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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION

PCAOB RULEMAKING DOCKET MATTER
NO. 37

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PUBLIC MEETING

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THURSDAY
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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JAMES R. DOTY, Chairman
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JEANETTE M. FRANZEL, Board Member
JAY D. HANSON, Board Member
STEVEN B. HARRIS, Board Member

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KOICHIRO KURAMOCHI, Deputy Chief Accountant, Corporate Accounting and Disclosure Division, Financial Services Agency - Japan

MIKE KWATINETZ, General Partner, Azure Capital Partners

RICHARD D. LEVY, Executive Vice President and Controller, Wells Fargo & Company

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ROBIN MADSEN, Chif Financial Officer, California State Teachers' Retirement System (CalSTRS)
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STEVEN M. WEST, Chairman of the Audit Committee, Cisco Systems, Inc.
THE HONORABLE HAROLD M. WILLIAMS, former Chairman, US Securities and Exchange Commission

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

(8:18 a.m.)

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

It's the second meeting on our Concept Release, but it's the first meeting that the PCAOB is held on the west coast of this type. This meeting will give us the opportunity to benefit from important perspectives with investors, financial statement preparers, academicians, and firm professionals and regulators who participate in our financial markets. We have venture capitalists, audit committee chairs and CFOs on today's panels, and we're eager to hear from all of them.

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

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

We're also deeply grateful for the time spent by the many other speakers who are scheduled here today, in preparing and participating -- preparing for and participating in this open meeting. We have had statements submitted by the Black Economic Council, the NACD, the National Association of Corporate Directors, has a strong interest in this program and in this outreach. And while we have not been able to include everyone on the panel today in the space of the day, we look forward to doing so in the future.

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

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

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

CHAIRMAN DOTY: Mr. Hanson?

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

I'm very interested to hear the viewpoints of all the panelists on things, in addition to mandatory firm rotation. The thing that we seem to hear the most about is the references to audit committees and what audit committees could and should be doing to discharge their responsibilities under Sarbanes-Oxley Act. And we've heard some -- from some very prominent audit committee members about the things they are doing. And I'm looking very much forward it hearing from some prominent audit committee members today as well.

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

And even in Chairman Doty's recent testimony before Congress, Congressman Waters asked specifically if that's something that would need legislation, and something that we would advocate. And so I personally think that we should have more discussion on that to see if it is something that would be of a benefit to the audit committee to help them discharge their responsibility so that we can raise the level of all audit committees to what we observe as some of the best practices.

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

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

I believe that the public policy-making process is best serve by hearing from all interested parties in open deliberative processes such as we are conducting today. And while some of the recommendations we have heard so far are within the SEC's jurisdiction, not ours, I believe the record we are creating may serve as a potentially valuable tool for their consideration as well. I join my colleagues here in looking forward to an illuminating and robust discussion of the many implications of our Concept Release on auditor independence. Thank you, Mr. Chairman.

CHAIRMAN DOTY: Board Member Franzel?

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

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

Through extensive input and feedback we've received to date, many people have expressed support for the Board's efforts in this area of enhancing auditor independence, objectivity and professional skepticism. And we've also heard through some of other projects broad support for the audit itself, and the value that the audit provides. And so the task before us is to really continue to find ways to maintain the relevance and reliability of those audits.

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

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

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

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

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

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

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

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

You have to press your mic.

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

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

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

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

I recognize that many audit committees have been much more active and proactive in their discharging their responsibilities under Sarbanes-Oxley. Certainly, both the written and oral testimony before this body pays high tribute. I do not believe, however, that the audit committee is capable of addressing the issues of lack of professional skepticism by its lack of independence addressed by the Concept Release.

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

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

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

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

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

Now, I support mandatory rotation, but I'm not saying whether it will produce the desired results. We start by addressing recurrent concerns raised about mandatory rotations. There may be but not necessarily would be costs associated with the rotation. I believe the concern is exaggerated. And to the extent that there are costs, I believe they would be justified.

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

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

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

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

And I'll be happy to respond to questions.

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

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

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

I'd like to ask you for a little more elaboration on another statement that you made. And that is, if mandatory rotation is undertaken, you recommend that it begin on a limited basis. And what do you envision by that?

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

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

MR. WILLIAMS: Yes.

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

MEMBER HARRIS: Well, I wanted to focus on the same sentence that, that Jeanette did. And that is if the profession doesn't see a problem and/or cannot be proactive in effectively addressing it, then perhaps the business model of the client-auditor relationship has to be changed. And a number of people have asked, you know, why are we doing this and what is the problem? And they want empirical evidence.

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

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

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

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

CHAIRMAN DOTY: Board Member Ferguson? Lewis?

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

But I want to ask you a specific question about that. To what extent does this conservatism, aside from the oligopolistic structure in the profession, come from the fact that the basic payment model of the audit is that the client pays for the audit? So that there's an inherent reluctance in the final analysis, I think, to do anything that is likely to upset the client too much, the person who's paying the bills. And particularly when the tenure of these audits are very, very long.

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

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

From the firm's standpoint, they want a long-term relationship. It's very understandable. I'd expect that. There's the partner in charge, his progress within the firm will depend upon how well you satisfy the client. If he loses a client, it doesn't do him much positive good within the firm. In fact, it may seriously disrupt his career.

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

And part of that is, obviously is, the payment model. It's hard to visualize a different model. I mean certainly at the extremes I have, you know, federal auditors come in, would certainly change the relationship. But it creates a whole new set of problems that we don't have to presumably deal with today. But it -- and to expect the audit committee -- and I'm in favor of strong audit committees. I think audit committees are doing much more and a better job today, on the basis of Sarbanes-Oxley, than they've done before.

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

CHAIRMAN DOTY: Board Member Hanson?

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

I'm sort of just curious about how your views might have changed over time on this topic, and especially since the package of the Sarbanes-Oxley Act 10 years ago now, next month, and what you maybe observed in conduct or any interactions with auditors, audit committees, companies more recently that -- since the reforms of Sarbanes-Oxley have been under way.

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

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

And where I come down basically is, that the extent that progress is going to be made, it's going to be made by you, and how strongly, how much authority you have, and how you can resist the pressures as you exert -- have to exert more authority to resist the pressures if you're doing your own audit. Because I think it's your audits and the exposure that they get, and the pressure that they bring to bear are the most constructive force towards the end you're trying to achieve.

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

Your written testimony really goes to the jugular vein of this subject, when you raised what Jeanette points to as the statutory mandate. And you also pull apart some of the complexities of audit independence -- of firm rotation as an independence issue when you say there are different segments, different industries that have different risks.

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

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

What would you think of some kind of a rule that invoked some form of rotation, some form of requirement of preserving independence through rotation if there is a build up, an accretion of factors that seem to be dangerous, that seem to be red flags such as frequent changes in auditors, such as recruiting from the accounting firm to the financial reporting area? Is that the kind of thing that we should pursue in terms of looking for areas where our regulatory difference could be invoked?

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

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

MR. WILLIAMS: Yes, exactly.

CHAIRMAN DOTY: Well, we are on schedule.

MR. WILLIAMS: Okay.

CHAIRMAN DOTY: You have got --

MEMBER HARRIS: Can we have --

CHAIRMAN DOTY: What?

MEMBER HARRIS: Can we have more?

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

MEMBER HARRIS: We've got less then a minute.

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

But at that time -- and let me ask a two-prong question. You indicated that, "I would urge the commission to consider a requirement that a public company retain its auditor for a fixed term with no right to terminate. This could be for five years, or perhaps the biblical seven. After that fixed term, the corporation will be required to change auditors. As a consequence of such a requirement, the auditor would be assured of the assignment, and therefore would not be threatened with the loss of the client, and could exercise truly independent judgment."

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

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

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

And your second question?

MEMBER HARRIS: How to promote competition within the profession.

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

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

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

MR. WILLIAMS: Yes.

MEMBER HARRIS: -- options in terms of alternatives.

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

CHAIRMAN DOTY: Steve is right that we have a couple of minutes. Are there other questions from other board members that you want to chip in?

Thank you for getting us off.

MR. WILLIAMS: Thanks a lot, Chairman.

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

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

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

But I think you've raised a very interesting point here, which we really -- which addresses another point that came up from testimony from one of the professors about unconscious bias that takes place in the audit, in the client kind of pay -- the auditor pay model. And so the audit committee can evaluate a lot of things, as you've suggested. But can they evaluate whether or not the auditor is lacking in skepticism or is lacking in bias. And I think that's an area for further pursuit on our part in terms of questioning of audit committee members.

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

MR. WILLIAMS: Well, I don't know that I have anything specific to add, other than to say I wish, you know, if an audit committee's been successful in this regard, let them come forward and tell us how to do it, because we can learn from it. I don't think you're going it find any examples.

MR. BAUMANN: Thank you.

MR. WILLIAMS: Thank you.

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

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

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

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

Jim Cox, Brainerd Currie Professor of Law at Duke

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

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

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

MR BAILEY: Thank you for inviting me. These conversations remind me of my time at the SEC, and almost make me wish I was there again, because there's so many issues involved here, very hard to deal with. Asking me to speak for five minutes is a real risk, but I'll try.

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

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

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

Throughout this transition, the leadership of the firms believe they could manage any independence conflicts arising out of the management-client service business model. I believe they consistently underrate the impact of the culture they have created.

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

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

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

But first, a few comments on issues that arise every time any kind of significant proposal for making independence changes come up; I'll make a few comments.

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

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

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

Expertise, that is, the auditor's expertise, and transition issues come up. No doubt, firms have developed specialties and have shared the market based on these specialties. Nevertheless, I find it interesting that we will entertain the idea that firms as large and talent-laden as those in question, and that pride themselves on advising managements on complex strategic and operational issues cannot develop the necessary methods to manage the required transitions and operations, and the expertise to do virtually any audit.

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

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

concerning the criteria in which the rotation can be refuted.

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

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

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

In my opinion, it will be staged, and it will give us time to work on the problems, and I think it will be worth the effort.

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

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

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

However, one thing is clear to me, and that is that management must be convinced that failure to protect their current auditor and future auditor's independence will incur costs for them and that their responsibility for those costs will be transparent in the marketplace.

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

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

One of the developments that was pointed out is almost 10 years ago, we did enact and create this body with Sarbanes-Oxley, and now we have a better roadmap about what some of the problems are with public accounting. That comes about by the inspection reports and by the enforcement actions. And, unfortunately, it's a trail that has a consistent theme, and it's what's been hit here earlier, and that is the lack of professional skepticism seems to lie behind every one of these cases.

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

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

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

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

You know, related to that as well, as the disquiet is fed by, you know, constant data points being put out by audit analytics in which we find, for example, at 30 percent of the large public companies have had the same auditor for 25 years, which means that we're not talking about an engagement that's serving the public interest, we're talking about a financial annuity, which is the nature of the relationship. And it goes back to our questions that Chairman Williams was talking about, about the lack of independence that flows from this.

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

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

Now, we do live, as we're all aware, particularly those who reside within the Beltway, in a political climate. And so it may be that what we heard Chairman Williams saying, I think is some very good wisdom, and that is that sometimes in a contemporary, legal political climate, one can think about steps toward where the ultimate goal are, and the suggestions were pilot programs, et cetera.

