that you will inevitably miss something. If that weren't
16 the case, we might not be sitting here today. So it's
17 all good and it works, and that's why we're here today.

18 CHAIRMAN DOTY: Thank you. Thanks to the panel.
19 We have time for a brief break. Why don't we take a 10-
20 minute break and get back here by just before 10 past
21 noon, and we'll finish up.

22 ALL: Thank you again.

1 CHAIRMAN DOTY: Thank you all.

2 (Whereupon, the above-entitled matter went off
3 the record at 11:57 a.m. and resumed at 12:10 p.m.)

4 CHAIRMAN DOTY: We have a panel. We have most of
5 a board. Audit committees, investors and corporate --
6 corporate chiefs, and people who have had actual
7 responsibility for making investment decisions and
8 directing audits.

9 We have Roger Dunbar, chairman of the board and
10 audit committee of Silicon Valley Bank. Roger Dunbar has
11 deep roots in Silicon Valley. He's the current chairman
12 of Silicon Valley Bank's board of directors, chairman of
13 its audit committee. Retired from Ernst & Young in 2004
14 where he he'd had a variety of positions since '74,
15 leadership positions in the firm from '85, global vice
16 chairman of EUI Global Limited, London Strategic Growth
17 Markets and venture capital partner in charge and area
18 managing partner of Silicon Valley and the Pacific
19 Northwest area for the firm. Taught at Santa Clara's
20 University Graduate School of Business. He's had
21 programs at Northwestern's Kellogg School, and a director
22 of Desert Mountain Property and Desert Mountain Club,

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1 Inc..

2 Eric Keller. Chief operating Officer, Kleiner
3 Perkins Caufield & Byers. Served as chief operating
4 officer since 2008. He has extensive operational and
5 finance expertise with entrepreneurs that KPCB backs in
6 the green, digital and life science technologies. Before
7 joining KPCB, he was CEO of Movaris, a private software
8 company providing a suite of financial governance
9 applications. Earlier in his career, chief financial
10 officer and application service provider Corio, business
11 communications companies Aspect Communications, medical
12 device manufacturer Ventritex, scientific instruments
13 firm Dionex. And he counsels CEOs on business strategy
14 and organizational and operational matters. In all
15 firms, he developed teams of the processes that enabled
16 the companies to grow. He was named in 2006 one of the
17 100 most influential people in finance by Treasury & Risk
18 Magazine. Holds a B.S. degree from Cornell, and an MBA
19 from the University of California at Berkeley.

20 Mike Kwatinetz. General partner Azure Capital
21 Partners. Founding general partner with Azure Capital
22 Partners, where he specializes in software and related

1 infrastructure technologies. His current board
2 memberships are BlogHer, Cooking, Education.com,
3 Knowledge Adventure, Medsphere, Open Road and Rooftop
4 Comedy. Prior to Azure, he was the group head of
5 technology research managing director, and the senior
6 software and hardware analyst at several major investment
7 banks, including Credit Suisse, First Boston, Deutsche
8 Bank Securities and Paine Webber. He was also a senior
9 research analyst at Sanford Bernstein. Prior to this
10 technology research career, he was the CEO of Woodbury
11 Computer Associates, and that was a successful
12 enterprise. And he was Institutional Investors number
13 one Large-Cap "Home-Run Hitter" for stock selection among
14 Wall Street analysts, and remained among the top five in
15 1999. Furthermore, Reuters and the "Wall Street Journal"
16 had selected him as the number one PC analyst in that
17 annual survey we all look at and read. Served on the
18 boards of the firm Woodbury Computer Associates, Bill Me
19 Later, later acquired by Ebay. He's been in a number of
20 the firms that have later gone on to merger with
21 household names as well.

22 Mike Maher. Chief financial officer, U.S.

1 Venture Partners, founding member National Venture
2 Capital Association CFO Task Force. He joined the U.S.
3 Venture Capital Partners as chief financial officer in
4 '91 responsible for financial reporting, legal and tax
5 matters, general administration for USVP and its funds.
6 He currently serves as a member of the IPED Board, a
7 participating member of a National Venture Capital
8 Association CFO Task Force, active member of the American
9 Institute of CPA Investment Companies Expert Panel. He
10 had been an audit partner with Ernst & Young serving
11 clients for 17 years in a variety of industries,
12 including financial services, health care, manufacturing
13 and pension plans. B.Sc. cum laude from Santa Clara
14 university.

15 So we have four distinguished Californians,
16 people who are rooted in the technology culture and the
17 valley here. We welcome you. We appreciate you taking
18 the time to do this with us. Please proceed, Mr. Dunbar.

19 MR. DUNBAR: I would tell you that it's
20 interesting, I've changed some of my comments from
21 sitting and listening to the opening presentations by
22 different participants, and I will say something. That

1 I've come to the conclusion you have a very difficult
2 challenge ahead of you.

3 CHAIRMAN DOTY: Thank you.

4 MR. DUNBAR: I think you are the only group that
5 hasn't been blasted by some of the prior -- prior
6 presenters. Most audit committees, and auditors, and
7 companies and CEOs have taken their fair shots. And so
8 sitting back in the audience, I'm reminded of a comment
9 that Andy Grove once said, that leadership requires flat
10 molars, which means you grind your teeth a lot. And so
11 it was interesting to listen to it. But what it really
12 did is, I think it somehow it does pertain to a couple
13 of my comments.

14 The first one being the difference between
15 correlation and causation. One of the challenges that
16 we've always dealt with is understanding what problem
17 we're trying to fix. And I think one of the things that
18 is confusing for some of us on this side is to -- we
19 clearly understand the problems we're trying to fix
20 today. I think certainly you can say, you know, we're
21 very concerned about failed audits.

22 I would also tell you that as a chair of an audit

1 committee, as a prior auditor, we're scared to death of
2 having a failed audit continually. I will tell you that
3 the Sarbanes-Oxley, the PCAOB has improved everything for
4 us from the standpoint that although it scares the
5 partners in the firms to have an inspection go on, it has
6 changed the attitude, and it's changed dynamics about how
7 they perform the services with companies, especially
8 public companies.

9 I would say that a couple of recommendations I
10 got, one of them is that -- I spent a number of years in
11 the Navy, and one of the most life changing concepts was
12 -- came from in naval operation is that said in most
13 large companies, in most large organizations, we tend to
14 penalize the majority for the acts of the minority as
15 opposed to keelhaul the offenders.

16 And so one of the things that I look at in this
17 is saying, you know, a lot of us can talk and be cynical
18 about the accountability that people have today and who
19 really -- who really experiences dire consequences for
20 their behaviors. I think at some level, we really do
21 need to keep that in consideration as you approach this,
22 is, are we really penalizing and holding accountable

1 those people who have really been off the reservation and
2 off track on this and have caused failures.

3 And that means, to me, both the firm, the
4 individual partner. I think at some level it relates to
5 the audit committee, what they did. And I know, I am
6 sure I will probably offend some people who are on audit
7 committees by this statement of, you know, how dare you,
8 but I think that that's one of the issues that we really
9 have to deal with. Because I do believe that when you
10 see -- as an audit committee chairman, when you see
11 people who are sanctioned or you see the issues they're
12 dealing with, the first question is to our auditor, do
13 we have this same problem; do you have this problem; talk
14 to me about what's going on here. And you really start
15 to drill down.

16 And so I would encourage you, to the extent -- I
17 know there's sensitivity about disclosing to the public
18 your findings, but I would really encourage you to
19 disclose those. I personally think it ought to be a part
20 of the required communications between the auditor and
21 the audit committee. We have a lot of other things we
22 talk about, but I would add that to the list of certain

1 key findings.

2 I would also say that I think that there's a need
3 for mandatory board education. Now, once again, I am
4 biased because I came out as a CPA and we had mandatory
5 continuing education. I think that there is a need --
6 and I just came back from yesterday's Stanford's
7 Directors College, there was a period for -- on Silicon
8 Valley Banks where we had to report how much education
9 we had, and then it went away.

10 And I realize that it may not be within your
11 purview, but I think at some level life is changing so
12 fast in business today that we need to have a continuing
13 education requirement. I realize that that has costs
14 associated with it, but once again, as one of the earlier
15 participants said, cost needs to be defined in a more
16 broad term. And I think the cost of educating the audit
17 committee and boards, or requiring a certain amount of
18 education, will add to -- will add to the -- to the --
19 or minimize the amount of audit failures.

20 One of the last things I want to talk about is,
21 firms have -- having been a practicing partner and client
22 handler, I went through the period where we had

1 consulting firms, we had consulting operations, and the
2 consultants came in and tried to generate revenue out of
3 your audit client. And, you know, you would hear all the
4 arguments that say well, you know, our auditors know our
5 system better, so it would be better for our consultants
6 to do the work than somebody else's consultant.

7 Having lost a number of clients because of the
8 independence, having to resign them, making that
9 decision, I think that's -- that's an item that I would
10 say where now the firms, all four of the previous five
11 big firms, have now reinstated advisory services, which
12 I think for consulting. And I would -- I would suggest
13 we look at that.

14 That's basically my opening comments. And I
15 appreciate the opportunity. And thank you very much.

16 CHAIRMAN DOTY: Thank you, Mr. Dunbar. Eric
17 Keller.

18 MR. KELLER: Chairman Doty, commissioners and
19 staff to the PCAOB, as others, I'm very appreciative of
20 the opportunity to speak here today. And in particular,
21 I want to thank you for making the travel out here too,
22 whether it turns out to be a nice day in northern

1 California, we would like to have more people from
2 various regulatory agencies come out here, and if you
3 ever have the opportunity to come down to Palo Alto, we'd
4 welcome you there as well.

5 My own perspective is based on 30 years as a
6 finance executive here in Silicon Valley for both private
7 and public companies, and more recently as the chief
8 operating officer for a venture capital firm. I'm
9 interested in the auditor rotation proposal and how it
10 would affect the more than 200 portfolio companies that
11 we're investors in, as well as the annual audits of our
12 venture funds.

13 All of us whose careers involve financial
14 reporting strongly agree with the importance of having
15 independent, objective auditors who understand the
16 financial statements of clients with relevant industry
17 expertise, full understanding of accounting principles,
18 and a healthy dose of professional skepticism. The key
19 question is whether mandatory auditor rotation is the
20 best approach for improving the accountability of
21 auditors.

22 I agree that there are challenges with the

1 current system, including conflicts for auditors, who,
2 once having issued reports on financial statements,
3 subsequently conclude that those statements are wrong.
4 However, I don't think the term limits for auditors are
5 the best approach to addressing these challenges. And
6 here briefly are my reasons.

7 First, as others have mentioned, I believe that
8 boards of directors are in the best position to make
9 auditor decisions and should retain responsibility for
10 appointing, and if appropriate, changing auditors.
11 Today, finance executives, audit committees and auditors
12 operate under tremendous pressure to get the financial
13 statements and associated disclosures right. This
14 pressure reflects the strong sense of fiduciary
15 responsibility to investors, liability concerns under
16 securities regulations, and importantly, inspections
17 performed both by the SEC and the PCAOB. And, candidly,
18 the strongest possible warning to auditors against
19 getting co-opted by their clients took place with the
20 dismantling of Arthur Andersen.

21 Second, term limits for auditors are as likely to
22 weaken audits and financial reporting as to strengthen

1 them. For example, rather than cleaning up its act just
2 prior to a new auditor coming on board, the existing
3 audit firm is much more likely to aggressively defend its
4 accounting subsequent to the auditor change.

5 In addition, audit firms may have reduced
6 incentives to staff, what I would call end-of-term
7 audits, with the best resources. This is a concern due
8 to the complexity of accounting rules that place a heavy
9 burden on auditors to fully understand client systems,
10 processes and controls, as well as GAAP and regulatory
11 financial reporting requirements.

12 Third, as others have mentioned, the number of
13 audit firms capable of conducting audits for many
14 organizations is very limited and may be further narrowed
15 by conflicts. Audit firms differ considerably in the
16 depth of their expertise by geographic area, industry,
17 and stage of company. Finding an audit firm that
18 understands your industry is critical, and mandatory
19 rotations could reduce incentives for these firms to
20 develop deep domain expertise, particularly in rapidly
21 emerging industries.

22 Finally, changing auditors will involve

1 considerable direct and indirect costs as the new auditor
2 gets up to speed. For large, global organizations, it
3 may require much more than a single audit cycle, because
4 the new audit firm adequately understands the client
5 organization. Inevitably, there will be significant
6 productivity losses for both the auditor and the client.

7 In the absence of evidence clearly linking the
8 statements in audit failures to the lack of auditor
9 objectivity and skepticism, I personally suspect that the
10 most important causes of these failures are the
11 burgeoning complexity of financial reporting, greatly
12 expanded disclosures, and the increased precision
13 required for financial statements. As an example,
14 venture capital firms determine fair value for their
15 investments in private companies pursuant to ASC 20. In
16 some cases, we use a differential equation created by two
17 famous financial theorists to establish the value of an
18 early-stage company that is years away from revenue.

19 Discussions with auditors on the application
20 evaluation model, input assumptions and sensitivity
21 analyses involves substantial time and costs. In my
22 view, the results suffer from a problem of implied

1 precision. The option pricing model generate a very
2 specific answer. However, whether this output is useful
3 to our investors in assessing the value of the early-
4 stage company is another matter.

5 So what more can be done to enhance auditor
6 independence, objectivity and professional skepticism in
7 the absence of magic bullets? I think we should focus
8 on the basics.

9 First, leverage audit committees to hold auditors
10 and finance teams to high standards and ensure that
11 auditors both appear and are independent. This means
12 setting expectations for performance of both management
13 and auditors, having robust discussions about financial
14 reporting matters and audits, and challenging management
15 to reconsider historical accounting policies as
16 businesses evolve.

17 Second, continued rotations of lead audit
18 partners and requiring detailed disclosure of non audit-
19 related services performed by the audit firms.

20 Third, continue audit inspections by the PCAOB,
21 that, as others have said, are having a very significant
22 impact.

1 And finally, as others have mentioned, it's very
2 important that you publicize the causes of these audit
3 failures, so that the audit firms, public companies and
4 audit committees understand the issues and take seriously
5 their responsibility to address them.

6 As finance executives, we're data driven. If you
7 give us the data, we can respond to it. These steps may
8 not sound as powerful as mandatory rotation, but in the
9 long term, I think they'll have a bigger impact. Thank
10 you for inviting me.

11 CHAIRMAN DOTY: Thank you. Mike Kwatinetz.

12 MR. KWATINETZ: First of all, thank you. Thank
13 you for inviting me to speak.

14 In my written statement, I've detailed a number
15 of concerns I have regarding auditor rotation. And I'm
16 not going to go into the same level of detail here,
17 probably reiterating a few points that Eric pointed out.

18 So, we believe very strongly that the first two
19 years of a new auditor, our costs would increase in two
20 ways. The cost of the audit itself will go up as
21 entirely new professionals learn about the company being
22 audited. But also the staff of the audited company would

1 spend considerably more time informing this new team and
2 providing documents that have already been well looked
3 at by the prior audit firm.

4 In addition, more dollars would be spent by the
5 audit firms in marketing and selling since you would have
6 more opportunities for new audits to come up.

7 Secondly, as a new audit firm would be far less
8 familiar with the company, we believe that the risk
9 associated with this unfamiliarity would actually
10 increase the potential for material misstatements to go
11 undetected.

12 And then, finally, to reiterate part of what Eric
13 was talking about, in some sectors, there's only one
14 audit firm that has really strong industry knowledge.
15 Forcing a company that is using that firm to rotate to
16 someone else may substantially increase the risk of
17 material misstatements being missed.

18 It also has several other consequences. A firm
19 that doesn't understand an industry may require the
20 entity to change accounting methods in a way that, while
21 technically correct, lowers the quality of financial
22 statements. On the other hand, auditors that are

1 industry experts can also help the firm being audited by
2 describing best practices in that industry and helping
3 the firm move more towards best practices.

4 So what are some of the -- and I have a lot more
5 in my written statement, but I'll move on to potential
6 alternatives. And I've put them in two categories. One
7 is within the framework of versus auditor rotation, and
8 the second is a little broader.

9 So there's been discussion of partner rotation
10 within a firm, and I agree that partner rotation within
11 the audit firm would improve independence while
12 preserving the built-up knowledge of the auditors.
13 However, it doesn't fully solve the key issues that
14 concern the Oversight Board. Namely, the potential that
15 an audit firm may become too close to a client, or
16 concerned about the annuity associated with the audit.

17 So while I believe partner rotation is
18 beneficial, it does not appear to be sufficient to
19 overcome some of the issues that have caused the Board
20 to consider mandatory rotation. So I have one possible
21 solution to those issues, which is independent manager
22 placement.

1 I think this is a pretty viable alternative to
2 mandatory rotation, especially -- so every firm, if this
3 was adopted, would -- every major audit firm would
4 require each audit manager in the firm to be subject to
5 mandatory rotation for about a year. Every audit firm
6 would be required to utilize at least one manager every
7 other year, or whatever's the appropriate time, from
8 another firm on every major audit.

9 The managers would be randomly chosen, but would
10 need to be from another firm. The manager selected would
11 replace one of the prior year's managers who came from
12 the audit firm conducting the audit. The independent
13 manager would participate in audit planning, have access
14 to all work papers, and participate in each step of the
15 audit. At the end of the audit, the manager would be
16 required to fill out a short report, commenting on issues
17 he or she thought relevant to the Oversight Board.

18 What this process would do, it would introduce an
19 independent player who's at a fairly senior level within
20 the audit without adding time or expense, and without
21 reducing the knowledge that the existing auditors brought
22 to the table. If independent manager placement is

1 adopted and an audit firm was found to have a number of
2 deficiencies related to a specific client, then audit
3 rotation could be mandated on that client by the PCAOB.

4 Now, Roger was talking a little bit about what
5 problem are we trying to fix. And I assume that the
6 broader issue for the PCAOB is to ensure that financial
7 statements provide the high quality of information to
8 help users make better decisions. In considering
9 alternatives to auditor rotation, what I'm about to talk
10 about responds to the broader issue.

11 Everyone should want accounting standards to lead
12 to the most correct representation of a company's
13 financial results. But what if a requirement that is
14 more theoretically correct, like the one talked about by
15 Eric, also leads to inconsistencies reporting among
16 companies in the same industry, creates more
17 opportunities for misstatements of results that are
18 difficult for auditors to detect, and/or reduces
19 transparency to ordinary users of financial statements.
20 I think that's something -- all of these things should
21 be considered in establishing audit standards.

22 And it would help if we did consider them to

1 reduce material misstatements if this was done. Because
2 financial reporting standards do not place understanding
3 current operating performance as the priority, many
4 investors rely on company pro forma statements, which are
5 not subject to the same scrutiny and regulation, but
6 better reflect ongoing earnings potential. And I have
7 a lot of experience as a former analyst on Wall Street,
8 where about a third of the companies that I followed at
9 that time, we ignored GAAP accounting completely.

10 So it's a dangerous situation when many users of
11 financial statements are essentially ignoring GAAP.
12 Especially since the non-GAAP pro forma statements they
13 rely on are far less regulated. A few examples of the
14 material differences between GAAP and pro forma earnings
15 are as follows.

16 For fiscal 2012, Salesforce recorded a GAAP
17 earnings per share loss of nine cents, and pro forma
18 earnings of \$1.36. The \$1.36 is what investors used.
19 For Q1 of fiscal 2013, NVIDIA reported GAAP earnings of
20 10 cents per share, and pro forma earnings that were 60
21 percent higher. For the first quarter of fiscal 2012,
22 Zynga reported a GAAP earnings loss of 85 million, pro

1 forma adjusted EBITDA of 87 million profit, and pro forma
2 net income of 47 million.

3 This was so confusing to the financial press
4 even, that Reuters initially announced that the company
5 had lost \$85 million, and that was the GAAP number, but
6 not the number that had been reported in the press
7 previously as the expected earnings number. Many assumed
8 they had substantially missed the Wall Street forecast.
9 Later in the day, the Associated Press reported that
10 Zynga had in fact earned six cents per share, which beat
11 the Wall Street expectations.

12 While this discussion may seem a sidetrack from
13 auditor rotation, it's very relevant to the Oversight
14 Board's goal of preventing material misstatements.
15 Investors may buy or sell a stock upon hearing the
16 initial GAAP number thinking the company has fallen far
17 short of the pro forma earnings estimate made by analysts
18 and reported by the press.

19 So, in summary, I believe the Oversight Board's
20 goal of reducing material misstatements in financial
21 reporting is quite worthy. The current approach appears
22 to be a little too specific from my point of view,

1 whether or not to require rotation of auditors. I
2 believe this approach has more negatives than positives,
3 and could lead to higher costs and less detection of
4 misstatements.

5 I've suggested two other means of improvement,
6 one is requiring both partner rotation within a firm, and
7 also placing independent audit managers from other firms
8 in larger audits on a rotating basis. The second is
9 shifting the emphasis of accounting standards from purist
10 accounting towards accounting that is more relevant to
11 uses of financial statements and more easily auditable.

12 In any case, I think a very careful, explicit and
13 objective cost benefit analysis needs to be performed on
14 all alternatives occurred. Thank you.

15 CHAIRMAN DOTY: Thank you. Michael Maher.

16 MR. MAHER: Mr. Chairman and members of the
17 board, thank you for the opportunity to participate in
18 this continuing dialogue on the Concept Release and
19 auditor independence and audit firm rotation. I'd like
20 to echo the comments with respect to appreciation for
21 your coming out here to the west coast. It's very much
22 appreciated, and we look forward to further -- further

1 trips.

2 While the Concept Release contained at least 17
3 specific questions, I believe the primary questions that
4 was asked was, would mandatory auditor rotation enhance
5 or ensure auditor independence, objectivity and
6 professional skepticism. And as I prepared for this
7 opportunity to address the board, I undertook a cursory
8 review of the number of the related materials, including
9 some of the over 600 comment letters that were received,
10 both pro and con, and some of the comments provided in
11 earlier panels, as well as having conversations with a
12 number of investing partners at venture capital firms and
13 CFOs.

14 By the way, I can tell you that as recently as
15 last week, I surveyed in excess of 100 VC private equity
16 CFOs, and 95 percent of that group are opposed to auditor
17 rotation.

18 I was particularly struck by the statement of the
19 Board's Investor Advisory Group found on page 15 of the
20 Concept Release regarding investor confidence, and that
21 prompted me to refine the audit firm rotation questions
22 as follows:

1 Does the achievement of greater auditor
2 independence, objectivity and professional skepticism
3 increase the quality of financial reporting and improve
4 investors' confidence in such reports?

5 Which leads to the final question, and I think
6 the goal of this exercise, is: What steps can be taken
7 to improve investors' confidence in the quality of
8 financial reporting?

9 That is the bottom line.

10 And I think it's too simple. And while a
11 desirable goal to suggest that we just have to eliminate
12 misleading financial statements, ultimately, this is not
13 going to be an auditor-only solution. I don't think that
14 auditor rotation is the final answer. It's a possible
15 answer.

16 But you've asked me to address thoughts on
17 auditor rotation, and so I'd like to lay a framework for,
18 first of all, understanding what causes misleading
19 financial statements.

20 For the sake of the dialogue, I'd like to
21 stipulate that there are five major players in the
22 development of a set of financial statements. You have

1 the standard setters, you have management of the company,
2 there's the audit committee of the company, the auditors
3 of the financial statements, and ultimately the
4 regulators. All five of them have a role in these
5 financial statements.

6 In addition to that, I'd like to stipulate what
7 the primary causes of materially misleading financial
8 statements are. Fraud with intentional deception by
9 management, or by management and the audit committee, or
10 by management and the audit committee and the auditor,
11 or any combination thereof. You have unintentional
12 errors. You have differences of opinion in terms of the
13 interpretation of facts. And you have differences of
14 opinion with respect to the application of GAAP.

15 So the question here is, how does the auditor
16 become involved in each of these causes for material
17 misstatement. We'll stipulate for a second that the
18 auditor should catch each of these. But the question
19 becomes, how does it -- how does he do it. And there are
20 cause says for why they don't identify these problems.

21 And what I ultimately concluded was that the
22 causes for not identifying them with respect to fraud and

1 unintentional error would -- would be insufficient scope
2 of work or a lack of objectivity and professional
3 skepticism. And that the causes for differences of --
4 or failure to catch a problem with respect to differences
5 of opinion could be lack of independence.

6 On the other hand, what we don't know is how many
7 of these material misstatements, or potential
8 misstatements have actually been caught by the auditors
9 before the financial statements were issued. And what
10 leads to the ability of the auditor to identify those
11 problems is the issue of -- of their continuity. So the
12 institutional knowledge, the knowledge of where to look,
13 the ability to have an open dialogue with the company,
14 with its management, with the board of directors or with
15 the audit committee all lead to an ability to identify
16 these problems. And that is something that you're going
17 to lose in a rotation situation.

18 So at the conclusion of that little exercise, I
19 came out and said okay, I'm 50/50 on auditor rotation,
20 you know. One problem is that auditor rotation -- and
21 I see my time is up -- only occurs every 10 years. And
22 so that means there's a period of time when you're not

1 going to identify rotation -- or rotation is not going
2 to identify the -- the error.

3 Very quickly, I did a very quick calculation of
4 the cost of rotation. We've heard people indicate that
5 in the year of rotation there's a 20 percent increase in
6 the cost. If you spread that over 10 years, that's two
7 percent. Two percent of the annual audit fees of just
8 the 10 largest firms, approximately -- it's about \$800
9 million according to one of the recent reports I read
10 online. \$800 million equates to something along the
11 lines of the sixth largest firm that currently exists.
12 That firm employs roughly 6,000 people.

13 So you're talking about a need to identify
14 somewhere between four and 6,000 additional man years in
15 the system every year to accommodate auditor rotation.
16 I would just suggest that there are easier ways -- not
17 easier ways, but better ways to spend that money. One
18 would be to modify how peer review works.

19 And that would be so that it's a -- instead of
20 being a retrospective review, it is a contemporaneous
21 review. The second would be for audit committees to have
22 independent experts at their disposal that would help

1 them to review the work. And then finally, in repeated
2 egregious situations, we should allow the PCAOB to create
3 a process that allows them to either mandate or recommend
4 auditor rotation, but that would be the last -- the last
5 step. Thank you.

6 CHAIRMAN DOTY: Well, thank you. Jay Hanson?

7 MEMBER HANSON: Thanks for all your comments.

8 I've been thinking about all the disconnects we
9 have between the views of some that so strongly advocate
10 that rotation is the only solution and those that
11 advocate that rotation is crazy and it wouldn't work even
12 if we could and would implement it. And I think about
13 life and how we all go through life viewing life through
14 a set of lenses that we're given, and it's our collective
15 experiences. And so I'd like to think that I've got a
16 set of bifocals on now that I've lived most of my life
17 as an auditor, and now I'm a regulator.

18 And we've got two gentlemen here, the book ends,
19 Michael Maher and Roger Dunbar, that were auditors, and
20 now are involved as investors. And especially, Michael,
21 I want to direct a question to you first, and any of you
22 are welcome to weigh in on it.

1 So Michael started his career as an auditor, a
2 substantial part of his career, and then since then he's
3 been a CFO and an investor. So you've got a very unique
4 perspective to see life with -- I'll call them trifocals
5 -- that you've seen life as an auditor, as a CFO, and an
6 investor. So I really, really respect the views of those
7 that come to us with that unique perspective.

8 And so my question is: Why do you think there's
9 such a big disconnect between those that -- that see
10 rotation as the only solution, and those that see
11 rotation as a -- as a crazy solution?

12 And I'll let any of you weigh in on that, but
13 that's one of the things that as a board member I'm kind
14 of struggling with that. Because I'm trying to see it
15 in as many lights as I can. I don't have the perspective
16 like many of you do, as being investors or investor
17 representatives on audit committees.

18 MR. MAHER: I believe that one of the issues with
19 respect to rotation, is that there's a tremendous cost
20 that is associated with it. And those of us -- I've been
21 through an auditor rotation. I've been through auditor
22 rotations in both sides, both as the auditor and as the

1 CFO, and when you go through that process, especially as
2 a CFO, there's a tremendous cost. There's a tremendous
3 disruption to the organization in terms of trying to
4 identify what the new auditors need.

5 In addition to that, with respect to whether a
6 rotation makes sense, I'm not sure that we have a full
7 understanding as to what the particular issues are.
8 We've heard, for example, that there are audit failures,
9 and then we've also heard, I believe the term was audit
10 -- Roger help me. Not, not -- audit deficiencies. Yes,
11 audit deficiencies. And I think there's a big difference
12 between audit deficiencies and audit failures.

13 In my sense, I believe most of what we're
14 experiencing are audit deficiencies. That while there
15 are restatements of financial statements in some
16 situations, in most cases, the -- it's a deficiency in
17 how the auditor carried out their job. And so from the
18 perspective of the chief financial officer of an
19 organization or as an investor, I don't want to see the
20 disruption in my organization for the lack of a positive
21 output. So it's a cost benefit relationship.

22 MR. DUNBAR: I would just say that -- maybe I did

1 in an inarticulate way -- but one of the things that
2 happens, and one of the appreciations I've walked away
3 from this today is that everybody has a different set of
4 glasses, and everybody's glasses were manufactured
5 somewhere else. And some people have their glasses on
6 and some people take their glasses off. And that's one
7 of the challenges you've got, because the people who have
8 talked are very passionate about their opinions.

9 And it's about to be a thing that they all
10 believe that this is the solution. That's why I always
11 come back and say what's the problem, what are we trying
12 to resolve, and are there multiple solutions to the
13 problem. My natural tendency of being an auditor and
14 having lived both sides of it is, the rotation is a
15 solution, I think it may be as -- as Mike just said, be
16 a higher-cost solution than the benefit.

17 I also think that it has some unintended
18 consequences about how the board takes responsibility and
19 how specifically the audit committee takes
20 responsibility. There are, as Mr. Baumann brought up --
21 I think there are things -- and once again, I'm biased,
22 this is my own bias -- our audit committee is different

1 once you put a retired audit partner on the audit
2 committee than what it was before. And there's a whole
3 issue about pushing the audit committee to do their job
4 and understand what their job is.

5 So I do think there's solutions to it. Once
6 again, it's a quick fix to say -- not a quick fix --
7 relatively it's a quick fix to say this is the way we're
8 going to deal with it, but you're really talking about
9 evaluating someone else's state of mind, and that becomes
10 difficult, because your perception and my perception may
11 disagree, or your judgment and my judgment might
12 disagree. How do you get the solution to say, okay, come
13 to it. And I think there's just a lot of passion and
14 anxiety around it because there has been a lot of
15 failures where people don't feel that people were
16 sufficiently held accountable.

17 MR. KELLER: I would just add a couple of things
18 to that. Analogies are always problematic. But what I
19 kept thinking about was this; it's like term limits.
20 We're running a term limits experiment here in the State
21 of California. We've had it in place for a number of
22 years. I have good friends who strongly support it. I

1 know others who don't support it. I think the jury's out
2 about whether it's really working or not.

3 The other -- so I think part of it is just an
4 orientation that people have about whether it's time to
5 sort of in effect throw the bums out, let's get somebody
6 new in; new broom sweeps clean, whatever you want to call
7 it. Right, there are people who believe that.

8 My experience in dealing with auditors, and I
9 worked with each of the big four firms, the remaining big
10 four firms over 30 years in Silicon Valley, having signed
11 more than 60 10-Qs and 10-Ks as a CFO of various public
12 companies. And the way I summarized them, the best ones,
13 and I've worked with the best ones, are the best partners
14 that audit firms are like a giant brick wall covered with
15 a very thin layer of marshmallow; they're soft and sweet
16 on the outside, but if you push, they're completely
17 immovable.

18 And the ones I've worked with are tough-minded.
19 They are very tough-minded people. And the difference
20 in orientation I think you're hearing here today, is
21 people who believe that there's this idea of collusion
22 that management gets into with its auditors, that their

1 fees are there. I can tell you, I have friends who have
2 lost their jobs and their life savings because of what
3 happened with Arthur Andersen. I'm not saying it was
4 handled correctly or incorrectly, I'm just saying it is
5 what it is.

6 After that, the idea that anyone would -- would
7 risk their careers, their livelihood because of audit
8 fees, I don't -- that doesn't resonate for me. But I
9 know other people, including some of the speakers here
10 from earlier panels who believe it strongly. So that's
11 a different orientation.