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

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

I mean, there's an oligopoly at the top. And so, you know, our fellow regulators across the pond in Europe are thinking about this not just in terms of professional skepticism, but also thinking about what the long-term approach is to introducing more competition. Okay? So we thought about this as not only as an industry-structured question, but also a professional competence question. I think they would -- the vectors would point the same way, and that is that you'd like to be able to see the jobs turn over a little bit more often.

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

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

So what are some of the half measures there that work? And, you know, without endorsing any one of these, I would just suggest that, one would be the approach where there would be a requirement that after X number of years -- and we can all sit down and wonder what the X is -- that the firm has to put the client has to put the audit up for a bid. And included in the bidders would be the former auditor, and then have a mandatory disclosure obligation about why, if it turns out that the company, the reporting company, chose to select the former auditor, have some explanation about that.

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

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

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

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

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

CHAIRMAN DOTY: Thank you, Professor Cox. Maureen McNichols.

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

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

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

My own research and the work of many others in accounting establishes that informative financial statements are crucial to the allocation of capital in our economy. Substantial research establishes that investors are informed by financial statements, and that stock prices respond significantly to earnings announcements.

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

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

In other research, my co-authors and I find that the ability to predict bankruptcy is impaired when firms manipulate earnings. These findings indicate that the benefits of high-quality financial statements are substantial, immeasurable. These findings also indicate that the potential to manipulate earnings is greatest where judgment is greatest.

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

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

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

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

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

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

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

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

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

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

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

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

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

The Sarbanes-Oxley reforms have been fully implemented, and substantial concern remains regarding the ability of auditors to remain appropriately skeptical of company assertions. I believe the lack of skepticism results from the structure of the client-payer model, and it is now time to pursue alternatives to the current model where the company being audited hires its auditor. I therefore support developing a plan that provides a form of term limit or mandatory rotations for auditors.

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

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

Third, the findings could reflect the fact that earnings quality contributes to auditor tenure, rather than the reverse. Lastly, these studies cannot capture the counterfactual at issue, how auditors perform audits when they are not concerned with maintaining the revenue stream provided by the firm they are auditing, and when they know their work will be reviewed by a successor auditor.

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

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

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

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

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

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

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

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

MR. BAILEY: Yes. It's hard for me to know whether an individual on an audit committee will be able to do that. I don't think that the structure of the audit committees gives me great comfort that that will be something that can be done on a regular basis.

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

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

CHAIRMAN DOTY: Jim?

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

They know the company. They spend more time out.

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

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

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

CHAIRMAN DOTY: Professor McNichols.

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

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

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

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

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

CHAIRMAN DOTY: Mr. Ferguson.

MEMBER FERGUSON: Professor McNichols, you made a statement that I found intriguing, and I think I got it down correctly. And I would like to you elaborate on it, if you would.

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

MS. McNICHOLS: Right.

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

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

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

MS. McNICHOLS: Well --

MEMBER FERGUSON: Is that what the concern is?

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

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

CHAIRMAN DOTY: Steve?

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

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

I have two questions. One, following up on Chairman Williams' testimony, if you were head of a -- one of the firms listening to this hearing today, how would you suggest they be proactive in terms of addressing the problems that you've articulated?

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

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

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

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

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

So I don't know how to deal with the price problem, except to recognize that it's there, that it's an unusual sort of relationship that the client doesn't actually pay you, somebody else does.

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

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

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

CHAIRMAN DOTY: Jim?

MR. COX: Yes, what I meant is, they don't compete on quality. They don't. I think there's a fair amount of reason to support that.

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

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

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

And then how can various people be proactive? I actually think it's time for leadership within the accounting profession, for individuals, not just outside the big four, but the big four themselves, to understand that this is kind of their last go ahead, quite frankly.

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

CHAIRMAN DOTY: Maureen?

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

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

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

CHAIRMAN DOTY: Jeanette Franzel?

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

But there seems to be an acceptance that any other model, just -- we can't really realistically look at that. So given that we've got a model that people believe is flawed, and you all have made references to structural changes that might be needed because of that, the inherent bias in that model, and we also talked about mandatory audit firm rotation and your views on that, I'd be curious in hearing any other structural changes that you think could or should be implemented, and what order of priority would you really place these in.

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

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

And so when you're looking at data and trying to understand whether auditor tenure -- auditors, I think are learning over time, I think the idea is, you know, do auditors do a better job on their audits early in the engagement versus later, or, obviously the -- you know, the argument for many is it's when they do a poor job there's greater audit risk early in the engagement because they don't know the firm as well.

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

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

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

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

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

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

And so one structural recommendation I would make is that there always be someone on, you know, the audit committee and the compensation committee jointly. And some boards, I think, actually have those meetings held at the same time, and so they're completely different compositions.

CHAIRMAN DOTY: Andy?

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

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

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

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

I mean, the GAO had a round-table in which the issue of splitting up the firms came up. Nobody really wanted to talk about it, but it came up. And it is technically feasible to do that. It's going to be very costly, but this might actually begin putting some pressure on the other side of the partnership to think about what it would mean to strip off the auditor, thus eliminating at least that particular part of the conflict, or influencing these firms to grow other consulting firms.

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

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

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

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

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

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

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

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

-- strongly in your statement.

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

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

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

What should we be looking at, though? Where, if there is additional work that we should do to focus on what is pragmatic and what is likely to preserve and to foster an independent audit profession and not move us to a government operation or to something that is an unattainable, such as an insurance model?

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

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

And we're not bad at it. I mean, it's interesting work, and -- but I just have this feeling on this one that it's never going to resolve. You're never going to get the kind of comforts you would like to have that. You're moving, on mandatory auditor rotation, for example, is going to resolve the problem. In fact, of course it will not resolve the problem; it will change the rules of the game. But I think it's a rule changer that might be much more difficult to deal with than the tinkering we've done in the past. And that tinkering, by the way, I don't mean to minimize it, it's important.

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

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

I actually think that, getting ready for this, I was surprised how much literature there is already out there. And it also made me start thinking about the following, and that this is a problem largely of large reporting companies; less of a problem, I think, of small companies. And the reason I'm saying that is that there there's a fair amount, what I'll -- just out of the corner of my eye -- a fair amount of changes of accounting firms each year of public reporting companies which tend to be more allocated to the smaller firms.

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

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

CHAIRMAN DOTY: Do you have a parting ---

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

If our interest is in protecting the markets, okay, then it's the large firms and the large clients, because small failures don't really impact the market much. If your interest is in protecting the investor, you've got a kind of a different kind of moral problem to deal with. So on a roll-out basis, however, starting big and working down in terms of the markets would be the way to go.

CHAIRMAN DOTY: Maureen?

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

I think the other thing that's possible for the boards to do is exploit what you have learned as much as possible from all of your investigations. Perhaps it's some kind of collaboration with academics. Maybe you were already doing some of that. I'm sure that many academics over the years have had, you know, tremendous interest in pursuing questions relating to audits, and are unable to access data through the firms. And so I think there's great potential to contribute to how to do better audits going forward.

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

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

MR. CROTEAU: Thank you, and good morning.

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

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

And I just wonder how you think about that in the context of the re-tendering option, and whether that actually would drive increased quality, or whether that actually could create additional incentives that could cause us to focus more on, in fact, cost rather than quality?

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

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

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

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

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

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

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

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

We also heard from Chairman Williams about can audit committees really dig into some of the issues, do they have the ability to dig into some of the unintentional, you know, the bias that's there, and do they really have the capability to get behind that.

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

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

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

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

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

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

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

CHAIRMAN DOTY: Andy?

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

MR. BAUMANN: There are plenty of retired --

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

MR. BAUMANN: Right. I know of one.

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

CHAIRMAN DOTY: It can't hurt.

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

MR. COX: Yes.

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

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

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

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

CHAIRMAN DOTY: Welcome. This is a panel of entrepreneurs who have actually founded and run businesses. Charlie Drott is an independent consultant, operated your own professional services company based on Novato, California since 1982, providing investigative CPA services, expert witnesses, primarily relative to audit failures and accounting fraud for law firms, law enforcement agencies. Mr. Drott was appointed to and served a full term as a member of the California Board of Accountancy serving as chair of the board's enforcement program oversight committee. He's been chair of a peer review task force, a member of the committee on professional conduct, and has practiced with two of the major public accounting firms.

Brian Fox is the founder of confirmation.com, the holder of two patents granted on electronic audit confirmation, which he used as the foundation for the company that's now used by all of the top 10 banks, the Federal Reserve, more than 8,000 accounting firms, by more than 45,000 individual accountants and 106 companies. Prior to founding Capital Confirmation, Mr. Fox was in Dallas as an auditor for Ernst & Young and mergers and acquisitions for PricewaterhouseCoopers, a four-time winner of the accounting profession's Top 40 under 40 CPA and accounting, and Entrepreneur of the Year, and on the board of the -- the advisory board of several businesses and services and mentor to entrepreneurs in 500 Military Entrepreneurship Program in Nashville. Welcome to you.

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

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

MR. DROTT: Thank you, Chairman Doty, members of the Board and PCAOB staff, for inviting me here today to express my views on auditor independence, mandatory audit firm rotation, professional skepticism and objectivity.

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

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

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

Mandatory rotation has several benefits. One, it establishes a limit on the continuous stream of audit fees. This will significantly free the auditor from pressure by clients to accept improper financial reporting. It would also have the benefit of a new and fresh evaluation of a client's financial reporting and internal controls. It would eliminate long-term cozy improper relationships between the auditor and its client. And it would eliminate further influences on the audit firm's decisions when many of the audit firm's partners, managers and staff have accepted positions with the client.

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

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

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

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

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

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

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

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

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

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

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

CHAIRMAN DOTY: Thank you. Brian Fox.

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

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

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

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

Results from the Association of Certified Fraud Examiners show that frauds usually take place for multiple years before they are discovered, which is far too late for investors who have already invested in the company. In fact, if I were a fraudster, I wouldn't have just written one letter opposing audit firm rotation, I would have written four using different letterhead with logos that I had taken off the internet.

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

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

Honest issuers also don't want to change audit firms. Change always creates a heightened level of anxiety, and changing external audit firms is no exception. Companies note that the new auditors will likely ask different questions, look in new areas, view things from a different point of view, and poke and prod new territory which the prior firm did not, which is exactly the point. People are creatures of habit and like what's familiar to them.

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

A recent look at short sellers, like companies like Muddy Waters illustrates that as a profession, we may be missing the forest for trees, as was the case with Sino-Forest and any others. We need to look at how and why external auditors with much greater insight and access to the company, management and detailed financial information can miss frauds that short sellers are able to identify using just publicly available information.

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

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

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

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

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

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

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

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

I want to thank the Board for allowing me to speak at this public panel and ask the Board to spend part of its deliberations thinking like a fraudster. Doing so will provide the Board with an interesting perspective on any proposed changes or current standards that I believe will allow you to see the world as the fraudster sees it, which should provide some clarity as to the direction the Board should go with its proposed changes.

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

CHAIRMAN DOTY: Thank you. Steve Thomas.

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

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

Over and over and over again the big firms deny that the public is any sort of a client of theirs, deny that they have any public duty, and deny that it's their job to detect fraud. This isn't an isolated instance, it's in virtually every case I have representing businesses as plaintiffs and defendants.