12 MR. KWATINETZ: I'd like to add from a lifetime
13 investor point of view, I think often what I've seen is
14 that -- is an idealism that comes in accounting. That
15 people could figure anything out, even with no
16 experience. And that purity is the perfect thing to go
17 for. And, you know, as a pragmatist -- and Eric brought
18 a little bit of this up with the VC industry -- there's
19 been some things that have been implemented that, while
20 theoretically we're getting a perfect answer, in fact
21 we've just created the next fraud.

22 And it's because we've gone to something that, in

1 theory, is objective and in practice is totally
2 subjective. And so there's no way that anybody who is
3 on the audit side can properly figure out our comparables
4 for a private company that are relevant. And we've been
5 told by our auditors we don't like to mop things up.
6 We're nervous if there's not a new round.

7 We had a company that just did a new round a
8 month ago, so an independent investor set the valuation,
9 they said that's not the right answer, the theory. The
10 actual result is not the right answer, the theory is the
11 right answer. So, and I've seen a lot of differences of
12 opinion in terms of where you come from. And I think you
13 should analyze which constituencies were on which side
14 of the table with this.

15 And I'm guessing ones that are more involved in
16 management and investing are further against auditor
17 rotation. This is a pure guess. Because, from a cost-
18 benefit point of view, it doesn't really make sense. And
19 also from a pragmatic point of view, the new auditors
20 won't have the depth of knowledge, and you're actually
21 increasing risk by doing it. And the theorists will be
22 more for it, so.

1 CHAIRMAN DOTY: Lewis Ferguson?

2 MEMBER FERGUSON: You all have raised a whole
3 pile of questions already in my mind. Each of you has
4 said things that I've found provocative and interesting
5 and would like to ask questions about. But to confine
6 myself to one question, and it's something we've been
7 thinking about as a Board here.

8 The PCAOB, as you know, has great expertise
9 through its inspection process, and -- and an enormous
10 depth of knowledge over the life of this organization
11 we've looked at about 1,800 separate audits both here and
12 abroad. We are limited in terms of what we can convey
13 to the public by the statute.

14 But with the consent of the auditing firm, and
15 the auditing firm itself can disclose to you the
16 confidential parts of its reports, would you find it
17 useful and interesting as members of audit committees to
18 know more about what we have found specifically with
19 respect to inspections that we have done of firms that
20 are members of the audit committee of members of the
21 board of directors?

22 Would you find it interesting to have

1 communications with the PCAOB and its staff, with the
2 consent of the auditor, about the results of the
3 inspection findings of an audit that you're particularly
4 involved with?

5 MR. DUNBAR: Absolutely. I think that's a really
6 needed item. And I think it needs to be done in a way
7 -- right now, a lot of the communications with the audit
8 committees is the result of complying with the letters
9 -- with the statute, is, we get big glossies. You know,
10 you get a multicolored glossy, and quite frankly, you
11 know, in a board, you flip through it. But what you
12 really need is a very -- you know, and this is probably
13 my Silicon Valley upbringing -- give me the five points
14 that we really need to focus with.

15 And I personally would encourage, you know, the
16 firm -- and I've just now made a note for my next audit
17 committee meeting, is that I want to understand what
18 their perception is of the issues that are causing audit
19 failures that they've been issued, or items where one of
20 their partners has been sanctioned, in very, very tacit
21 ways.

22 MR. KELLER: So I would say it is not

1 interesting, it is essential to get that information out
2 to people. Let me give a specific example.

3 Silicon Valley in the 30 years I've been here has
4 transitioned. It used to be a hardware place. It used
5 to be a place where people made widgets, and then we went
6 to software, and now we're making intangibles.
7 Accounting for these things is very exciting for all of
8 us. But what happened with software rev rec, revenue
9 recognition, was, it took a concerted effort by public
10 companies, by the SEC, by the FASB and other -- and the
11 big six or big four or whatever we were at at that
12 particular point in time to figure this out.

13 It was only by shining a spotlight on the bad
14 things that had happened, that we figured out that we had
15 to have a much more coherent set of rules about how to
16 recognize revenue in a software company. And I would
17 encourage you, I think there's a wealth of data that
18 exists within the PCAOB, the results of your inspections,
19 and you could do an enormous benefit for audit committees
20 by disclosing that information so we can see what are the
21 hot areas, what are the things you're concerned about.
22 Believe me, we can react to them.

1 I also serve on the -- I chaired audit committee
2 of a public committee, and we will be all over this. But
3 we need the data to do that. That would be helpful.

4 MR. KWATINETZ: Yeah, I would agree that it's
5 essential that you release it in actually two ways. One
6 is on the specific audit that I'm on the committee of,
7 I'd like to have information. But then I also think it
8 would be very helpful in a very generic way to point out
9 where risks are that the audit committee should be
10 focused on and thinking about. So I think both of those
11 would be very valuable.

12 MR. MAHER: I would agree that the information is
13 important. I'd be a little bit more specific about it.
14 I would have the results of each -- each PCAOB review
15 discussed with the specific audit committee. I'd include
16 PCAOB reviewers in that meeting, and I would have from
17 that -- essentially what they used to do in the old days
18 when we gave out management letters, which is that
19 there's a written plan.

20 We either agree with the deficiencies, or in some
21 cases, and these are the changes that are going to be
22 made either in the internal controls of management or in

1 the process by which the audit is completed. Or we agree
2 that while the deficiency is noted, it's not that
3 material, and we're not going to do anything about it.

4 CHAIRMAN DOTY: Steve Harris.

5 MEMBER HARRIS: Well, I'm most interested in
6 independence, objectivity and professional skepticism and
7 how to increase that. You know, mandatory rotation is
8 -- I wouldn't say it's a peripheral issue; it's directly
9 related. But the issue to me is, how to increase
10 objectivity, independence and skepticism. And that's a
11 concern shared internationally.

12 I mentioned that in my very brief statement there
13 was a meeting of regulators in Korea recently, and the
14 common finding that they all articulated was auditors'
15 professional skepticism and auditor independence. That
16 was in their press release. So how do we deal with that
17 not only domestically but internationally is what I'm
18 focused on.

19 I do find that there's a little bit of a
20 disconnect. I do not want to vouch for these figures,
21 because I don't have any idea whether they're credible
22 or whether they're not. But later on today, we're going

1 to hear the 52 percent of public companies voluntarily
2 changed auditors between 2003 and 2006, and auditor
3 rotation is already a way of life for local government
4 and non-profit audit clients, and the costs are not
5 prohibitive. I don't know whether that's accurate or
6 inaccurate, but we've got to get the empirical data one
7 way or another. That's -- that's something that we have
8 to focus on.

9 But, Mr. Dunbar, you raised an issue with respect
10 to -- I think I heard you say concern about advisory
11 services. What did you have in mind with that? And what
12 should we be focusing on in terms of the independence of
13 advisory services or otherwise?

14 MR. DUNBAR: One of the things that we have
15 instituted is to absolutely set parameters on how much
16 our auditors can provide us in non-audit services in
17 dollar amounts.

18 My concern is, having lost companies because of
19 the actions of our consultants, having watch a partner's
20 career be destroyed when it really wasn't his fault. But
21 because the consulting generation of revenue, all the
22 firms appear to me to have reinstated -- they call them

1 different things -- advisory services, aka consulting,
2 and the firms may find this testimony, that I'm a
3 turncoat on them -- but quite frankly, I just yesterday
4 had a conversation with our CFO saying no, these -- our
5 auditor cannot do these services.

6 So there's an increase in creep, what I call
7 scope creep, of wanting to provide these ancillary
8 services to audit clients as opposed to, in my firm, we
9 used to call it channel one revenues and channel two
10 revenues. Channel one was audit clients, channel two was
11 non-audit clients. And we've managed it that way.

12 So I am personally worried, as I watch this come
13 in, it seems innocuous now, but the scope creep around,
14 trying to get your audit for -- your auditor's firm was
15 trying to get you to spend money with them in that area,
16 I think, is a challenge or a risk.

17 MEMBER HARRIS: Do any of the others of you have
18 any concerns?

19 MR. KELLER: I think it's a very interesting
20 question, and it is something that I think, serving on
21 an audit committee, I think I'm very sensitive to as
22 well. I also think it would be worth looking into what

1 the history's been here, because there was a time in the
2 late 1990s where there was an effort to get the large
3 accounting firms to spin off their consulting practices.
4 So Ernst & Young spun theirs off to Capgemini, and
5 BearingPoint was a spin out of KPMG. It may be worth
6 looking into what that experience was. I don't -- I
7 can't summarize it for you, but I think it would be worth
8 looking into what that experience was, what worked in
9 that effort and what did not work in that effort.

10 But I do think that part of it isn't just
11 independence, it's the appearance of independence, and
12 that's also important. And I think when you look at that
13 disclosure, which is a great disclosure, by the way,
14 maybe it be expanded in the annual proxy statement to say
15 where the fees come from. If you look down there and see
16 huge fees relative to the audit fees that are being spent
17 on other ancillary kinds of services, I think it's --
18 it's not unreasonable for a -- for an investor to look
19 at that and scratch their head and worry about
20 independence. It's a fair question.

21 MR. KWATINETZ: So I was a manager in the
22 consulting side of Ernst & Young. And I can readily see

1 some of the issues that could -- could happen that way.
2 I also felt that by having the consulting side -- and
3 this is a tricky thing, we actually enhanced some of the
4 audit value. And there were things that the consultants
5 brought from a knowledge point of view that the auditors
6 didn't have in their training. This was ages ago, so I
7 don't know how it's changed.

8 So there is an offset, but I think that, you
9 know, the way that it's moved toward trying to restrict
10 the amount that auditors will do in consulting is
11 probably the right thing. But if you go back to the
12 history of auditing, it was supposed to be a value added
13 service in terms of helping the company as opposed to a
14 service that was a mandated service.

15 And I think it's more viewed as a mandated
16 service now as opposed to a valued added service. And
17 it's a very important distinction in terms of how
18 companies look at their auditors. So the consulting side
19 added value. And so that's something to weigh when
20 you're thinking about it. And value could be helping the
21 company improve the way it reports, and, you know, having
22 more things that are valuable to investors in the

1 company.

2 I just want to add one thing. The suggestion I
3 made of partner -- of manager rotation, I'd really
4 encourage you to think about whether that's something
5 that would be on a -- semi -- you know, a biannual basis.
6 And that would, I believe, increase the diligence of the
7 existing auditors, knowing that a manager from another
8 firm would be part of their audit team every other year.
9 I think that's something that might be another way to go
10 and accomplish some of the objectives of auditor rotation
11 without the cost and the loss of knowledge that's
12 associated with it.

13 MR. MAHER: I would just add that I think it's
14 correct to minimize the amount of consulting services
15 that the firms provide. On the other hand, I wouldn't
16 want to see that definition be so tight as to preclude
17 collaborative efforts on major accounting issues.

18 To be blunt, the size of the most recent ASU on
19 fair value was 331 pages. I don't have a staff that's
20 big enough to sit there and look at a 331-page document
21 from FASB on fair value. Fair value is the biggest issue
22 that I have to face internally on financial reporting.

1 So I have to look to my auditors for some assistance in
2 how to deal with -- with this.

3 So if consulting is limited to, you know, some of
4 the tax services that we get because they tie in, and
5 working with them on a collaborative basis, I think
6 that's fine. Going to these much larger situations where
7 you're selling systems -- and I don't think the firms do
8 that anymore -- but that would be a concern. So I would
9 -- I would agree with Roger and the rest of the
10 panelists; we need to monitor how much that consulting
11 is becoming.

12 CHAIRMAN DOTY: Jeanette?

13 MEMBER FRANZEL: This has been a very rich
14 discussion. And you all have mentioned the complexity
15 of financial reporting and disclosures and some of the
16 very difficult situations your particular companies have
17 faced. And -- but that the goal is reliability of
18 financial reporting overall. And so that does involve
19 more than the audit.

20 And I wonder if you have any comments on the
21 balance there and what you're seeing in terms of
22 effective ways to mitigate the financial reporting risks

1 through the audit?

2 MR. KWATINETZ: I -- you know, Michael talked
3 about the different constituencies that are involved, and
4 I think you have to think of the constituencies that
5 mandate reporting. To me, it doesn't matter what the
6 auditor's to do, a lot of people are losing money because
7 of the way that financial reporting is mandated.

8 I had a personal experience when I was on Wall
9 Street, and I have it in my written thing, Compaq
10 acquired DEC. They then said they were growing 36
11 percent when they were actually shrinking. And there was
12 no requirement for them to put anything in their
13 financial reports about organic growth versus purchase
14 growth. And it's not that it couldn't be detected, but
15 it just happened I was the only analyst on Wall Street
16 that showed the comparison based on adding the two
17 together the prior year.

18 What happened is, the stock collapsed when they
19 got close to the -- you know, to annualizing. They had
20 to reveal that they weren't going to keep growing at 36
21 percent, that it was almost like a fraud, but it was all
22 within accepted reporting. They didn't do anything that

1 was un-allowed. Nothing wrong with the auditors.

2 Nothing was required.

3 So I think that if you study the broader issue,
4 which is how do we make the reporting better, you may
5 come to conclusions that you have to go to a 331-page
6 requirement. Is that actually enriching the reporting
7 to the users of the statement? Or is it adding a
8 financial burden that actually causes every firm to
9 report the same thing differently? And you're actually
10 increasing the risk of misstatement by doing that.

11 MR. KELLER: So I have a simple thought
12 experiment to suggest. If we had a company called ABC,
13 Inc. that makes -- is a cloud -- a based widget company,
14 all right; and we take the five largest audit firms and
15 we give them -- actually, it's a hypothetical, so they
16 all go in at the same time, they get the same budget, the
17 same number of hours, and they audit this company. I
18 have two questions that comes out of the following
19 experiment.

20 One, will the resulting five sets of financial
21 statements, MD&A footnotes, et cetera, be the same? The
22 answer is, of course they won't be the same. Because the

1 firms will pursue different issues. They'll look at
2 different issues. And they focus on different things.
3 And it also reflects the complexity that's inherent in
4 our financial reporting system. And by the way, I don't
5 think that's going to go away. I think we're in a world
6 of intangibles now, and it's not going to go away.

7 The more interesting question to me is to ask
8 this question: Does the fact that those results are
9 different, even materially different, mean that one of
10 those financial statements is right and the others are
11 wrong? And I suggest to you that in a very complex
12 accounting world that we live in, that is not necessarily
13 the case. That it's possible to have different sets of
14 financials, even for the same identical company at the
15 same point in time that are -- that are both GAAP and
16 GAAS compliant, and that's just a -- that is an outcome
17 of a very, very complicated set of accounting
18 requirements. So we just have to recognize that.
19 There's no one right set of numbers for any entity. It's
20 just not possible.

21 MEMBER HANSON: Eric, can I just interrupt with
22 a quick question on that? Would you view or do you think

1 it's possible that if you were trying to evaluate the
2 quality of the accounting principles behind vastly
3 different numbers for the identical company, that they
4 be equal quality of the accounting principles, it's just
5 that there's different assumptions built in?

6 MR. KELLER: I think -- here's an example. Is if
7 you're using an option -- I'll go back to the option
8 pricing model, which is the hammer that we're using for
9 every real and perceived nail out there today in the
10 world we live in, venture capital, right.

11 The input assumptions in that are not statutory.
12 We have to figure out what they are. They involve
13 judgment. Depending on how you pick those assumptions
14 and test them and measure them and those kind of things,
15 you will get radically different outcomes. And so I do
16 think you can have high-quality audits done with the best
17 of intentions by people that end up in very different
18 parts.

19 I would actually go a step further. I don't know
20 that that's necessarily a bad thing. I think it's
21 actually good to have different people focused on
22 different things, because they'll find issues where

1 others would no. So that's just a -- you know, again,
2 it's fun in Silicon Valley, it's sort of a sport to rail
3 against the complexity of accounting standards. You
4 know, non-finance people like to do it. But it is the
5 world we live in today. I don't think it's -- it is not
6 -- simply not going to go away.

7 I'd love to have, instead of an 800 -- a 320-page
8 document, a 30-page document. But I don't think we're
9 going to get there, frankly.

10 CHAIRMAN DOTY: Are there other questions? Are
11 there other questions by board members or staff?

12 We're over time, but there comes a -- there comes
13 out of this a certain sense that the four of you embrace
14 the situation we have. Different numbers, as long as we
15 don't penalize the majority and we can't find the
16 wrongdoer to keelhaul, or make that public, don't
17 keelhaul the wrongdoer, it's -- there's a certain
18 sporting legitimacy to finding -- for an analyst to be
19 able to find out from the financial reporting that we
20 have what the average investor can; it's part of the
21 game. And after all, it's tough to change your auditors.

22 Why don't I come -- I'm going back to what Andy

1 Bailey said this morning, that the accounting profession
2 -- we are here today because at critical moments in our
3 country's history, the accounting profession dug its
4 heels in and -- and said no change, don't do it, too
5 expensive, too difficult. That's troubling to a lawyer
6 who has admired the accounting profession and has lived
7 through a few of these terms of his career.

8 Is it the considered judgment of the panel that
9 there is no circumstance in which the PCAOB, looking at
10 the performance of an audit by a firm that has had an
11 engagement for 20 years, and has gone through a process
12 that may have resulted in actually influencing the
13 consultation process to get to a result that management
14 wanted, there's no circumstance in which we should step
15 in and say we think there's been a failure of skepticism
16 here; we think there's been a failure to perform audit
17 procedures that even would have existed under GAAS, let
18 alone our existing standards; no circumstance in which
19 we should look at the auditing firm, big, large or small,
20 medium size and say in this engagement, in this case you
21 are no longer independent? Show us cause why we should
22 determine that you're not independent as to this firm.

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1 Is it your view that that is overstepping the
2 area that we should not tread for the audit committee and
3 the sanctity of the audit?

4 MR. KWATINETZ: I've actually put in my written
5 statement that you should do that. So I have it under
6 the manager rotation. But it's the -- it's the same
7 exact thing. If you find whether it's through manager
8 rotation or your own internal -- if you find that a firm
9 has not fulfilled its responsibilities and you feel
10 they've been -- let's not say negligent, but less than
11 perfect, you know, on some scale not up to where they
12 should be, then I think you should mandate a change.

13 CHAIRMAN DOTY: And that's information --

14 MR. KWATINETZ: That's different than required
15 rotation.

16 CHAIRMAN DOTY: It is. I mean, I'm really trying
17 to understand where you all come together on common
18 ground. I think it also is the understanding that you
19 think that in a case we find that, we ought to be able
20 to go straight -- there ought to be a kind of reporting
21 up or sounding out by the Board directly to the audit
22 committee right there and then.

1 MR. DUNBAR: That would be my one caveat, is that
2 I would think that that ought to be brought immediately
3 to the audit committee, and I guess at some level, once
4 again, it's -- you can always put yourself out there.
5 But I would think if the audit committee doesn't react
6 to that and you look at it, and there's always difference
7 upon opinion and judgments, but I would be suspect of an
8 audit committee that didn't act on that, quite frankly.
9 But I would -- I would not give audit committees the
10 opportunity to abdicate responsibility.

11 MR. KELLER: I would only add to that, that if
12 during a PCAOB inspection you found that an audit was --
13 was flawed, and that led to a restatement of the
14 financials for the company, I think if that audit
15 committee doesn't consider swapping out the auditors, I
16 think that's -- that would be -- that they would have a
17 responsibility to do that. They would have to do that.

18 I can't comment on your statutory authority. But
19 again, I think that the -- I think that the dialogue --
20 that's why the specifics here are important to us, so you
21 can hear we're all saying much the same thing about
22 giving us more specifics. The more specifics we have,

1 the better off we are. And I think we will react to it.

2 CHAIRMAN DOTY: Well you, along with Jim Cox
3 earlier today and Andrew Bailey, others that had been
4 here, and that were in Washington on the 21st, what
5 you're doing in part is asking us to reflect on our own
6 process and our own remedies, and to think about whether
7 our remedies, perhaps, are inadequate, but should be
8 looked at again.

9 MR. KWATINETZ: You know, just to throw it back
10 at you, don't you think it's almost negligent on the
11 PCAOB's part to know that something is being done wrong
12 and not communicate it?

13 CHAIRMAN DOTY: Well, the Congress took a
14 different view. The Congress took a -- on that note --
15 on that note, perhaps we'll adjourn for lunch. Thank you
16 all.

17 (Whereupon, the above-entitled matter went off
18 the record at 1:14 p.m. and resumed at 2:00 p.m.)

19 CHAIRMAN DOTY: Well, good afternoon. Thank you
20 for being here. The panel today gets us back into the
21 public sector.

22 We have David Eaton, the Vice President of Proxy

1 Research, Glass, Lewis & Co. He is -- his department
2 analyzes proxies in more than a hundred countries and
3 publishes analyses for nearly 20,000 shareholder meetings
4 annually. At Glass Lewis, he has held multiple positions
5 including U.S. research analyst, director of Glass Lewis'
6 Common Law Research Team. More recently, AVP of
7 Compensation Research, partly responsible for the
8 company's compensation analysis globally, with oversight
9 of the firm's say on pay policies. In this role, he also
10 oversaw environmental, social and governance research and
11 proposal analysis. Prior to joining Glass Lewis, he
12 worked as a research analyst for GovernanceMetrics. He
13 joined Mercer Consulting, managed their Global Executive
14 Remuneration Research and Insights Team for two years
15 before returning to Glass Lewis. He's a frequent speaker
16 in industry conferences, client events and webcasts, and
17 his views on governance and compensation-related issues
18 have been cited in media throughout the country. He
19 holds a Bachelors degree in Economics from Haverford
20 College, a Masters degree in Business Administration from
21 the Yale University School of Management. David, we
22 welcome you.

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1 Janice Hester Amey, Portfolio Manager, Corporate
2 Governance, California State Teachers' Retirement System
3 (CalSTRS). She is a portfolio manager in the Corporate
4 Governance Unit at CalSTRS, responsible for day-to-day
5 management and the development of policies and guidelines
6 relative to the activist investment managers and
7 corporate governance. CalSTRS is a public pension fund,
8 of course, established for the benefit of California
9 public school teachers over 80 years ago. It serves
10 800,000 members, retirees and beneficiaries, has a
11 portfolio valued at \$152 billion as of February 29, 2012,
12 and Corporate Governance represents about \$4 billion of
13 those assets. She has spent -- Ms. Amey has spent over
14 20 years in the investments area, most equally split
15 between the public and the private sectors. And we
16 welcome you, Janice Hester Amey.

17 Robin Madsen, Chief Financial Officer, California
18 State Teachers' Retirement System, responsible for
19 providing leadership, strategic planning, management
20 direction and policy guidance to CalSTRS Financial
21 Services Function. Joined CalSTRS in June 2009 as a
22 special consultant to the CFO. Prior to joining CalSTRS,

1 she was involved in financial information technology
2 consulting for private and -- public and private sector
3 entities in California, Oregon and Washington for more
4 than 20 years. Began her consulting career with Peat
5 Marwick. Owned and operated two consulting organizations
6 for 13 years, and then prior to that she was the
7 assistant controller and assistant vice president for
8 Kaufman and Broad's Mortgage Company, as well as the loan
9 accounting manager for a wholesale mortgage banker,
10 Farmers Savings Bank. So she brings a great deal of
11 private sector investment experience to this table.

12 And we are delighted you're here. We're
13 grateful for your insights.

14 And I will turn it over to David Eaton. Please,
15 you may begin, David.

16 MR. EATON: Okay. Thank you for having me. And
17 thank you for inviting Glass Lewis to participate in this
18 public forum. Should -- should I go through just a brief
19 statement? Is that the --

20 CHAIRMAN DOTY: Of course. Deliver a few
21 remarks, and then we'll pass it down the table; we'll
22 come back and ask questions.

1 MR. EATON: Perfect. I'll -- I'll keep it brief.
2 So, in short, Glass Lewis supports the PCAOB's efforts
3 to ensure auditor independence. We certainly believe
4 that disinterested, independent judgment of a company's
5 financial statements plays a vital role in investor
6 confidence in the company and its management, and in the
7 board of directors.

8 Glass Lewis, for those of you who are unfamiliar
9 with our role, we're an independent governance analysis
10 and proxy voting firm. We serve institutional investors
11 globally. We have over 900 clients who manage over \$15
12 trillion in assets. These include some of the largest
13 pension plans, asset managers and mutual funds. Our
14 research focused on the long-term financial impact of
15 investment and proxy vote decisions. We empower
16 institutional investors to make sound decisions by
17 uncovering and accessing governance, business, legal,
18 political and accounting risks.

19 The purpose of our research and what we look at
20 is, we look to drive -- we look for to give advice to
21 institutional investors, to all of our clients, in fact,
22 to facilitate shareholder voting in favor of governance

1 structures that will drive performance, that will create
2 shareholder value, and that will maintain a proper tone
3 at the top at the, at the company. And in this sense,
4 we do look for -- count the boards with a record of
5 protecting shareholder value, mitigating risk, and
6 delivering value over the medium to long term.

7 We -- we strongly believe that the auditor's role
8 is as a gatekeeper. It's crucial in ensuring the
9 integrity and transparency of the financial information
10 necessary to protecting the shareholder value.
11 Shareholders rely on an auditor to ask the tough
12 questions and to do a thorough analysis of a company's
13 books to ensure that the information provided to
14 shareholders is complete, accurate and fair. And that
15 -- and so it is a reasonable representation of a
16 company's financial position.

17 The only way shareholders can make a rational
18 investment decision is if the market is equipped with
19 accurate information about a company's fiscal health.
20 We -- Glass Lewis does believe that auditor rotation can
21 ensure both the independence of the auditor and the
22 integrity of the audit. We will typically recommend

1 supporting proposals, although they are very rare, that
2 do ask for auditor rotation.

3 We do feel, however, that mandatory audit
4 rotation is something to be considered; though mandatory
5 is definitely debatable. We do feel that Sarbanes-Oxley
6 has put some -- some strong checks and safeguards
7 regarding independence and integrity and objectivity in
8 place, including -- particularly moving the
9 responsibility to the audit committee for supervising,
10 selecting and compensating the external auditor.

11 And I guess in conclusion, I would just say that
12 audit rotation, when combined with -- with limiting non
13 audit-related services, moving audit committee -- the
14 responsibility to the audit committee, as well as the SOX
15 requirement that we audit -- partner rotations is
16 mandatory when combined -- when combining all of those
17 aspects, we feel that the independence and objectivity
18 of auditors has improved in the past decade.

19 CHAIRMAN DOTY: That's very helpful, and thank
20 you, David. Ms. Amey.

21 (Pause.)

22 CHAIRMAN DOTY: Janice put your -- yeah, there we

1 go.

2 MS. AMEY: Thank you for having me. My name is
3 Janice Hester Amey. I'm a portfolio manager in the
4 corporate governance area of the CalSTRS investments
5 office. Been there since the mid '80s.

6 We have done a lot of comments all the way back
7 to 2002 on this governance issue and the proper role of
8 the Board Oversight of the audit process. And just as
9 David said, we certainly believe that auditor rotation
10 can be a tool that audit committees can use in order to
11 get a -- a better quality audit, or an audit that has
12 greater integrity, greater independence of the auditor.
13 However, as a fund, we have not been in support of making
14 that requirement mandatory. We'd like to leave the audit
15 committee as the people that are in charge of the
16 relationship.

17 However, in doing our research for this meeting,
18 I did look at some surveys and studies, the last one done
19 by Protiviti, which actually was surveying public
20 companies on this very question. And even though as
21 investors what we're trying to do is not give companies
22 more regulations and structures than they need to -- to

1 look over the assets and grow the assets, it may look at
2 those from -- if this survey is -- it can hold up, it may
3 look as though the companies are somewhat differently
4 responding.

5 For instance, nearly half of the public companies
6 that were surveyed by Protiviti agreed that rotation
7 would improve auditing. And that was among accelerated
8 filers. And among large accelerated filers, 47 percent
9 were in favor of rotation. While in non-accelerated
10 filers, 50 percent were in favor of rotation.

11 So I think we -- we are looking for a solution
12 that still leaves the oversight role at the board level,
13 and leaves the decision at the board level. And I think
14 we would still come out in not being in favor of
15 mandatory rotation. But it does seem that if the
16 companies feel that they're not getting the right kinds
17 of audits, and that this is a tool that they should have,
18 we'd certainly support that.

19 CHAIRMAN DOTY: Robin Madsen.

20 MS. MADSEN: Hi. I'm really just here to tell
21 you about our experience with auditor rotation, because
22 we have been through several auditor rotation cycles, and

1 are just into our second year with the new auditor that
2 came out of a -- a public sector procurement process.
3 So because of our unique position in the public sector
4 and the transparency required in our board reporting, we
5 really do need to go through rotation. So -- and we have
6 over the course of the last three or four audit cycles.

7 We have had -- our auditors have tenure with us
8 for between four and eight years. In this last RFP
9 process, we looked significantly at the issue of
10 independence and whether it was important to exclude the
11 prior auditor from the procurement process, and
12 determined that it was not. So the prior auditor, as
13 well as a competitor were part of our finalists, and were
14 interviewed by our audit and risk management committee.

15 There was some discussion about the independence
16 issue in that committee meeting, but that did not end up
17 being the determining factor for the award of the
18 contract. We did end up selecting new auditors, but not
19 as a byproduct of any requirement for rotation in
20 particular, but just because it seemed like that was a
21 better choice. So there was a management recommendation
22 and a robust discussion with our audits and risk

1 management committee.

2 Given the structure of our board as
3 representative of our membership, as well as composition
4 from statutory offices and public representatives, we
5 actually have a financial expert that the audit and risk
6 management committee has hired. So most of the dialogue
7 was prompted by questions from that financial expert, who
8 happens to be a professor at the University of California
9 Davis. So, you know, from a more academic perspective.

10 And, again, my -- my recollection -- although I
11 didn't go back and listen to the tape -- my recollections
12 were that, there were -- you know, there were discussions
13 of the pros and cons of actually rotating the auditor.
14 But the cost in terms of actual dollar costs, because
15 there were differences in price, as well as the, you
16 know, more of the soft cost, what's it going to cost us,
17 what are we losing in terms of expertise, and what are
18 we gaining in terms of a new set of perspectives.

19 As the person who's been largely responsible for
20 interacting with the new auditors, and whose staff are
21 on the line with the new auditors, I can tell you that
22 it is expensive, both in dollars terms, and in staff

1 time.

2 My conclusion, personally from this particular
3 seat that I'm sitting in, is that that expense has been
4 compensated and then some by the value that we have
5 gained from a new set of eyes on our business. And it's
6 not just in terms of the quality of the financial
7 statements, because we haven't actually had them
8 recommend any changes to the financial statements, but
9 it's been in the conversations with the audit team and
10 the fact that they are asking a new set of questions that
11 have led staff and management alike to look at their own
12 operations and determine whether they should be asking
13 different questions.

14 So I would see it as a ripple effect out into the
15 organization and not purely limited to the financial
16 statement results. Because, as I said, there really have
17 not been any -- any discussions about making changes to
18 those financial statements. But it really has been a
19 different perspective on questions about our business
20 operations, where the risks are, have we been thinking
21 of all those places where we could be subject to material
22 misstatement, those kinds of thought processes have

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1 definitely been amplified by the presence of a new -- a
2 new partner in -- in our auditing firm.

3 So what I can tell you is -- and, again, we're in
4 a public procurement environment, so I have no idea how
5 this translates into another arena, but we did experience
6 actually a 30 to 40 percent increase in cost in the first
7 year. Now we went from a regional firm to a more -- a
8 national firm, so there's obviously a gap there. I'm not
9 sure how to mitigate that. I haven't done any economic
10 research to discount it, but certainly there,, that could
11 be done.

12 I will say that the partner involvement in our
13 audit in the differences in the scale of the firm has
14 been significant. There's been a significant difference
15 there which would also contribute to the variation in
16 cost.

17 In terms of the comments about -- that people
18 have made about the expertise in the industry, I -- I
19 haven't found that to be the case. And we have a fairly
20 complicated set of -- we have -- we're in a complicated
21 business. So, especially with all of the public
22 notoriety of pensions right now, it is complicated not

1 only from the actual running of the financial services
2 organizations, but also in terms of public perception.

3 And I think our new auditors have done a very
4 good job of coming up to speed bringing the right
5 expertise to the table to be able to give us a very high-
6 quality audit.

7 On the consulting front, we use a variety of
8 firms that are not our auditors. We cannot use our
9 auditors at all, although that is not precluded, our
10 audit and risk management committee would have to approve
11 it. But we have not -- we have not had trouble getting
12 expertise to the table to do the other kind of work we
13 need done, whether it's assistance in internal audits,
14 because we do hire assistants for internal audits,
15 particularly when it comes to the investment portfolio,
16 to management consulting, the industry that I came out
17 of, CATS compliance, we deal with those issues as well.
18 So hopefully that provides a different perspective.

19 CHAIRMAN DOTY: Thank you. The brevity of this
20 is going to allow us to have more than one pass through
21 this panel. But to clarify, CalSTRS does not have a
22 policy in place now that you will rotate your audit firm

1 every X number of years; or do you have that?

2 MS. MADSEN: Well, there's no specific policy on
3 audit rotation for CalSTRS. What we have are public
4 procurement requirements. And so because we are bidding
5 audit as a public sector contract, when we go up for bid,
6 we establish the tenure of that engagement, and there is
7 code that allows us to extend for a year. But after
8 that, we need to re-solicit.

9 CHAIRMAN DOTY: Thank you, that's a helpful
10 clarification. Jeanette Franzel, question?

11 MEMBER FRANZEL: Yes. You've all noted that you
12 don't necessarily favor mandatory audit firm rotation,
13 but that there are cases where it could be useful to
14 rotate, but not under a mandatory regime.

15 Can you talk a little bit about the criteria
16 that you use at Glass Lewis and CalSTRS? And then, Ms.
17 Madsen, maybe some of the criteria that you all were
18 considering as well in your procurement for the need to
19 rotate.

20 MR. EATON: Sure. As I was telling a few people
21 at lunch, there's -- there's few and far between
22 opportunities for Glass Lewis to -- to recommend to our

1 clients on the -- specifically on the issue of auditor
2 rotation. It just doesn't show up on an annual meeting,
3 on a ballot as a proposal.

4 However, there is, of course, the ratification of
5 the auditor. And over time, that proposal's really
6 become a routine item. And -- and, you know, we're --
7 we're the first ones to admit that. And I think most of
8 our clients admit that too. And as such, you know, we
9 do have some very stringent points where we will
10 recommend against that ratification. However, it's been
11 approximately two percent of all ratification of auditor
12 proposals that we have recommended against in the last
13 three years.

14 And the main reason driving that recommendation,
15 that negative recommendation, over four-fifths of the
16 time, it has to do with the auditor relationship with the
17 company in terms of the contract, whether that is limit
18 liability issues or other sorts of provisions that we are
19 opposed to.

20 We -- we do look to recommend against the
21 ratification of an auditor in -- we have eight different
22 things in our policy guidelines. I won't go through them

1 all, but the primary reasons that we do, like I said,
2 first there is the contractual reasons between the
3 company and the auditor that we might oppose. But also,
4 we do look at the -- at the fees. And we look at, you
5 know, the audit fees plus the audit-related fees as
6 compared to the tax fees and other non-audit fees.

7 And we have a -- what I would say is a pretty
8 lenient threshold there, where we believe that at least
9 50 percent of those -- of the aggregate fees need to be,
10 you know, paid in terms of audit and audit-related. I
11 know some of our clients have a much -- much more
12 stringent, you know, thresholds in that -- in that sense.

13 We will -- I think what gets a little more to the
14 point is we also will recommend against the ratification
15 of an auditor and do feel that a rotation of the auditor
16 is necessary when there's been recent material
17 restatements of annual financial statements, including
18 those resulting in -- the reporting of material
19 weaknesses and internal controls, and including late
20 filings where the audit -- where it's -- we can determine
21 that the auditor bears some responsibility for the
22 restatement or late filing.

1 MS. AMEY: Yeah, I would support many of the
2 reasons that David said. I think he makes a really good
3 point that as shareholders, you get to vote on the
4 ratification. You don't get to vote on the rotation
5 unless there's a proposal from a shareholder asking that
6 auditors be rotated.

7 But I think there are things that the audit
8 committee could do if they want to involve investors more
9 in this question. And some of that would be disclosing
10 in the proxy statement the tenure of the audit, or of the
11 audit firm. And any other issues, how they issue -- how
12 they judge the performance of the audit firm, and what,
13 what that judgment says about this firm that they are
14 recommending. I think that would help investors.

15 Like David, we certainly look when there have
16 been restatements at companies. We do use some analysis
17 when you have an issue that shows you that there's a
18 problem with an audit firm. We look at the information
19 that's provided by unit of MSCI called CSRA that we hire.
20 We also hire Audit Integrity. We pay attention to
21 research from Audit Analytics, and we realize that, you
22 know, 25 percent of the companies in the S&P 500 have had

1 the same auditor for 25 plus years.

2 If you go to the Russell, the number is I think
3 36 percent have had the same auditor for over 40 years,
4 and within the Russell index, I think there are eight
5 companies that have of the same auditor for a hundred
6 years.

7 So I think that, you know, we need some more
8 disclosure, even if you're not asking companies to
9 necessarily recommend a rotation, certainly I think the
10 CalSTRS process of putting it out for bid and having --
11 having everybody on both sides of the table look at what
12 they've been getting and what they've been providing, and
13 possibly getting some insight as to ways that you might
14 get a better auditor is also an idea that I think we're
15 firmly in support of.

16 MS. MADSEN: So, Jeanette your question for me as
17 to kinds of things that we've thought about in making the
18 recommendation, and I guess, you know, as I was looking
19 to other people's spots, I think the things that would
20 drive me in my seat are, you know, the worst problems to
21 have are the ones you don't know about.

22 So I don't know how else to say it. And so a new

1 set of eyes coming in to help you find those so that you
2 can take the appropriate steps to mitigate the risk that
3 are causing those to be a problem.

4 CHAIRMAN DOTY: Steve Harris?

5 MEMBER HARRIS: In terms of the expertise to
6 conduct an audit as say, CalSTRS, how many firms outside
7 the big four have the expertise, and to what extent is
8 the -- to what extent can we increase the competition
9 with respect to firms bidding on your work? I mean, how
10 many people have the necessary professionalism to do it?

11 MS. MADSEN: Well, we haven't had a big four,
12 six, eight -- I forget when it diminished, you know.
13 When I was there it was nine, because there was still --
14 there were still nine.

15 So we, we actually look at the top 30 audit firms
16 when we went out for bid. I mean, that was kind of the
17 way we walked into it. We have somebody who's in the,
18 you know, mid -- the lower half of the top 10. We got
19 two bids in that range. We didn't get any of the big
20 four. You know, we have a liability provision that is
21 challenging for many audit firms to deal with. And it
22 took negotiation. I mean, the hardest part of our

1 transition was negotiating the contract.

2 MEMBER HARRIS: With other than the big four?

3 MS. MADSEN: With other than the big four. So
4 somebody in the -- in the top 10, but not in the big
5 four.

6 MEMBER HARRIS: And have you found that they're
7 able do the work that's required?

8 MS. MADSEN: Oh, yes, absolutely. And it's a
9 combination of people. It's not from a single office.
10 It's -- it's really spread out. You know, we have a
11 partner who's an expert in the public sector. We have
12 a valuation partner. We have a separate -- they brought
13 in their separate valuation firm. I mean, you can
14 understand, given the nature of our financial statements
15 that that would be where the risk is, on the investment
16 side.

17 So, so we've got both actuarial and investment
18 expertise, as well as a valuation firm that they've hired
19 to -- to help ensure that what we are stating the value
20 of our assets are, and our gains and losses are accurate.
21 So, so it's -- I'm not going to say it's, it's all been
22 resident in the single office of that -- that firm, but

1 I'm definitely very impressed with their expertise and
2 the ability they have to reach into resources in various
3 places to bring those people to the table.

4 MEMBER HARRIS: Thank you.

5 CHAIRMAN DOTY: Lewis.

6 MEMBER FERGUSON: I have a question that sort of
7 comes out of the -- grows out of sort of the implication
8 of the practice that's followed by public sector agencies
9 like yours. And it seems like most public sector,
10 whether they're pensions or government agencies do rotate
11 their auditors periodically. They may not have mandatory
12 auditor rotation requirements, but they do it. TIAA-
13 CREF, for example, does it as a matter of policy. You
14 and I suspect CalPERS does it because of the procurement
15 rules.

16 But what underlies the procurement rules is a
17 sense that we don't want these relationships to become
18 privileged relationships. That they need to be looked
19 at again periodically.

20 Given this -- my question comes out of that.
21 Given the fact that you all believe that is the correct
22 policy for yourselves, and given the fact that agencies

1 like yours are huge owners of the stock of public
2 companies; in fact, perhaps if you look at the equity
3 holdings of the largest American companies -- maybe not
4 a majority, but certainly a significant plurality of the
5 holdings are held by, by pension firms, investment firms
6 of various sorts that have these policies -- why do you
7 all not push those companies to adopt -- not necessarily
8 mandatory rotation, but periodic rotation if you believe
9 for yourselves that that's the appropriate policy?

10 MS. AMEY: No, I don't think that's over. I
11 think that one of the things that we wanted to do was to
12 see what happens with what the PCAOB is doing before we
13 approach companies. But we certainly -- I don't know
14 that we would push them for a mandatory rotation, but I
15 do think that there is a -- there will be engagements,
16 talking to companies about putting the business out for
17 bid after a certain amount of years. And I think the
18 issue is we don't know if it's the 15 years that Bob
19 Pozen recommends. We think it's more than five.
20 Certainly less than 40.

21 But we certainly want to approach companies about
22 at least putting the business out for bid, allowing the

1 existing auditor to bid on the business, and to give
2 investors more of the information that presumably they're
3 using to evaluate the auditor.

4 MEMBER HANSON: Okay. More questions for Robin.

5 And this is -- my question's really to -- if you
6 can share just a little bit more about the context of
7 your -- of the scale of your engagement and how many --
8 how many people you have. Or how many people in the
9 financial reporting structure within CalSTRS, how many
10 -- how many people the audit firm has all involved, how
11 many locations, and how many locations you have. I don't
12 know if you're all in, what Sacramento or if you've got
13 locations all over the country or world. And if the
14 auditors need to be in those places too.

15 MS. MADSEN: So in terms of our operations, we
16 have a large headquarters facility in west Sacramento,
17 and we have a small satellite office in Glendale,
18 California, where we do retirement counseling for
19 teachers in southern California. So we're certainly not
20 a multinational presence. Where -- where we get
21 multinational is in due diligence that we do with our
22 external managers and our private investments. So we do

1 experience that, but that's not the scale of our
2 operation.

3 As you can imagine, a lot of the accounting that
4 is done for our investments is elsewhere. So of the
5 private assets -- we get audited financial statements;
6 that's what we rely on. So, you know, it's, again, from
7 where I sit in terms of the side of the operation that
8 I'm responsible for, it's very small in comparison to the
9 companies that we invest in. Hence my desire to be a
10 part of this panel and not a panel of those -- from those
11 companies that we invest in.

12 But in terms of the complexity of the business
13 that we need to present to our audience -- so, granted
14 the scale is different. You know, my accounting shop is
15 75 people, okay, not -- not big at all. In terms of the
16 audit team that's working -- and I have not gone through
17 and done this calculation and listed all of the people
18 out, but there are five different partners. The staff
19 underneath them I'm thinking maybe is 20. I mean, that's
20 kind of where I'm guessing things are. But I don't have
21 that specific number. So that could be wrong. I just
22 want to give you that caveat.

1 MEMBER HANSON: Good. And just a follow-up
2 question to the question that Board Member Harris asked.

3 With the number of firms that you felt were
4 qualified to propose, and whether it being based in the
5 Sacramento area was important to you. I don't know if
6 the firm -- the lead partner and team if it's based here
7 or if it's based somewhere else.

8 MS. MADSEN: Well, the -- let's see, the signing
9 partner is in Indiana. The engagement partner is in
10 Texas. The valuation partner is in Kentucky. The senior
11 manager is in Ohio. The actuarial firm is in Chicago.
12 I think that's the list that I can come up with at the
13 moment. They fly.

14 CHAIRMAN DOTY: If history teaches us anything,
15 it would be that when the people at the table and others
16 like you decide that it's a good thing that firms
17 reconsider their audit relationship every 15 years, every
18 10 years, and when your opinions are headed in that
19 direction, that this is something that's going to happen.

20 It's -- and the PCAOB could do nothing here, and
21 it may well be that whatever board is sitting here five
22 years from now or six years from now, will be looking at

1 a very different circumstance in which many, many
2 companies are going just as they did, going away from
3 staggered boards, just as they went towards separating
4 chairmen from CEO -- you name it. Just as they went
5 toward a poison pill that would only be exercised in the
6 -- after a shareholder vote, et cetera, et cetera, et
7 cetera, as a great man once said, then it may well be
8 that there are many of the best firms that are already
9 doing this.

10 And in fact, we heard today from one of our most
11 distinguished panelists, and what people need is really
12 the ability to plan. Once you have a schedule, and if
13 people knew that by the year 2020 there would be a
14 predictable regime in effect, that that would be plenty
15 of time for a lot of good things to happen, for people
16 to start training up, for people to start making their
17 choices about where their consulting business was going
18 to go. All sorts things could happen.

19 But what it's made me think sitting here today
20 listening to a lot of very thoughtful comments, is that
21 the people who are the least likely to make the plans,
22 the least likely to reexamine their relationships, are

1 exactly the one -- exactly the ones that we hear about.
2 They are the marginal players, they are the fraudsters,
3 they are the people that one of our panelists clearly
4 pointed out are always thinking about how to cut the
5 corners, and that we need to think more like.

6 Are we, in other words, in the position -- if
7 we're going to focus our efforts, shouldn't we be
8 thinking, for example, principally about what to do to
9 make sure that the people that we -- that we reduce the
10 business clientele for Charlie Drott, that in fact we go
11 out and start working on the companies that are the least
12 likely to make the right choice for the right reason,
13 with some kind of rule-making scheme, or some kind of a
14 procedure.

15 And what would that be? What should we do about
16 that? You could agree, or you could say I'm out of my
17 mind, or you could -- you could -- but you're going to
18 have to make -- you will be making these choices as
19 people who vote the proxies, or tell others to do it.

20 MS. AMEY: Yeah. I mean, I don't think we can
21 argue about what you just said. I think as an investor
22 one of the things that, in our discussions at CalSTRS

1 about this policy is, that, you know, we think that there
2 are -- and I'm not sure if it would be the industry or
3 if it's going to be the client telling the audit firm --
4 but to minimize the risk of mistakes, if there is a
5 transition to a new auditing firm, we think that there
6 should be some sort of schedule for turning over the
7 documents to the new audit firm so that we can cut down
8 on the risk for investors.

9 Much like what you see happening in medicine
10 today where you, you can go to another doctor but they've
11 all got information and all the tests that you have
12 already had. And, you know, you can get a solution
13 that's a lot faster than everybody starting from scratch
14 and making mistakes or overlooking things and just
15 driving up the cost for no good business reason. So I
16 think we would like to see some protections of -- like
17 that before, you know -- well, not before, but certainly
18 in conjunction with transitions, whether it's 15 years
19 or 10. You know, and I think --

20 MS. MADSEN: You know, and I, I did some thinking
21 about the solutions, just again from our own perspective.
22 And we're very reliant on our actuaries, and there are

1 no standards of practice that require rotation in
2 actuaries. But we have established -- and again, this is
3 a peer review process that we -- where we hire another
4 actuarial firm to come in and audit the work of our
5 actuaries to see if they can replicate it within
6 reasonable tolerances.

7 The other thing that -- just in terms of
8 comparing those -- those domains, which have some similar
9 characteristics, is the actuaries actually sign their
10 opinions with their names. So again, it's a --

11 CHAIRMAN DOTY: Wow.

12 MS. MADSEN: -- yeah, they do. So, I mean, it's
13 just a -- there's just difference in the standards of
14 practice. And so, again, that was just something that
15 I thought about given the feat that I'm in, that provided
16 some comparability in terms of another perspective.

17 MR. EATON: Just to echo a little bit of what
18 Janice said, I completely agree that the process and
19 structure around that transition really needs to be
20 established. And really -- from an investor point of
21 view, no matter what the issue is, like you said, whether
22 it's separation of chair/CEO or whatever the topic du

1 jour is, it really involves a degree of transparency and
2 a degree of process that is involved so investors do have
3 that -- that confidence that a proper process is being
4 followed. And that the intentions of the -- of that
5 process, which, of course is ensuring the independence
6 and objectivity of the -- of the audit, is in fact what
7 it's working towards.

8 CHAIRMAN DOTY: If opponents of rotation do point
9 out that if you -- if you in fact had a handover period,
10 and if the audit firm knew the hand over period was
11 coming, if that were the regime that operated throughout
12 the auditing regime, then there would be an identity of
13 interest in the handing over and the receiving firm to
14 make sure that each case, the handing over -- the
15 handover and the completeness of the record was
16 satisfactory to both of them.

17 Did you -- did you do any of that when you
18 changed auditors?

19 MS. MADSEN: So, and again, I was reflecting on
20 that as I was listening to people earlier in the day.
21 So, yes, there was a transition period in terms of access
22 to the records, so that was part of our contractual

1 requirements. We saw that the new auditor went in and
2 reviewed the work papers of the prior auditor. We have
3 that same requirement in the -- in this contract, so that
4 there is a transition process that -- you know, and
5 again, we're a public entity, so there are different
6 issues associated with it.

7 And my experience in -- because I was there both
8 during the last audit of the prior auditors and -- and,
9 you know, and through this transition period, that the
10 prior auditors actually were very conscientious about
11 making sure that they had thoroughly documented their
12 conclusions, probably more so than in prior audits. So,
13 just anecdotal information.

14 CHAIRMAN DOTY: Are there questions by the
15 observers or panelists?

16 MEMBER HARRIS: I had a question with respect to
17 your attachment A dealing with financial experts.
18 Although you don't quite label it as financial experts.
19 But once again, you focus on CEOs or other senior
20 executive officers. I'm just reading it from here, and
21 so it's a generic question, you don't have to have it in
22 front of you.

1 But just a CEO or other senior officer. And once
2 again, I wonder why you don't focus on either retired
3 auditors. Because, we heard this morning, I think, from
4 the chair of an audit committee, that he's a little bit
5 concerned about retired CEOs, and I've got absolutely
6 nothing against retired CEOs, but they might not be the
7 best financial experts.

8 And so why would you focus, in terms of who you
9 would want on an audit committee, auditors who, certainly
10 once they retired and maybe -- well, they would have the
11 experience and the expertise. So I would just ask you
12 to consider that. Because, as I say, on item three it
13 says all members of the audit committee or person's whose
14 past and current employment experience, education
15 demonstrate expertise in finance and/or accounting,
16 including being or having been a CEO or other executive
17 officer. I would just encourage you to think about a
18 broader definition of financial expert.

19 MS. AMEY: I think that was -- that guideline was
20 written around the time of the SOX package. And I think
21 we wanted to -- not so much narrow it to CEOs as to say
22 that it would be okay if a CEO was also -- a retired CEO

1 was a financial expert. But we'll certainly -- when we
2 look at the guidelines again, we'll certainly consider
3 retired auditors.

4 MEMBER HARRIS: And the last question I got.
5 Glass Lewis is a premier research firm. And so what
6 we're hearing throughout the day is the need for
7 empirical data to support whatever action we may or may
8 not take. So when you say we typically support audit-
9 related proposals regarding mandatory auditor rotation,
10 when the proposal uses a reasonable period of time,
11 usually not less than five to seven years, if you can --
12 if you develop any empirical data supporting why you
13 would do that, that would be helpful.

14 MR. EATON: Yeah, I think that's a really good
15 question. And, you know, one of the -- one of the things
16 I should point out is the way that our policies are
17 really driven is twofold. It's one from our clients,
18 what our clients believe strongly in and also academic
19 research and studies. And this is actually an area where
20 the -- the quote that you have is not surrounded by
21 particular depth beyond that, because -- just for that
22 fact.

1 Our, our clients have not -- have not really
2 pushed on this issue. As I said before, there hasn't
3 been -- there's really not an opportunity for investors
4 to vote on this issue very frequently. But also, that
5 the academic literature and studies around it, from what
6 I've seen, have been pretty much a mixed bag, if you
7 will. So where those exact years that are in that quote
8 come from, has to do with, I believe a shareholder
9 proposal from a few years ago. But I wouldn't quote me
10 on that.

11 CHAIRMAN DOTY: We're at the end of time on this
12 panel. I want to thank you. It's been terrific. And
13 while the -- we're now going back to independent
14 directors, and while the independent directors make their
15 way to the table, we will say thank you again to you all
16 for doing this.

17 The new panel is Julie Allecta, Trustee and
18 Chairman of the Audit Committee of Forward Funds. Vice
19 president and director of Wild Care Bay Area, a non-
20 profit. First vice president and director of the Ottoman
21 Kenya and Research non-profit. Began her legal career
22 in 1977 with the United States Securities and Exchange

1 Commission in Washington DC and its Office of General
2 Counsel. In her private practice, moved to San
3 Francisco, specialized in consulting financial
4 institutions -- counseling financial institutions and
5 boards on financial institutions -- boards of financial
6 institutions, providing legal advice on complex financial
7 regulation and investment products. She had a career at
8 Paul Hastings, a distinguished law firm here, retired in
9 2009 as senior partner chair Emeritus of that firm's
10 renowned investment management practice group. She
11 lectures and she provides investment advice and has been
12 admitted to several Bars around the country, a real
13 specialist in this area.

14 Bill Baribault, Trustee and Independent director
15 of American Funds, and chairman of Oakwood Enterprise.
16 Has served as Chief Executive Officer and Chairman of
17 Oakwood Enterprises, previously chief operating officer
18 and director of Henry Company, the chairman of
19 Professional Business Bank until 2009. Throughout his
20 career, he has held various positions including chief
21 executive officer and chairman of Elect-Air for a number
22 of companies. So he's been -- he's been in senior

1 management positions with several companies, a number of
2 advisory and trustee boards for charitable, educational
3 and non-profit organizations in the area.

4 Bill Cvengros, Janus Funds. Cvengros is a
5 Trustee and Independent Director of Janus Funds, a
6 leading mutual fund company offering equity, fixed income
7 and alternative funds to individuals, companies and
8 retirement plans. Also has served as chairman of its
9 committee. He's been Chairman of National Retirement
10 Partners, a national network of advisors to corporate
11 retirement plans. And previously a Chairman of
12 PacketVideo Corporation. Past CEO and president of Pimco
13 Advisors, LLC, and has been on a number of boards. He
14 is -- he is currently the chairman of the audit committee
15 of Janus Funds.

16 So we're -- we have a group of people who have
17 seen it from several areas. So we welcome you and thank
18 you, and turn it over to Julie Allecta.

19 MS. ALLECTA: Good afternoon. And thank you
20 very much, Chairman Doty. That was a very nice
21 introduction.

22 And I also add that as a young lawyer I had the

1 privilege of training under Bob Pozen and Harvey Pitt,
2 so --

3 CHAIRMAN DOTY: I would say that's satisfying two
4 of the most demanding critics. It will make this panel
5 no problem.

6 MS. ALLECTA: Yes.

7 CHAIRMAN DOTY: This board no problem for you.

8 MS. ALLECTA: And welcome other board members as
9 well. I hope you're -- you're enjoying good California
10 weather.

11 I'm the independent director of the Forward
12 Funds, which is a San Francisco-based mutual fund group.
13 And I'll just point out that you've got a really nice
14 cross section here, because the Forward Funds represent
15 what I would call a smaller fund group, five billion.

16 Janus represents a very sizeable fund group. And
17 then we have the American Funds, who are in the -- you
18 know, extremely large fund group, would you say, right
19 up there. So it's a great cross section. And I
20 appreciate being part of the panel.

21 My comments today are my personal views and not
22 the views of the Forward Funds. And I want to focus

1 specifically on two areas where the PCAOB requested
2 comments, and two areas that I don't think have been
3 talked about a lot so far. Because you've heard, I
4 believe it's Barbara -- or Bonnie Hill pointed out,
5 you've heard a lot of things over and over again. I'm
6 trying to find something different, different information
7 to bring to you.

8 One of -- one point I'd like to make is that
9 there is a unique aspect to the structure. Perhaps not
10 unique, maybe it's just an unusual aspect of the
11 structure of a mutual fund that makes a rule like
12 mandatory audit firm rotation particularly inappropriate
13 for funds. So this might go to the question 26 on the
14 Concept Release, page 21, which says is there a subset
15 of issues that maybe we ought to think about differently.
16 And I think mutual funds might be one such subset.

17 In the United States, we developed a highly
18 successful model for mutual fund governance based on the
19 Investment Company Act. And that Act incorporates a lot
20 of independent guarantees, particularly with respect to
21 the audit process. The Sarbanes-Oxley amendments in 2002
22 enhanced those quite a bit. So this may be a small

1 segment of the issue or industry that isn't as affected
2 by audit scandals and problems.

3 I want to endorse the comments submitted by the
4 Mutual Fund Directors Forum and the Investment Directors
5 Council, and very quickly just generally point out that
6 they made good points that rotation, audit firm rotation
7 would impose burdensome costs to mutual funds, which
8 would get directly passed onto shareholders. There's no
9 products that mutual funds make where we can somehow
10 build it into the cost of our goods sold or something
11 like that.

12 The increase in cost is going to go directly to
13 a diminished return to investors. It would likely be
14 diminished in audit quality and an increase in the risk
15 of errors or things not as well looked into, valuation
16 issues not as carefully explored.

17 Plus, there's a very limited number of audit
18 firms. We've talked about that. And I think that Bonnie
19 Hill made that wonderful observation of timing. Well
20 think how much more complicated it is for the mutual fund
21 where you have a variety of investment pools with
22 different year ends, one every month. I mean, now you're

1 -- now you've logarithmically leveraged the difficulty
2 of moving from one audit firm to another. Because even
3 a small group like the Forward Funds uses -- heavily uses
4 two of the four firms that do 99 percent of the work in
5 this area. And, well, there just are practical
6 constraints on audit firm rotation.

7 But what I think is really special, and what I'd
8 like to emphasize in my remarks, is to be very clear in
9 thinking about the investment pool, which is the mutual
10 fund and the management and administration companies that
11 prepare the financial statements for the investment fund.

12 Investment companies are just the assets. It
13 doesn't have employees. It really doesn't have
14 operations. But it is a client of management firms,
15 distribution firms and administration firms. And it pays
16 those firms, it outsource to those firms for preparation
17 of financial statements, among other things. Those
18 firms, they have their own boards, their own
19 shareholders, their own auditors. But for the pool of
20 asset, there's a very independent board there, and
21 independent audit committee and those individuals select
22 the auditors that are going to review the financial

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1 statements prepared by the management firms and
2 administration firms that the fund employs.

3 So there is already a separation of function that
4 provides additional firewalls or insulations or -- or
5 independence protection. And I -- I'm not sure that in
6 the comments that I've read so far, in the comment
7 letters that, that that has really come out as a -- as
8 an excellent reason why mutual funds and similar entities
9 need to be thought of differently.

10 The other issue that I want to point out, and
11 maybe it's just a reminder, is that there are so many
12 independent guarantees in the Investment Company Act and
13 in the regulations. Not only is the pool separate and
14 the board separate, but independent directors are
15 exclusively in control of adding new independent
16 directors. The ability of management to exert influence
17 diminished quite a bit by statutory protections.

18 There also is, by required law, a compliance
19 officer that looks at financial statement and accounting
20 matters and reports to the board. And this is -- this
21 is a staff person, if you want to think of it that way,
22 that is an exclusive watchdog over the service

1 organizations for the independent directors, then the
2 financial expert and the other guarantees of quality and
3 independence.

4 So this structure means that it's very difficult
5 for -- it's like it's hard for me to envision any way in
6 which the management companies or administration
7 companies can -- can bias or lean on the audit firms with
8 respect to the tough audit calls. I loved, I loved the
9 analogy this morning of a good audit partner to the inch
10 of marshmallow around the brick column, because that
11 really is the ideal audit partner. And the -- the
12 ability of -- of -- well, of being able to influence a
13 tough call on valuation or how a security should be
14 classified for purposes of valuation, or how a tax issue
15 should be looked at, I think is -- it's very difficult
16 to do in the fund industry.

17 I've probably used up my time, but there's
18 another part of the Concept Release that I would like to
19 address, and that is, despite the fact that I feel mutual
20 funds are different and already have great audit
21 integrity, I think there's always room to think about
22 improvement. And it's healthy to think about ways that

1 audit integrity can be improved. And in thinking about
2 it, I have two observations to throw out to you.

3 One is, it would be expensive to mandatorily
4 rotate audit firms, and it might be impossible even. But
5 there's no reason why a concurring audit couldn't be done
6 every -- I don't want to be like Bob Pozen and pull out
7 an arbitrary number -- but every seven years, every eight
8 years by another firm. A second audit, yes, there's a
9 cost, but that's defrayed over a period of time. And
10 that might also serve the benefit of a periodic RFP
11 because it introduces another of the audit firm's to the
12 board and to the audit committee in the primary role of
13 auditor. So I think the concurring audit approach might
14 be one you bed think about.

15 I also think if you want to start with areas
16 where there are the most -- the most conflicts. In my
17 experience, the most conflict-full situation is the
18 situation where the audit firm that is auditing the pool
19 of assets is also doing the primary audit or substantial
20 non-audit work for one of the major administration,
21 management or distribution companies. In other words,
22 you've got the same firm working on both sides of the

1 stem, either as primary auditor or as a substantial
2 consultant.

3 There you've got some economic pressures. I
4 don't want to say there's a conflict. But it might be
5 in those situations that you would want to think about
6 introducing additional, either PCAOB inspections or
7 controls.

8 And with that, I'll turn the mic over to my
9 colleague, Bill Baribault.

10 MR. BARIBAULT: Thank you very much. And thank
11 you, Mr. Chairman and the board for traveling to
12 California and giving us an opportunity to present to
13 you.

14 I'm going to -- thank you for that introduction
15 as well, so I'll skip that in my notes here. But it's
16 important that we recognize that my views are not
17 necessarily the views of other board and audit committee
18 members of the American Funds and Capital Research and
19 Management Investment Advisor, the investment advisor in
20 our case.

21 I am an independent director and a trustee of the
22 16 of the fixed income American Funds. American Funds

1 Insurance Series, American Funds Portfolio Series, and
2 American Funds Target Date Funds. Most importantly
3 regarding my perspective, I am also a shareholder in the
4 funds.

5 Based on the responsibilities and interests of an
6 independent director and shareholder, I'm especially
7 interested in audit independence and quality. I concur
8 with the recommendation made last December by our
9 American Funds audit committee chairpersons.

10 Their recommendation, and I quote, are, "Diverse
11 backgrounds combined with our expertise, our experiences
12 as audit committee chairpersons, lead us to the
13 conclusion that mandatory audit firm rotation does not
14 achieve a subjective."

15 Two comments, and you've heard of a lot of pros
16 and cons during the day of -- of audit firm rotation, but
17 two observations in our case. First, based on the size
18 of our fund complex, we have two audit firms, which gives
19 our boards a very great opportunity to review the work
20 of two firms, to review their perspective on challenges,
21 regulatory changes and all the issues that we face with
22 our board of responsibility.

1 Second, and thank you to the PCAOB's most recent
2 inspection, we were able to sit with one of our audit
3 firms and go through the Part II report and deal in great
4 detail with what had occurred, how they handled, and what
5 immediate action they were taking, and basically a very
6 open discussion and dialogue between that audit firm as
7 a consequence of your inspection.

8 So while you hear many criticisms, this is an
9 interesting opportunity to point out that we had a very
10 lively exchange with an audit firm because of your
11 inspection.

12 This panel discussion presents an opportunity to
13 share ideas that contribute to the fundamental goal of
14 auditor independence and quality. The following list of
15 recommendations, I believe, facilitates auditor
16 independence, skepticism, objectivity, audit quality,
17 which leads to an increase in audit committee
18 effectiveness.