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

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

So the statement by a long-time audit partner at a big four firm, "I don't know what public means," well, it's defined in their own ethical rules. The accounting profession's public consists of clients, credit granters, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce. That's what the rules say. But they don't know it.

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

Auditor rotation is a good idea, but it's like hitting a lion with a fly swatter. The problem is not that we need to change from one great big auditing firm to another. That's just bringing in someone else who doesn't have the incentive to act in the public interest.

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

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

I would propose things that change the

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

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

The second thing I would suggest is, if we're talking about public companies and the Public Company Accounting Oversight Board, your work should be public. The work of the PCAOB should be public. So each audit opinion that we see all look the same, right? They all look the same when they sign off. There's nothing behind it to tell you what happened. But where there's audit failure, the public, the investors and companies who are going to hire that accounting firm in the future deserve to know. They deserve to know the details of the investigation, and there shouldn't be something that's kept secret for years until, you know, one of the big four just refuses to make any change, if you say, "You ultimately have to disclose it."

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

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

Therefore, if there's an issue about management representations, meaning that the accounting firm is relying on management representations, those must be disclosed in writing to the audit committee, and as part of the audit opinion, and that disclosure should say what the auditor did to actually test management's representations. That written disclosure will make accountability easier, easier for the Board, and easier for investors.

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

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

CHAIRMAN DOTY: Thank you. Lewis Ferguson?

MEMBER FERGUSON: Yes, I must say this. I thought the points that all of you made were intriguing here. But I'd like to ask a kind of funny question that goes to the nature of the way audits are conducted today.

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

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

That we will essentially do a forensic audit of a particular part of the company's operations, starting with the assumption that something's wrong here, not that something's right, but bring a different presumption. It could even be done by a different firm. But even with the firm, because oftentimes the forensic sections of these big firms are separate parts of the firm. Would that help? Would that help to make these -- to basically put management more -- sort of make management more concerned about the nature of the audit, about what's going on?

Would it help find frauds? Would it be more -- would it make the auditor think more like a fraudster himself to try to find audits? What do you think about it?

MR. THOMAS: Well, I think yes, it would help. But I think the problem is not so much the rules, as the incentives. Right now SAS 99 requires that an auditor, for revenue recognition, assume that something could be wrong beyond professional skepticism. But we find the firms don't -- often don't even point to SAS 99.

So I think there are already strong rules that say that an auditor who is giving an opinion about whether there is a material misstatement due to error or fraud undisputedly had the obligation to find fraud, and

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

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

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

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

But as we look at it, SAS 99 does require you to brainstorm, assume a revenue recognition risk. And yet as I do presentations and speeches to two or three hundred folks at a time, and I ask them, I said if that's the case in order to audit revenue you'd have to look at either cash receivables, because you either received it or it's owed, how many people have altered the nature, time and the extent of their confirmation procedures from the time you were staff members, and not one person raises their hand.

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

And as Steve said, realigning the incentives. I mean, if you went to the far extreme, what if you -- and this is impractical to do, but what if you said any audit team that actually catches the fraud, they get to split the audit fee that year amongst them. Right? I mean, that's impractical to say, but, but at least you see where we're going. That would properly align their incentives.

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

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

MEMBER FERGUSON: I said every year.

MR. DROTT: Every year.

MEMBER FERGUSON: But in different areas.

MR. DROTT: Right.

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

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

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

CHAIRMAN DOTY: Steve Harris?

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

MR. FOX: Sure.

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

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

And so as an example, one of the things that we've seen is where in one case one of the short sellers went out and they looked at the gross margin analysis, and they mapped the gross margin movement percentage to the competition. And when they saw very little standard deviation over a four-, five-, or six-year period, they said that's -- that's statistically impossible that that company, their gross margins are going to remain so steady, and yet their competition is going to move up and down with the market, and so they said something's going on. They're playing with their earnings.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Jeanette?

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

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

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

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

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

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

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

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

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

And so, to that question, to your question, Jeanette, the answer to me is this. We've got to go in and perform audit procedures that the fraudsters don't know we're going to perform. We've got to jump and move. We've got to look in different areas, poke, prod and ask questions. Do things differently than we've done before. If we've just been doing things at year end with small sample sizes, let's do them quarterly, let's do them semiannually.

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

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

MR. THOMAS: I appreciate what Brian's saying, and I think that's helpful. Although our experience is that that's not the problem. I mean, I think now maybe the second or third biggest fraud of all time that came out at the same time of Madoff was the Petters fraud.

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

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

And what I proposed in my original remarks was that there should be, for management representations where most of these problems come from, we call it auditing by conversation, is that when they speak to management and get a representation, they should have to detail to the audit committee, and in their audit opinion, what they did to test out management's representations.

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

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

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

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

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

ALL: Thank you very much.

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

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

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

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

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

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

Mr. Hewitt, please.

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

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

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

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

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

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

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

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

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

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

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

The PCAOB and SEC should devise a set of guidelines for audit committees to consider periodically with respect to the independence of the audit firm. The guidelines could be the foundation of the audit committees to discuss and document all aspects of independence with its auditors. And to me this would create a greater focus on the independence and transparency.

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

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

The Federal Advisory Committee recommended that the SEC should issue a statement, a policy articulating how it evaluates the reasonableness of accounting judgments in making an evaluation. It also went on to say the PCAOB should adopt a similar approach with respect to auditing judgments.

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

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

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

In summary, I implore this PCAOB to reexamine the auditors' independence and mandatory rotation of auditors. The solution to the problem is not simple. The PCAOB should focus on strengthening the audit committees, so that they can carry out their responsibilities in auditing under SOX without making mandatory rules and regulations.

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

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

Two, that PCAOB and SEC need to develop and implement a reasonable judgment policy for internal use, and then require accounting firm professionals to have a professional judgment policy.

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

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

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

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

If my recommendations are adopted, I believe the auditors' independence will be enhanced for everyone. SOX, SEC and the PCAOB have greatly improved the quality of audits as evidenced by the great decline in the number of restatements. Because of SOX, investors do have a greater reliability on the financial statements than existed 10 years ago.

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

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

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

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

And I begin with the premise that the members of the board of directors are elected by shareholders, and the audit committee is selected from that board. Since the enactment of Sarbanes-Oxley, audit committees have at least one financial expert on the board, on the committee, and that is by choice. I know it isn't required. But my experience is that is very beneficial and that most boards do, in fact, look for a financial expert, and that the remainder of the members be financially literate.

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

Audit committees are directly responsible, under Sarbanes-Oxley, and related SEC and stock exchange rules for overseeing the independent auditor. Audit committees are also tasked with fiduciary responsibility to shareholders and the oversight of the integrity of a company's financial statements. It is the audit committee that can better understand the needs and risks faced on its company, and determine whether the cost of rotation are outweighed by the need for a new team and a fresh set of eyes.

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

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

With regard to the relationship between the auditor and the audit committee, the concerns about independence, objectivity and professional skepticism are good, they're interesting, and particularly since most audit committees regularly evaluate the independent auditor's performance. And clearly I'm dealing with my experience and not, you know, everyone else's. But they do that to ensure that they are both independent and qualified.

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

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

There is practical concern about whether audit firms will be able to sufficiently staff their audit teams with qualified personnel if each year they are facing the logistical challenge of placing entirely new teams with multiple clients in different locations throughout the country and internationally.

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

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

To ensure an independent alternative, a company would also have to consider rotating its non-audit services, periodically ending engagements with other firms far enough in advance to allow them to serve as the independent audit firm. Many of these non-audit services are for matters that cover an extended period of time, such as an M&A transaction, tax matters, investigations or consulting services where it is not practical or cost effective to terminate an engagement before completion.

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

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

They also currently audit our principal competitor. So we would not be inclined to retain them as our independent auditor for competitive reasons. If I were faced with a situation in which we had to use them as our audit firm, given the lack of alternatives, we'd insist on a completely separate D&T team, and face possible resource availability and allocation issues.

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

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

I won't go through the non-audit -- the non-monetary costs, because I think you understand those. You've heard enough. But like most companies, we've leaned our staff down with our financial accounting personnel fully engaged in supporting the business. Large portions of time spent with a new audit team would either force us to add staff who need to be trained, or require our personnel to prioritize or delay tasks that are critical. And so this is not just a one-year impact, but can last for several years.

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

And, so, I would encourage you -- I'm not going to give you a way to do your job, I'm not even going to give recommendations, because you've had enough of those, but I would just say that when you look at the issues that are involved, that you would consider a closer relationship with audit committees and audit committee chairs, and really an understanding of what happens in the audit committee, as well as the boardroom as you deliberate on this important issue. Thank you.

CHAIRMAN DOTY: Thank you. Christopher Lynch.

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

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

During my career, I've been an audit partner, a staff member of a standard setter, a technical partner in our national office, a senior partner running an industry practice, an audit committee chair, and a board chair. And while the value I've derived from the external auditors' role has varied depending upon the seat that I occupied, I've always insisted that the independence of the firm, its lead partner, and its entire engagement team were critical to those collaborations.

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

I don't see a meaningful correlation between these variables, nor do I believe that mandatory auditor rotation would achieve this objective. The Concept Release establishes a premise that an audit firm with a long client relationship, say greater than 10 or 15 years, may lose its independence, or that the engagement team may be less capable of exercising professional skepticism.

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

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

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

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

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

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

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

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

Second, clients need to be more involved in the selection of the lead partner. Given the importance of this role, most market participants expect that audit committee chairs and the candidates have had qualitative interactions beyond the one or two brief meetings that typically occur before that appointment. My experience also suggests that the transition time of these incoming lead partners varies considerably depending upon the size, complexity, and yes, profitability of the account.

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

We need to be more proactive. We have to reach out as audit committee members to regulators, employees and business units and support functions, and we need to do that without senior management present. I've used this technique where I try and have these one-on-one sessions outside of the audit committee agenda because it just doesn't lend itself. But we have a responsibility to make sure that the information that's coming to us has not been censored and has not been filtered in any inappropriate way.

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

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

In the other instance, the board and our audit committee charter had the provision that we would consider once every five years whether an RFP is appropriate or not for the external auditor.

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

CHAIRMAN DOTY: Thank you. Steven West.

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

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

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

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

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

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

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

I believe sacrificing this relationship due to length of service would be counterproductive to achieving a high level of audit quality that audit committee shareholders and the PCAOB expect.

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

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

While I am supportive of -- while I am not supportive of a one size fits all approach that would result in making a change when the incumbent auditor is providing a quality audit, I am supportive of any of the alternatives that facilitate consistently higher effectiveness of audit committees in evaluating independent auditors. These alternatives could include enhancing reporting of PCAOB inspections to audit committees, to include key themes and root causes of quality problems.

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

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

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

CHAIRMAN DOTY: Thank you. Jeanette Franzel.

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

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

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

MS. HILL: One of the things that I think is very helpful in this is the executive sessions that audit committees have with the auditors, and it's rather interesting what you get out of those meetings when management is not present and you ask directly about various sundry items that you think really need to be reviewed. So I highly advocate the executive sessions, and I think they're very effective in helping the committee get to the root of some issues directly with the auditors.