19 First, it would be great if you were able to
20 share individual inspection reports with the audit firm's
21 clients, whose audits have been selected for review, in
22 order to have transparency, promote discussion, and

1 enhance the audit committee's review of the engagement.

2 Second, expand PCAOB's advisory network to
3 include various industry representations. For example,
4 investment fund audit committee members can add
5 perspective issues and opportunities for quality
6 improvement specific to their industry sector.

7 Third, consider sanctions and penalties that
8 encourage audit firm rotation for material findings, such
9 as undiscovered financial statement fraud from the lack
10 of professional skepticism.

11 Four, review all auditing standards and practices
12 adopted by the PCAOB since its inception to determine
13 their impact on quality and independence.

14 Five, compile and publish a list of best
15 practices from the database of inspections to share with
16 all audit committees to facilitate their learning and
17 review of audit firm performance.

18 Six, recommend guidelines for audit committees to
19 consider audit firm rotation based on calendar, event or
20 partner change, for example.

21 Seven, compile in a systematic manner the
22 circumstances that gave rise to the lack of professional

1 skepticism, and share those with audit committee.

2 There is a running theme here, and you've heard
3 a bunch of it earlier today, is to the extent that
4 there's more transparency, more communication, and better
5 education for audit committee members, the results will
6 be that much more positive.

7 I appreciate the opportunity today to discuss the
8 issues on auditor independence.

9 MR. CVENGROS: Thank you. And I second the
10 remarks about comes to the west coast. Very helpful to
11 meet the people and person face-to-face as well.

12 My name is Bill Cvengros, and I am an independent
13 trustee and director of the Janus funds, and chair of the
14 audit committee. I think some of my background here, it
15 might be helpful, and I just want to just highlight a few
16 things in terms of this -- this discussion.

17 I've been a CEO of a public company and reported
18 audit results to analysts and other investors as well.
19 I'm the director of three other public companies, and
20 each of those I've been a member and a chair of the audit
21 committee at some point in that cycle.

22 It's interesting to note, as I look back, that

1 this has taken place over the span of about 25 years.
2 I'm not as young as Andy Bailey, but -- so I've had the
3 '80s and '90s and about 2000s and so on. I think it's
4 relevant in that it's been an opportunity to observe the
5 progression that's taken place for oversight and
6 regulatory issues over this period of time, as well as
7 the improvement and the best practices, I think, of audit
8 committees.

9 Like others, I can't speak for my colleagues at
10 Janus, but I can say that the trustees of the Janus funds
11 have a very strong view on the issue of independence in
12 terms of the trustees themselves, as well as the audit
13 firm. We view that as fundamental and critical to our
14 mission of representing the shareholders of our funds.
15 And in this regard we have a couple of points I'd like
16 to point out.

17 In contrast to some funds who merely have -- who
18 have requirements to have, I think, three-quarters
19 independent directors, we have 100 percent of our
20 trustees are independent. There's no management from the
21 advisor. It's totally independent, including the audit
22 committee, of course.

1 We have a board practice of, including all the
2 trustees in the audit committee meetings, even though
3 they're not members of the audit committee, they think
4 it's such an important thing to be part of those
5 meetings, so hear what the auditor has to say, and also
6 to be part of the executive session that takes place with
7 the auditor. And it's also true that the audit firm is
8 separate on the funds from the auditing firm that's the
9 chief firm for the advisor, Janus Capital.

10 So my views are in -- not in favor of mandatory
11 audit rotation, and I have several reasons. I'll go over
12 some of them. A major reason, frankly, is what happened
13 with the PCAOB since the creation of its, you know,
14 authorization with SOX. You have made numerous and wide-
15 ranging improvements, proposals and standards, some might
16 say prodigious. These have been focusing, in many cases,
17 on audit quality and independence of auditing firms. You
18 certainly have been very busy. So, you know, hats off
19 to you.

20 And I've observed over the last 25 years, as I've
21 said, a true progression of these requirements in best
22 practices. And I think overall the audit process and the

1 oversight has improved drastically. Not to say we
2 haven't had mistakes, but the bar has certainly been
3 raised. And, you know, you've been leading the effort
4 in that regard.

5 I think two things really stand out to me, and
6 one is the audit partner rotation which does bring a new
7 set of eyes, often from a different part of the country,
8 a different part of the firm, and as well as as the PCAOB
9 review of the audit firm's audit process. There is no
10 audit partner in the country that was excited about the
11 fact that the PCAOB was going to review them.

12 I also think as a result of all this there's been
13 fewer, not more, audit failures and misstatements of a
14 material nature. And this is all in the context of a
15 world that is much more complex, particularly in the
16 mutual fund business, much more complicated instruments,
17 as well as a world that's been under a lot of stress
18 economically in terms of the financial markets.

19 Another reason I'm not in favor is, that many
20 have talked about, the increased costs, the proposal
21 process, the transition, the sales and marketing efforts,
22 and these would be, in fact, borne by the shareholders

1 of the funds. There's just nobody else there to bear it.
2 And on top of that, there's -- beyond the mutual fund
3 business, there's also the already-increased requirements
4 that are costing public companies more and more money to
5 be public, particularly small and mid-sized companies.

6 There's one thing about the sales and marketing,
7 if there were different persons involved in that process,
8 you might hear fewer accountant jokes because of the
9 nature of the marketers, but -- strike that from the
10 record -- but anyway.

11 I'm very concerned about the disruption at the
12 time of change, the orientation period. Many have talked
13 about that. There is a window there for increased risk
14 in audit failure. I think there's a general sense here
15 by many that shorter-term engagements that are forced by
16 mandatory change would be introducing another level of
17 risk.

18 In the case of the Janus funds, as other funds,
19 mutual fund companies are a special breed. The '40 Act
20 is very complicated, specialized, et cetera, we all know
21 that. And it is very essential to have the leaders in
22 the industry that are on top of the '40 Act in terms of

1 the auditing firms. And there aren't that many. I think
2 the -- we use like, Julie mentioned, two of the four
3 firms already. And I think the audit committees and the
4 clients are best served if, in fact, they are able to
5 find the best and retain the best, if they still think
6 they are the best.

7 Finally, I have a concern about unintended
8 consequences about something like this. It may encourage
9 different business model changes at the auditing firms.
10 This could increase the already extensive travel. One
11 impact may be on women in the profession because of the
12 increased travel of partners and managers on audits, they
13 may not be as interested as being a partner, if that's
14 going to be the case. And there probably might be some
15 other locational issues as well.

16 That being said, is there room for improvement;
17 I think so. But the question is how. And others have
18 given their views. My view would be to focus on making
19 the existing oversight standards as effective as possible
20 to allow a period of continued digestion and evaluation
21 of the impact of the numerous changes and proposals that
22 have been made over the last few years.

1 But there is one thing I think would be a major
2 improvement right now within the context of those
3 standards, and that would be share the non-public
4 information of the PCAOB reviews with the audit
5 committee. And I can assure you that, you know, a well-
6 intentioned independent audit committee is going to take
7 those to heart very seriously. And if they are of the
8 nature that it dictates that they are taking the proper
9 skepticism, independence, and competence, than there
10 would be a review and re-tendering of that audit
11 assignment.

12 So, if after further review and research, the
13 PCAOB thinks there should be something more done in this
14 area besides what's in place now, I could see a step in
15 the direction of having a mandatory re-tendering of the
16 audit firm assignment after a long tenure. Maybe it's
17 10 years or more. If they would open up the process and
18 still allow the audit committee to have the authority and
19 control to retain the firm that they think is the best
20 or hire a new one. So, thank you very much.

21 CHAIRMAN DOTY: Well, thank you all. And we have
22 some question time. And we're going to start with Steve.

1 Once again, Steve Harris.

2 MEMBER HARRIS: Well, Ms. Allecta, I can't resist
3 the temptation, because you worked for two legends and
4 you cited them. As you just cited one as well.

5 Putting the mutual fund complex aside, with
6 respect to the entire rest of the universe, because I
7 think you had mentioned Bob Pozen has written about
8 mandatory re-tendering under limited circumstances, but
9 he's editorialized on that. And then Chairman Pitt has
10 indicated in highly limited circumstances -- and I don't
11 want to get in cross purposes with Chairman Pitt -- but
12 in highly limited circumstances, were there very
13 deficiencies in audit quality, he would support some form
14 of mandatory rotation.

15 Are there any circumstances at all that you would
16 support mandatory re-tendering or mandatory rotation?

17 MS. ALLECTA: Are you asking with respect to
18 operating companies? Yes, I think that's correct.

19 MEMBER HARRIS: Yes. Yes.

20 MS. ALLECTA: And I think the answer is yes. I
21 think there are circumstances that were actually
22 highlighted very nicely by the panel that preceded this

1 one. There are circumstances where there's enough --
2 financial statements are really -- the integrity of the
3 financial statements can't be overstated.

4 And where there is evidence that the accounting
5 firm has been sloppy, has been lazy or perhaps more
6 culpable in producing financial statements that are just
7 erroneous or perhaps even fraudulent in some respect,
8 misleading, certainly that is, you know, a call for
9 replacement.

10 But mandatory replacement for -- just because the
11 clock is ticking, there may be industries where there are
12 so many subjective issues, where GAAP is so unclear or
13 allows a variety of interpretations, there may be
14 industries just as special in those respects as mutual
15 funds are in our respects, that require that fresh set
16 of eyes and that disciplined change. So I would never
17 say no. I suppose the answer is yes, but I'm not
18 knowledgeable enough about which industries might, might
19 really benefit from a mandatory audit firm rotation.

20 Did I dodge the question well enough? Good.

21 MEMBER HARRIS: No. And Mr. Baribault?

22 MR. BARIBAULT: I think I established in my

1 bullet point a theme that would be applicable to -- to
2 all business sectors. If there's a material misstatement
3 or an issue with a financial statement, an audit
4 committee has a responsibility to challenge the audit
5 firm, revisit the question, possibly look outside for
6 help in evaluating what that was. PCAOB, in a case of
7 an inspection report, might raise something to that
8 level. And I think there is a responsibility. And I
9 think it should be encouraged.

10 I think, again, what I'm focused on most clearly
11 here is the concept of a calendar replacing a process.
12 I think responsible audit committees are well-prepared,
13 well-trained. I heard a comment earlier today about
14 encouraging retired partners from audit firms to
15 participate. We in fact do have that in our structure.
16 We have people from the regulatory side. So our attempt
17 is to create an audit committee and a board that's very
18 responsive to current issues and current engagements.
19 And we would be very suspect of a finding that would rise
20 to that level.

21 CHAIRMAN DOTY: Lew? Lewis?

22 MEMBER FERGUSON: First I just want to ask a

1 quick question, but I don't want this to count as my real
2 question. An information question. It's a half
3 question. And this is to Mr. Baribault.

4 You mentioned that one of your audit firms had
5 shared with you what we call part two of our inspection
6 report, which is the sort of confidential part of the
7 audit report that deals with the firm's quality control.
8 Did you happen to know whether that part had already been
9 made public by the firm -- or by us for a failure to
10 remediate, or were they shared that with you which they
11 can do, during the period while we still have no ability
12 to make it public? Because that's a very important
13 question to me. Do you know?

14 MR. BARIBAULT: The answer's somewhat -- it
15 overlapped during that period of time. But we became
16 directly involved after it was public.

17 MEMBER FERGUSON: Okay.

18 MR. BARIBAULT: But we did understand there might
19 be -- or probability that it would be made public. What
20 I'm encouraging the board to consider is, it would
21 enhance the process if audit committees would
22 automatically receive that information. It would create

1 for a much sooner, spirited discussion, an open dialogue,
2 and the information would be helpful.

3 MEMBER FERGUSON: You could get that by -- if you
4 mandated it or put into your agreement with the auditor
5 that that part -- that that be made available to you even
6 during the period when it's confident. But we can't make
7 it -- we have no ability to make it available during the
8 confidential, but the auditor can.

9 MR. BARIBAULT: But what the request is that,
10 could you consider for the particular firm that's been
11 audited, the client relationship, making that report
12 public, I think that's something that we would like the
13 PCAOB to consider.

14 MEMBER FERGUSON: My real question to all of you
15 is a different kind of question.

16 As trustees of these mutual funds, you're
17 shareholders; you also act as shareholders of
18 enterprises. And, frankly, shareholders with a lot of
19 clout. Do you ever think of, or would it be an advisable
20 thing to use your voting power as shareholders -- not
21 necessarily to push for mandatory rotation, but just to
22 use your power as shareholders to suggest to firms that

1 perhaps they want to consider auditor rotation.

2 Particularly in cases, for example -- I used the
3 example of the financial industry recently when not a
4 single major bank in this country had a going concern
5 opinion, and shortly after some of these financial
6 statements were issued in 2007 and 2008, massive bailouts
7 had to be undertaken by the federal government. Is that
8 a case where perhaps people like you all, holders in
9 large of shares should have suggested to these firms that
10 maybe they wanted to consider auditor rotation in that
11 case?

12 MR. CVENGROS: Well, my view is, the shareholders
13 should speak up in those instances. The large
14 institutional investors try to do that at times, and
15 sometimes it makes a dent and moves the dial. And in our
16 case, I'm not sure we control enough of the, you know,
17 investment assets in a hundred billion dollar complex in
18 the case of Janus to really move that dial that way.

19 MR. BARIBAULT: I would submit, in our
20 environment, our proxy committee has some very healthy
21 debates on voting and what the issues will be, and
22 decisions and recommendations. So it does come under

1 great scrutiny in our -- in our complex.

2 MS. ALLECTA: Even in our small fund group, we
3 take our proxy voting very seriously. But there is --
4 there's very little influence beside billion dollars
5 spread around can do, so. But it's a -- but all of us
6 together have a lot of influence. And firms like Glass
7 Lewis are very helpful in providing guidance to us.

8 And increasingly, I think, there's more
9 willingness -- now I'm just speaking generally -- there's
10 more willingness to take mutual fund proxy voting
11 seriously. It used to be that we voted with our feet.
12 If you didn't like a company, you sold it. That was --
13 or, regardless of whether you liked it or not, if you
14 thought the price was going to go up, you bought it or
15 held it. Now, I think there's much more consideration
16 about ethics and issues like that within the proxy
17 voting, rules and procedures and protocols that all fund
18 groups have. So, yes, there's a movement in that
19 direction, low-hill trend.

20 CHAIRMAN DOTY: Jeanette Franzel?

21 MEMBER FRANZEL: I want to make sure I understand
22 the unique structure that you cited that would maybe make

1 a mandatory firm rotation requirement inappropriate for
2 the mutual fund industry.

3 You talked about the pool of assets and then the
4 management and administration company that prepares the
5 financial statements. And the, I guess the safeguards
6 that were there. If you could elaborate on that a little
7 bit.

8 And then each of you mentioned you were using two
9 audit firms. And I wanted to just follow up to ask if
10 those firms were doing, were both doing audit work, or
11 one was the consulting firm and one was the audit firm.

12 MS. ALLECTA: I'll answer the second question,
13 because it's a quick answer. With the exception of the
14 American Funds, I think it's fair to say that most fund
15 groups have one firm that does the primary audit. But
16 because of the nature of the securities that are held in
17 these investment pools, and because of the tax issues and
18 tax issues in India and foreign countries, and a variety
19 of complex issues like that, there usually is a second
20 firm that is brought in for consulting purposes in that
21 area. And there may be other non-audit work that's done
22 by a second firm that has to do with the tax evaluation

1 issues.

2 And Bill can elaborate as to what Janus uses its
3 second auditor firm. But one primary firm.

4 The second -- or on the first question, I think
5 the point that I was trying to make is that -- I'm going
6 to use an example not at this table. I'm going to use
7 the Franklin Funds. At Franklin resources, you have a
8 public company. You've got a board of directors. You've
9 got shareholders who own money in that public company.
10 You've got an auditor that audits those financial
11 statements. And people buy and sell that stock in
12 reliance on financial statements. They haven't -- may
13 have a penny -- not a penny invested in a Franklin fund.

14 Over on the funds side, you've got a separate
15 group of shareholders who are the investors in the pool
16 of money that Franklin resources employees have decided
17 should be in that pool. And you've got a separate board,
18 and you've got a separate audit committee. And there's
19 more independence on that side than on the Franklin
20 resources side.

21 Management of Franklin resources, quite frankly,
22 has impact on the composition of its board of directors,

1 on what happens in the audit committee, and what happens
2 in the preparation of financial statements for itself and
3 in the selection of auditors. It has less impact, less
4 ability to influence the selection of auditors and the
5 work of the auditors and the integrity of the audit on
6 the side of the funds where there's this other structure,
7 other board in charge.

8 I don't know if that makes it any clearer, but
9 hopefully it does.

10 MEMBER FRANZEL: Yes, thank you.

11 MR. CVENGROS: And in our case, we use the -- we
12 have a primary audit firm. And then the other one that
13 we use is there for a non-required, but we think best
14 practice to have a SAS 16 for all of our major service
15 providers. So it gives us checks on the controls of
16 those service providers.

17 MR. BARIBAULT: In the case of our funds, we have
18 two audit firms, each one basically auditing different
19 parts of the complex. So they are, they're equals in a
20 sense. They're not one subservient to the other.

21 What I think makes that situation work well for
22 us, is it gives us the ability each year, when we are

1 reviewing the engagement for an upcoming period, do we
2 have the kind of criticism we're expecting, do we have
3 the skepticism, the curiosity to really chase issues that
4 are important to us as a board. And by having two
5 different audit firms basically, as we have, really
6 facilitates the process, because you'll find different
7 nuances coming from one, and the other enables us to
8 spend time with each of them, and really almost get the
9 best practices from -- from each.

10 The other information that's, I think, relevant
11 to this is, we, unlike any other -- you might say public
12 company boards -- we not the board of the investment
13 advisor. We're not the same as a public company. We're
14 not looking at compensation of officers of the company.
15 We are really there to look critically at two activities.
16 One, the audit process engagement for the public
17 accounting firm. We also have the same two of four that
18 everybody kind of refers to.

19 But equally important; on an annual basis, we
20 actually renew the engagement for the investment advisor.
21 We discuss fees. We discuss performance. But where our
22 firewall on that other side of not trying to run the

1 investment advisor or the management company. And that
2 gives this board a tremendous increase in its
3 independence, the scope and breadth of what it looks to.

4 And I think there's a risk element that's
5 different in the fund business. The books get closed
6 every day. Everything is market to market at the closing
7 of a day. So I listened to one of your earlier panels
8 and there was a discussion of fair valuation. Well, we
9 do it every single day. And one of the audit firm's
10 primary responsibilities is to really validate that
11 process, make certain its accurate and look for
12 variations or anything that might be a challenge.

13 So there's a great intensity on what is important
14 to our investor. And our investor is our shareholder.
15 And we view that we have the responsibility, I think the
16 supreme court somewhere along the way made a reference
17 that we are the watchdogs on behalf of the stockholder,
18 investor.

19 MEMBER HARRIS: I want to follow up on a couple
20 points you've made about expertise of the audit firm in
21 the mutual fund area in this '40 Act. And the drawback
22 to a format like this where you're talking to us is, you

1 don't get a chance to sit face-to-face with the people
2 that have the opposite view, and actually have a debate
3 about some of the issues. And so this is my way of
4 creating the debate about that expertise issue.

5 We've heard in other round-tables, other forums,
6 in fact from some speakers this morning that, you know,
7 audit firms, they might not have an expertise in
8 something, but they will never claim they can't do the
9 work, and they will always figure it out and get it done.
10 And looked at what happened when Andersen failed, that
11 lots of firms jumped in and got the work done. And so
12 this expertise argument is way overblown, way overrated.
13 There's plenty of firms that you could pick from, the big
14 four and any one of the top hundred firms could do the
15 work.

16 So if I were the cynic in your face saying that's
17 an overblown excuse, what's your response?

18 MR. CVENGROS: My response would be that the
19 market sort of tells you, you know, which firms in a way
20 are showing their expertise and they become the leaders
21 in that field. And the other ones that never made it or
22 didn't last, they didn't have the expertise to keep up

1 with the myriad of regulations and rules and so on that
2 go on with the Investment Company Act of '40. And they
3 don't have the staff to keep up with the number one
4 thing, which Bill mentioned, which is valuing the
5 securities daily.

6 And not every one of them is liquid, you know,
7 with a real active market. So you have to have other
8 checks and balances to make sure that your level two and
9 your level three valuations are put in place properly.
10 And then you get into some of the things in terms of
11 international funds, and they have their own particular
12 rules which a local, a very reputable local firm, you
13 know, a regional firm, you know, may be capable. But
14 when they start to go internationally for funds, well,
15 that's a different thing, you know. You get in a
16 different world.

17 MS. ALLECTA: And let me start by saying I think
18 the word expertise might not be quite the right word.

19 In the beginning, life was simple. We invested
20 primarily in publicly-traded stock exchange listed
21 securities, and there were excellent boutique '40 Act
22 accounting firms, as well as numerous larger firms. Life

1 got more complicated, particularly in the valuation area.

2 And now with the need to have independent
3 valuation verification, the audit firms that can do
4 mutual funds -- and by the way, we're not a huge industry
5 segment. So if you're making a decision to specialize
6 in this area and to build in the technology, you've got
7 to have enough market out there to support it. They have
8 to spend an incredible amount of money, energy and
9 resource on developing valuation sophistication. Smaller
10 firms can't make this investment. So smaller firms, the
11 better ones, have been absorbed by the larger firms.
12 Just because the world's become more complicated, you
13 need a much higher degree of technical support for that.

14 It's also true on the tax side. The tax side of
15 mutual fund investing has become much more complicated,
16 because we now own Slovenian-defaulted debt. We now own
17 securities in Sri Lanka through different entities,
18 because you can't have direct non-local ownership, et
19 cetera. So there are -- there have come into existence
20 huge areas of complexity that smaller firms simply can't
21 support the investment.

22 It's not that they don't have the expertise, they

1 just don't have the capital. There's been a capital
2 hurdle that they can't overcome.

3 MR. BARIBAULT: My personal response on the
4 concept of specialization is to easily summarize as --
5 in the context of the audit partner, and are there enough
6 audit partners who are around to have these expertise.
7 There may be. But it goes far beyond that.

8 When we see the audit partners rotating, when we
9 see new, young aspiring partners in this growth mode of
10 learning this particular industry or specialization, when
11 we see the people supporting them, it's clear that, as
12 you comment, the investment that's involved, but it's
13 also the resolve and commitment to aggregate and pull
14 together that talent into one firm.

15 And that's very difficult to outsource to other
16 resources. Because it is a career. It's a point of
17 specialization. And we've been able to see -- I've been
18 able to see specifically the growth of young people in
19 a firm, and one day will make partner, and one day maybe
20 be, you know, partner assigned to our assignment, and all
21 the breadth and depths that they've had as real
22 experience would be hard to duplicate on the outside.

1 MEMBER HARRIS: What's the universe that we're
2 talking about with respect to the audit firms that have
3 the appropriate level of expertise of what we're talking
4 about here? Because you take a look at the various
5 industry figures in terms of concentration. Are we
6 talking about a handful, a half a dozen? Or what's, in
7 terms of the audit firms that are capable of auditing a
8 mutual fund complex, what --

9 MS. ALLECTA: I don't want to get into trouble
10 here. There are the big four. And among the big four,
11 there are probably three that are -- that enjoy a little
12 bit better reputation. Although that varies a little
13 bit. Hedge funds and funds that are more on that side
14 might see it differently.

15 There's one that is dominant among the big four,
16 but perhaps not hugely dominant. And there are a few
17 smaller firms that are competent, but they couldn't --
18 they couldn't handle a company of Forward Fund's size,
19 which is quite modest, five billion. But they certainly
20 could handle smaller pools and have some degree of
21 sophistication, provided the instruments in those pools
22 weren't too difficult to value.

1 And I believe in the Independent Directors
2 Council letter, they pointed out that 99 percent of the
3 assets of the industry are in fact audited by these four
4 firms. So that tells you something about the
5 concentration.

6 MEMBER HARRIS: I'm just wondering why partners
7 at these firms, for example, wouldn't set up a boutique
8 firm.

9 MS. ALLECTA: Well, many of the best partners at
10 those firms were in boutique firms. One was them was
11 McGladrey & Pullen. They could not afford to invest in
12 the technology to do the independent valuation work
13 necessary to independently value the securities held in
14 the portfolios of a Janus international fund or a Forward
15 alternatives fund.

16 So it was just a question of the world becoming
17 more complicated and demanding more technology than a
18 small audit firm with a few number of partners could
19 afford to take on.

20 MEMBER HARRIS: So are we essentially saying that
21 this is a natural oligopoly?

22 MS. ALLECTA: It has -- yes, it has. And I was

1 intrigued by the way in the immediate past panel, CalSTRS
2 went from a regional provider to a national provider.
3 I don't know why, but I just made a note. Here's another
4 case we've gone the oligopolistic path.

5 And I think it's something important for the
6 PCAOB to look at, is whether the demands we make on the
7 integrity and quality of the audit are such that firms
8 that want to play in the audit business for big companies
9 or for companies like mutual funds that have complex
10 instruments have to make such significant capital
11 investments that you're promoting natural oligopolies.

12 MR. BARIBAULT: I think it was presented at an
13 earlier session, that by going to the top 10, there was
14 a significant cost increase, and the belief there was,
15 that that was in the best interest of independence and
16 maybe accuracy.

17 It's our perspective, with the two people -- the
18 two firms that we use that we have that bit of
19 competition in-house already. We have the kind of due
20 diligence that we have pursued.

21 And if we then begin to compare costs and the
22 alternatives, we would be spending our shareholders'

1 money, then that becomes, as an independent director and
2 a shareholder and not with the audit firm or with the
3 investment management company, it really is all about the
4 shareholder. So we're very focused on that balance
5 between quality, independence, skepticism and cost.
6 That's why you find us concerned about cost.

7 MEMBER FERGUSON: I have a question that, you
8 know, I'm intrigued by the fact that you have the
9 benefits of watching two audit firms do the same thing
10 essentially. And we've had various -- or heard of
11 various proposals at different times about -- for
12 example, you may have heard the panel early today where
13 one of the panelists suggested rotating in a manager from
14 a different firm. We've had people suggest to us that
15 periodically the concurring partner come from a different
16 firm. Or that sometimes, perhaps periodically there
17 should be a concurring audit. I think you suggested this
18 is a second audit.

19 Based on your own experiences, the experiences of
20 any of you with seeing two audit firms work at once where
21 you see that, do you think a proposal like that makes
22 sense where audit committees should periodically have a

1 second person, kind of a second firm or second
2 individuals in the team or from outside it is firm take
3 a look at what the auditor is doing to give the board of
4 directors and the audit committee a broader perspective
5 on the -- or particularly where the relationship is a
6 long one between the auditor and the company?

7 MR. BARIBAULT: I do not support that. The cost
8 associated versus what's really occurring in the
9 marketplace -- so my question would be, what evidence,
10 what's happened in this marketplace to create the
11 interest and the need? What are the metrics?

12 There was some conversation earlier about
13 understanding of the research. If PCAOB were to share
14 with us best practices and share with us maybe without
15 naming parties, the information that's contained in those
16 examinations, then I think you'd be achieving the same
17 thing. You'd be achieving the challenge that's
18 appropriate, and yet the audit committee would still
19 maintain its primary responsibility to the shareholder,
20 and in one of those roles under the '40s Act selection
21 of the audit firm.

22 MS. ALLECTA: I suggested it because, in part

1 because -- I and hope this is not a violation of
2 attorney-client privilege, but at one point I had the
3 honor of being counsel to the American Funds, and I saw
4 this practice, and in my mind it created some very
5 healthy benefits, not the least of which was the ability
6 to negotiate contract terms.

7 For somebody like the Forward Funds, trying to
8 put in a clause like we want to be able to see part two
9 of any PCAOB -- I mean that would be like going onto
10 iTunes and clicking don't agree and then expecting to get
11 something. I mean, there's no negotiating leverage that
12 any fund group under \$20 billion has with an audit firm.

13 So two audit firms does enrich the experience,
14 just the way going out on an RFP enriches the experience.
15 And it's a cost. And so I think one needs to do the cost
16 benefit analysis carefully. You don't want to do it
17 casually. You don't want to invite people to come in and
18 -- I don't like the RFP suggestion, because that's kind
19 of like saying we're really inclined to keep the guys we
20 have but we feel like, you know, we got to have a beauty
21 contest.

22 I like it because we're saying, "We're paying you

1 for a real service. You're going it come in and do an
2 audit." And in the meantime, we get to see a whole new
3 approach, a whole new way of doing things. And as an
4 audit committee chair, it gets me thinking. And so I
5 think it could be a healthy process, and I think the cost
6 could be made reasonable.

7 Do I think it's necessary? No. I mean, my
8 bottom line is, I think it's an unnecessary additional
9 assurance right now. But if you find that you need
10 additional assurances from mutual funds, I think that's
11 an idea that I'd like to hear other people comment on.

12 MR. BARIBAULT: I have one additional thought.
13 There could be an assumption -- and I'm adverse to it --
14 that there's an opinion-shopping process going on that
15 could be introduced into the process unintentionally, but
16 still there. So I revert back to having a highly
17 disciplined audit committee with good information who's
18 well-educated, is committed to continuing education, and
19 asks all the right questions. And by you pointing that
20 out to us, helping us in that forum will make us much
21 more effective.

22 MR. CVENGROS: And I would just add that not all

1 mutual fund complexes are in a position, really, to have
2 two auditing firms. I mean, if you're -- if there's many
3 trusts, separates trusts and funds as maybe American
4 Funds, it gives you that opportunity to do it because
5 there's a scale there that you can operate with each of
6 these auditing firms.

7 But to segment smaller number of funds and have
8 two auditors in with the advisors working with them is
9 -- it would be cumbersome and additional costs to the
10 shareholders. But I think it's a great idea that
11 American can do that.

12 CHAIRMAN DOTY: We are scheduled for a break, a
13 five-minute break. But I want to thank this panel,
14 because all of your comments, of course, and your papers
15 go into the record. We have the record to look back on
16 and to be able to rely on all of your thoughts.

17 You have made a very thoughtful presentation of
18 some very important distinctions between the mutual fund
19 industry in the operating company universe, and they're,
20 all of them, very useful to us in evaluating what we have
21 to do, especially with regard to the specific proposals
22 that Bill Baribault made, and that you each in our own

1 way have indicated in your materials. So thank you.

2 And we'll break briefly. And we'll be back here
3 at, let's say 3:50.

4 (Whereupon, the above-entitled matter went off
5 the record at 3:44 p.m. and resumed at 3:50 p.m.)

6 CHAIRMAN DOTY: Well, I'm sure the preparers feel
7 that it's been a long day, and that we're late getting
8 to the preparers. But we're now -- that's where we are
9 now.

10 Ken Goldman, Senior Vice President and Chief
11 Financial Officer, Fortinet, Inc., a provider of unified
12 threat management solutions. He served as senior vice
13 president, finance and administration and chief financial
14 officer of Siebel Systems, Inc., the software solutions
15 and services giant acquired by Oracle in January 2006.
16 Prior to August 2000, he served as senior vice president
17 of finance, chief financial officer of Excite@Home
18 Corporation and Sybase. He served as chief financial
19 officer at Cypress Semiconductor and VLSI Technology.
20 Named among America's 15 most connected capitalists for
21 2010 by Forbes Magazine. We're going to have to talk
22 about that, Ken Goldman. And served on the board --

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1 numerous boards of public companies, and he was a member
2 of the Treasury Advisory Committee on the auditing
3 profession. And previously served on the FASB's primary
4 Advisory Group, the Financial Accounting Standards
5 Advisory Council.

6 Welcome, Kenneth Goldman. You bring a lot to
7 this discussion. And we do want to know -- we do want
8 to know what you had to do to be connected; whether it
9 was electronic or virtual is going to be very important.

10 Richard Levy. Rich Levy is Executive Vice
11 President and Controller of Wells Fargo. Joined Wells
12 Fargo as controller in 2002. Has over 30 years of public
13 accounting and financial services industry experience.
14 Before joining the company, he was senior vice president
15 and controller for New York Life. Previously a partner
16 with Coopers & Lybrand where he headed the firm's
17 national tax practice for financial institutions. And
18 before his experience at Coopers & Lybrand, he was a
19 senior VP at Mid-Atlantic, a New Jersey-based regional
20 bank holding company. Began his career with Deloitte &
21 Touche. Welcome, Rich Levy. Good to have you.

22 Kevin McBride, External Reporting and Treasury

1 Accounting Controller of Intel Corporation. Mr. McBride
2 is the -- is responsible in Intel for leading Intel's
3 treasury accounting and SEC reporting activities. He
4 joined Intel in 2000 as an accounting policy manager.
5 In 2005, he completed a two-year fellowship at the
6 Financial Accounting Standards Board. Mr. McBride has
7 led and managed Intel's technical accounting activities
8 through 2009. And prior to joining Intel, he was an
9 audit manager at KPMG in Portland, Oregon. He's
10 participated in numerous professional initiatives,
11 including the FBI's annual current financial reporting
12 issues, the AICPA National Convention, and the SEC
13 Institute Conference on Fair Value Measurements. He is
14 a member of the Center for Audit Quality SEC Regulations
15 Committee. Welcome, Kevin, McBride.

16 Welcome to all of you. Thank you. And we'll
17 start, Ken Goldman, with you.

18 MR. GOLDMAN: How's that? Starting now? Okay.

19 So, anyway, thank you, Chairman Doty, and other
20 members for inviting myself and others, and frankly for
21 coming out here to the west coast and getting our
22 thoughts.

1 I do plan on, very quickly, talking about my
2 background relative to this committee. Some things I've
3 done to prepare for this panel, my sense of pros and cons
4 related to the mandatory auditor rotation, and honestly
5 some other alternatives that I think would help improve
6 auditor effectiveness to this committee.

7 You are correct, by way of background, I am a CFO
8 of Fortinet. I have been actually CFO over a number of
9 public companies that you note. Actually, 30 years going
10 on being a CFO of public -- primarily public companies.
11 Over 25 years, actually, of public. On a number of
12 public boards and private boards. Actually, well over
13 20 over the last few years.

14 Currently chairman of the audit committee of NXP
15 Semiconductor, on the -- also Infinera, and was chairman
16 of the audit committee of Juniper, Starent and Legato.
17 So I've been in a variety of things. Plus I'm on the --
18 I still remain on the board of Cornell University, and
19 I'm going to come back to that in a while.

20 In terms of preparing for today, I did review my
21 experiences, my experience on the FASAC board of
22 1999/2003, the Advisory Committee on the Auditing

1 Profession that you mentioned, and you said a number of
2 the recommendations that we came up with, sort of
3 unfortunately that report, you may note, came out in
4 October of 2008, very timely, and I think now sits in a
5 museum, all 12 binders of such. But I will come back to
6 some of the comments and recommendations there, because
7 I think they -- they bear on today.

8 Let me take -- let me actually do -- talk about
9 some of the progress. And I think people forget this, and
10 I did hear some other panelists talk about that today.
11 So since Sarbanes-Oxley in 2002, we now have CEOs' and
12 CFOs' certifications. We have mandatory five-year
13 partner rotations. We have SOX for internal controls.
14 We have auditor services independence requirements. We
15 have the audit committee response overseeing the
16 auditors. We have a more robust private regulatory
17 regime, thankfully under yourselves. We have audit
18 committees composed of expert members. We have more
19 frequent mandatory filing reviews by the SEC and a whole
20 host of other changes.

21 So actually you have to step back, and before you
22 want to make some changes, think about some of the

1 progress that has been made. And I also thought that
2 back to -- because I remember the period well in the late
3 '90s, in like 1990s, and there were a few bad apples, so
4 to speak, and I would sometimes remind people not to take
5 too much from some bad folks when most folks do -- and
6 I would say the CFOs and audit committees that I know
7 take this job -- and auditors take this job very, very
8 seriously.

9 And I did note, I was looking at some of the
10 data, that audit restatements are down 80 percent from
11 2005. Class action lawsuits down by over half in that
12 time frame. So let me now address mandatory auditor
13 rotation, which I am not in favor of, which you can
14 probably expect.

15 For those with short memories, I would remind
16 you, we used to have eight firms. Through misplaced
17 consolidation, in my judgment, and elimination of Arthur
18 Andersen, we're now down to four. And I think I just
19 actually heard the prior panelist note that these four
20 firms now audit 98 percent of the market capitalization
21 of U.S. public companies. That's actually comparable for
22 other major capital markets.

1 In practice, we use, I use other firms for
2 various other non-audit services, which now, by the way
3 -- and our own financials, our own auditors, and as well
4 as the others, you know, our non-audit service from our
5 own firm is down to like 20 percent from 50 percent that
6 it was back in 2002. And in many cases, you may have
7 other auditors as your customers. So it makes it very,
8 very hard.

9 Other industries you find constraints relative to
10 industry experience by geographic presence that severely
11 limits the alternatives. And ironically and perversely,
12 changing auditors many times has a negative connotation
13 for investors. Either an existing auditor prefers not
14 to work for the company or vice versa, and hard to really
15 -- it's hard to understand fully the rationale for the
16 auditor change by investors.

17 In a related situation, I was on a -- I'm
18 actually still on the Cornell University board, a number
19 of years ago, we actually did put up our audit for a
20 competitive bid. And we did change from an existing
21 auditor to a new auditor, not for cost, which was
22 incidentally -- which ended up becoming more competitive

1 then our prior firm, but because the new firm uniquely
2 possessed relevant industry experience auditing the very
3 top university similar to our size, and could field a
4 team for us in Ithaca, which is no easy task.

5 I also mentioned we never really looked at a
6 non-big four firm. And so -- and this firm also -- so
7 when you look at it, actually it's interesting. For
8 example, the four firms -- we did move from the existing
9 firm in this case, and it was really one firm that really
10 had what we considered to be not only the relevant
11 experience, but in this case, geographic presence both
12 in Ithaca and actually coming out of Syracuse.

13 So I -- I've broken up my general recommendations
14 into two parts here just to sort of make it easier to
15 digest, and some more relate to mandatory auditor
16 rotation, and then others some other general suggestions.

17 I would actually require large companies to bid
18 out the audit every 10 to 15 years, some flexibility in
19 that time frame. And if they choose to keep their
20 existing firm, explain why. Additionally, all public
21 company audit changes and reasons must be disclosed.
22 Auditing firms must notify the PCAOB of premature auditor

1 -- premature engagement partner changes at audit clients.

2 You know, in thinking of this, I actually was
3 thinking about last study results of companies that have
4 changed auditors relative to audit quality. Is there a
5 link between audit quality and changing auditors? Do
6 negative perceptions exist regarding auditor changes?
7 What is the fundamental reason and benefit or problem
8 were trying to fix via audit rotation? And so think
9 about all of those in terms of making a change.

10 Two, I like Arthur Levitt's suggestion of when a
11 mandatory audit change may need to be addressed. For
12 example, when there are restatements, non-audit services
13 become too high, and so forth.

14 Three -- you're going to like this one -- require
15 both engagement partner and reviewing partner to sign the
16 opinion, either a 10-K or the proxy. Span scope of audit
17 committee reporting proxy relating to auditor
18 independence, objectivity and professional judgment. I
19 would more formalize the role of the reviewing partner.
20 I find the reviewing partner, even though it's a very
21 important aspect, is not totally clear sometimes.

22 Five, publicize and issue best practices and

1 learning developed through the PCAOB reviews of company
2 audits and make these more public to the companies
3 involved. Continue to publicize and replicate
4 improvements made in firm audit methodologies. Audit
5 firms to discuss inspection results more fully with the
6 company audit committees.

7 Controversially, perhaps, increase the mandatory
8 -- contrary to what you -- what everybody was talking
9 about -- increase the mandatory partner rotation from
10 five years back to seven. In reality, the first two
11 years -- I see this over and over -- are training and
12 learning the account.

13 There are a couple of good years in the middle,
14 about three years maybe, and then year five is when
15 rotation. So before you get into changing, you know, the
16 five years, the first couple of years the new person --
17 the new partner's getting onboard, you know two or three
18 years where they're fully onboard, and then all of a
19 sudden you're back into a partner rotation. It just
20 seems like every -- I'm going through this constantly in
21 terms of partner rotation.

22 And you know something, it's all about the

1 people. I would focus on ensuring appropriate human
2 capital steps to ensure trained and competent auditors
3 at all levels. And I certainly hope we don't suggest a
4 mandatory CFO rotation.

5 Let me just take -- you know, one more minute,
6 and I'll talk about some other suggestions that I thought
7 of. One, PCAOB consider developing and disclosing key
8 indicators of audit quality, disclose such indicators and
9 monitor them. PCAOB to ensure -- to issue constructive
10 recommendations based on its findings relative to audit
11 quality.

12 All public companies adopt annual shareholder
13 ratification of public company auditors. One of the
14 things we did address a lot in the treasury was the
15 ensuring of viability and preservation of four firms I
16 would hate to see if we went lower. So large auditing
17 firms produce a public annual report with audited GAAP
18 financials, including key indicators of audit quality,
19 effectiveness, and also consider adding independent board
20 members.

21 Four, recognize many of the restatements result
22 from recently issued and complex pronouncements such as

1 those relating to complex financial instruments, fair
2 value accounting and so forth. Let's work to balance
3 accounting theoretical accuracy with practical
4 implementation implications.

5 Five, provide training and develop -- and
6 promulgate best practices in terms of running audit
7 committees. Provide training of audit committee members
8 and audit committee expertise.

9 I would add that we've gone from a period where
10 we used to have four to six meetings a year to 10, 12 and
11 more audit committee meetings.

12 And six, align standard certifications for audit
13 firm and employees between federal, state and other
14 related bodies. It's interesting how you have different
15 standards between states and federal and so forth. And
16 consolidate the rules of various oversight bodies such
17 as the SEC, PCAOB and AICPA regarding independence
18 requirements among public company auditors free of
19 conflicts of interest.

20 And the very last one, my last comment, there is
21 really no substitution for reasoned professional judgment
22 and possessing a good ethical compass. And remembering,

1 as I was told early in my very first job, disclosure is
2 my friend, is shining a light on transparency.

3 So with that, I leave it to Richard.

4 CHAIRMAN DOTY: Ken, are your comments written?
5 Can you -- you're leaving us a manuscript, I hope.

6 MR. GOLDMAN: I could leave this if you want,
7 yes.

8 CHAIRMAN DOTY: It would be very helpful.

9 MR. GOLDMAN: Yes.

10 CHAIRMAN DOTY: All right.

11 MR. LEVY: Chairman Doty, members of the PCAOB
12 and observers, thank you for inviting me to participate
13 in this public meeting to address the very important
14 topic of audit firm rotation and auditor independence.

15 Auditor independence is critical to ensuring
16 audit quality. However, existing professional standards
17 and practices, including additional safeguards
18 established pursuant to the Sarbanes-Oxley Act of 2002
19 already effectively ensure that auditors remain
20 independent in both fact and appearance.

21 While the intentions of the PCAOB proposal to
22 promote and improve audit quality are laudable, we do not

1 believe there is sufficient evidence to support the
2 underlying assertion that lack of auditor independence
3 is a pervasive problem or a primary cause of audit
4 failures. Our audit committee is best qualified to
5 determine when external auditors should be replaced. In
6 order to credibly challenge both management and the
7 external auditors, the audit committee must retain full
8 oversight responsibility.

9 When in the judgment of the audit committee the
10 performance of management or the quality of the audit is
11 adversely impacted by a perceived or actual lack of
12 auditor independence, it is the fundamental
13 responsibility of the audit committee to determine
14 whether a change in the external auditor is necessary.
15 That responsibility should not be undermined by
16 regulatory intervention.

17 Audit inspections performed by the PCAOB have not
18 yielded a significant number of deficient audits.
19 Several years after the implementation of Sarbanes-Oxley,
20 the PCAOB has acknowledged that audit quality has
21 improved. Neither academic studies nor the use of
22 inspection activities, which typically target higher-risk

1 audits have indicated correlation between audit failures
2 and a lack of auditor independence.

3 Effective and comprehensive quality control
4 measures that ensure and enhance auditor independence
5 exists today, and we directly experience the
6 effectiveness of these measures as our auditors
7 continuously adopt their audit procedures as a result of
8 feedback from the PCAOB.

9 Audit firms are subject to onerous internal and
10 external quality control measures, including measures
11 enacted under Sarbanes-Oxley to improve auditor
12 independence. Audit firms are required to communicate
13 the description of all client relationships, the audit
14 firm's quality control procedures, and material findings
15 from peer or internal reviews and PCAOB inspection
16 activities. Other rules place limitations on hiring
17 audit firm personnel, prohibit performance of certain
18 non-audit services, and limit the tenure of the audit
19 engagement partners.

20 Meaningful distinctions also exist to ensure
21 quality control measures are adhered to, including the
22 signaling of potential audit failures in public SEC

1 filings, the assessment of financial penalties,
2 employment actions, or more severe sanctions. It is not
3 reasonable to assume incumbent auditors would audit any
4 more rigorously simply because they would be subject to
5 mandatory rotation.

6 There's a practical limit to the number of viable
7 replacement audit firm candidates. Large, complex
8 multinational companies are realistically limited to
9 using -- to using one of the big four accounting firms.
10 However, given the unique market, operational and
11 technical accounting perspectives of the financial
12 services industry, we believe only two of the big four
13 accounting firms would be viable candidates for our
14 company and our large bank peers.

15 The field of viable audit firm candidates is also
16 limited by existing rules meant to enhance auditor
17 independence by prohibiting the performance of certain
18 non-audit services, a portion of which is typically
19 divided among the remaining big four firms. Non-audit
20 service frequently represent significant complex
21 multi-year projects, and it is not feasible to expect
22 that such projects could be completed or transferred to

1 a replacement firm in a timely manner without significant
2 cost or interruption -- or disruption.

3 When potential replacement firms do not have
4 adequate expertise or resources, audit firms may have no
5 other choice but to hire resources from the incumbent
6 audit firms. For similar reasons, we are concerned that
7 audit or non-audit service may be awarded to
8 less-qualified audit firms.

9 Each of these reasonably possible scenarios will
10 counteract the perceived benefit of mandatory rotation
11 while bidding up the cost of industry expertise. The
12 potential incremental cost of mandatory audit rotation
13 will be significant, with some estimates increasing
14 first-year audit costs by 20 percent.

15 However, this assessment does not contemplate the
16 implemental costs associated with reporting requirements
17 imposed by post Sarbanes-Oxley legislation, and pending
18 new regulations under the Dodd-Frank Act, the increased
19 leverage that audit firms may have in setting fees, and
20 the audit inefficiencies and learning-curve costs a
21 replacement firm will incur examining complex
22 registrants.

1 Lastly, there are potentially significant
2 unquantifiable costs related to audit-detection risks
3 after a rotation. We are troubled that the PCAOB has not
4 performed a meaningful study to determine if the
5 incremental cost of mandatory auditor rotation are
6 justified.

7 Although we do not support mandatory auditor
8 rotation, we do believe there are opportunities to
9 enhance audit quality and promote auditor objectivity
10 that would be more effective and less disruptive than
11 mandatory auditor rotation. We recommend that the PCAOB
12 consider enhancing required communications and
13 information available to audit committee by sharing with
14 them the results of its inspections of registrants'
15 auditors, as well as publishing the results of its
16 overall inspection program in a format specifically
17 tailored for the use by audit committees.

18 Revisiting the requirements for qualifying as a
19 financial expert of the audit committee to ensure audit
20 committee financial experts have the requested financial
21 reporting expertise to effectively perform the oversight
22 responsibility over the auditor relationship is another

1 suggestion.

2 And finally, enhancing auditor training
3 requirements to specifically address audit quality
4 concerns identified by the PCAOB inspections, as well as
5 assessing the adequacy of existing training programs at
6 auditing firms, with appropriate emphasis on professional
7 skepticism training.

8 In closing, we believe existing safeguards
9 provide -- provided by professional standards and
10 practices, combined with the oversight provided by audit
11 committees have been effective in ensuring and promoting
12 auditor independence. Mandatory auditor rotation will
13 increase audit risk, subject reporting entities to
14 substantial incremental costs, create conflicts of
15 interest among potential replacement audit firms, and
16 limit competition due to the concentration of industry
17 expertise and geographical reach.

18 We believe mandatory auditor rotation will
19 replace a perceived audit risk with tangible and more
20 serious audit risks which could severely damage audit
21 quality. Therefore, we strongly encourage the PCAOB to
22 review other alternatives to enhance audit quality and

1 promote auditor objectivity.

2 CHAIRMAN DOTY: Kevin McBride.

3 MR. McBRIDE: Good afternoon. Thank you for the
4 opportunity to provide Intel's views on auditor
5 independence and rotation. The Board has conducted
6 extensive research and outreach on this topic, and in my
7 opinion certainly has demonstrated its commitment to
8 protect investors and fulfill its mission.

9 I am Kevin McBride, and as mentioned in my
10 introduction, I serve as Intel's external reporting and
11 treasury and accounting controller. My responsibilities
12 include ensuring that our finances comply with SEC rules
13 and regulations, and that our process in developing and
14 preparing our financial statements are transparent to
15 management, the auditors and the audit committee.

16 I'd like to spend just a few moments summarizing
17 Intel's position and make a couple of additional comments
18 on ideas that have been shared during the Board's
19 outreach.

20 Auditor skepticism and objectivity are essential
21 to high audit quality. I think the question is, how to
22 enhance skepticism and objectivity. With respect to

1 skepticism, I believe that there are two critical
2 components, deep subject matter knowledge and the desire
3 to get to the right answer. Let me take the first
4 component, which is the deep subject matter knowledge.

5 Intel's annual revenue for 2011 was approximately
6 54 billion with over 80 percent of that revenue generated
7 outside the United States. We also manufacture, test,
8 and assemble products in six countries outside of the
9 U.S. So in addition to our consolidated reports filed
10 with the SEC, we file over 150 statutory reports around
11 the world, and in fact in over 40 countries.

12 Our business model and geographic dispersion
13 require deep knowledge of our business, as well as
14 domestic and international rules and regulations. So in
15 order to file those high-quality reports with the
16 relevant jurisdictions, we develop and train a highly
17 skilled workforce. It takes us about four to six years
18 to develop our technical staff, and another four to six
19 years to develop an individual with the skills necessary
20 to manage that staff, and our controllers with oversight
21 over those managers generally have about 20 years
22 experience.

1 And we enhance that experience through periodic
2 rotations to ensure that our managers, as well as our
3 controllers have broad experience necessary to deal with
4 the complexity of our business. And we need that deep
5 expertise to be matched by our auditors.

6 Which brings me to my first objection with
7 mandatory firm rotation. I don't believe that a fresh set
8 of eyes will have the deep subject matter expertise in
9 the early years of the new audit relationship to
10 demonstrate the skepticism that the Board desires and the
11 companies need.

12 So when I look at the cost benefit equation
13 associated with audit rotation, I see three costs. One
14 in an increase in fees, which has already been talked
15 about. Second is the cost associated with taking
16 management time to help the auditors understand the
17 people, the processes and the systems that translate the
18 business into meaningful financial information.

19 And third is the cost associated with rotating
20 service providers for the non-audit related services that
21 companies like Intel procure from the other big four
22 audit firms. In fact, that steep learning curve makes

1 the auditors acutely reliant upon management, which I
2 think is the very thing that auditor rotation is trying
3 to avoid.

4 In applying auditor rotation in the largest
5 companies exacerbates these issues, given the complexity
6 of those companies. Further, it undermines the company's
7 ability to select a big four firm that is best suited to
8 provide the relevant non-audit service. So when I think
9 of the cost benefit equation, I believe mandatory
10 rotation will not produce the desired outcome in the
11 early years of the new audit.

12 The other component of skepticism in my mind is
13 the desire to get to the right answer. That means
14 looking at reasonable alternatives and understanding the
15 relevant merits of those alternatives. I believe this
16 is an important attribute. But it's consistently
17 demonstrated by our auditors. Perhaps more can be done
18 to share that information with the audit committee to
19 give them visibility into the -- into our auditors'
20 passion for getting to the right answer.

21 The other necessary trait is objectivity. To
22 address this concern, I've heard of the insurance-based

1 alternative to existing client-payee model. I believe
2 the notion is that the auditors cannot be objective if
3 they're paid directly by the company. But the changes
4 set forth in Sarbanes-Oxley Act make a marked improvement
5 in numerous areas, including requiring that the auditors
6 work for the audit committee and requiring that the audit
7 committee is comprised of individuals independent of the
8 company.

9 Let's put that fact aside for a moment and talk
10 about the insurance model. And I'm selecting this model
11 because I think it's particularly illuminating with
12 respect to a potential way forward.

13 The insurance-based model presumes that the
14 auditors are more objective if paid by the insurance
15 company rather than the audit committee. But I think
16 there's more to it than that. First, the company, the
17 audit insurance company would need more insight into
18 audit failure. The model presumes that a subpar audit
19 could lead to an increase in the insurer's claims, and
20 thus a decrease in revenue to the offending firm.

21 I think there's an important element missing from
22 that equation, and that is information. In order to

1 properly risk adjust insurance premiums and value the
2 services provided by the firm, the insurer would need to
3 understand the nature of the audit issues. Was the issue
4 systematic or was it isolated. Was it a matter of a
5 failed procedure, a lack of independence, lack of good
6 judgment, lack of education? Was it something related
7 just to the audit team? Is it the office or is it the
8 entire firm.

9 The insurance provider could then use that
10 information and model and appropriately extrapolate the
11 issue. Also, the insurance provider would need immediate
12 feedback about audit failure. It couldn't wait months
13 or even years to learn about audit failures. In order
14 to understand the quality of the audit, I believe audit
15 committees require no less timely and thorough
16 information. And armed with that type of timely and
17 thorough information, an audit committee can make a more
18 informed decision about auditor retention.

19 So to be clear, I oppose mandatory auditor
20 rotation. However, I clearly recognize that auditor
21 rotation is an appropriate solution in certain
22 circumstances. But I believe it's the audit committee's

1 duty to make that determination, and audit committees
2 would benefit by understanding the results of PCAOB's
3 inspections. Thank you.

4 CHAIRMAN DOTY: Okay. Jay, do you want to start?

5 MEMBER HANSON: Thanks. Good comments from all
6 of you.

7 This morning, we heard from a couple of our
8 opening panels make assertions about audit committees;
9 that effectively, they're not up to the job of policing
10 auditor independence, objectivity and skepticism. You're
11 in the position of having -- having felt the brunt of
12 what auditors are going through in terms of reform from
13 our inspections and new standards over the last 10 years,
14 and I -- and I think probably more acutely in the last
15 three or four years. And you're also in the position of
16 having to answer to the audit committees in terms of what
17 they're asking you more acutely about, you know, today,
18 from what we're hearing and saying.

19 So I would ask of each of you to share a bit of
20 personal experience about how things are different now
21 in even just the last couple of years compared to the pre
22 Sarbanes-Oxley era, both in terms of your interaction

1 with the auditors, as well as interactions with the audit
2 committee. So that's my main question.

3 And then -- and then for Rich and Kenneth, I want
4 to follow up on something that Kevin just said about --
5 about advocating that -- or supporting the idea that we
6 should be able to give -- or it would be desirable for
7 us to give audit committees more timely, direct, specific
8 feedback on what we've seen in audits of your -- of your
9 businesses. And whether as preparers you would find that
10 troubling or if you would support that. So, two
11 questions wrapped into my time.

12 MR. GOLDMAN: Yes, well, I guess -- I think the
13 -- you know, in terms of the committee -- you know, in
14 terms of committees and how we see it, I mean, I think
15 -- I'm trying to understand your first question in terms
16 of what really --

17 MEMBER HANSON: The question, it's really what
18 has changed in how you interact with both the audit
19 committee and the auditors in the last -- the last few
20 years that --

21 MR. GOLDMAN: Well, I think that the number one
22 change actually starts with a comment I made is, instead

1 of having four or five meetings a year, you literally
2 have, you know, 10, 12. And let me just explain how to
3 really works in practice, and maybe you don't know this.

4 I mean, you obviously have a meeting to review
5 before the earnings -- before the earnings come out, you
6 have a meeting to review the relevant Q or K. When I'm
7 -- and I'm talking about when I'm on the -- when I'm on
8 the audit committee, you know, I tend to have a couple
9 extra meetings to go over special subjects, and so easily
10 have 10 to 12 meetings a year. It is -- I'd say before
11 we had this, it used to be four or five.

12 I would also say, I sort of -- I probably talked
13 fast before -- you know, when I thought about, you know,
14 pre Sarbanes, it's interesting a lot of people in the
15 Valley are pretty down on Sarbanes, and you'll hear a lot
16 of negatives, and I actually think there's a lot of good
17 that came out of it. So I'll probably get some lashings
18 when I get back home. But the reality is, the fact that
19 you now need, you know, independent members of the audit
20 committee, they need to be relevant -- understanding of
21 the -- have the relevant experience and understanding
22 accounting.

1 I mean, I can think of several firms that got
2 into, quote/unquote, trouble in financial services, which
3 were composed of audit committee members which weren't
4 related to the industry, didn't have the appropriate
5 accounting expertise. And so I think the -- all of us,
6 whether I look at myself as a preparer, I look at myself
7 as an audit committee member, because I do both, you
8 know, we all -- or at least the people I know, take the
9 job very, very seriously. The requirements are much more
10 extreme.

11 And -- and so the point that I made is, the thing
12 I asked for -- I actually have a meeting with a KPMG case
13 with -- because I've asked them to give me what you're
14 saying is best practices for audit committees. Because
15 one of the things is, it's hard to get really a sense of
16 what are other people doing, and so I was up to risk now
17 and so forth. But what I'm trying to say is what's
18 really -- what's new in the last year or two years or
19 three years. So I've asked this case, KPMG meeting to
20 provide the audit committee of NXP, what is the -- what
21 are the best practices you are seeing relative to audit
22 committees.

1 But the last point I make relative to the
2 question you asked is, I think in terms of the PCAOB, I
3 think -- I think there's a mix, if I could say. I think
4 the auditors feel a little bit of, certainly lashings
5 that they're getting. Some of it I think they feel is
6 deserve; some of it they may feel is undeserved.

7 But I think it's -- we all would benefit just
8 sort of -- and you could find a way to parse that out and
9 say, you know -- and the comment to that is here are the
10 general comments that we think could be helpful in terms
11 of things you're seeing across the board, not unique, but
12 across the board that would be helpful for us as
13 preparers, and our committee members, that we should be
14 on the lookout for. I mean, I think that would be very,
15 very helpful to have better -- and the other thing is
16 they have it more current. And so to have findings that
17 are a year old and not two or three years old in terms
18 of what you're seeing when you do your -- your audits.
19 So that would be my first comment.

20 MR. LEVY: Just to weigh in also on the impact of
21 Sarbanes-Oxley, I actually can understate this, I think
22 it was a very profound impact on both the audit

1 profession, and quite frankly, on registrants. It's not
2 just about the financial statements as they've been
3 rendered, but also the control environment. And so we
4 spend a considerable amount of time not just talking
5 about what the results are, but what the control
6 environment is, and what could be a material weakness,
7 significant deficiency, or even a deficiency.

8 So it's not just something that would emerge in
9 a period or an issue in the period, but something that
10 you're processing your -- your whole infrastructure
11 could -- infrastructure could potentially not detect and
12 allow to be ultimately a financial statement issue, or
13 a misstatement. So I think that the auditors themselves,
14 as well as the registrants have really had to lift the
15 game up as a result of the whole SOX process.

16 In addition, I think that, you know, you guys
17 have actually played a meaningful role, because typically
18 in the relationship with a registrant and its auditor
19 prior to Sarbanes-Oxley, prior to the advent of the
20 PCAOB, there really would be the constructive tension
21 around the SEC, maybe in a financial institution in terms
22 -- well, from a common letter perspective and their

1 oversight, from a financial institutional perspective,
2 obviously the bank regulators play a continual role with
3 their presence, and that actually can impact financial
4 results.

5 But now, quite frankly, you are coming in and
6 doing your targeted reviews and inspections, and when you
7 see an issue, it may not be at a Wells Fargo, it might
8 be at another large bank peer, you are raising that
9 issue, and you're raising that issue with the firms,
10 you're raising that issue with the SEC. A good example
11 is the Level 2 market valuations, and that was a
12 concerted effort that we -- we certainly felt as an
13 industry. And at Wells Fargo obviously demonstrating to
14 our auditor that we in fact had a good sense on our, you
15 know, Level 2 provided market values.

16 And so the process has actually morphed to the
17 better. Yes, that might entail more audit work from the
18 firm and more hours and more costs, but quite frankly,
19 I can tell you that there is -- there is a constructive
20 tension that exists in the current environment with
21 regards to our audit committees. I would also say that
22 they've benefited from the Sarbanes-Oxley Act. Clearly

1 having financial expertise is very important on the
2 committee.

3 And, again, having that skepticism really has to
4 start from that top. You know, in terms of a well-
5 controlled organization, it's the tone and tenor from the
6 top that you will always say is one of the global
7 controls that you want to look for. Well, I would -- I
8 would second that at the audit committee level. That
9 tone, tenor, attention to detail being an activist board.
10 All right?

11 And I would tell you that the level of activity
12 and engagement that I've seen at, not only Wells Fargo,
13 but quite frankly, in what I'll call my prior life, has
14 really been elevated. So to the extent that there's an
15 opportunity here, it's to continue to increase and
16 elevate that engagement by the firm by the audit
17 committee. And quite frankly, ensuring that it's not
18 just the large registrants that are able to attract
19 talent to their audit committees, and the -- and the
20 required subject matter expertise, but that actually you
21 -- we want to make sure that all public registrants have
22 a good quality audit committee.

1 MR. McBRIDE: I think there's four notable
2 changes that I see post Sarbanes-Oxley.

3 Well, the first one is the ongoing management of
4 technical issues that arise each quarter. What we do,
5 as a matter of process is, as the quarter develops, we
6 identify those issues that are going to be important to
7 the quarter, and we have a meeting with management, talk
8 about the relevant views on that and the alternatives,
9 and I we present that -- those issues to the auditor.
10 We actively manage that list throughout the quarter. And
11 at the end of the quarter, once the issues are resolved,
12 then we select the items that we need to talk to the
13 audit committee about. And that's, that's something
14 that's new post Sarbanes-Oxley.

15 I think another one is the -- I think Rich
16 touched on this -- is the identification of things that
17 are occurring, either new accounting standards or, you
18 know, issues coming out of the SEC inspections, or PCAOB
19 inspections; that we meet every quarter with our auditors
20 and have a conversation with senior management about
21 those issues. It's an opportunity for our auditors, as
22 well as they bring in the national office -- an office

1 expert to talk about those issues and the firm's views
2 with respect to those issues. And we get an opportunity
3 to ask questions and really understand where auditor --
4 where our auditors are coming from.

5 The third -- and Rich did hit on this one
6 absolutely -- is a discussion of control deficiencies.
7 The discussions we have with respect to control
8 deficiencies is really trying to get to what went wrong,
9 what's the root cause. One of the things we see -- and
10 this is actually very relevant to the comment I made with
11 respect to audit quality in the earlier years of -- of
12 an audit rotation, is what we see when people rotate in
13 jobs at our company, is that we have to provide quite a
14 bit more oversight and review on particular desks when
15 people rotate, because of the risk of a person immersing
16 themselves in a new process with new issues that they're
17 not familiar with.

18 And so issues arise out of that, and we talk
19 about those every quarter in our -- in our quarterly
20 controls review. So that's new since Sarbanes-Oxley.

21 The other point I wanted to make is with respect
22 to auditor rotation. When -- we've had, within the last

1 three years, a new lead audit partner that came in and
2 questioned some of our critical accounting estimates, so
3 some of the things we did was we prepared a kind of
4 report out on our accounting process, our key estimates,
5 our judgments.

6 We walked their lead partner through those --
7 those items, as well as he brought in -- this is on an
8 issue related to fair value in particular that I'm
9 thinking of -- they brought in the national partner in
10 charge of valuation. They brought in valuation experts.
11 They had staff, and senior and other partners in that
12 meeting. We brought in our relevant experts that are
13 involved in valuation and the process, and we walked
14 through the issues. And it's an opportunity for them to
15 get educated, as well as for us to get educated on the
16 latest views of these issues.

17 So I think those are some of the things that I
18 noticed, some of the changes that we've seen since the
19 start of Sarbanes-Oxley.