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

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

And the third element I would state that I think has been very helpful is, we've introduced the concept, and I think most of the firms have been, but a heat map of where they see the risk in the organization, the volume, the potential magnitude for error. But most importantly, not that they have a heat map, but that I aligned that heat map with the risk assessments that exist in my enterprise risk management function in the company, my internal audit function, and my compliance function.

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

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

CHAIRMAN DOTY: Steve Harris.

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

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

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

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

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

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

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

MR. HEWITT: That would not bother me.

MEMBER HARRIS: -- solving it all?

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

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

MS. HILL: Thank you.

CHAIRMAN DOTY: Lewis Ferguson.

MEMBER FERGUSON: One of things a couple of you mentioned was the fact that one of the problems with mandatory auditor rotation is that, given the fact that for any large company you're likely to have services of various sorts performed by all of the big four, a number of the big four, so that in any given -- if you were to make a determination to rotate, you'd be very limited in what your choices were.

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

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

MR. LYNCH: I guess one reaction. You're right, particularly the big four of which I'm most familiar with, do have -- offer a litany of services. But I would say that when I look in totality at the global spend of a company like AIG, there are a whole variety of -- a long list of boutique firms that bring valuation skills, modeling skills, actuarial skills, transformational skills, project management skills, technology skills.

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

MS. HILL: I would agree with what my colleague just said. I would -- I would say that yes, we probably have gotten ourselves in a box. But many of us do use other firms. I mean, we use other firms, small firms for different activities that you have throughout the company. But when you're dealing with things, you know, such as mergers and acquisitions and share repurchase and, you know, some major issue, you really are limited by the capability of the firms that you use.

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

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

CHAIRMAN DOTY: Jay Hanson?

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

And so I appreciate everything that you do.

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

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

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

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

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

MS. HILL: I don't see any downside to having that kind of interaction. I think back to the time when it was considered a no-no, if you will, to have directors talking with shareholders, with major investors, and now there's a move afoot to have much more of that engagement. Certainly understanding Reg FD, but really having more engagement.

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

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

But I do think, in fairness to the process, the external auditor was very candid. They indicated that there were a variety of shortcomings. They were very forthright in saying, you know, we have to address these deficiencies, they are real and we are on it. And that has been incorporated and integrated into the current audit scope and technique.

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

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

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

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

CHAIRMAN DOTY: Marty? Chief Auditor Baumann.

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

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

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

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

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

I think what happens, is that it's not that they don't disclose when management is sitting there, because they do when we look at the review say we've had a difference of opinion here, and the auditor's in the room during this time, the internal auditors, or management, and they'll say but we have resolved it.

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

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

So it really does just give a little bit of additional opportunity for things that just don't cross over in the course of the regular meetings.

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

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

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

MR. LYNCH: I would just say, Marty, in quick response, in a way, if I hear something during an executive session, I feel like I haven't done my job. I am probing, reaching, challenging transactions, judgments, go live dates, I want to hear from them. And I -- you know, right or wrong, we all play devil's advocate a little bit. We challenge management. You better be the one to bring it to me first. And I challenge the external auditors, you better be the one to bring it to me first.

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

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

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

ALL: Thank you again.

CHAIRMAN DOTY: Thank you all.

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

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

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

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

Mike Kwatinetz. General partner Azure Capital Partners. Founding general partner with Azure Capital Partners, where he specializes in software and related infrastructure technologies. His current board memberships are BlogHer, Cooking, Education.com, Knowledge Adventure, Medsphere, Open Road and Rooftop Comedy. Prior to Azure, he was the group head of technology research managing director, and the senior software and hardware analyst at several major investment banks, including Credit Suisse, First Boston, Deutsche Bank Securities and Paine Webber. He was also a senior research analyst at Sanford Bernstein. Prior to this technology research career, he was the CEO of Woodbury Computer Associates, and that was a successful enterprise. And he was Institutional Investors number one Large-Cap "Home-Run Hitter" for stock selection among Wall Street analysts, and remained among the top five in 1999. Furthermore, Reuters and the "Wall Street Journal" had selected him as the number one PC analyst in that annual survey we all look at and read. Served on the boards of the firm Woodbury Computer Associates, Bill Me Later, later acquired by Ebay. He's been in a number of the firms that have later gone on to merger with household names as well.

Mike Maher. Chief financial officer, U.S.

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

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

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

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

CHAIRMAN DOTY: Thank you.

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

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

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

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

And so one of the things that I look at in this is saying, you know, a lot of us can talk and be cynical about the accountability that people have today and who really -- who really experiences dire consequences for their behaviors. I think at some level, we really do need to keep that in consideration as you approach this, is, are we really penalizing and holding accountable those people who have really been off the reservation and off track on this and have caused failures.

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

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

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

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

One of the last things I want to talk about is, firms have -- having been a practicing partner and client handler, I went through the period where we had consulting firms, we had consulting operations, and the consultants came in and tried to generate revenue out of your audit client. And, you know, you would hear all the arguments that say well, you know, our auditors know our system better, so it would be better for our consultants to do the work than somebody else's consultant.

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

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

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

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

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

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

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

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

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

Second, term limits for auditors are as likely to weaken audits and financial reporting as to strengthen them. For example, rather than cleaning up its act just prior to a new auditor coming on board, the existing audit firm is much more likely to aggressively defend its accounting subsequent to the auditor change.

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

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

Finally, changing auditors will involve

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

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

Discussions with auditors on the application evaluation model, input assumptions and sensitivity analyses involves substantial time and costs. In my view, the results suffer from a problem of implied precision. The option pricing model generate a very specific answer. However, whether this output is useful to our investors in assessing the value of the early-stage company is another matter.

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

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

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

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

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

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

CHAIRMAN DOTY: Thank you. Mike Kwatinetz.

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

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

So, we believe very strongly that the first two years of a new auditor, our costs would increase in two ways. The cost of the audit itself will go up as entirely new professionals learn about the company being audited. But also the staff of the audited company would spend considerably more time informing this new team and providing documents that have already been well looked at by the prior audit firm.

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

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

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

It also has several other consequences. A firm that doesn't understand an industry may require the entity to change accounting methods in a way that, while technically correct, lowers the quality of financial statements. On the other hand, auditors that are industry experts can also help the firm being audited by describing best practices in that industry and helping the firm move more towards best practices.

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

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

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

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

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

What this process would do, it would introduce an independent player who's at a fairly senior level within the audit without adding time or expense, and without reducing the knowledge that the existing auditors brought to the table. If independent manager placement is adopted and an audit firm was found to have a number of deficiencies related to a specific client, then audit rotation could be mandated on that client by the PCAOB.

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

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

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

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

For fiscal 2012, Salesforce recorded a GAAP earnings per share loss of nine cents, and pro forma earnings of $1.36. The $1.36 is what investors used. For Q1 of fiscal 2013, NVIDIA reported GAAP earnings of 10 cents per share, and pro forma earnings that were 60 percent higher. For the first quarter of fiscal 2012, Zynga reported a GAAP earnings loss of 85 million, pro forma adjusted EBITDA of 87 million profit, and pro forma net income of 47 million.

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

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

So, in summary, I believe the Oversight Board's goal of reducing material misstatements in financial reporting is quite worthy. The current approach appears to be a little too specific from my point of view, whether or not to require rotation of auditors. I believe this approach has more negatives than positives, and could lead to higher costs and less detection of misstatements.

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

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

CHAIRMAN DOTY: Thank you. Michael Maher.

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

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

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

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

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

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

That is the bottom line.

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

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

For the sake of the dialogue, I'd like to stipulate that there are five major players in the development of a set of financial statements. You have the standard setters, you have management of the company, there's the audit committee of the company, the auditors of the financial statements, and ultimately the regulators. All five of them have a role in these financial statements.

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

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

And what I ultimately concluded was that the causes for not identifying them with respect to fraud and unintentional error would -- would be insufficient scope of work or a lack of objectivity and professional skepticism. And that the causes for differences of -- or failure to catch a problem with respect to differences of opinion could be lack of independence.

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

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

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

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

And that would be so that it's a -- instead of being a retrospective review, it is a contemporaneous review. The second would be for audit committees to have independent experts at their disposal that would help them to review the work. And then finally, in repeated egregious situations, we should allow the PCAOB to create a process that allows them to either mandate or recommend auditor rotation, but that would be the last -- the last step. Thank you.

CHAIRMAN DOTY: Well, thank you. Jay Hanson?

MEMBER HANSON: Thanks for all your comments.

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

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

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

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

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

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

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

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

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

MR. DUNBAR: I would just say that -- maybe I did in an inarticulate way -- but one of the things that happens, and one of the appreciations I've walked away from this today is that everybody has a different set of glasses, and everybody's glasses were manufactured somewhere else. And some people have their glasses on and some people take their glasses off. And that's one of the challenges you've got, because the people who have talked are very passionate about their opinions.

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

I also think that it has some unintended consequences about how the board takes responsibility and how specifically the audit committee takes responsibility. There are, as Mr. Baumann brought up -- I think there are things -- and once again, I'm biased, this is my own bias -- our audit committee is different once you put a retired audit partner on the audit committee than what it was before. And there's a whole issue about pushing the audit committee to do their job and understand what their job is.

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

MR. KELLER: I would just add a couple of things to that. Analogies are always problematic. But what I kept thinking about was this; it's like term limits. We're running a term limits experiment here in the State of California. We've had it in place for a number of years. I have good friends who strongly support it. I know others who don't support it. I think the jury's out about whether it's really working or not.

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

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

And the ones I've worked with are tough-minded. They are very tough-minded people. And the difference in orientation I think you're hearing here today, is people who believe that there's this idea of collusion that management gets into with its auditors, that their fees are there. I can tell you, I have friends who have lost their jobs and their life savings because of what happened with Arthur Andersen. I'm not saying it was handled correctly or incorrectly, I'm just saying it is what it is.

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

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

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

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

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

CHAIRMAN DOTY: Lewis Ferguson?

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

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

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

Would you find it interesting to have

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

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

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

MR. KELLER: So I would say it is not

interesting, it is essential to get that information out to people. Let me give a specific example.

Silicon Valley in the 30 years I've been here has transitioned. It used to be a hardware place. It used to be a place where people made widgets, and then we went to software, and now we're making intangibles. Accounting for these things is very exciting for all of us. But what happened with software rev rec, revenue recognition, was, it took a concerted effort by public companies, by the SEC, by the FASB and other -- and the big six or big four or whatever we were at at that particular point in time to figure this out.

It was only by shining a spotlight on the bad things that had happened, that we figured out that we had to have a much more coherent set of rules about how to recognize revenue in a software company. And I would encourage you, I think there's a wealth of data that exists within the PCAOB, the results of your inspections, and you could do an enormous benefit for audit committees by disclosing that information so we can see what are the hot areas, what are the things you're concerned about. Believe me, we can react to them.

I also serve on the -- I chaired audit committee of a public committee, and we will be all over this. But we need the data to do that. That would be helpful.

MR. KWATINETZ: Yeah, I would agree that it's essential that you release it in actually two ways. One is on the specific audit that I'm on the committee of, I'd like to have information. But then I also think it would be very helpful in a very generic way to point out where risks are that the audit committee should be focused on and thinking about. So I think both of those would be very valuable.

MR. MAHER: I would agree that the information is important. I'd be a little bit more specific about it. I would have the results of each -- each PCAOB review discussed with the specific audit committee. I'd include PCAOB reviewers in that meeting, and I would have from that -- essentially what they used to do in the old days when we gave out management letters, which is that there's a written plan.

We either agree with the deficiencies, or in some cases, and these are the changes that are going to be made either in the internal controls of management or in the process by which the audit is completed. Or we agree that while the deficiency is noted, it's not that material, and we're not going to do anything about it.

CHAIRMAN DOTY: Steve Harris.

MEMBER HARRIS: Well, I'm most interested in independence, objectivity and professional skepticism and how to increase that. You know, mandatory rotation is -- I wouldn't say it's a peripheral issue; it's directly related. But the issue to me is, how to increase objectivity, independence and skepticism. And that's a concern shared internationally.

I mentioned that in my very brief statement there was a meeting of regulators in Korea recently, and the common finding that they all articulated was auditors' professional skepticism and auditor independence. That was in their press release. So how do we deal with that not only domestically but internationally is what I'm focused on.

I do find that there's a little bit of a disconnect. I do not want to vouch for these figures, because I don't have any idea whether they're credible or whether they're not. But later on today, we're going to hear the 52 percent of public companies voluntarily changed auditors between 2003 and 2006, and auditor rotation is already a way of life for local government and non-profit audit clients, and the costs are not prohibitive. I don't know whether that's accurate or inaccurate, but we've got to get the empirical data one way or another. That's -- that's something that we have to focus on.

But, Mr. Dunbar, you raised an issue with respect to -- I think I heard you say concern about advisory services. What did you have in mind with that? And what should we be focusing on in terms of the independence of advisory services or otherwise?

MR. DUNBAR: One of the things that we have instituted is to absolutely set parameters on how much our auditors can provide us in non-audit services in dollar amounts.

My concern is, having lost companies because of the actions of our consultants, having watch a partner's career be destroyed when it really wasn't his fault. But because the consulting generation of revenue, all the firms appear to me to have reinstituted -- they call them different things -- advisory services, aka consulting, and the firms may find this testimony, that I'm a turncoat on them -- but quite frankly, I just yesterday had a conversation with our CFO saying no, these -- our auditor cannot do these services.

So there's an increase in creep, what I call scope creep, of wanting to provide these ancillary services to audit clients as opposed to, in my firm, we used to call it channel one revenues and channel two revenues. Channel one was audit clients, channel two was non-audit clients. And we've managed it that way.

So I am personally worried, as I watch this come in, it seems innocuous now, but the scope creep around, trying to get your audit for -- your auditor's firm was trying to get you to spend money with them in that area, I think, is a challenge or a risk.

MEMBER HARRIS: Do any of the others of you have any concerns?

MR. KELLER: I think it's a very interesting question, and it is something that I think, serving on an audit committee, I think I'm very sensitive to as well. I also think it would be worth looking into what the history's been here, because there was a time in the late 1990s where there was an effort to get the large accounting firms to spin off their consulting practices. So Ernst & Young spun theirs off to Capgemini, and BearingPoint was a spin out of KPMG. It may be worth looking into what that experience was. I don't -- I can't summarize it for you, but I think it would be worth looking into what that experience was, what worked in that effort and what did not work in that effort.

But I do think that part of it isn't just independence, it's the appearance of independence, and that's also important. And I think when you look at that disclosure, which is a great disclosure, by the way, maybe it be expanded in the annual proxy statement to say where the fees come from. If you look down there and see huge fees relative to the audit fees that are being spent on other ancillary kinds of services, I think it's -- it's not unreasonable for a -- for an investor to look at that and scratch their head and worry about independence. It's a fair question.

MR. KWATINETZ: So I was a manager in the consulting side of Ernst & Young. And I can readily see some of the issues that could -- could happen that way. I also felt that by having the consulting side -- and this is a tricky thing, we actually enhanced some of the audit value. And there were things that the consultants brought from a knowledge point of view that the auditors didn't have in their training. This was ages ago, so I don't know how it's changed.

So there is an offset, but I think that, you know, the way that it's moved toward trying to restrict the amount that auditors will do in consulting is probably the right thing. But if you go back to the history of auditing, it was supposed to be a value added service in terms of helping the company as opposed to a service that was a mandated service.

And I think it's more viewed as a mandated service now as opposed to a valued added service. And it's a very important distinction in terms of how companies look at their auditors. So the consulting side added value. And so that's something to weigh when you're thinking about it. And value could be helping the company improve the way it reports, and, you know, having more things that are valuable to investors in the company.

I just want to add one thing. The suggestion I made of partner -- of manager rotation, I'd really encourage you to think about whether that's something that would be on a -- semi -- you know, a biannual basis. And that would, I believe, increase the diligence of the existing auditors, knowing that a manager from another firm would be part of their audit team every other year. I think that's something that might be another way to go and accomplish some of the objectives of auditor rotation without the cost and the loss of knowledge that's associated with it.

MR. MAHER: I would just add that I think it's correct to minimize the amount of consulting services that the firms provide. On the other hand, I wouldn't want to see that definition be so tight as to preclude collaborative efforts on major accounting issues.

To be blunt, the size of the most recent ASU on fair value was 331 pages. I don't have a staff that's big enough to sit there and look at a 331-page document from FASB on fair value. Fair value is the biggest issue that I have to face internally on financial reporting.

So I have to look to my auditors for some assistance in how to deal with -- with this.

So if consulting is limited to, you know, some of the tax services that we get because they tie in, and working with them on a collaborative basis, I think that's fine. Going to these much larger situations where you're selling systems -- and I don't think the firms do that anymore -- but that would be a concern. So I would -- I would agree with Roger and the rest of the panelists; we need to monitor how much that consulting is becoming.

CHAIRMAN DOTY: Jeanette?

MEMBER FRANZEL: This has been a very rich discussion. And you all have mentioned the complexity of financial reporting and disclosures and some of the very difficult situations your particular companies have faced. And -- but that the goal is reliability of financial reporting overall. And so that does involve more than the audit.

And I wonder if you have any comments on the balance there and what you're seeing in terms of effective ways to mitigate the financial reporting risks through the audit?

MR. KWATINETZ: I -- you know, Michael talked about the different constituencies that are involved, and I think you have to think of the constituencies that mandate reporting. To me, it doesn't matter what the auditor's to do, a lot of people are losing money because of the way that financial reporting is mandated.

I had a personal experience when I was on Wall Street, and I have it in my written thing, Compaq acquired DEC. They then said they were growing 36 percent when they were actually shrinking. And there was no requirement for them to put anything in their financial reports about organic growth versus purchase growth. And it's not that it couldn't be detected, but it just happened I was the only analyst on Wall Street that showed the comparison based on adding the two together the prior year.

What happened is, the stock collapsed when they got close to the -- you know, to annualizing. They had to reveal that they weren't going to keep growing at 36 percent, that it was almost like a fraud, but it was all within accepted reporting. They didn't do anything that was un-allowed. Nothing wrong with the auditors. Nothing was required.

So I think that if you study the broader issue, which is how do we make the reporting better, you may come to conclusions that you have to go to a 331-page requirement. Is that actually enriching the reporting to the users of the statement? Or is it adding a financial burden that actually causes every firm to report the same thing differently? And you're actually increasing the risk of misstatement by doing that.

MR. KELLER: So I have a simple thought experiment to suggest. If we had a company called ABC, Inc. that makes -- is a cloud -- a based widget company, all right; and we take the five largest audit firms and we give them -- actually, it's a hypothetical, so they all go in at the same time, they get the same budget, the same number of hours, and they audit this company. I have two questions that comes out of the following experiment.

One, will the resulting five sets of financial statements, MD&A footnotes, et cetera, be the same? The answer is, of course they won't be the same. Because the firms will pursue different issues. They'll look at different issues. And they focus on different things. And it also reflects the complexity that's inherent in our financial reporting system. And by the way, I don't think that's going to go away. I think we're in a world of intangibles now, and it's not going to go away.

The more interesting question to me is to ask this question: Does the fact that those results are different, even materially different, mean that one of those financial statements is right and the others are wrong? And I suggest to you that in a very complex accounting world that we live in, that is not necessarily the case. That it's possible to have different sets of financials, even for the same identical company at the same point in time that are -- that are both GAAP and GAAS compliant, and that's just a -- that is an outcome of a very, very complicated set of accounting requirements. So we just have to recognize that. There's no one right set of numbers for any entity. It's just not possible.

MEMBER HANSON: Eric, can I just interrupt with a quick question on that? Would you view or do you think it's possible that if you were trying to evaluate the quality of the accounting principles behind vastly different numbers for the identical company, that they be equal quality of the accounting principles, it's just that there's different assumptions built in?

MR. KELLER: I think -- here's an example. Is if you're using an option -- I'll go back to the option pricing model, which is the hammer that we're using for every real and perceived nail out there today in the world we live in, venture capital, right.

The input assumptions in that are not statutory. We have to figure out what they are. They involve judgment. Depending on how you pick those assumptions and test them and measure them and those kind of things, you will get radically different outcomes. And so I do think you can have high-quality audits done with the best of intentions by people that end up in very different parts.

I would actually go a step further. I don't know that that's necessarily a bad thing. I think it's actually good to have different people focused on different things, because they'll find issues where others would no. So that's just a -- you know, again, it's fun in Silicon Valley, it's sort of a sport to rail against the complexity of accounting standards. You know, non-finance people like to do it. But it is the world we live in today. I don't think it's -- it is not -- simply not going to go away.

I'd love to have, instead of an 800 -- a 320-page document, a 30-page document. But I don't think we're going to get there, frankly.

CHAIRMAN DOTY: Are there other questions? Are there other questions by board members or staff?

We're over time, but there comes a -- there comes out of this a certain sense that the four of you embrace the situation we have. Different numbers, as long as we don't penalize the majority and we can't find the wrongdoer to keelhaul, or make that public, don't keelhaul the wrongdoer, it's -- there's a certain sporting legitimacy to finding -- for an analyst to be able to find out from the financial reporting that we have what the average investor can; it's part of the game. And after all, it's tough to change your auditors.

Why don't I come -- I'm going back to what Andy

Bailey said this morning, that the accounting profession -- we are here today because at critical moments in our country's history, the accounting profession dug its heels in and -- and said no change, don't do it, too expensive, too difficult. That's troubling to a lawyer who has admired the accounting profession and has lived through a few of these terms of his career.

Is it the considered judgment of the panel that there is no circumstance in which the PCAOB, looking at the performance of an audit by a firm that has had an engagement for 20 years, and has gone through a process that may have resulted in actually influencing the consultation process to get to a result that management wanted, there's no circumstance in which we should step in and say we think there's been a failure of skepticism here; we think there's been a failure to perform audit procedures that even would have existed under GAAS, let alone our existing standards; no circumstance in which we should look at the auditing firm, big, large or small, medium size and say in this engagement, in this case you are no longer independent? Show us cause why we should determine that you're not independent as to this firm.

Is it your view that that is overstepping the area that we should not tread for the audit committee and the sanctity of the audit?

MR. KWATINETZ: I've actually put in my written statement that you should do that. So I have it under the manager rotation. But it's the -- it's the same exact thing. If you find whether it's through manager rotation or your own internal -- if you find that a firm has not fulfilled its responsibilities and you feel they've been -- let's not say negligent, but less than perfect, you know, on some scale not up to where they should be, then I think you should mandate a change.