20 MEMBER FERGUSON: One of the things that I think
21 each of you mentioned -- and you're sort of not unique
22 in this; it's been mentioned throughout the day by

1 panelists, has to do with one of the problems with
2 mandatory rotation. And it would be -- it might just be
3 with rotation in general -- is the fact that to the
4 extent that large enterprises use non-audit services from
5 other big four firms under the independence rules you're
6 very limited. So if you had to rotate, either that would
7 limit your choice of those service providers, or, you
8 know, might -- if you had to rotate in a very short-term
9 basis, might preclude certain people from being your
10 auditors at all.

11 It strikes me in many ways that this is a problem
12 of the firm's own creation. They have chosen to go into
13 these businesses. And frankly, the most rapidly-growing
14 parts of the business of the big audit firms are the
15 advisory service, growing much more rapidly than the --
16 than the audit business.

17 Does this argue for strict limitations on the
18 kinds of non-audit services that audit firms should be
19 able to provide, including going so far as to having
20 audit-only firms, a proposal that's being considered by
21 the European community right now?

22 But, I mean, you know, these problems which I

1 think we realize or recognize are very real in today's
2 environment, are problems created by the firms
3 themselves. They have created this universe. I mean,
4 you haven't. So what's your reaction to that?

5 MR. GOLDMAN: Well, it sounds good in principle.
6 The problem in practice, and it comes back to the 98
7 percent which some of us talked about, if you want good
8 tax advice that you can't use your own firm for, the
9 reality is, you know -- and I looked at, yes, I don't
10 want to be negative on some of the firms you'll be seeing
11 on session 10 here, but the reality is there aren't many
12 firms that could provide that.

13 And so if you want the best service that can do
14 these questions you have, you've got to look for the best
15 folks. And so you have to find -- how do you find a way
16 to have other firms provide those services. So in our
17 case, we use Ernst & Young for tax services when our
18 auditor is Deloitte. I mean, I don't know -- I mean, I
19 could look -- you know -- so you're saying how do you use
20 a non-big four, so to speak, and I don't think the others
21 have nearly the competency that we want to see in terms
22 of some of the structures that we're looking at right

1 now.

2 So, you know, you're right, we didn't create the
3 problem. I would argue the problem was created when we
4 collectively allowed eight to go to four, and we are
5 where we are.

6 The other problem I have is, there are a lot of
7 firms I ask for, you know, to provide tax, probably the
8 most relevant one that I think all of us will agree we
9 use the firms for. And there's a lot of firms that just
10 don't have the people and capability to provide that
11 service. And so that is, I think, heart of the issue.

12 MR. LEVY: And just to jump on -- first of all,
13 if you were to go down that direction, clearly you would
14 need to have a respectable time frame for transition,
15 because you certainly wouldn't the want disruption
16 between a firm that was engaged, to then have to exit
17 before finishing a project. But that's it.

18 I'm really not a supporter. I think this is a
19 bad proposal. It's really kind of creating just a, if
20 you will, the high priest of audit. We just had audit
21 purists. I think it's been a debate that's -- that's been
22 kicked around and seems to be recycling. I think there's

1 a tremendous amount of benefits that the firms actually
2 are able to provide -- to pick up on where Ken was going
3 -- by virtue of their experience. So when -- when you
4 bring together the accounting knowledge, the tax
5 knowledge, the consulting knowledge, it actually creates
6 quite a powerful capability and skill set that actually
7 is lacking in the marketplace without that synergy.

8 So, you know, there is a real benefit to users of
9 service like tax or consulting, because when there's new
10 legislation like Dodd-Frank, and there's an aspect of --
11 of complexity, living will, how do you interpret, who do
12 you implement, those are all items that even large
13 sophisticated financial institutions would like to get
14 the best and brightest minds' input on. And I think that
15 you want to have that capability at its -- at a high
16 level. So just a couple thoughts.

17 MR. McBRIDE: My concern is where do you draw the
18 line there. In particular, we enter into a complex
19 business arrangements, and oftentimes the firm can draw
20 on transaction services to help and work through the
21 accounting issues relevant to that transaction. Or it
22 could be a valuation issue, where they can draw on their

1 valuation services practice to help review particular
2 accounting issues.

3 So, you know, right now I know that those areas
4 serve as a resource to the audit team, and in some cases
5 to the company in working through technical matters. So,
6 you know, my concern is where do we draw the line. Where
7 would you draw the line if we were going to go down that
8 road?

9 MR. GOLDMAN: I would add, one of the things
10 that's interesting enough that we learn when we're on the
11 treasury committee, and you can ask this question later,
12 but the -- and we had all the CEOs of the various -- or
13 most of the firms below the top four, and interestingly
14 enough -- if I could paraphrase most of them had no
15 desire to get much bigger. They actually like the spot
16 they were in. They were under the radar. They liked the
17 less, quote/unquote, legal liability they thought they
18 had.

19 And so the idea of having them -- I mean, I'm
20 sure you're probably looking at whether you get any of
21 those to become a big -- a five or six -- the reality is,
22 the sense we had in the committee, none of them wanted

1 to go there. They were actually very happy with where
2 they were. So the practicality of having that expertise
3 to the next level, you know, is really a very different
4 level.

5 MEMBER HARRIS: Mr. Goldman, when you said that
6 disclosure is my best friend, what did you have in mind
7 in terms of improving audit quality and independence
8 objectivity?

9 MR. GOLDMAN: Well, you know, that's funny, I
10 learned that -- I literally heard that from an audit
11 partner at E&Y, and you can tell it struck with me ever
12 since -- stuck with me ever since. And it was a very
13 simple comment, is when it doubt, disclose everything to
14 your auditors. When it doubt, disclose it in your
15 footnotes.

16 And so -- and then you shine a light on
17 everything and then everyone can make their own
18 assessment as to, you know, the issue, if you will. And
19 so it's something I've lived with, you know, if you will,
20 since I've been doing this, is, you know, disclosure.
21 It's a simple comment, disclosure is my friend. If it's
22 disclosed, everyone can see it, and you find a lot of the

1 issues.

2 Then you -- you may have disagreements as to it,
3 but at least it's all out there, and it's understood.
4 And so that's something I've used forever. And it's a
5 when in doubt, to me, put it in the footnotes, put more
6 than -- more than you need in there, disclose everything
7 to the auditors, and -- and then you -- then you may have
8 to arm wrestle them some things, but at least everyone
9 knows what it is. And you make, hopefully, professional,
10 reasonable judgments. So that's the way I've lived in
11 terms of my job.

12 MEMBER HARRIS: In terms of the disclosure to
13 investors, what would that mean? How does that
14 translate?

15 MR. GOLDMAN: Well, I mean, I think -- you know,
16 again, it's the same concept. I mean, the thing is you
17 asked that question -- because I do IR as well -- I mean,
18 the thing you have to be a little careful about is what
19 metrics do you want disclosed, because, you know, you
20 find once you disclose a metric you have to consistently
21 disclose it.

22 But it's the same comment, if you -- if you --

1 any of you -- you know, you'd probably get bored silly
2 -- but if you listen to what we provide at Fortinet, yes,
3 we probably go -- I go about 25 minutes discussing my --
4 you know, results of the quarters, we were one of the
5 very first companies -- and actually auditors didn't want
6 me to do this -- but we actually provided pro forma
7 comments, you know, obviously back to the GAAP numbers
8 in our filings, because that was one of the things the
9 SEC asked for or suggested to make the numbers -- you
10 know, make your communications very consistent between
11 what you provide the investors and what you provide the
12 -- in your filings. And we did that.

13 And, you know, my auditor said, geez, you know,
14 it's not GAAP - blah-blah-blah -- and we said I'm going
15 to do it anyway because the SEC wants it, and we're going
16 to make sure it's consistent, we're going to make sure
17 we do the reconciliations, which we do. And you're
18 probably going to be now looking at my numbers.

19 But -- but I think, again, it's the idea of show
20 it there, let everyone see the numbers, see how -- see
21 how the public and the investors see our numbers. And
22 so, again, I look very carefully at what's required. And

1 obviously if -- if we hadn't -- if that I hadn't
2 encouraged it, I wouldn't have done it. But I actually
3 think that's good, as an example.

4 MEMBER FRANZEL: I want to follow-up a little bit
5 on Jay's question about what has changed. And you all
6 indicated that things have certainly gotten better since
7 the Sarbanes-Oxley Act.

8 But I'd like you to elaborate on how this played
9 out during the financial crisis in terms of increased
10 auditor skepticism, if you saw such a thing, as well as
11 audit committee oversight.

12 MR. LEVY: Well, given it's a financial crisis
13 question, I think we've -- we are living through it. And
14 I would tell you that there was a lot of focus around
15 almost all things financial, probably starting with the
16 valuation of financial instruments during a time frame
17 where the market had ceased. And so what was the right
18 valuation from a fair value perspective.

19 A lot of -- a lot of discussion, a lot of
20 inquiry, a lot of justification to provide on our part,
21 and actually good dialogue all the way through and up to
22 the audit committee on the allowance for loan loss and

1 the adequacy of the allowance for loan loss, especially
2 in a time frame where, you know, linear trends no longer
3 were working, where there were step functions and values
4 of underlying collateral that wasn't thought would be
5 secured loans becoming, essentially, unsecured loans.

6 The value of the, let's say, a second lien, home
7 equity lien where the, the value of the house no longer
8 supports it. You know, what is the adequacy of the --
9 of the allowance. Or, in essence, what's the right
10 estimate of the loss content. That skepticism actually
11 has continued in terms of -- I think -- I call it
12 constructive tension.

13 Because even to this point when we still see that
14 the GSCs are putting back more and more of the mortgages
15 that were sold, that they, they are looking at having
16 repurchased. And so that process, as you look to anyone
17 in the service, mortgage servicing space will attest and
18 it's clear in the financial statements continues to be
19 an evolving area, what is the amount of the probable and
20 estimable repurchase obligation.

21 So I would tell you that across the board on
22 almost all of -- in fact, all of the critical accounting

1 policy areas, more, more in-depth examination, in
2 essence, fortified, lots more time spent, and also during
3 acquisitions because we happened to be in the position
4 to acquire and merge with Wachovia, Wachovia had a -- has
5 a wonderful franchise, but in 2008 it also had a pretty
6 significant level of loans that would be classified as
7 purchase credit impaired loans. What is a purchase
8 credit impaired loan? How did you determine it? What
9 was the amount of the loss content that has to be set up
10 in terms of the SOP 03-3?

11 So very technical, very deep dive. And quite
12 frankly, if I'm on your side of the table I want to make
13 sure that the examiners, the firm is actually up to those
14 -- those tasks. Again, I came back to my opening
15 remarks, at the level that we're at and our other large
16 bank peers, there's really two firms that -- that really
17 audit those.

18 So it's not even a four-firm oligopoly. But
19 that's very critical to have, if you want to continue
20 using my term constructive tension, it's very important
21 to have the best, most capable firm doing that
22 examination.

1 MR. McBRIDE: And I'd add to that. And we have
2 an investment portfolio that includes an equity kind of
3 a venture capitalist arm. So we have -- excuse me -- we
4 had valuation issues. It sounds like Rich's were much
5 more complicated -- but we had a number of valuation
6 issues in the investment portfolio.

7 But it went beyond that. We're, you know, quite
8 a few intangible assets on our balance sheets, so we were
9 getting into the valuation of businesses and tangible
10 assets, etcetera, and there's quite a bit of scrutiny
11 placed on, you know, the future cash flows associated
12 with the businesses and recoverability good will, as well
13 as the intangible sites.

14 And then you have to look at, you know, the tax
15 side of all those issues, whether, you know, you could
16 recover some of the deferred tax assets associated with
17 the things that are on our balance sheets. So valuation
18 up and down the balance sheet was really the key to that
19 year-end audit.

20 CHAIRMAN DOTY: Intel has substantial foreign
21 operations, as you noted earlier, Kevin. What are you
22 doing about the emerging pattern, the patchwork of tenure

1 and rotation requirements that are emerging around the
2 world, different parts of the world? How are you dealing
3 with that?

4 MR. McBRIDE: So is the question -- just to make
5 sure I understand the question -- is the question: Are
6 we concerned about what would happen if, say, in Europe,
7 they do move to mandatory rotations and how that could
8 impact?

9 CHAIRMAN DOTY: Yes, that's of interest also.
10 What kinds of plans are you making for the rotation
11 regimes that are already in effect in certain countries?
12 And certainly the proposal that looks as if it's moving
13 forward in the UK of tenure, if you don't re-tender you
14 must explain? There are a number of variants of this
15 that we've been talking about through the day that are
16 sort of gaining steam in their different levels in
17 different parts of the world. And it seems to me that
18 you all would be thinking about that.

19 MR. McBRIDE: You're right. We do file -- like
20 I said, we file in 150 different jurisdictions. What I'm
21 not sure of with respect to those proposals, is whether
22 or not those impact listed companies, because we're only

1 listed in the U.S., or whether it relates to the
2 statutory audits.

3 And if it does relate to the statutory audits --
4 right now we have an integrated audit, and that's very
5 important to us, because we get the efficiencies, because
6 having one firm throughout the world that understands our
7 practices gives us the ability to, you know, leverage the
8 practices, the understanding of that institutional
9 knowledge that both we and the auditors have.

10 But I'm not familiar enough with respect to those
11 proposals to understand whether they do impact the
12 statutory requirements. And if they do impact the
13 statutory requirements, then that's something we need to
14 get.

15 CHAIRMAN DOTY: Well, that's fair enough. I
16 think we've exhausted time. Are there any other
17 questions from anyone on the staff or the Board?

18 If not, it remains to thank you for having done
19 this. This was a very informative presentation, and we
20 look forward to seeing you again.

21 MR. GOLDMAN: Thank you. I just had one more
22 comment actually. Just to give you a sense the

1 importance. I think all the -- both our company and all
2 the committees I have been on, what you see today is the
3 CEOs will now attend audit committees. And just showing
4 how important and how substantive and fundamental the
5 work that's being done is, you find CEOs now -- it's
6 almost obligatory, but, you know, but -- because they're
7 not on the committee, as you know, but they do now
8 attend.

9 I don't know if they're your companies, but. So
10 it's one of the things you have seen over the last 10
11 years since Sarbanes, and maybe even before that started,
12 but the CEOs now attend these meetings. And again, the
13 business aspects that are reviewed in these committee
14 meetings are much more substantive, again, than they were
15 back, say in the '80s or '90s.

16 So I -- again, just showing how -- how the audit
17 committee has sort of become much more profound as a
18 committee relative to running the company.

19 CHAIRMAN DOTY: Do you see any change increment
20 in the attempts of the CEO to determine the membership,
21 the constitution or control the general tenure of the
22 audit committee? There's a concern that many people have

1 raised that as the audit committees become more
2 important, as it is in fact the centerpiece of
3 Sarbanes-Oxley, that management in the form of the CEO
4 does take a lot of care in trying to be sure who's on
5 that committee.

6 MR. GOLDMAN: I think in a positive way,
7 actually. And I'm not sure what direction you were
8 going. But, I mean, I think the CEO actually, you know,
9 does want to make sure that we have, you know, good audit
10 committee members that do add value. So, whereas I think
11 in the past they may have thought just another committee,
12 I don't need to go to it, you know. It's sort of
13 interesting, but now they actually care who is on the
14 committee because they attend the committee.

15 And they, you know, I think they want to make
16 sure it's people that they can -- you know, make sure
17 that it's people that they can understand that they find
18 helpful to them running the business, and know the
19 business.

20 CHAIRMAN DOTY: But you don't think there's been
21 an impairment of independence of the audit committee in
22 that circumstance?

1 MR. GOLDMAN: I don't think so. I don't, you
2 know --

3 MR. McBRIDE: I mean, the CEO is certifying
4 financial statements along with the CFO, and it's
5 important for them to understand the issues that are
6 being discussed at that level. So yes, I mean, I echo
7 the comments.

8 MR. LEVY: I just want to second what Ken is
9 saying. I think the -- the objective of the CEO would
10 be to have the best quality members who actually can
11 understand, because accounting has become very
12 sophisticated, and the audit resulting. And quite
13 frankly, also, the risk focus that the committee has to
14 examine, even outside of just the financials, has become
15 such critical elements of making sure a company's well
16 run, that it is really a focus that has enhanced the
17 independence and enhanced the caliber of the members on
18 the committee.

19 CHAIRMAN DOTY: With tenure of CEOs and CFOs
20 becoming predictable, as you pointed out, Rich, it is an
21 ironic result that sort of occurs. And of course what
22 we've heard during the day, that in fact the audit firm

1 that is not rotated every 10 years or that goes for 30,
2 40, 50, 70 years, that firm really becomes more in
3 control of the corporate accounting enterprise than the
4 CEO or the CFO perhaps.

5 Is there any -- is there any thought that if CFO
6 or CEO terms are becoming subject to this kind of a
7 rotation that it becomes very important, as Ken Goldman
8 says, that at least every 15 years, that there be a
9 tender and if you retained you explain?

10 In other words, does the tenure issue talked
11 about on the management side reinforce the necessity of
12 having a having a fresh look at the audit relationship
13 at least every 15 years?

14 MR. LEVY: It's probably a worthwhile item to
15 consider. I mean, I think there are opportunities for
16 enhancing the existing structure. I think that the
17 fundamental issue in the accounting space is, is actually
18 the chief accountant, quite frankly. And in fact, also
19 having accounting or, you know, chief accountants, CFOs
20 and/or former partners on the committee, that is very
21 helpful to that constructive tension. Because I don't
22 think it matters if the CFO is there for 10 years or a

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1 year, or the CEO for that matter. I think it's really
2 the governance and the infrastructure and what has been
3 laid in terms of the foundation.

4 So if a mandatory re-bid is helpful to the
5 process, that's fine. I find, I find that there's still
6 a very steep learning curve at any organization. And
7 it's hard enough -- to the point where Kevin was making
8 -- for our own staff to come up to speed. And I think
9 that is a very big -- a factor that the decision-makers,
10 the committee would have to consider.

11 CHAIRMAN DOTY: Yes. But we may have the burden.
12 It's very interesting that in this complex world,
13 accounting becoming complex, the operations scattered,
14 the necessity of having at least many affiliate firms
15 involved, even some non-affiliates, the 900 plus member
16 of the audit team scattered worldwide, the audit team
17 rotating, many of the issues of management are there if
18 you don't reexamine your audit relationship, it would
19 seem to me. There are many, many of the retraining
20 issues that you're going to have without regard to
21 whether there's a new audit team coming in. Think about
22 it.

1 You've done a great job. Thank you for being
2 such a great panel.

3 Yes, we'll go to the next panel. we have two
4 regulators; two regulators from a foreign -- a non-U.S.
5 jurisdiction.

6 We have David Gerald, Founder, President and
7 Chief Executive Officer of the Securities Investors
8 Association of Singapore. He founded the association in
9 1999 to contest the freeze of new shares owned by 172,000
10 Singapore investors and Malaysian companies by the
11 Malaysian government. They now have 70,000 investor
12 members. They are the voice of retail investors in
13 Singapore. They are supported by the OECD and the
14 Accounting and Corporate Regulatory Authority of
15 Singapore, the Singapore Exchange. Mr. Gerald was
16 appointed in 2010 by the Monetary Authority of Singapore
17 to be a Singapore -- to the Singapore Corporate
18 Governance Council Task to review the Corporate
19 Governance Code to promote high standards. And he has
20 been in private practice in his career, a legal career
21 spanning 30 years.

22 Kiochiro Kuramochi is the Deputy Chief Accountant

1 for Internal Accounting and Auditing and Disclosure
2 Division of the Financial Services Agency of Japan, a
3 very close collaborator with our own PCAOB and Audit
4 Inspection Cross-Border Board Oversight, and a member of
5 IFIAR, appearing here for the first time before the Vice
6 Chairman of IFIAR.

7 We welcome you both and look forward to hearing
8 what you have to tell us about your own regimes and what
9 you see in these concepts.

10 MR. GERALD: Thank you. Thank you Chairman and
11 members of the PCAOB. Thank you very much very inviting
12 me to share my views as an investor on auditor
13 independence, objectivity, professional skepticism.

14 You are seeking public comment on how this could
15 be enhanced on mandatory audit firm -- especially
16 mandatory audit firm rotation. At the outset, I wish to
17 say, sir, the views expressed in my opening remarks are
18 entirely my own and do not necessarily reflect those of
19 Singapore or the Securities Investors Association,
20 Singapore. I am neither an accountant nor an auditor.
21 As you have said, I'm a lawyer with -- in practice for
22 many years, but only recently my involvement with

1 auditors; a simple-minded investor, sir, so please do
2 accept my apology if I reflect the ignorance of the
3 practice of auditors as understood by this honorable
4 Board.

5 With markets opening up in Asia and the
6 liberalization of investing rules, it is now easier for
7 investors to do cross-border investing. Corporate
8 governance and accounting standards are not well
9 developed, especially in countries like China and India.
10 Shareholder activism is also not prevalent in Asia.

11 Auditor independence is the key to investor
12 confidence in financial statements. The fact that the
13 financial statements are audited gives them a level of
14 comfort when placing reliance on the auditor's statements
15 for investing in the public listed company. But the
16 current method of appointing and remunerating auditors
17 have raised doubts in the minds of some investors on the
18 independence of auditors. This is exacerbated by
19 instances of failure on the part of auditors like
20 Andersen and Enron. Central to this issue is a question
21 whether there are sufficient safeguards and effective
22 supervision of auditors in place to minimize failures.

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1 Some investors in Singapore are of the view that
2 since it is the audit client who pays the auditor's fee,
3 they doubt the complete independence of auditors. Such
4 a situation, according to them, threatens the auditor's
5 independence. But they are in the minority.

6 Whilst some clamor for third-party appointment of
7 auditors and payment, canvassing that would be the answer
8 to their worries, I take the considered view that so long
9 as there are sufficient and effective safeguards to
10 protect investors and sufficient sanctions put in place,
11 together with stringent oversight by independent
12 regulators, the call for independent third-party
13 appointment and payment may not be necessary now. One
14 should continue to place faith in qualified and regulated
15 auditors as professionals capable of exercising integrity
16 and independence.

17 Not to do so may affect the future of the
18 profession adversely. Unless statistics support such a
19 drastic move, status quo should be preferred. Such a
20 move would also, I am advised, require Congressional
21 approval here. One should not paint the entire audit
22 profession with the same brush used to paint those few

1 who have failed. Every profession, sir, has had its fair
2 share of shame brought by recalcitrant members. After
3 all, to err is only human. One can never stop audit
4 failures completely as long as humans are involved.

5 To date, in Singapore, there has not been a call
6 from investors for a change in the mode of appointment
7 and payment of auditors, because they have lost
8 confidence in the integrity of the audit profession. In
9 fact, on the value that external auditors bring to
10 shareholders, ACCA and SIAS in Singapore conducted a
11 survey in 2010 dealing mainly with the perspectives of
12 educated and savvy investors. We surveyed 30,000
13 investors, and the findings are as follows:

14 Overall, 90 percent of the respondents felt that
15 the external audit in its current form and scope bring
16 value to them. Only a minority felt it had very little
17 or no value to them because of the historical nature of
18 financial statements on which the audit opinion was
19 formed.

20 Eighty percent of respondents felt that audited
21 financial statements were important to them in making
22 investment decisions.

1 More than 85 percent of the respondents felt that
2 the provision of non-financial information such as
3 corporate governance practices and corporate social
4 responsibility issues would serve their decision-making
5 purposes.

6 Independent audit oversight, the question
7 investors have asked for many years, who audits the
8 auditors. Expectation of investors have been met in some
9 Asian countries. Supervision of audit quality and
10 auditors now in place, but not in China, India, Hong Kong
11 and a few others. On auditing the audit firm, Singapore,
12 Malaysia, Thailand and South Korea have implemented
13 independent audit oversight by audit regulators.
14 Application of International Standards Quality Controls
15 1, ensuring certain systems and quality controls are also
16 in place in these countries.

17 Investors in some of the above-mentioned
18 countries are becoming aware of the function of audit
19 regulator, and therefore the comfort level is increasing.
20 Investors' understanding of audit committee, however,
21 especially in Asia, needs improvement. They need to
22 understand the role of audit committees better, and need

1 to engage the audit chairman at meetings to ensure that
2 the committee has discharged its role adequately.
3 Singapore Companies Act 201B subsection (5) outlines the
4 functions of the audit committee, which is to review the
5 audit.

6 Firstly, the audit plan; secondly, the evaluation
7 of the system of internal accountancy controls; thirdly
8 is audit report; fourthly, the assistance given by the
9 company's officers to the auditor, et cetera. Investors
10 need to question the audit chairman on these matters at
11 meetings.

12 Investor confidence in audit work could be
13 boosted through with greater education, awareness about
14 audit quality, the independent audit regulator's rule of
15 auditing the auditors. This helps to ensure that
16 auditors follow standards and perform well in key areas
17 like professional skepticism, which helps ensure that the
18 corporate governance system works as it stands -- as it
19 should.

20 On mandatory rotation of auditors, the arguments
21 in favor and against mandatory rotation are well
22 documented, publicized and will therefore not be

1 canvassed here by me. Currently, to avoid too much
2 familiarity between auditors and their client, the Stock
3 Exchange in Singapore listing rules, and many other
4 jurisdictions require the audit partner to be rotated
5 every five years. The International Federation of
6 Accountants also requires rotation of audit partners
7 every seven years. Quality control reviews are also
8 undertaken by a second partner of the audit firm carrying
9 out the audit.

10 It is sufficient to say that the current practice
11 of rotation should continue with enhanced and effective
12 safeguards, and allow the PCAOB and other regulators
13 around the world to monitor the effectiveness of the
14 current practice of rotation of auditors every five
15 years.

16 Moreover, the measures introduced by Sarbanes-
17 Oxley, pursuant to the Enron debacle, does provide
18 important and useful safeguards. The shifting of
19 responsibility to the audit committee from the management
20 to hire auditors and oversee the engagement and the
21 prohibition of certain non-audit services to clients
22 should give further assurance to investors. But more

1 importantly, the establishment of the independent
2 oversight of the auditing profession by PCAOB in the U.S.
3 and equivalent bodies ACRA in Singapore should increase
4 the level of assurance to investors. The Accountants Act
5 also in Singapore is similar to those in the west,
6 prohibits auditors from providing certain services,
7 including internal audit services to clients. There are
8 regulations under the Act governing independence and
9 ethics applicable to auditors, breach of which will
10 attract sanctions.

11 In view of the above, it is sufficient to leave
12 it to the audit committee and the shareholders of the
13 company at annual meetings to decide on the appointment
14 of suitable auditors for the company, and it is for the
15 board to decide on the auditors appropriate remuneration.

16 It must also be noted that it is the shareholders
17 who appoint the auditors at the annual general meeting
18 proposed by the board of directors. Shareholders need
19 to be active at meetings and query the board on the basis
20 for the recommendation of the auditor to be voted on, the
21 quantum of payment recommended and the length of the
22 engagement of the issues that will be addressed by the

1 auditors to justify quantum.

2 Shareholder activism is necessary to ensure that
3 the right auditors are appointed and paid correctly.
4 Should the shareholders be active on these issues, in my
5 view, the likelihood of auditors and the management of
6 the listed companies acting in cahoots will be further
7 minimized.

8 I would like to make very quickly three
9 recommendations.

10 Mandate full time internal auditor. Perhaps to
11 enhance not only vigilance against fraud and criminal
12 activity, but also professional skepticism and quality
13 of audit, public listed companies should be mandated to
14 appoint full-time internal auditors. A full-time
15 internal auditor, though engaged by the company through
16 the audit committee, should report directly to the audit
17 committee, the chairman and the board, and not the CEO.
18 He should report to the CEO only on operational and
19 administrative matters.

20 The advantage of this suggestion is that it will
21 give the necessary assurance investors are looking for
22 in avoiding a situation like Enron, and will also

1 minimize mistakes. As demonstrated by Cynthia Cooper in
2 the WorldCom case, an internal auditor can act quickly
3 to bring misconduct to justice. The internal auditor
4 could be the watchdog for the investors and the
5 stakeholders of the company. In my view, this will also
6 enhance the independence of external auditors. It will
7 also help in the appointment and remuneration of external
8 auditors. It will make the issue of mandatory rotation
9 a moot point. This way the management will be kept in
10 check. Internal auditors presence will help external
11 auditor to shorten time to understand the company's
12 culture, besides minimizing fraud within.

13 Second recommendation would be that we should
14 enhance board's responsibility. The most effective fraud
15 prevention is to have an effective board that is
16 responsible for risk governance and internal controls.
17 The board is now required to play a more proactive role
18 under these new and tough rules issued by the Singapore
19 Exchange, effective on 29 September, 2011, the 2012 Code
20 of Corporate Governance issued by the Monetary Authority
21 of Singapore on 2nd May 2012, and the Risk Governance
22 Guidance for Listed Boards Guidelines issued by Corporate

1 Governance Council on 10th May, 2012.

2 The board must identify risk areas, set risk
3 tolerance strategies, and oversee implementation of risk
4 management. On an ongoing basis, the board needs to
5 continually monitor and assess the adequacy of the risk
6 management managers it has put in place, oversee the
7 system of internal controls, and ensure that management
8 takes appropriate steps to mitigate risks.

9 Thirdly, transparency. There must be
10 transparency of independent oversight work. I support
11 the view that the independent oversight regulator's work
12 should be made public so that investors will be in the
13 know. It will enable the investors as shareholders to
14 make an informed decision on the appointment of auditors.

15 In conclusion, it is the enhancement of
16 safeguards, and not changing the current model of
17 appointment of auditors and payment to them is what is
18 needed. Thank you, sir.

19 CHAIRMAN DOTY: Thank you for that thoughtful
20 view of Singapore and law and the markets.

21 And Koichiro?

22 MR. KURAMOCHI: Chairman Doty, members and staff

1 of the PCAOB, thank you very much for this opportunity
2 to participate in this discussion of auditor
3 independence, objectivity and professional skepticism.
4 Please be reminded that at the outset that the views I
5 express this afternoon are my own remarks and are not
6 necessarily representing those of Japan or the Financial
7 Services Agency.

8 With respect to the enhancement of the audit
9 quality, we have also had many discussions in Japan for
10 decades and have made a series of reforms to our systems
11 and auditing standards. The steps we have taken on
12 auditor independence, objectivity and professional
13 skepticism include the following:

14 The Certified Public Accountants Act, our
15 legislation governing CPAs and auditor activities,
16 stipulates principles such as independence, and further
17 prescribes specific requirements for independence. For
18 example, lead audit engagement partners and audit
19 reviewing partners are subject to five-year rotation
20 requirements with a five-year cooling-off period, similar
21 to the United States. And all the other audit partners
22 are subject to a seven-year rotation requirement with a

1 two-year cooling-off period.

2 Other examples include stringent restrictions on
3 non-audit services. In addition, the Certified Public
4 Accountants and Auditing Oversight Board, which is called
5 CPAAOB was established as an independent body in the
6 ambit of the FSA in 2004, and it has been conducting CPA
7 examinations, as well as inspections of the audit firms.
8 The Japanese auditing standards as set by the Business
9 Accounting Council, which is established under the FSA.

10 Furthermore, we are currently engaged in revising
11 the Japanese auditing standards to enhance auditors'
12 professional skepticism, as well as auditors' response
13 to accounting frauds. Audit committee of the Business
14 Accounting Council started deliberation on this topic in
15 May 2012, aiming at concluding the discussion in about
16 one year. I personally expect the following matters
17 would be covered in the deliberation.

18 One, reaffirming the importance of professional
19 skepticism.

20 Two, clarifying auditors' response to accounting
21 frauds.

22 Three, how the firm-level involvement should be

1 articulated.

2 Four, enhancing auditors' report by including
3 additional information.

4 Five, improving education and training to deal
5 with accounting frauds.

6 Six, how audit evidence should be evaluated.

7 Seven, how auditors should modify auditor --
8 audit planning to address a revised assessment of risk
9 of material misstatement or an identification of fraud
10 risk factor.

11 The PCAOB's Concept Release discusses audit firm
12 rotation from various aspects. We also debated over
13 potential audit firm rotation six years ago. At that
14 time, there was an accounting fraud incident committed
15 by a large listed company and the company's auditor
16 issued a clean opinion, although the auditor's audit
17 partners had knowledge of the fraud.