CHAIRMAN DOTY: And that's information --

MR. KWATINETZ: That's different than required rotation.

CHAIRMAN DOTY: It is. I mean, I'm really trying to understand where you all come together on common ground. I think it also is the understanding that you think that in a case we find that, we ought to be able to go straight -- there ought to be a kind of reporting up or sounding out by the Board directly to the audit committee right there and then.

MR. DUNBAR: That would be my one caveat, is that I would think that that ought to be brought immediately to the audit committee, and I guess at some level, once again, it's -- you can always put yourself out there. But I would think if the audit committee doesn't react to that and you look at it, and there's always difference upon opinion and judgments, but I would be suspect of an audit committee that didn't act on that, quite frankly. But I would -- I would not give audit committees the opportunity to abdicate responsibility.

MR. KELLER: I would only add to that, that if during a PCAOB inspection you found that an audit was -- was flawed, and that led to a restatement of the financials for the company, I think if that audit committee doesn't consider swapping out the auditors, I think that's -- that would be -- that they would have a responsibility to do that. They would have to do that.

I can't comment on your statutory authority. But again, I think that the -- I think that the dialogue -- that's why the specifics here are important to us, so you can hear we're all saying much the same thing about giving us more specifics. The more specifics we have, the better off we are. And I think we will react to it.

CHAIRMAN DOTY: Well you, along with Jim Cox earlier today and Andrew Bailey, others that had been here, and that were in Washington on the 21st, what you're doing in part is asking us to reflect on our own process and our own remedies, and to think about whether our remedies, perhaps, are inadequate, but should be looked at again.

MR. KWATINETZ: You know, just to throw it back at you, don't you think it's almost negligent on the PCAOB's part to know that something is being done wrong and not communicate it?

CHAIRMAN DOTY: Well, the Congress took a different view. The Congress took a -- on that note -- on that note, perhaps we'll adjourn for lunch. Thank you all.

(Whereupon, the above-entitled matter went off the record at 1:14 p.m. and resumed at 2:00 p.m.)

CHAIRMAN DOTY: Well, good afternoon. Thank you for being here. The panel today gets us back into the public sector.

We have David Eaton, the Vice President of Proxy

Research, Glass, Lewis & Co. He is -- his department analyzes proxies in more than a hundred countries and publishes analyses for nearly 20,000 shareholder meetings annually. At Glass Lewis, he has held multiple positions including U.S. research analyst, director of Glass Lewis' Common Law Research Team. More recently, AVP of Compensation Research, partly responsible for the company's compensation analysis globally, with oversight of the firm's say on pay policies. In this role, he also oversaw environmental, social and governance research and proposal analysis. Prior to joining Glass Lewis, he worked as a research analyst for GovernanceMetrics. He joined Mercer Consulting, managed their Global Executive Remuneration Research and Insights Team for two years before returning to Glass Lewis. He's a frequent speaker in industry conferences, client events and webcasts, and his views on governance and compensation-related issues have been cited in media throughout the country. He holds a Bachelors degree in Economics from Haverford College, a Masters degree in Business Administration from the Yale University School of Management. David, we welcome you.

Janice Hester Amey, Portfolio Manager, Corporate Governance, California State Teachers' Retirement System (CalSTRS). She is a portfolio manager in the Corporate Governance Unit at CalSTRS, responsible for day-to-day management and the development of policies and guidelines relative to the activist investment managers and corporate governance. CalSTRS is a public pension fund, of course, established for the benefit of California public school teachers over 80 years ago. It serves 800,000 members, retirees and beneficiaries, has a portfolio valued at $152 billion as of February 29, 2012, and Corporate Governance represents about $4 billion of those assets. She has spent -- Ms. Amey has spent over 20 years in the investments area, most equally split between the public and the private sectors. And we welcome you, Janice Hester Amey.

Robin Madsen, Chief Financial Officer, California State Teachers' Retirement System, responsible for providing leadership, strategic planning, management direction and policy guidance to CalSTRS Financial Services Function. Joined CalSTRS in June 2009 as a special consultant to the CFO. Prior to joining CalSTRS, she was involved in financial information technology consulting for private and -- public and private sector entities in California, Oregon and Washington for more than 20 years. Began her consulting career with Peat Marwick. Owned and operated two consulting organizations for 13 years, and then prior to that she was the assistant controller and assistant vice president for Kaufman and Broad's Mortgage Company, as well as the loan accounting manager for a wholesale mortgage banker, Farmers Savings Bank. So she brings a great deal of private sector investment experience to this table.

And we are delighted you're here. We're grateful for your insights.

And I will turn it over to David Eaton. Please, you may begin, David.

MR. EATON: Okay. Thank you for having me. And thank you for inviting Glass Lewis to participate in this public forum. Should -- should I go through just a brief statement? Is that the --

CHAIRMAN DOTY: Of course. Deliver a few remarks, and then we'll pass it down the table; we'll come back and ask questions.

MR. EATON: Perfect. I'll -- I'll keep it brief. So, in short, Glass Lewis supports the PCAOB's efforts to ensure auditor independence. We certainly believe that disinterested, independent judgment of a company's financial statements plays a vital role in investor confidence in the company and its management, and in the board of directors.

Glass Lewis, for those of you who are unfamiliar with our role, we're an independent governance analysis and proxy voting firm. We serve institutional investors globally. We have over 900 clients who manage over $15 trillion in assets. These include some of the largest pension plans, asset managers and mutual funds. Our research focused on the long-term financial impact of investment and proxy vote decisions. We empower institutional investors to make sound decisions by uncovering and accessing governance, business, legal, political and accounting risks.

The purpose of our research and what we look at is, we look to drive -- we look for to give advice to institutional investors, to all of our clients, in fact, to facilitate shareholder voting in favor of governance structures that will drive performance, that will create shareholder value, and that will maintain a proper tone at the top at the, at the company. And in this sense, we do look for -- count the boards with a record of protecting shareholder value, mitigating risk, and delivering value over the medium to long term.

We -- we strongly believe that the auditor's role is as a gatekeeper. It's crucial in ensuring the integrity and transparency of the financial information necessary to protecting the shareholder value. Shareholders rely on an auditor to ask the tough questions and to do a thorough analysis of a company's books to ensure that the information provided to shareholders is complete, accurate and fair. And that -- and so it is a reasonable representation of a company's financial position.

The only way shareholders can make a rational investment decision is if the market is equipped with accurate information about a company's fiscal health. We -- Glass Lewis does believe that auditor rotation can ensure both the independence of the auditor and the integrity of the audit. We will typically recommend supporting proposals, although they are very rare, that do ask for auditor rotation.

We do feel, however, that mandatory audit rotation is something to be considered; though mandatory is definitely debatable. We do feel that Sarbanes-Oxley has put some -- some strong checks and safeguards regarding independence and integrity and objectivity in place, including -- particularly moving the responsibility to the audit committee for supervising, selecting and compensating the external auditor.

And I guess in conclusion, I would just say that audit rotation, when combined with -- with limiting non audit-related services, moving audit committee -- the responsibility to the audit committee, as well as the SOX requirement that we audit -- partner rotations is mandatory when combined -- when combining all of those aspects, we feel that the independence and objectivity of auditors has improved in the past decade.

CHAIRMAN DOTY: That's very helpful, and thank you, David. Ms. Amey.

(Pause.)

CHAIRMAN DOTY: Janice put your -- yeah, there we go.

MS. AMEY: Thank you for having me. My name is Janice Hester Amey. I'm a portfolio manager in the corporate governance area of the CalSTRS investments office. Been there since the mid '80s.

We have done a lot of comments all the way back to 2002 on this governance issue and the proper role of the Board Oversight of the audit process. And just as David said, we certainly believe that auditor rotation can be a tool that audit committees can use in order to get a -- a better quality audit, or an audit that has greater integrity, greater independence of the auditor. However, as a fund, we have not been in support of making that requirement mandatory. We'd like to leave the audit committee as the people that are in charge of the relationship.

However, in doing our research for this meeting, I did look at some surveys and studies, the last one done by Protiviti, which actually was surveying public companies on this very question. And even though as investors what we're trying to do is not give companies more regulations and structures than they need to -- to look over the assets and grow the assets, it may look at those from -- if this survey is -- it can hold up, it may look as though the companies are somewhat differently responding.

For instance, nearly half of the public companies that were surveyed by Protiviti agreed that rotation would improve auditing. And that was among accelerated filers. And among large accelerated filers, 47 percent were in favor of rotation. While in non-accelerated filers, 50 percent were in favor of rotation.

So I think we -- we are looking for a solution that still leaves the oversight role at the board level, and leaves the decision at the board level. And I think we would still come out in not being in favor of mandatory rotation. But it does seem that if the companies feel that they're not getting the right kinds of audits, and that this is a tool that they should have, we'd certainly support that.

CHAIRMAN DOTY: Robin Madsen.

MS. MADSEN: Hi. I'm really just here to tell you about our experience with auditor rotation, because we have been through several auditor rotation cycles, and are just into our second year with the new auditor that came out of a -- a public sector procurement process. So because of our unique position in the public sector and the transparency required in our board reporting, we really do need to go through rotation. So -- and we have over the course of the last three or four audit cycles.

We have had -- our auditors have tenure with us for between four and eight years. In this last RFP process, we looked significantly at the issue of independence and whether it was important to exclude the prior auditor from the procurement process, and determined that it was not. So the prior auditor, as well as a competitor were part of our finalists, and were interviewed by our audit and risk management committee.

There was some discussion about the independence issue in that committee meeting, but that did not end up being the determining factor for the award of the contract. We did end up selecting new auditors, but not as a byproduct of any requirement for rotation in particular, but just because it seemed like that was a better choice. So there was a management recommendation and a robust discussion with our audits and risk management committee.

Given the structure of our board as representative of our membership, as well as composition from statutory offices and public representatives, we actually have a financial expert that the audit and risk management committee has hired. So most of the dialogue was prompted by questions from that financial expert, who happens to be a professor at the University of California Davis. So, you know, from a more academic perspective.

And, again, my -- my recollection -- although I didn't go back and listen to the tape -- my recollections were that, there were -- you know, there were discussions of the pros and cons of actually rotating the auditor. But the cost in terms of actual dollar costs, because there were differences in price, as well as the, you know, more of the soft cost, what's it going to cost us, what are we losing in terms of expertise, and what are we gaining in terms of a new set of perspectives.

As the person who's been largely responsible for interacting with the new auditors, and whose staff are on the line with the new auditors, I can tell you that it is expensive, both in dollars terms, and in staff time.

My conclusion, personally from this particular seat that I'm sitting in, is that that expense has been compensated and then some by the value that we have gained from a new set of eyes on our business. And it's not just in terms of the quality of the financial statements, because we haven't actually had them recommend any changes to the financial statements, but it's been in the conversations with the audit team and the fact that they are asking a new set of questions that have led staff and management alike to look at their own operations and determine whether they should be asking different questions.

So I would see it as a ripple effect out into the organization and not purely limited to the financial statement results. Because, as I said, there really have not been any -- any discussions about making changes to those financial statements. But it really has been a different perspective on questions about our business operations, where the risks are, have we been thinking of all those places where we could be subject to material misstatement, those kinds of thought processes have definitely been amplified by the presence of a new -- a new partner in -- in our auditing firm.

So what I can tell you is -- and, again, we're in a public procurement environment, so I have no idea how this translates into another arena, but we did experience actually a 30 to 40 percent increase in cost in the first year. Now we went from a regional firm to a more -- a national firm, so there's obviously a gap there. I'm not sure how to mitigate that. I haven't done any economic research to discount it, but certainly there,, that could be done.

I will say that the partner involvement in our audit in the differences in the scale of the firm has been significant. There's been a significant difference there which would also contribute to the variation in cost.

In terms of the comments about -- that people have made about the expertise in the industry, I -- I haven't found that to be the case. And we have a fairly complicated set of -- we have -- we're in a complicated business. So, especially with all of the public notoriety of pensions right now, it is complicated not only from the actual running of the financial services organizations, but also in terms of public perception.

And I think our new auditors have done a very good job of coming up to speed bringing the right expertise to the table to be able to give us a very high-quality audit.

On the consulting front, we use a variety of firms that are not our auditors. We cannot use our auditors at all, although that is not precluded, our audit and risk management committee would have to approve it. But we have not -- we have not had trouble getting expertise to the table to do the other kind of work we need done, whether it's assistance in internal audits, because we do hire assistants for internal audits, particularly when it comes to the investment portfolio, to management consulting, the industry that I came out of, CATS compliance, we deal with those issues as well. So hopefully that provides a different perspective.

CHAIRMAN DOTY: Thank you. The brevity of this is going to allow us to have more than one pass through this panel. But to clarify, CalSTRS does not have a policy in place now that you will rotate your audit firm every X number of years; or do you have that?

MS. MADSEN: Well, there's no specific policy on audit rotation for CalSTRS. What we have are public procurement requirements. And so because we are bidding audit as a public sector contract, when we go up for bid, we establish the tenure of that engagement, and there is code that allows us to extend for a year. But after that, we need to re-solicit.

CHAIRMAN DOTY: Thank you, that's a helpful clarification. Jeanette Franzel, question?

MEMBER FRANZEL: Yes. You've all noted that you don't necessarily favor mandatory audit firm rotation, but that there are cases where it could be useful to rotate, but not under a mandatory regime.

Can you talk a little bit about the criteria that you use at Glass Lewis and CalSTRS? And then, Ms. Madsen, maybe some of the criteria that you all were considering as well in your procurement for the need to rotate.

MR. EATON: Sure. As I was telling a few people at lunch, there's -- there's few and far between opportunities for Glass Lewis to -- to recommend to our clients on the -- specifically on the issue of auditor rotation. It just doesn't show up on an annual meeting, on a ballot as a proposal.

However, there is, of course, the ratification of the auditor. And over time, that proposal's really become a routine item. And -- and, you know, we're -- we're the first ones to admit that. And I think most of our clients admit that too. And as such, you know, we do have some very stringent points where we will recommend against that ratification. However, it's been approximately two percent of all ratification of auditor proposals that we have recommended against in the last three years.

And the main reason driving that recommendation, that negative recommendation, over four-fifths of the time, it has to do with the auditor relationship with the company in terms of the contract, whether that is limit liability issues or other sorts of provisions that we are opposed to.

We -- we do look to recommend against the ratification of an auditor in -- we have eight different things in our policy guidelines. I won't go through them all, but the primary reasons that we do, like I said, first there is the contractual reasons between the company and the auditor that we might oppose. But also, we do look at the -- at the fees. And we look at, you know, the audit fees plus the audit-related fees as compared to the tax fees and other non-audit fees.

And we have a -- what I would say is a pretty lenient threshold there, where we believe that at least 50 percent of those -- of the aggregate fees need to be, you know, paid in terms of audit and audit-related. I know some of our clients have a much -- much more stringent, you know, thresholds in that -- in that sense.

We will -- I think what gets a little more to the point is we also will recommend against the ratification of an auditor and do feel that a rotation of the auditor is necessary when there's been recent material restatements of annual financial statements, including those resulting in -- the reporting of material weaknesses and internal controls, and including late filings where the audit -- where it's -- we can determine that the auditor bears some responsibility for the restatement or late filing.

MS. AMEY: Yeah, I would support many of the reasons that David said. I think he makes a really good point that as shareholders, you get to vote on the ratification. You don't get to vote on the rotation unless there's a proposal from a shareholder asking that auditors be rotated.

But I think there are things that the audit committee could do if they want to involve investors more in this question. And some of that would be disclosing in the proxy statement the tenure of the audit, or of the audit firm. And any other issues, how they issue -- how they judge the performance of the audit firm, and what, what that judgment says about this firm that they are recommending. I think that would help investors.

Like David, we certainly look when there have been restatements at companies. We do use some analysis when you have an issue that shows you that there's a problem with an audit firm. We look at the information that's provided by unit of MSCI called CSRA that we hire. We also hire Audit Integrity. We pay attention to research from Audit Analytics, and we realize that, you know, 25 percent of the companies in the S&P 500 have had the same auditor for 25 plus years.

If you go to the Russell, the number is I think 36 percent have had the same auditor for over 40 years, and within the Russell index, I think there are eight companies that have of the same auditor for a hundred years.

So I think that, you know, we need some more disclosure, even if you're not asking companies to necessarily recommend a rotation, certainly I think the CalSTRS process of putting it out for bid and having -- having everybody on both sides of the table look at what they've been getting and what they've been providing, and possibly getting some insight as to ways that you might get a better auditor is also an idea that I think we're firmly in support of.

MS. MADSEN: So, Jeanette your question for me as to kinds of things that we've thought about in making the recommendation, and I guess, you know, as I was looking to other people's spots, I think the things that would drive me in my seat are, you know, the worst problems to have are the ones you don't know about.

So I don't know how else to say it. And so a new set of eyes coming in to help you find those so that you can take the appropriate steps to mitigate the risk that are causing those to be a problem.

CHAIRMAN DOTY: Steve Harris?

MEMBER HARRIS: In terms of the expertise to conduct an audit as say, CalSTRS, how many firms outside the big four have the expertise, and to what extent is the -- to what extent can we increase the competition with respect to firms bidding on your work? I mean, how many people have the necessary professionalism to do it?

MS. MADSEN: Well, we haven't had a big four, six, eight -- I forget when it diminished, you know. When I was there it was nine, because there was still -- there were still nine.

So we, we actually look at the top 30 audit firms when we went out for bid. I mean, that was kind of the way we walked into it. We have somebody who's in the, you know, mid -- the lower half of the top 10. We got two bids in that range. We didn't get any of the big four. You know, we have a liability provision that is challenging for many audit firms to deal with. And it took negotiation. I mean, the hardest part of our transition was negotiating the contract.

MEMBER HARRIS: With other than the big four?

MS. MADSEN: With other than the big four. So somebody in the -- in the top 10, but not in the big four.

MEMBER HARRIS: And have you found that they're able do the work that's required?

MS. MADSEN: Oh, yes, absolutely. And it's a combination of people. It's not from a single office. It's -- it's really spread out. You know, we have a partner who's an expert in the public sector. We have a valuation partner. We have a separate -- they brought in their separate valuation firm. I mean, you can understand, given the nature of our financial statements that that would be where the risk is, on the investment side.

So, so we've got both actuarial and investment expertise, as well as a valuation firm that they've hired to -- to help ensure that what we are stating the value of our assets are, and our gains and losses are accurate. So, so it's -- I'm not going to say it's, it's all been resident in the single office of that -- that firm, but

I'm definitely very impressed with their expertise and the ability they have to reach into resources in various places to bring those people to the table.

MEMBER HARRIS: Thank you.

CHAIRMAN DOTY: Lewis.

MEMBER FERGUSON: I have a question that sort of comes out of the -- grows out of sort of the implication of the practice that's followed by public sector agencies like yours. And it seems like most public sector, whether they're pensions or government agencies do rotate their auditors periodically. They may not have mandatory auditor rotation requirements, but they do it. TIAA-CREF, for example, does it as a matter of policy. You and I suspect CalPERS does it because of the procurement rules.

But what underlies the procurement rules is a sense that we don't want these relationships to become privileged relationships. That they need to be looked at again periodically.

Given this -- my question comes out of that. Given the fact that you all believe that is the correct policy for yourselves, and given the fact that agencies like yours are huge owners of the stock of public companies; in fact, perhaps if you look at the equity holdings of the largest American companies -- maybe not a majority, but certainly a significant plurality of the holdings are held by, by pension firms, investment firms of various sorts that have these policies -- why do you all not push those companies to adopt -- not necessarily mandatory rotation, but periodic rotation if you believe for yourselves that that's the appropriate policy?

MS. AMEY: No, I don't think that's over. I think that one of the things that we wanted to do was to see what happens with what the PCAOB is doing before we approach companies. But we certainly -- I don't know that we would push them for a mandatory rotation, but I do think that there is a -- there will be engagements, talking to companies about putting the business out for bid after a certain amount of years. And I think the issue is we don't know if it's the 15 years that Bob Pozen recommends. We think it's more than five. Certainly less than 40.

But we certainly want to approach companies about at least putting the business out for bid, allowing the existing auditor to bid on the business, and to give investors more of the information that presumably they're using to evaluate the auditor.

MEMBER HANSON: Okay. More questions for Robin.

And this is -- my question's really to -- if you can share just a little bit more about the context of your -- of the scale of your engagement and how many -- how many people you have. Or how many people in the financial reporting structure within CalSTRS, how many -- how many people the audit firm has all involved, how many locations, and how many locations you have. I don't know if you're all in, what Sacramento or if you've got locations all over the country or world. And if the auditors need to be in those places too.

MS. MADSEN: So in terms of our operations, we have a large headquarters facility in west Sacramento, and we have a small satellite office in Glendale, California, where we do retirement counseling for teachers in southern California. So we're certainly not a multinational presence. Where -- where we get multinational is in due diligence that we do with our external managers and our private investments. So we do experience that, but that's not the scale of our operation.

As you can imagine, a lot of the accounting that is done for our investments is elsewhere. So of the private assets -- we get audited financial statements; that's what we rely on. So, you know, it's, again, from where I sit in terms of the side of the operation that I'm responsible for, it's very small in comparison to the companies that we invest in. Hence my desire to be a part of this panel and not a panel of those -- from those companies that we invest in.

But in terms of the complexity of the business that we need to present to our audience -- so, granted the scale is different. You know, my accounting shop is 75 people, okay, not -- not big at all. In terms of the audit team that's working -- and I have not gone through and done this calculation and listed all of the people out, but there are five different partners. The staff underneath them I'm thinking maybe is 20. I mean, that's kind of where I'm guessing things are. But I don't have that specific number. So that could be wrong. I just want to give you that caveat.

MEMBER HANSON: Good. And just a follow-up question to the question that Board Member Harris asked.

With the number of firms that you felt were qualified to propose, and whether it being based in the Sacramento area was important to you. I don't know if the firm -- the lead partner and team if it's based here or if it's based somewhere else.

MS. MADSEN: Well, the -- let's see, the signing partner is in Indiana. The engagement partner is in Texas. The valuation partner is in Kentucky. The senior manager is in Ohio. The actuarial firm is in Chicago. I think that's the list that I can come up with at the moment. They fly.