18 In response to the incident, we deliberated on
19 how auditor independence should be enhanced. After a
20 thorough deliberation, the stringent partner rotation I
21 mentioned earlier, rather than audit firm rotation, was
22 introduced, because of the following reasons.

1 One, disruption of the auditor's accumulation of
2 knowledge and experiences.

3 Two, costs associated with the change in
4 auditors, on the auditors' as well as issuers' sides.

5 Three, the fact that mandatory audit firm
6 rotation had not been put in place in major developed
7 countries.

8 Four, practical difficulties in audit firm
9 rotation due to limited number of large audit firms.

10 As a result of the financial crisis, we
11 understand that various debates are in progress in --
12 with regards to audits in the United States, as well as
13 Europe, although direct effects of the financial crisis
14 were relatively limited in our country compared with the
15 situations in the United States and in Europe.

16 Japan also experienced the burst of the bubble
17 economy in the 1990s, and subsequent collapse of large
18 companies. Prompted by such incidents, we have debated
19 over the role of audits for decades and implemented
20 various changes in our systems. We consider that the
21 measures responding to accounting frauds should evolve,
22 as accounting frauds become increasingly scheming and

1 complicated. At the same time, we believe that
2 exercising professional skepticism should be the
3 foundation for the financial statement audit.

4 We understand that institutional measures such as
5 audit firm rotation are debated when audit failure
6 occurs, as we also have similar experiences. However,
7 when revising the established system, we believe that it
8 is important to have cool-headed discussions, carefully
9 exploring whether or not the possible change would truly
10 have positive effects on professional skepticism or
11 accumulation of knowledge/experiences of auditors.

12 Given the globalization of corporate activities,
13 audit systems are getting increasingly prone to global
14 influence, and PCAOB's decision could have certain
15 effects on Japanese companies and Japanese audit firms.

16 I appreciate this opportunity to express my views
17 today, and I hope that PCAOB gives due consideration to
18 various views and reaches an appropriate decision at the
19 end.

20 Thank you very much.

21 CHAIRMAN DOTY: Thank you both.

22 I have to say before asking any of my colleagues

1 whether they have questions, that, on behalf of the
2 PCAOB, I know that you know that we value very much the
3 relationship we have with each of your governments on
4 cross-border oversight. It's meant a great deal to us
5 to know that where there are issues of inspection that
6 can be troubling, that you -- we've always found a very
7 helpful, cooperative attitude in both of your regimes,
8 both of your countries toward our inspections. And we
9 think it's worked to our mutual benefit. And we look
10 forward to continuing to do it.

11 I hear David's comments on some of the regimes --
12 on some of the states in his region that are not
13 accessible and that are not transparent, and I know that
14 in your own -- in Japan, it's been a special benefit, we
15 think, that we've been able to conduct inspections and
16 reach the point at which in the last year we achieved as
17 absolute -- an actual formal protocol on it.

18 With that, and not knowing how much our board
19 members want to get into foreign law, I will nonetheless
20 ask Steve Harris, any thoughts?

21 MEMBER HARRIS: I do have a question. But I want
22 to defer it to our Vice Chairman.

1 CHAIRMAN DOTY: All right. Lewis, anything?

2 MEMBER FERGUSON: I have a question. It's kind
3 of one that puts you on the spot here. This has nothing
4 to do with the auditor rotation. As you know, the -- you
5 may or may not know, the PCAOB has over 900 non-U.S.
6 audit firms registered with us, including 100 in China,
7 50 in the People's Republic of China and roughly 50 in
8 Hong Kong. We're not able to inspect those firms. We've
9 been negotiating with China, but we're not able to
10 inspect those firms. I don't know if we will be able to.

11 Those firms audit registrants and companies that
12 are registered in the United States that actually have
13 billions of dollars of market capitalization in this
14 country held by U.S. shareholders.

15 What's your advice to us? What do we do? How do
16 you advise -- I mean, you all live in Asia, you know the
17 market there, you know the climate there. What do you
18 suggest we do with these, with these audits?

19 MR. GERALD: These are companies that are listed
20 NASDAQ or --

21 MEMBER FERGUSON: The New York Stock Exchange,
22 yes.

1 MR. GERALD: Oh, the New York Stock Exchange.
2 And these companies have -- and we have the same problem
3 as Singapore, they are listed in Singapore but they are
4 operating in China, management in China, monies are kept
5 in China, and they have two people sitting in an office
6 in Singapore.

7 And we've had -- on my return, I'm having a
8 dialogue session with the shareholders of a company
9 called China Sky. They are refusing to comply with the
10 listing rules, and challenging the Exchange, taking the
11 Exchange to court, but they're all in China; they won't
12 come to Singapore. So I think the regulators have to now
13 really think about how to deal with foreign listings,
14 because foreign listings are becoming a liability to the
15 shareholders.

16 What do we do with them? If they're listed in
17 Singapore, I'm suggesting to the exchange that they ought
18 to provide a bond, a bank, you know, bond, or they must
19 provide some sort of safety net for the investors in
20 Singapore before taking the monies outside Singapore.
21 From Singapore, if you want to transfer it to China, you
22 ought to have the safeguards.

1 I'm asking the Exchange can we look at the
2 safeguard. This is not about a Singapore company doing
3 something wrong to Singapore investors; we can take them
4 to court. But this is about the foreign company which
5 runs away and cannot subject themselves -- do not want
6 to subject themselves to the jurisdiction of Singapore
7 or United States.

8 So you've got to ask these people, if they want
9 to come to the United States or Singapore and raise funds
10 from the public, from our citizens, they have to give
11 some assurance that they will not deal with the citizens
12 wrongly; they will not do the things that, you know, that
13 the others have done. Because I'm sorry, all have to be
14 treated equally. You've got a constitutional issue
15 there.

16 But in Singapore we are thinking of putting
17 pressure on the, you know, on the regulators to ask if
18 they would put safeguards in place, either requiring
19 independent directors or the auditors of the companies
20 to certify that the monies are being transferred for
21 genuine bona fide reasons and that it should not be
22 transferred like they did in one case, because I know in

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1 one case 80 million was transferred.

2 And do you know what, I spoke to the chairman
3 through an interpreter on the phone, and he said all the
4 monies are safe, 80 million. And the next day, the
5 independent -- the executive directors made the statement
6 that we are only 17 million. And then the following day,
7 another person makes a statement saying that we are not
8 going to give you any more.

9 So, you see, if foreign listings are coming to
10 the United States or to our country, we need to put
11 safeguards in place. That's my reply to your question.

12 MR. KURAMOCHI: Thank you for the question. This
13 is a very difficult question. At the same time, what I
14 can say here is, I think we have to continue the
15 discussion so that they realize, international
16 corporations really provide the mutual benefit.

17 Actually, I am also working for IOSCO. IOSCO is
18 the International Corporation for the Security Regulator,
19 and I'm working on the Accounting and Disclosure
20 Committee, which is a standing committee, and China has
21 a representative on that committee. And we have a lot
22 of dialogue. And this kind of continued dialogue

1 actually, you know, changed the perception.

2 What I can say is, we have to continue the
3 dialogue. And having seen the globalization over the
4 capital market, it is kind of impossible to isolate one
5 country from other countries. So I think the continued
6 dialogue could open the door. Thank you.

7 MR. GERALD: Chairman, if I may add a few more
8 comments. From my experience, the Chinese government
9 does not want to cooperate with the foreign exchanges,
10 because the Chinese -- they do not like Chinese companies
11 listing elsewhere. They said they have not gone through
12 us. I went to see the Chinese ambassador in Singapore,
13 and they appointed a very senior officer to see me, and
14 he said that we will do everything we can, but never got
15 back to me. When I got back to them, the answer is
16 there's nothing we can really do.

17 There isn't an extradition treaty between
18 Singapore and China to bring those culprits back. And
19 I do not know about the United States, but they are
20 refusing to everyone. So it's going to be very difficult
21 to enforce. So investors are being asked to look at
22 these companies very carefully by us before they embark

1 on investing or parting with their precious dollars. And
2 I think there must be this reckoning by investors, that
3 if you invest in a foreign company where everything is
4 outside, you're not going to get -- trace or track your
5 money -- you may not be able to track your dollar; that's
6 the bottom line. So you've got to be very, very careful.

7 Having said that, there are also very
8 enlightening Chinese companies in Singapore who follow
9 proper governance and who are interested in, you know,
10 working with us. So these are the -- we've got about 14
11 companies that have gone astray. But the rest of the
12 156, you know, we find many of them are realizing that
13 they need to, if they come to Singapore, they need to
14 work with us, they need to work with our regulators'
15 Exchange on corporate governance.

16 MEMBER HARRIS: Well, Mr. Gerald, I just want to
17 express my appreciation for your testimony in Busan,
18 South Korea in terms of the importance of establishing
19 independent audit regimes in the Asia community, which
20 is not currently the case in a number of jurisdictions.

21 MR. GERALD: Yes.

22 MEMBER HARRIS: I thought that was very powerful

1 testimony. And we realize you traveled quite a bit to
2 get here today, and very much appreciate your testimony
3 today.

4 MR. GERALD: Thank you, sir. Thank you very much
5 for inviting me. I'm always available to improve the
6 situation for shareholders.

7 MEMBER HARRIS: And then, Mr. Kuramochi, it's --
8 once again, we very much appreciate your being a member
9 of the Investor Working Group of IFIAR, and your
10 participation has been very helpful, and we look forward
11 to that continued assistance in London.

12 MR. KURAMOCHI: Thank you very much.

13 MEMBER HARRIS: I note that, that you indicate
14 here that there's other audit partner rotations and team
15 rotations subject to a seven-year rotation requirement
16 in Japan. If you could either send us some background
17 in terms of how you reached the seven-year team rotation
18 and why that's important in Japan and how that came
19 about, that would be appreciated, or if you know the
20 answer right now.

21 Others have talked about not only engagement
22 partner rotation, which we have under Sarbanes-Oxley, but

1 people have recommended team rotation. And if you care
2 to comment, why does Japan think it's important to have
3 seven-year team rotation?

4 MR. KURAMOCHI: Okay. And so first I have to
5 clarify. So we have a like two-tier partner rotation
6 system. The engagement partner, I mean the lead
7 engagement partner has to be rotated by five years. And
8 the rest of the partners or lead partners have to be
9 rotated by seven years.

10 The reason why we think all the partners have to
11 be subject to the, you know, this rotation requirement
12 is, you know, there's interaction between management and
13 the partners, and in certain periods we have to change,
14 you know, all the partners. And I think this is very
15 important to keep the independence of the audit firm to
16 change all the partners.

17 MEMBER HARRIS: Thank you.

18 CHAIRMAN DOTY: We have about less than 10
19 seconds left on time.

20 Brian, yes, go.

21 MR. CROTEAU: Thank you very much. My question
22 I think is a quick question for David, and it relates to

1 what I think -- and you might correct me if I'm wrong,
2 or if you're able to talk about this that would be
3 helpful -- but I think there was a requirement for
4 rotation of firms, at least for banks in Singapore, that
5 was lifted in 2008 but had been implemented before that.
6 I'm not sure if it ever took effect, but I think in 2008
7 there were concerns over disruption. It was lifted. But
8 I wondered if you could just say a few words about that
9 and provide a little background about that.

10 MR. GERALD: Yes, you've got me there. But the
11 reason is I think that Singapore is also grappling with
12 bringing in little island, institutions, financial
13 institutions, listing companies, and companies to list
14 in Singapore, and there had been some feedback on the
15 disruption is costly to the banking industry, and
16 therefore there was a review.

17 But those methods are still under review, and I
18 do not know -- I'm not a part of the regulators, you
19 know, in business. But I think as we go along, new rules
20 will evolve to make it easier for banks to do business.

21 If I may ask, Mr. Chairman, any reaction to the
22 suggestion that you should mandate internal auditors as

1 a full-time officer in the, in the public listed
2 companies? We are trying to do that in Singapore now.
3 I mean, our association is pushing for that.

4 CHAIRMAN DOTY: U.S. public companies routinely
5 now have full-time internal audit services. It's not
6 something the PCAOB would normally do under our
7 authority. Our authority is over registered firms, not
8 over corporate governance structures or the management
9 structure of a business corporation. I think the SEC
10 disclosure regime gets very clearly to us. So a company
11 that did not have an internal audit function would have
12 to say something about that. That would be something I
13 think that would make it very difficult. Marty?

14 MR. BAUMANN: Thanks. I have a question for
15 Koichiro.

16 Many who have talked here today talked about the
17 fact that it would be very hard to change auditors in the
18 United States because there's only four firms auditing
19 98 percent of the market cap or whatever it is. And for
20 Japanese listed companies, do you have essentially the
21 same thing? Is your market dominated by just four firms
22 for the Japanese-listed companies in Japan?

1 MR. KURAMOCHI: The situation is very similar,
2 especially for the large listed companies. Most of the
3 large listed companies are audited by four audit firms,
4 the four accounting firms. Because large listed
5 companies have subsidiaries all over the world, and they
6 have to get audited, and their international network is
7 very, very essential. So that is why, you know,
8 concentration situation in Japan is very similar to the
9 United States. Thank you.

10 CHAIRMAN DOTY: I guess I should also say that
11 our communications with auditor committee standards
12 would, David Gerald, it would require the auditor to talk
13 to the audit committee about their assessment of the
14 strength of internal audits, whether or not it was
15 adequate, and whether or not they were reliable. So we
16 get at -- there are two disclosure channels into the
17 existence of being a full-time internal audit.

18 I think it's for me to say thank you all again
19 for coming a long way and for being good partners in
20 cross-border oversight.

21 MR. GERALD: Thank you.

22 MR. KURAMOCHI: Thank you very much.

1 CHAIRMAN DOTY: And we now are going to the
2 firms.

3 David Follett. Dave Follett is the Chief
4 Practice Officer of Moss Adams, LLP. He's practiced
5 public accounting since 1992. He's been a partner since
6 2001. In October 2011, he was appointed Chief Practice
7 Officer of Moss Adams. In this roll, he has full
8 responsibility for client service, oversight of industry
9 service groups, and responsibility for the firm's
10 business development functions. Extensive experience
11 working with larger middle-market companies, public and
12 private. Past chair of the firm's SEC corporate finance
13 group. Co-chair of the International Services Group.
14 Continues to serve as the reviewing partner on audits of
15 public companies. Professional accounting fellow with
16 the Division of Corporation and Finance of the SEC.
17 Welcome to Dave Follett. And other professional
18 qualifications that are in his resume.

19 Tom Gard joined Armanino & McKenna, LLP as an
20 audit partner in 1996. Became partner in charge of the
21 audit practice, 2005. Seven years with KPMG, became an
22 audit senior manager, and served as CFO and COO for a

1 regional and commercial insurance brokerage. He's been
2 a certified public accountant since 1984, member of the
3 AICPA. In 2002, received his accreditation from the
4 AICPA in Business Valuation. Been qualified as an expert
5 witness in various jurisdictions. Extremely involved
6 with clientele on the distribution of financial services
7 and technology sections, has deep experience with
8 publicly-traded clientele and the rules and regs of the
9 SEC. Welcome Tom Gard, and to Dave Follett.

10 Paul Regan, Chairman of Hemming Morse. Mr. Regan
11 is chairman. Has been a certified public accountant for
12 more than 40 years. His work in the accounting
13 profession includes experience as an auditor and a
14 consultant. As an auditor, he served as an engagement
15 partner, supervised audits of public and private
16 companies. As an accounting expert, he has testified in
17 more than 100 trials and arbitrations and in more than
18 200 depositions, and has worked on more than 750 complex
19 litigation matters, many of these involving extensive
20 analysis and determination of GAAP, our own auditing
21 standards, and SEC reporting. His testimony has been on
22 behalf of companies, as well as for various state and

1 federal agencies. He has undergraduate and graduate
2 degrees in accounting. Designated by the American -- by
3 the AICPA as a Certified Financial Forensics, a CFF. He
4 is a past chair of the California Society of Certified
5 Public Accountants, and is a current member of its
6 council. Also past member of the AICPA's governing
7 council.

8 Gilbert Vasquez, Managing Partner, Vasquez &
9 Company. He has managed and directed a successful
10 practice in public accounting, auditing, taxation, and
11 financial consulting since 1967. Recognized as a
12 prominent CPA, community leader and entrepreneur. Past
13 president of the California Board of Accountancy. Many
14 honors, including the Mexican-American Legal Defense and
15 Education Fund Achievement Award, the Coca Cola Golden
16 Hammer Award, Citizen of the Year by the Northeast
17 Chapter of the American Red Cross. And there are other
18 awards here that go on and on. Holds a Bachelor of
19 Science in Business Administration and a major in
20 accounting from Cal State Los Angeles, and is a
21 credentialed professor of accounting.

22 Welcome to all of you. You bring a very

1 important segment of all of this issue of the
2 independence and objectivity to this Board, and we thank
3 you for being here.

4 Dave Follett.

5 MR. FOLLETT: All right. Thank you, Chairman
6 Doty, members of the PCAOB, and observers.

7 I am David Follett, the Chief Practice Officer
8 from Moss Adams. Moss Adams is the largest accounting
9 firm based in the western United States, and we are the
10 auditor of many middle-market and smaller public
11 companies. In addition, we serve privately-held and
12 other public interest entities, including those who plan
13 to seek capital in the U.S. equity markets in the future.
14 We have been inspected by the PCAOB three times,
15 including our initial inspection six years ago.

16 My firm appreciates the opportunity to
17 participate in this public meeting on auditor
18 independence and audit firm rotation, to further
19 discussion on ways to enhance auditor independence,
20 objectivity and professional skepticism. We are committed
21 to the ongoing efforts to continue to improve audit
22 quality in our firm and in the profession.

1 We believe SOX has had a positive impact on audit
2 quality. The creation of the PCAOB and the strengthening
3 of the role of the audit committee have built a solid
4 foundation for enhancing investor protection. I
5 personally served as the signing engagement partner on
6 the audits of issuers, and believe in and have witnessed
7 improvement in audit quality since the enactment of
8 Sarbanes-Oxley in 2002. This includes the enhanced
9 oversight and participation of audit committees.

10 Auditor objectivity and professional skepticism
11 are at the root of audit quality. The PCAOB and the
12 profession should continue to seek ways to improve
13 objectivity and skepticism. Actions taken for
14 improvement by the PCAOB should be supported by objective
15 evidence of the cost to implement, and more important,
16 the achievement of the benefit of improved audit quality.
17 As I will discuss further, we do not believe mandatory
18 firm rotation achieves the objectives of improving audit
19 objectivity, and therefore we, along with the majority
20 of stakeholders who have commented on this Concept
21 Release, are opposed to the PCAOB's proposal.

22 We believe mandate of firm rotation would

1 undermine the authority of the audit committee whose role
2 has been enhanced by the implementation of SOX. Audit
3 committees are essential to maintaining an appropriate
4 oversight of the issuer-auditor relationship. Mandatory
5 firm rotation inappropriately prohibits an entity's
6 ability to continue with an existing auditor even if the
7 audit committee determines it's in the best interest of
8 the entities shareholders.

9 And I would insert that while there's been some
10 comments on the activities and the role that the audit
11 committees play, I can comment in the smaller and
12 middle-market companies. I'm pleased to say that what
13 we see is a very robust activity and communications in
14 dialogue with those committees, and they're very engaged
15 in the company's operations and their role. Further,
16 research does not support audit firm longevity as a root
17 cause for audit failures or a lack of objectivity or
18 skepticism. Mandatory rotation would cause significant
19 disruption and an increase in costs. We believe there
20 would be a disproportionate burden on middle-market and
21 smaller public companies as a result of mandatory
22 rotation.

1 SOX has improved audit quality in many ways. In
2 response to the increased responsibility placed on
3 management to assess and report on internal controls of
4 financial reporting, SEC issuers have been more
5 responsive to improving upon internal control
6 deficiencies. Audit committees have also become more
7 involved in the understanding of the internal control
8 deficiencies identified by management and the auditor,
9 and more insistent in requiring changes be implemented
10 to address these deficiencies.

11 In addition, requiring audit committees to be
12 responsible for the hiring, retention and termination
13 decisions of the independent registered accounting firm
14 has created a better oversight to the relationship
15 between management and the auditor. Finally, the PCAOB
16 inspection process has helped firms identify areas to
17 improve audit quality. Overall, these areas create
18 foundations and opportunities for continued improvement.

19 As noted in many of the comment letters received
20 by the PCAOB, there are alternatives to mandatory firm
21 rotation that involve less risk and less cost. We
22 recommend that PCAOB focus its efforts on constructive

1 dialogue with stakeholders to determine alternative
2 approaches to mandatory firm rotation that will have a
3 positive impact on auditor independence, objectivity and
4 professional skepticism, such as the following.

5 Engaging with audit committees to improve their
6 corporate governance practices, including the training,
7 evaluation of auditor performance, and the sharing of
8 best practices.

9 Performing root cause analysis of audit
10 deficiencies identified during internal and PCAOB
11 inspections, and providing more open collaboration
12 between the PCAOB and the profession on steps to be taken
13 in response to these findings.

14 Third, increasing transparency between auditor
15 and audit committees, including the communication
16 inspection findings, and enhancing audit firm quality
17 control and training with a focus on continued
18 improvement of objectivity, skepticism and audit
19 performance.

20 The profession has come a long ways over these
21 last 10 years, but we also recognize that continued
22 improvement is necessary. Moss Adams looks forward to

1 the opportunity to participate in the efforts to improve
2 audit quality. We appreciate the opportunity to
3 participate in these important round-tables and look
4 forward to the discussion today.

5 MR. GARD: Thank you. On behalf of Armanino
6 McKenna, I appreciate the opportunity to participate in
7 this panel to express our views on various means to
8 enhance auditor independence, objectivity and
9 professional skepticism.

10 I'd like to take this opportunity to give the
11 Board a brief overview of our firm. Over the past 50
12 years, Armanino McKenna has become largest
13 California-based accounting firm with over 350
14 professionals located in the San Francisco Bay Area and
15 throughout the west coast. We provide audit, tax and
16 consulting services to a diversified client base
17 operating in multiple industries. Our audit clients are
18 both privately held and publicly traded, and include many
19 with either national or international operations.

20 Typically, these accounts are headquartered in
21 the Bay Area, with multiple locations either across the
22 country or around the globe. We have provided services

1 to registrants for nearly 20 years, including services
2 in connection with various offerings.

3 Quality is the cornerstone of our firm's audit
4 service approach. We are proud that the results of our
5 peer reviews and periodic inspections demonstrate the
6 quality with which we approach our work. The primary
7 goal of our profession has to be to develop and preserve
8 investor and creditor confidence in financial
9 information. Anything less than that is not acceptable.
10 I think most of us could agree on this objective. If we
11 do not enhance investor and creditor confidence in the
12 client's financial statements, we must question the value
13 of the services we are providing.

14 The pursuit of audit quality is a major objective
15 for standard-setting organizations around the world. In
16 December of 2011, various audit reform proposals were
17 advanced in the European Union, including mandatory
18 rotation of audit firms with defined cooling-off periods
19 and prohibition from providing non-audit services to
20 public interest entities. Similar requirements are being
21 evaluated around the globe to determine their effect on
22 audit effectiveness. We applaud all actions towards the

1 goal of increasing audit effectiveness.

2 Audit firm rotation is a significant
3 consideration. Since the adoption of the Sarbanes-Oxley
4 Act, engagement partner rotation has been required after
5 five years. If audit firm rotation is to be implemented,
6 the ramifications of such a change will need to be fully
7 evaluated. The costs and benefits of such change must
8 be carefully weighed and balanced. Requiring rotation
9 of the audit firm will have some negative consequences.
10 These have been discussed repeatedly in prior public
11 meetings and comment letters. I will not repeat all of
12 these possible consequences here.

13 However, a main ramification is the disruption
14 caused by any change and the additional time and effort
15 required to bring a new audit firm up to speed with the
16 company being audited. No matter how well-coordinated
17 the transition is, a change does involve significant time
18 and effort of both registrant and audit firm personnel.

19 It is also my experience that it may take an
20 audit firm at least one audit cycle, if not more, to
21 fully acquaint themselves with the company being audited,
22 to be able to design and implement the most effective

1 audit they can plan. Thus, audit firm rotation may
2 actually decrease audit effectiveness in the early years
3 of the rotation.

4 This statement in no way implies that the
5 first-year audit is in some way deficient, that it's just
6 not planned with the same level of understanding of
7 company operations that is obtained after going through
8 the entire audit process. Subsequent audits benefit from
9 this understanding, and the efficiency and effectiveness
10 of subsequent years audit improve.

11 The main driver for audit firm rotation is to
12 prevent complacency in the auditor by introducing new
13 perspectives at regular intervals. However, I'm not
14 aware of strong evidence showing a direct correlation
15 between auditor tenure and audit deficiencies, much less
16 the amount of time before complacency begins to occur.
17 The PCAOB in its Concept Release stated preliminary
18 analysis appears to show no correlation between auditor
19 tenure and number of comments in PCAOB inspection
20 reports. Thus, are we considering a remedy to audit
21 deficiencies that will not be effective?

22 In any respect, doesn't the rotation of the

1 engagement partner already make significant strides
2 toward preventing such complacency? Certainly, a new
3 perspective and a fresh re-questioning of audit approach
4 in past decisions is inherently healthy in the audit
5 process. Thus, are we really obtaining diminishing
6 returns on improving audit effectiveness by requiring
7 audit firm rotation in lieu of the current audit partner
8 rotation? In other words, are the costs incurred to
9 rotate the audit firm worth the incremental benefits?

10 We do see one potential benefit of audit firm
11 rotation that should not to be understated. In a
12 marketplace with many viable audit firms vying for a
13 company's business, there should be inherently healthy
14 competition. A company can typically choose its audit
15 firm from firms of varying size, skill sets and
16 demographics, and with certain differences in audit
17 approach. However, for registrants, the overwhelming
18 audit service providers are national firms, and of
19 national firms, very markedly, the big four firms.

20 Thus the competitive landscape in selecting an
21 audit firm for public companies is very different from
22 the landscape enjoyed by private companies. Preference

1 for national firms is dictated by several factors, some
2 very valid, and other reasons, perhaps legacies from
3 common practice.

4 Certainly, very large public registrants may
5 require the largest public accounting firms to benefit
6 from the audit firm's geographical diversity and
7 locations. However, many registrants are not as
8 geographically spread and could benefit from the service
9 approach that smaller firms provide. We believe there
10 are many registrants that a regional firm like ours can
11 service in a more responsive manner, where we are just
12 a better match of resources to the company's primary
13 needs.

14 However, given the current competitive landscape,
15 the frequency of registrants looking beyond the national
16 firms is relatively low. Underwriters, private equity
17 firms and financial institutions with long business
18 relationships with various national firms help perpetuate
19 this marketplace. Again, sometimes are warranted for the
20 size and geographical footprint of the company in
21 question, but many times not.

22 Requiring audit firm rotation could assist in

1 changing the competitive landscape for audit services to
2 registrants. As the vast majority of registrants are
3 audited by the big four accounting firms, requiring audit
4 firm rotation would make for some interesting decisions
5 for registrants. Many times consideration of other big
6 four firms is not feasible as many may be conflicted
7 given other services provided to the registrant. It's
8 not uncommon for a registrant to utilize other firms to
9 perform tax provision, internal audit, internal control,
10 IT and valuation services. Thus the registrant's choices
11 upon firm rotation may be few, if they solely look to the
12 national firms, and more particularly the big four firms.

13 With fewer alternatives, perhaps the registrant
14 will be more inclined to consider regional audit firms.
15 More likely, other large firms will make the investment
16 to become stronger national and/or global firms to
17 increase the alternatives available to large registrants.
18 Competition generally leads to new solutions and
19 providers. I do not believe we should be afraid of
20 increasing competition because the pool of large audit
21 firms now appears small. If the opportunity is strong,
22 other providers will position themselves to fill this

1 need, especially given lead time to prepare.

2 Requiring audit firm rotation could lead to a
3 more interactive and participatory market for audit
4 services. This increased marketplace will provide more
5 options to the registrant, and thereby will enable the
6 registrant to find the firm that best fits the
7 registrant's particular needs and circumstances.
8 Long-term increased audit quality of course cannot be
9 compromised; however, competition generally leads to
10 innovation and improvement, results that investors and
11 creditors will value. The benefits and costs of
12 mandatory audit firm rotation are difficult to quantify
13 with precision, but must be obviously carefully weighed.

14 I want to express my appreciation to the PCAOB
15 for the opportunity to participate in this panel. I look
16 forward to continued dialogue and evaluation of this
17 issue.

18 CHAIRMAN DOTY: Paul Regan.

19 MR. REGAN: Good afternoon, Mr. Chairman, and
20 thank you for giving me the opportunity to make comments
21 on the audit firm rotation issue. And thank you to the
22 Board as well.

1 I'll try not to read my comments. I understand
2 you have my comments in front of you. There's a couple
3 of paragraphs that I might read to make particular
4 points. You do have an understanding that my background,
5 a couple of particular points that really provide the
6 basis for my comments. And the basis for my comments are
7 my individual experience. They're not the views of my
8 firm. They're not the views of organizations that I am
9 associated with.

10 I have been audit chair of a public company. I
11 have been on audit committees of public companies and I
12 have and continue to be on audit committees of non-profit
13 companies.

14 The experience that particularly, is particularly
15 relevant to my comments here today is in my investigation
16 of significant audit failures since the early 1980s.
17 You'll see I've listed in item 4 on page 1 of my comments
18 some companies that I have investigated and I have
19 testified on. And they include the Sunbeam Corporation,
20 Enron Corporation, Xerox Corporation, Parmalat which is
21 an Italian entity, and Mini-Scribe which was one of the,
22 one of the early audit failures that I was associated

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1 with, the bricks that were disguised as 20 and 40
2 megabyte hard drives.

3 My work has principally been for the Securities
4 and Exchange Commission, testifying as an expert on both
5 GAAP and GAAS, as well as the FDIC, but certainly the
6 Resolution Trust Corporation in the '80s got me involved
7 in this process, mostly in financial institutions in
8 Texas, Oklahoma, Florida, New York, California, Colorado.
9 And I also assist the PCAOB, and I have testified for the
10 PCAOB with respect to audit failure issues.

11 My work has involved investigations around the
12 world. They have involved auditors that are big eight,
13 big six, big five, big four, medium-sized companies,
14 medium-sized firms, as well as small firms. I have done
15 and reviewed audits that were performed in the United
16 States, Europe, Canada, Asia, South and Central America,
17 as well as India.

18 As a consequence, my comments on mandatory firm
19 rotation come principally from that experience and that
20 environment. And when I read the Concept Release, there
21 were some statements in that Release that I'm very
22 familiar with, and I witnessed and I've seen and I think

1 are troubling. On page 2 of my comments, you'll see that
2 I've identified five that I think are particularly
3 important.

4 I think that the annual inspections, you've
5 commented in the Concept Release, the inspections now are
6 approximately 2,800, and that you've discovered and
7 analyzed several hundred cases involving what they deem
8 to be audit failures. In assessing that, I find that
9 very troubling. It's a significant number, and it's
10 concerning to me and it's concerning to, I think, a lot
11 of other users of audited financial statements.

12 What's perhaps even more troubling is, included
13 in the concept statement, is that although your, your
14 results on the 2010 inspections are not complete, you do
15 observe that you're identifying more issues now than in
16 prior years. And that in some instances, you're looking
17 at entities again, and there is repetition of past
18 identified significant deficiencies. And that is, in
19 addition, very troubling.

20 The last three points, rather than repeating
21 them, are very similar to what I consistently have seen
22 in my work; that is, an absence of professional

1 skepticism and acceptance of client representations
2 without the application of appropriate auditing
3 procedures, and an absence of objectivity. And in many
4 instances, even activity that borders on advocacy rather
5 than independence and professional skepticism.

6 In the cases that I've worked on, what I have
7 seen, and what I apply a filter of, if there had been an
8 audit rotation, is it likely that the defects in the
9 underlying financial statements, the material departures
10 from GAAP, would they have been detected. I think it's
11 likely that they would have been, certainly would have
12 been detected sooner, either because of the concern by
13 the existing engagement team, that a new team would be
14 replacing them in the near future from a new firm, or,
15 in the absence of the new firm, having caution because
16 of that concern of being replaced by another firm with
17 a new, fresh set of eyes, then the new firm might not be
18 willing to accept the improprieties which were in place
19 causing a material misstatement of financial statements.

20 I've certainly read a lot of the comments that
21 you folks have been reading and hearing. I also see the
22 comment about partner rotation, and in the cases that I

1 worked on, partner rotation has proven to be very
2 ineffective. And there are two principal reasons for it
3 being ineffective.

4 And that is, that the partner who is rotated in
5 is typically self-selected by the firm. And in some
6 instances, selected with influence by the client. Self
7 selection by the firm tends to select someone who is
8 already familiar with the issues and/or familiar with the
9 improprieties which are eventually disclosed.

10 In addition, even if the new partner comes in
11 from -- and not having a vested interest in prior
12 engagements, if the new partner witnesses a circumstance
13 where there is a material misstatement of
14 previously-issued financial statements, that new partner
15 is subjected to monumental pressures. Because with a
16 restatement brings massive costs to the accounting firm,
17 massive costs to the client, probably loss of the client,
18 massive costs of litigation, and potentially the loss of
19 an ability to continue to practice. And some new
20 partners are very -- well they in fact have been
21 reluctant to bring that onslaught of cost and difficulty
22 on them.

1 I've got a couple of comments which I think may
2 be particularly helpful. I see a number of comments that
3 have been made about the enormous cost of changing the
4 auditors, but I also, in my experience, have seen changes
5 in auditors where the costs have been reduced; the fees
6 are less by the new auditor than the old auditor.

7 A suggestion with respect to cost reductions and
8 quality enhancement that I would encourage you to
9 consider. If there is rotation, the firms need help in
10 being efficient and effective in rotation. And I think
11 a very good source of that help is requiring the
12 predecessor auditor to provide access, not only to
13 certain working papers, but certainly the risk
14 assessments and the audit work papers relating to key
15 areas of risk with respect to the financial statements.
16 Cooperation from the predecessor auditor would help the
17 new auditor plan and perform an audit on a more
18 cost-effective basis and more effective auditing
19 procedures.

20 Finally, with respect to implementation, you
21 certainly can't require that everyone change in seven
22 years or five years. This is something that does need

1 to be staggered in your implementation plan. Thank you.

2 CHAIRMAN DOTY: Gilbert Vasquez.

3 MR. VASQUEZ: Thank you, Chairman Doty, members
4 of the panel, and other guests.

5 I've been managing partner of a firm since its
6 inception almost -- more than 40 years ago. I'm very
7 proud to say that in that time period, we've never been
8 sued, we've never had any complaints issued against our
9 firm. Our firm will always be probably classified as a
10 minority firm.

11 In addition to being past president of the
12 California Board of Accountancy, I'm also the founder of
13 ALPFA, which used to be Latino CPAs, and from an idea to
14 -- I understand that our next conference which will be
15 in August we're going to have more than 20,000 members
16 -- I feel pretty good about that. And I started that
17 organization because I wanted to have Latinos be
18 represented in the accounting profession.

19 I have the distinction of serving on more than 10
20 private companies and more than 20 non-profit companies.
21 Of the private companies I've been involved in, five have
22 been publicly traded. I currently sit on two boards, and

1 on the two boards since I've been chair, we've changed
2 the auditors. In both instances the fees went down
3 fairly significantly. There's always a learning curve,
4 but the learning curve with smaller companies; I don't
5 think it's as great as it is with large companies.

6 Our firm has a choice of registered PCAOB, we
7 have a small SEC practice, but mostly we do a lot of
8 governmental clients, a lot of non-profit clients, small
9 private companies, tax consulting work like many other
10 firms do. And so my experience in doing this, kind of
11 makes me look at auditor rotation/firm rotation slightly
12 differently than perhaps some of the other presenters.

13 One of the things that I've always felt is that
14 the incumbent firm has a relationship with clients that
15 will span decades, that there's a lot of pressure on that
16 partner to be -- to make sure that that client doesn't
17 leave that firm. And therefore, sometimes it can have
18 an effect on independence, as well as perception.

19 And so when it comes to both firm rotation and
20 auditor rotation, my perception is different. And aside
21 from performing audits under the PCAOB standards,
22 because\ we do so many governmental clients, we do work

1 under, under GAGAS, and then we do a lot of work under
2 Circular AB-134.

3 And so in this industry there's a lot of RFPs
4 that are going off. There's a lot of firm rotation. We
5 get used to bidding consistently in our -- for these
6 engagements. And obviously we always have to be
7 competitive. The proposals are very extensive. They're
8 very detailed because we're providing, really, the basis
9 of how we're going to perform the audit. Some of our
10 engagements have been in excess of \$2 million, so we're
11 talking about pretty good fees.

12 In the prior testimonies that, that you received,
13 one of the ones that I read, 52 percent of the public
14 companies voluntarily changed auditors between 2003 and
15 2006. So in a sense we have firm rotation taking place
16 now. The European Commission's Green Paper talks about
17 joint audits. In especially the government audit area,
18 we do joint audits all the time. We're subcontractors,
19 we're joint ventures. The process is seamless. The
20 larger the entity, the more reason to have a firm like
21 ours involved and other smaller firms.

22 So I don't maybe have the bias that others might

1 have when they look at either firm rotation and working
2 at auditing, because, again, where I've seen that it's
3 going to be cost prohibitive or it's ineffective and it
4 doesn't work well, when you've been doing it as long as
5 I have for 25 years with some of the big four firms and
6 other firms, it's worked very, very well.

7 So my recommendation, based on 45 years of
8 experience, and again coming from a slightly different
9 environment is, I would be in favor of certainly
10 mandatory rotation of accounting firms after a
11 predetermined period. And if not mandatory, certainly a
12 mandatory RFP period. Because that way, the firm that
13 is doing the audit I think understands that somebody else
14 may be looking over their shoulder, and there's a bit of
15 complacency.

16 When I was working in federal, I was onboard 19
17 years, we had the same audit firm from the inception
18 until we sold out. So for years we had the same audit.
19 And of course there was no PCAOB, there was no partner
20 rotation, but there was a sense of, you know, we didn't
21 need to go out to bid. This company sold in 1995, so a
22 little bit before, you know, our time period here for

1 this issue.

2 In addition to that, I believe that if you do
3 have mandatory rotation, that you'd be looking at
4 multiple-year audit opportunity. And of course you're
5 bidding it out hopefully with firms that would have an
6 audit team in place. I think the audit team also gives
7 the lead firm a reason to be a little more conscious
8 about how they do work.

9 As it relates to publicly-traded companies, I
10 think that the CPA firms that have been found in
11 violation of SEC or PCAOB should at least be prohibited
12 from doing work for that company for three years, until
13 after the violations have been cleared up.

14 And finally, as it relates to policies that you
15 see with federal contracting opportunities, the National
16 Football League recruited minority coaches, minority
17 firms should be given an opportunity to be joint members
18 of audit teams that are bidding for services, especially
19 in the private sector. We're kind of locked out of a lot
20 of these opportunities, especially the larger ones.

21 And again, we're talking about industries. And
22 here in California, we have large utilities. I believe

1 that those are, again, both size, I think, and industry,
2 are easier in a sense of trying to implement either
3 mandatory rotation or at least an RFP after a certain
4 period of time. I think you see it will affect your
5 cost. I think it will make more people a little more
6 efficient. I think they'll be more conscious.

7 Thank you very much for allowing me the
8 opportunity to present my views, and I look forward to
9 our discussion.

10 CHAIRMAN DOTY: Thank you, all.

11 Jeanette?

12 MEMBER FRANZEL: Well, I think it's very
13 appropriate that we have this panel as our final panel,
14 because you all presented all of the dilemmas and the
15 various viewpoints that we have been hearing and that we
16 need to weigh.

17 On the other hand, we hear that Sarbanes-Oxley
18 Act actually has increased audit quality, and therefore
19 maybe we don't need to, to take further steps. We hear
20 we've got a difficult competitive landscape out there,
21 and maybe rotation could help with that, serious fraud
22 cases that could have potentially been discovered earlier

1 with rotation, and then the government non-profit
2 experience with very commonly -- where they commonly use
3 teams of audits to do joint audits and regular rotation,
4 and that market seems to have adjusted to that just fine.
5 So I think we've got a lot to think about here.

6 I am curious about the Sarbanes-Oxley Act
7 increasing audit quality. And maybe to the extent that
8 all of you can speak to this, what specifically have you
9 seen that you can say has increased audit quality in your
10 experience? And I would ask all of the panelists to
11 address that question.

12 MR. FOLLETT: Well, I'll go ahead and start us
13 off. You know, I've seen it on almost every level.
14 Starting, first and foremost, the relationship that we
15 have as the audit firm with the audit committee, and
16 specifically the chair of that audit committee is just
17 dramatically different than it was.

18 And, you know, the companies that we typically
19 deal with are in the range of the, you know, market
20 capitalizations of 30 to 40 million all the way up to
21 north of a billion dollars in market cap, so there's some
22 diversity there.

1 But what we've seen in, in pretty much most
2 cases, and it took some of those companies the first
3 early years of SOX to evolve and to see how the new world
4 was, but the level of dialogue that we have with those
5 audit committees is, is very similar to what you heard
6 from the presenters from the larger companies. I mean,
7 dialogue with committee chairs on a routine basis. I'm
8 talking about, not just the, the quarterly issues that
9 you run into, but looking at prospective matters that may
10 be facing the company, how they're evaluating risk, where
11 we're seeing new areas of audit risks. And just the
12 changing nature of the companies.

13 And the one thing that you have with companies of
14 this size is they're, I'll use the term volatile. And
15 what I mean by that, there's usually something going on.
16 They could be evaluating a transaction; they, sometimes
17 they get acquired; numerous things go on in this space.
18 And just the level of dialogue we have with the
19 committees, that's the starting point.

20 And then that trickles down to the relationship
21 we have with management. And certainly the interaction,
22 our approach to our internal inspections and what the,

1 the dialogue we have with the PCAOB inspectors, it
2 certainly, you know, did not exist pre- SOX. It's just,
3 it's just dramatically changing in all respects.

4 And maybe I'll turn it over to you, Tom, at this
5 point.

6 MR. GARD: Yes, I think I'd echo what was just
7 said as far as the engagement of the audit committees.
8 The market cap -- the companies that we audit, their
9 market cap is very similar to what, what was just
10 indicated that Moss Adams handles as well. But the, the
11 engagement of the audit committee has improved
12 dramatically. Clarifying or maybe emphasizing their role
13 and their responsibilities has really led to active
14 engagement on their part.

15 I think a couple other thoughts too, is requiring
16 the certification of statements by the CFO and CEO. In
17 some cases, perhaps that is focus the CEO a little more
18 clearly that he's signing off as well, that he needs to
19 know what's happening in some of those areas in some of
20 those key decisions, the fact that they're looking at,
21 I think increased internal control awareness, just the
22 whole -- whether it's tested or attested to by the

1 auditors or not, the companies having to go through and
2 make sure that their internal control systems are in
3 place and functioning on a quarterly basis I think has
4 led to some great improvements in that area.

5 MR. REGAN: I would agree that both the
6 strengthening of the audit committee and the
7 certifications have enhanced awareness and the importance
8 of accurate financial reporting. I think the strength
9 of the individuals on the audit committee has been
10 improved. My own personal practice and chair of the
11 audit committee of a public company is, I very much
12 wanted the engagement partner and the concurring partner
13 to have my home phone number, my work phone number, my
14 email address, and I got calls at night, I got calls on
15 Sundays to discuss anything that was concerning the audit
16 partner.

17 However, in the audit frauds that I've looked at,
18 the auditor and management have been very careful to not
19 include the audit committee members in an understanding
20 and an awareness of the matters which eventually turn to
21 restatement and were found to be improper GAAP reporting.
22 So the audit committees are walled off in those

1 circumstances. And unfortunately I see circumstances
2 where people are dishonest. And so I have a distorted
3 perspective and a bad sample size.

4 That's why when I look at your sample size, it's
5 2,800, and when I see that you too are experiencing
6 hundreds of the significant deficiencies, I'm wondering
7 how bad my sample size is. My sample size for
8 significant audit failure is probably less than a
9 hundred, but it's getting close to a hundred.

10 MR. VASQUEZ: Well, I happen to sit on both sides
11 of the fence as an audit committee chair. I can see that
12 the firms are better versed on all the issues that our
13 clients seem to have, at least I think on the
14 organizations and companies that I sit on; more frequent
15 communication.

16 I think on our firm side, the big difference is
17 auditor skepticism. I think, I think that in the old
18 days you just kind of presumed that things were okay. Now
19 you come in and you take a look, you're always concerned
20 about internal controls, you're always concerned about
21 -- you do a background check on people. So you really
22 are better trained, more willing to ask the tougher

1 questions, required to ask the tougher questions, and
2 understanding that at any point in time you can get sued.
3 And so that certainly makes you want to do a better job,
4 and I think that's why we do a better job as well.

5 MR. REGAN: In my prior answer, I don't mean to
6 imply that the auditor was dishonest. The fraud resided
7 with, principally within management. Parmalat may have
8 been a different situation. There are some situations
9 where perhaps the auditor was involved in the fraud. The
10 auditors tend to have a lack of professional,
11 professional skepticism and acceptance of client
12 representations, and a failure to gather persuasive
13 evidence. And when you got a dishonest client, that's
14 not going to lead to a good result many times.

15 MEMBER HARRIS: Do you have any wrap-up thoughts
16 in terms of how the profession or the PCAOB can further
17 enhance investor confidence in the audit?

18 MR. REGAN: Well, I think the database of
19 solution probably resides within your 2,800 inspections.
20 It preceded 2010. On that, I think you've got to analyze
21 those failures that occurred, and those failures that are
22 repeating.

1 And within that analysis, you have to make a very
2 difficult decision of whether things like audit firm
3 rotation is, you know, the balance of -- is it going to
4 be costly. Certainly it's going to be disruptive in the
5 public accounting world and in the client world. But
6 you're going to have to -- you're armed with that
7 information, and you're going to have to make that
8 assessment.

9 Again, in my experience, firm rotation would
10 likely have shortened the period of time or precluded
11 many of the frauds that I've seen. So that -- and you're
12 doing that. And this is not an easy task, I'm sure,
13 because the comment letters that I read are not very
14 favorable toward this, but I believe it would improve
15 audit quality and significantly.

16 MR. GARD: I think the step has to be, in some
17 respects, me as an auditor, I'm looking for causation and
18 analyzing the results of your inspections, and being able
19 to -- right now we're saying there is no direct
20 correlation, or you haven't found a direct correlation
21 between audit tenure and audit deficiencies. I think
22 that causes a lot of problems for people, seeing that

1 this could be a solution, mandatory audit rotation.

2 Somehow, better analysis of that data, and being
3 able to extract root cause for significant deficiencies
4 or audit failure I think is the step that needs to be
5 done.

6 MR. VASQUEZ: One other note. You mentioned
7 auditor-only firms. I think that that would cause more
8 opportunities for more CPA firms. Clearly, if you have
9 auditor rotation, that's also going to expand the number
10 of firms that can grow in expertise. Right now you have
11 the vast majority of registrants are with four firms.
12 I think that's never a good policy. That's never a good
13 business for America. So this is maybe another item to
14 think about.

15 MR. FOLLETT: I'll just add that when listening
16 to testimony, including our own panel, it seems to me
17 that the issue tends to go back to two fundamental
18 questions or issues. And that is, the first is, again,
19 this fresh eyes argument. Getting a different group of
20 people, whether it's a different firm, just different
21 individuals to look at the issues at a company in both
22 an audit and accounting perspective.

1 And, you know, I would argue that what we have
2 seen with the audit, the audit partner required rotation,
3 the concurring partner rotation, and then the other
4 limitations on other partners involved with the
5 engagement, you have a natural evolution of teams and the
6 people who are involved. You don't have the same staff
7 accountant working on engagements year after year,
8 because obviously they progressed in their career. So
9 when you look back on the history of tenures, you have
10 different people involved.

11 And in addition, you also have different people
12 involved with the company, managements change, internal
13 auditors come in. And so I think we're getting fresh
14 eyes today under the current system that we have. I
15 think we just need to identify where are those areas
16 that, that within that construct, need to be addressed,
17 where maybe there isn't the level of skepticism that we
18 need to have.

19 The other issue has to do with the issue of pay
20 model. And I do think that you do need to take a look
21 at -- the firms need to take a look at, is there any one
22 client or a series of clients that individually, you

1 know, for the firm, for an office, for a partner, is
2 significant to the level you would certainly, from an
3 independent standpoint, question whether or not someone
4 could be objective if, you know -- an extreme example,
5 you have one audit firm that has one audit client that
6 represents a hundred percent of their fees, there would
7 certainly be an issue there.

8 I think that what you find, and certainly I can
9 speak for my own firm, is that any one client represents
10 such a small fraction of one percent of certainly the
11 firm's revenue's, or even an office's percent of
12 revenues, that, you know, it just doesn't -- it
13 intuitively does not make sense why a firm would risk it
14 all, from a litigation, regulatory risk, a reputation
15 risk, to make -- to be inclined to make decisions that
16 would put it all on the table for such a small percentage
17 of the -- of the revenues of the firm.

18 So again, I think that looking at the underlying
19 causes of deficiencies, of the magnitude of those
20 deficiencies that the inspectors are finding, and the
21 cause of audit failures, is really the focus. And, you
22 know, that's my thoughts.

1 MEMBER FERGUSON: And one of the things that's
2 been mentioned by panels today, including, I believe on
3 yours, although everything is sort of beginning to run
4 together for me now, but was that it would be helpful,
5 in an alternative to rotation, it would be helpful if
6 audit committees had a better understanding of sort of
7 the PCAOB inspection process and how it works and what
8 it means.

9 And one of the ways -- you know, because we do
10 have a lot of knowledge about audit firms, and it's very
11 detailed knowledge -- one of the things is that, you
12 know, part of our inspection reports are not public.

13 As people who are inspected by the PCAOB, would
14 you be willing to, and what do you think about sharing
15 the non-public portion of your PCAOB inspection reports
16 with, with your audit clients as their evaluating
17 auditor? Because you can do that. We can't share it,
18 but you can. What do you think about that?

19 MR. FOLLETT: Well, I guess maybe I'll start. I
20 think that, you know, certainly my firm would be open to
21 that. And we have the dialogues with audit committees
22 of what we're seeing, whether it's inspection questions

1 that are raised by the inspectors during their work at
2 our firm, or trends that we're seeing. You know, when
3 we started seeing the trends with the level two, level
4 three issues that were coming out within the inspections,
5 is that having that level of dialogue with audit
6 committees, proactively letting them know where we're
7 seeing areas of risk, how we're modifying our audit
8 accordingly to address those matters, you know, is
9 important.

10 I would suggest that -- I don't want to get
11 myself in trouble -- but I think it would be beneficial
12 as to the inspection process, because as you know there's
13 sometimes a very significant time lag between the
14 inspection and the posting of the report, is that maybe
15 there's an interim step where the inspectors can come
16 back with, you know, early indications of areas to focus
17 on, or things that they're seeing in terms of best
18 practices at the other firms, or early indications from
19 the findings without having to wait; which, you know,
20 many times is more than a year from the inspection until
21 the posting of the report. So the firms can more quickly
22 react, have those communications with audit committees

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1 and address risk, you know, further in advance than they
2 can today.

3 MR. GARD: I think actually our firm would be
4 very happy to share that information. We actually do
5 discuss that with our clients. We've had the luxury of
6 having -- we've been through three inspections as well,
7 and our results have been very good. We do a lot of
8 private companies as well, and certainly people are
9 always asking about our peer review results and any
10 comments and things like that. And that's something that
11 we routinely share with prospects or clients and so
12 forth. I think it's important information for them to
13 know the quality of the firm that they're dealing with.

14 MEMBER FERGUSON: What about sharing also to the
15 extent that you had a finding, or a part two finding,
16 sharing your experience in the remediation process and
17 keeping your clients up to date in terms of that, how's
18 the remediation going, what are you doing in terms of
19 remediation, what about that?

20 MR. GARD: Well, I think that would be important.
21 That would probably be the second step. If you had a
22 finding, I logically would want to say, here's what we're

1 doing about it, and here's why we believe we've addressed
2 that issue, here's the things that we put in place to
3 address it, and how it will be prevented in the future
4 and so forth.

5 So again, just, I think, open dialogue about that
6 information, any findings that might be there and steps
7 being taken, is part of a very positive, healthy
8 relationship between the client and the auditor.

9 MR. FOLLETT: Well, I would add that once you
10 start to raise inspection findings, you're almost forced
11 to then discuss the remediation effort the firm is
12 taking, you know, and how you reacted to that by its
13 nature.

14 MR. VASQUEZ: Our firm's been through three PCAOB
15 inspections as well, and I would echo everybody else's
16 comments. Also, as chair of the audit committee, I would
17 definitely want to know what is going on when there is
18 a remediation.

19 MR. REGAN: Speaking as an audit committee member
20 or chair, I would like to be informed and have that be
21 as transparent a process as possible, and I would like
22 the communication to start as early as possible. I mean,

1 waiting until a year after is something that I would
2 really like to avoid. I'd like to be aware of the issues
3 soon as possible. And I would like to understand the
4 remediation that is, that is going on. I think it's a
5 very important communication.

6 MEMBER HANSON: Your firms, you've described,
7 have significant practices in companies that are not
8 subject to our oversight, non-public companies and public
9 sector clients. One of the challenges that I would like
10 you to just tell me if you find it a challenge and how
11 you're dealing with it.

12 On the plane here yesterday, I was dutifully
13 reading my Journal of Accountancy and I think you're all
14 members of the AICPA, and I am too, and the Journal of
15 Accountancy generally is full of really insightful
16 articles about ways for CPAs to provide more services to
17 their clients. It's really about client service from the
18 perspective of serving the needs of management. And
19 we've had a lot of discussion here today about serving
20 the needs of the investors. And Steve Harris is real
21 good about asking who the client is, and we've had a
22 discussion about that, that in public company audit, the

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1 auditor's client is really the investors.

2 How do you balance that messaging that your
3 professionals are often presented with that the
4 profession is about growing services and selling services
5 to clients, and the client is defined as management
6 versus what we're finding challenges with, is resetting
7 that so that auditors and public companies really think
8 first about the needs of the investor, not about the
9 person sitting across the table from them, that they're
10 debating a particular accounting issue?

11 And you don't all need to respond to that, but
12 I'll just pick on Tom and Dave for reactions.

13 MR. GARD: Okay. It is a challenge. Within our
14 firm we probably do about 80 percent of our audit work
15 is for privately-held companies versus about 20 percent
16 publicly traded. I would say, I guess, first of all, we
17 started -- our audit process is very similar. Our risk
18 assessment and everything, really we address the risks
19 in the same manner. But there's always a keen awareness,
20 well, who is, who is the client, who is the reader of the
21 financials. And it might not be the client, it might be
22 a financial institution, is the main reader of those

1 financials for a bank loan or whatever. But who, who is
2 the ultimate reader of those financials, and what's
3 important to them.

4 That helps us dictate some of our materiality
5 considerations in different ways that we look at
6 different things, whether it's a per share calculation,
7 whether it's measure of equity, whether it's a variety
8 of different things, much so that is a very, very
9 important step in our risk assessment.

10 But I think having said that, still, and I guess
11 it -- while it's not universally true, most of the people
12 that work on our publicly-traded clients primarily work
13 in publicly-traded clients, mostly because of their
14 knowledge about the different regulations of the SEC and
15 the different forms and filings and so forth. Although
16 it's not universally true, they still do some private
17 work. But I think that helps. Since they're primarily
18 centered in that market, they're typically, as they're
19 going through the risk assessment, thinking about its
20 investor and its per share information is important in
21 a variety of different aspects in that respect.

22 Ultimately, the goal is the same: getting the

1 right answer. Applying the appropriate test work in the
2 various areas to make sure that you've minimized audit
3 risk and gotten to the right answer. But we have
4 planning meetings, interactive planning meetings on every
5 engagement with the audit partner manager, the entire
6 team to do brainstorming, obviously, and a variety of
7 different techniques and thought processes. And one of
8 those is very, very definitely centered on who's the
9 ultimate reader here, who's the client, who's the reader,
10 let's design our procedures in an appropriate manner.

11 MR. FOLLETT: Well, I guess my comments would
12 echo Tom's. You know, it's interesting when you have a
13 client base like ours, where you're going to, you know,
14 have to audit the Port Authority, to benefit plans,
15 there's a number of, you know, things that we are
16 involved with that, they're not a listed public company,
17 but they're in the public interest.

18 And so from a tone at the top, whether it comes
19 to, you know, our approach to the audit, assessment of
20 risk, who are the users of the financial statements, and,
21 you know, who's investing in this company, I mean, it
22 could even be a private equity firm or a hedge fund of

1 that nature, you know, we do start with the same, the
2 same starting point. But akin to Tom, for those of us
3 who have chosen in our careers to, to be a public company
4 auditor, you know, there is obviously the heightened
5 level of -- everything with independence rules, and, you
6 know, we don't, we don't delve into gray areas.

7 I mean, there's certainly the prohibited services
8 that, that have been outlined, but you'd be pleased,
9 there's many times we get into conversations about a
10 particular service or something that's being requested,
11 and we say, you know, let's just not go there, because
12 it's just, we don't even want to even get close to that
13 line. So, you know, there's differences with what I
14 guess on some level once you start getting down to, you
15 know, a particular service or the needs of the client,
16 and certainly some of the smaller companies we deal with,
17 the private ones are less sophisticated, and we can use
18 our services in different ways. But there's a line. But
19 I would say the tone at the top is really the key on, on
20 everything that we do from an assurance perspective.

21 MR. GURBUTT: Thanks. I guess I have a question
22 that's specifically related to a remark that Mr. Follett

1 made in his opening remarks, but I'd also be interested
2 in the views of the rest of the panel.

3 You said in your statement that there would be a
4 disproportionate burden on middle markets and smaller
5 public companies as a result of mandatory rotation. And
6 I guess I just wanted to understand that a little bit
7 more. And I think my immediate question would be: Why
8 is it that smaller companies change their auditors more
9 frequently than larger companies, if that's the case?

10 MR. FOLLETT: Well, I think the comment's
11 alluding to the fact that -- well, and I do understand
12 -- and some of the previous panelists do have
13 limitations, given the industry and the size and
14 complexity of their international business, they have
15 certain limitations on the ability to rotate. But in
16 terms of the cost, the teams involved, sometimes there's
17 geographic location, there's a number of other factors
18 that affect the smaller to middle-size, mid-market type
19 companies that also have an implication.

20 And again, where some of the larger ones aren't
21 likely to have a transaction, I mean, I could foresee a
22 situation. I mean, I'm often in conversations with these

1 companies about, you know, are they going to do a private
2 transaction? Are they going to do an acquisition? Are
3 they going to be acquired by another company? Well, you
4 could see situations where they're coming up to the
5 mandatory period and being forced to change due to
6 regulation when they are in the midst of doing something
7 that could, you know, materially change their company.
8 And you see more of those types of transactions that, you
9 know, that have huge impacts on the companies, I think,
10 in the space that we operate in.

11 MR. VASQUEZ: I think it's easier for small- and
12 mid-market companies to change, because if you're unhappy
13 with a partner, it's a lot easier to change if you're
14 smaller and the firm's smaller.

15 Cost, I've noticed, always seems to be a factor.
16 It seems like all the smaller companies I've sat on, when
17 we change auditors, rarely does the cost go up. And the
18 costs have a way of creeping up just slowly but surely
19 the longer you're there. It's just like salaries of
20 individuals that work for companies for a long time; one
21 day you look up and you say, gee, how did this happen?
22 And so I think that's part of the reason as well.

1 MR. REGAN: I think at some point, in terms of a
2 company's size, particularly -- not merely its total
3 assets or sales, but how many countries is it in and its
4 geographic dispersion, they may be asking themselves: are
5 we too big to rotate? And I think that's -- that may be
6 a practical and important question, but some of those
7 companies may need to rotate. And they may be forced --
8 they may never rotate unless forced to.

9 CHAIRMAN DOTY: Brian Croteau.

10 MR. CROTEAU: Just quickly, and it may be
11 somewhat rhetorical, and it may be a question for David,
12 picking up on a loose point. And I'm asking you because
13 you said it most recently, but I've heard it from other
14 firms, and so I thought I would raise it.

15 The point about more timely inspection reports is
16 a good one. I know it's a point that the PCAOB has
17 focused on, as well as thinking about other ways to get
18 broadly more information about inspections out sooner.
19 But at the same time, don't firms have an opportunity,
20 relative to inspection comment forms and sort of at the
21 end of inspection field work, and results of internal
22 inspections, to really make use of that information much

1 sooner than the time when an inspection report is issued?

2 MR. FOLLETT: Yes, absolutely. I mean, we do
3 have the dialogue during the inspection period. But you
4 understand when you have the time lag, you know, it's
5 better to have more information, I guess, sooner. And
6 so I think, even if it wasn't the issuance of the report
7 sooner, but just to even have the opportunity for a more
8 robust exit interview process than I think we're
9 currently afforded under the inspection regime, I think
10 is just, you know, an option for you.

11 CHAIRMAN DOTY: Other Board questions? Marty?

12 MR. BAUMANN: Just one more question. In
13 discussion a number of times today, should audit
14 committee members get copies of part two, should you
15 discuss part two with them? I'm just interested in your
16 view.

17 Do you think the audit committee members have a
18 -- would get value out of part two in the sense that --
19 would they understand it, have context, maybe they'll --
20 does part two indicate a certain type of deficiency in
21 your firm? Do they have the ability to put that into
22 context as to: how important is that in your firm? How

1 is it in relation to other firms? So would that, in
2 fact, be useful?

3 MR. GARD: Well, I think some of the comments
4 made earlier, that the more transparent, probably the
5 better. And I think discussing the comment, we would be
6 able to supply the context. We would have to fully
7 explain what was the origin of that finding, that
8 comment? Does it have a bigger root cause? What's the
9 remediation? -- and so forth.

10 So, yes, I don't see any real issue as far as us
11 being able to -- I think it would be incumbent upon us
12 to provide context to help in the understanding of where
13 that comment came from.

14 MR. FOLLETT: And I would add that I do think
15 that something that has been raised by other panelists,
16 you know, something to really consider, and that is
17 getting audit committee members that have prior audit
18 experience. The CFOs are wonderful, and ex-CEOs. But
19 there's nothing better for me than to have an audit
20 committee member who's a former auditor. So when we're
21 discussing areas of risk, fraud risk factors, things that
22 are changing, I mean, it's certainly very helpful to do

1 that, and I think that's something that we can certainly
2 encourage.

3 And I have encouraged the boards that I've worked
4 with to consider that when they have vacancies, as an
5 alternative. And I think that's something that we have
6 an opportunity, and that would facilitate a more robust
7 dialogue about inspection findings. And even beyond
8 that, just areas of emerging risk.

9 MR. VASQUEZ: I might add, it also helps when
10 you're trying to negotiate fees.

11 CHAIRMAN DOTY: This may be an appropriate place
12 to leave it. You represent a segment -- a section of the
13 audit profession that we are very interested, keenly
14 interested in hearing from, understanding and knowing
15 more about. We don't have the chance often to see you
16 in Washington. So one thing that this trip has
17 accomplished is it's given us the chance to sit down and
18 have this discussion with you.

19 It's, I think, extremely significant that Dave
20 Follett's citing to what Sarbanes-Oxley has done by way
21 of improving audit quality focuses on the internal
22 control of financial reporting, the ICFR certification

1 by management, and the report by the auditors. We will
2 be interested in seeing what the JOBS Act does to that.

3 Your views here on what the JOBS Act has done or
4 will do to audit quality and to the benefits of Sarbanes-
5 Oxley, as we go through the process, are going to be very
6 interesting and very important to us. So you've made a
7 difference today. It's been a great privilege and a
8 pleasure to hear from you. And we hope to do more of
9 that in the future. Thank you.

10 With that, I think we can adjourn the meeting.

11 (Whereupon, the above-entitled matter went off
12 the record at 6:36 p.m.)

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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

Before: James R. Doty, Chairman

Date: 06-28-12

Place: San Francisco, CA

was duly recorded and accurately transcribed under
my direction; further, that said transcript is a
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Court Reporter

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