CHAIRMAN DOTY: If history teaches us anything, it would be that when the people at the table and others like you decide that it's a good thing that firms reconsider their audit relationship every 15 years, every 10 years, and when your opinions are headed in that direction, that this is something that's going to happen.

It's -- and the PCAOB could do nothing here, and it may well be that whatever board is sitting here five years from now or six years from now, will be looking at a very different circumstance in which many, many companies are going just as they did, going away from staggered boards, just as they went towards separating chairmen from CEO -- you name it. Just as they went toward a poison pill that would only be exercised in the -- after a shareholder vote, et cetera, et cetera, et cetera, as a great man once said, then it may well be that there are many of the best firms that are already doing this.

And in fact, we heard today from one of our most distinguished panelists, and what people need is really the ability to plan. Once you have a schedule, and if people knew that by the year 2020 there would be a predictable regime in effect, that that would be plenty of time for a lot of good things to happen, for people to start training up, for people to start making their choices about where their consulting business was going to go. All sorts things could happen.

But what it's made me think sitting here today listening to a lot of very thoughtful comments, is that the people who are the least likely to make the plans, the least likely to reexamine their relationships, are exactly the one -- exactly the ones that we hear about. They are the marginal players, they are the fraudsters, they are the people that one of our panelists clearly pointed out are always thinking about how to cut the corners, and that we need to think more like.

Are we, in other words, in the position -- if we're going to focus our efforts, shouldn't we be thinking, for example, principally about what to do to make sure that the people that we -- that we reduce the business clientele for Charlie Drott, that in fact we go out and start working on the companies that are the least likely to make the right choice for the right reason, with some kind of rule-making scheme, or some kind of a procedure.

And what would that be? What should we do about that? You could agree, or you could say I'm out of my mind, or you could -- you could -- but you're going to have to make -- you will be making these choices as people who vote the proxies, or tell others to do it.

MS. AMEY: Yeah. I mean, I don't think we can argue about what you just said. I think as an investor one of the things that, in our discussions at CalSTRS about this policy is, that, you know, we think that there are -- and I'm not sure if it would be the industry or if it's going to be the client telling the audit firm -- but to minimize the risk of mistakes, if there is a transition to a new auditing firm, we think that there should be some sort of schedule for turning over the documents to the new audit firm so that we can cut down on the risk for investors.

Much like what you see happening in medicine today where you, you can go to another doctor but they've all got information and all the tests that you have already had. And, you know, you can get a solution that's a lot faster than everybody starting from scratch and making mistakes or overlooking things and just driving up the cost for no good business reason. So I think we would like to see some protections of -- like that before, you know -- well, not before, but certainly in conjunction with transitions, whether it's 15 years or 10. You know, and I think --

MS. MADSEN: You know, and I, I did some thinking about the solutions, just again from our own perspective. And we're very reliant on our actuaries, and there are no standards of practice that require rotation in actuaries. But we have established -- and again, this is a peer review process that we -- where we hire another actuarial firm to come in and audit the work of our actuaries to see if they can replicate it within reasonable tolerances.

The other thing that -- just in terms of comparing those -- those domains, which have some similar characteristics, is the actuaries actually sign their opinions with their names. So again, it's a --

CHAIRMAN DOTY: Wow.

MS. MADSEN: -- yeah, they do. So, I mean, it's just a -- there's just difference in the standards of practice. And so, again, that was just something that I thought about given the feat that I'm in, that provided some comparability in terms of another perspective.

MR. EATON: Just to echo a little bit of what Janice said, I completely agree that the process and structure around that transition really needs to be established. And really -- from an investor point of view, no matter what the issue is, like you said, whether it's separation of chair/CEO or whatever the topic du jour is, it really involves a degree of transparency and a degree of process that is involved so investors do have that -- that confidence that a proper process is being followed. And that the intentions of the -- of that process, which, of course is ensuring the independence and objectivity of the -- of the audit, is in fact what it's working towards.

CHAIRMAN DOTY: If opponents of rotation do point out that if you -- if you in fact had a handover period, and if the audit firm knew the hand over period was coming, if that were the regime that operated throughout the auditing regime, then there would be an identity of interest in the handing over and the receiving firm to make sure that each case, the handing over -- the handover and the completeness of the record was satisfactory to both of them.

Did you -- did you do any of that when you changed auditors?

MS. MADSEN: So, and again, I was reflecting on that as I was listening to people earlier in the day. So, yes, there was a transition period in terms of access to the records, so that was part of our contractual requirements. We saw that the new auditor went in and reviewed the work papers of the prior auditor. We have that same requirement in the -- in this contract, so that there is a transition process that -- you know, and again, we're a public entity, so there are different issues associated with it.

And my experience in -- because I was there both during the last audit of the prior auditors and -- and, you know, and through this transition period, that the prior auditors actually were very conscientious about making sure that they had thoroughly documented their conclusions, probably more so than in prior audits. So, just anecdotal information.

CHAIRMAN DOTY: Are there questions by the observers or panelists?

MEMBER HARRIS: I had a question with respect to your attachment A dealing with financial experts. Although you don't quite label it as financial experts. But once again, you focus on CEOs or other senior executive officers. I'm just reading it from here, and so it's a generic question, you don't have to have it in front of you.

But just a CEO or other senior officer. And once again, I wonder why you don't focus on either retired auditors. Because, we heard this morning, I think, from the chair of an audit committee, that he's a little bit concerned about retired CEOs, and I've got absolutely nothing against retired CEOs, but they might not be the best financial experts.

And so why would you focus, in terms of who you would want on an audit committee, auditors who, certainly once they retired and maybe -- well, they would have the experience and the expertise. So I would just ask you to consider that. Because, as I say, on item three it says all members of the audit committee or person's whose past and current employment experience, education demonstrate expertise in finance and/or accounting, including being or having been a CEO or other executive officer. I would just encourage you to think about a broader definition of financial expert.

MS. AMEY: I think that was -- that guideline was written around the time of the SOX package. And I think we wanted to -- not so much narrow it to CEOs as to say that it would be okay if a CEO was also -- a retired CEO was a financial expert. But we'll certainly -- when we look at the guidelines again, we'll certainly consider retired auditors.

MEMBER HARRIS: And the last question I got. Glass Lewis is a premier research firm. And so what we're hearing throughout the day is the need for empirical data to support whatever action we may or may not take. So when you say we typically support audit-related proposals regarding mandatory auditor rotation, when the proposal uses a reasonable period of time, usually not less than five to seven years, if you can -- if you develop any empirical data supporting why you would do that, that would be helpful.

MR. EATON: Yeah, I think that's a really good question. And, you know, one of the -- one of the things I should point out is the way that our policies are really driven is twofold. It's one from our clients, what our clients believe strongly in and also academic research and studies. And this is actually an area where the -- the quote that you have is not surrounded by particular depth beyond that, because -- just for that fact.

Our, our clients have not -- have not really pushed on this issue. As I said before, there hasn't been -- there's really not an opportunity for investors to vote on this issue very frequently. But also, that the academic literature and studies around it, from what I've seen, have been pretty much a mixed bag, if you will. So where those exact years that are in that quote come from, has to do with, I believe a shareholder proposal from a few years ago. But I wouldn't quote me on that.

CHAIRMAN DOTY: We're at the end of time on this panel. I want to thank you. It's been terrific. And while the -- we're now going back to independent directors, and while the independent directors make their way to the table, we will say thank you again to you all for doing this.

The new panel is Julie Allecta, Trustee and Chairman of the Audit Committee of Forward Funds. Vice president and director of Wild Care Bay Area, a non-profit. First vice president and director of the Ottoman Kenya and Research non-profit. Began her legal career in 1977 with the United States Securities and Exchange

Commission in Washington DC and its Office of General Counsel. In her private practice, moved to San Francisco, specialized in consulting financial institutions -- counseling financial institutions and boards on financial institutions -- boards of financial institutions, providing legal advice on complex financial regulation and investment products. She had a career at Paul Hastings, a distinguished law firm here, retired in 2009 as senior partner chair Emeritus of that firm's renowned investment management practice group. She lectures and she provides investment advice and has been admitted to several Bars around the country, a real specialist in this area.

Bill Baribault, Trustee and Independent director of American Funds, and chairman of Oakwood Enterprise. Has served as Chief Executive Officer and Chairman of Oakwood Enterprises, previously chief operating officer and director of Henry Company, the chairman of Professional Business Bank until 2009. Throughout his career, he has held various positions including chief executive officer and chairman of Elect-Air for a number of companies. So he's been -- he's been in senior management positions with several companies, a number of advisory and trustee boards for charitable, educational and non-profit organizations in the area.

Bill Cvengros, Janus Funds. Cvengros is a Trustee and Independent Director of Janus Funds, a leading mutual fund company offering equity, fixed income and alternative funds to individuals, companies and retirement plans. Also has served as chairman of its committee. He's been Chairman of National Retirement Partners, a national network of advisors to corporate retirement plans. And previously a Chairman of PacketVideo Corporation. Past CEO and president of Pimco Advisors, LLC, and has been on a number of boards. He is -- he is currently the chairman of the audit committee of Janus Funds.

So we're -- we have a group of people who have seen it from several areas. So we welcome you and thank you, and turn it over to Julie Allecta.

MS. ALLECTA: Good afternoon. And thank you very much, Chairman Doty. That was a very nice introduction.

And I also add that as a young lawyer I had the privilege of training under Bob Pozen and Harvey Pitt, so --

CHAIRMAN DOTY: I would say that's satisfying two of the most demanding critics. It will make this panel no problem.

MS. ALLECTA: Yes.

CHAIRMAN DOTY: This board no problem for you.

MS. ALLECTA: And welcome other board members as well. I hope you're -- you're enjoying good California weather.

I'm the independent director of the Forward Funds, which is a San Francisco-based mutual fund group. And I'll just point out that you've got a really nice cross section here, because the Forward Funds represent what I would call a smaller fund group, five billion.

Janus represents a very sizeable fund group. And then we have the American Funds, who are in the -- you know, extremely large fund group, would you say, right up there. So it's a great cross section. And I appreciate being part of the panel.

My comments today are my personal views and not the views of the Forward Funds. And I want to focus specifically on two areas where the PCAOB requested comments, and two areas that I don't think have been talked about a lot so far. Because you've heard, I believe it's Barbara -- or Bonnie Hill pointed out, you've heard a lot of things over and over again. I'm trying to find something different, different information to bring to you.

One of -- one point I'd like to make is that there is a unique aspect to the structure. Perhaps not unique, maybe it's just an unusual aspect of the structure of a mutual fund that makes a rule like mandatory audit firm rotation particularly inappropriate for funds. So this might go to the question 26 on the Concept Release, page 21, which says is there a subset of issues that maybe we ought to think about differently. And I think mutual funds might be one such subset.

In the United States, we developed a highly successful model for mutual fund governance based on the Investment Company Act. And that Act incorporates a lot of independent guarantees, particularly with respect to the audit process. The Sarbanes-Oxley amendments in 2002 enhanced those quite a bit. So this may be a small segment of the issue or industry that isn't as affected by audit scandals and problems.

I want to endorse the comments submitted by the Mutual Fund Directors Forum and the Investment Directors Council, and very quickly just generally point out that they made good points that rotation, audit firm rotation would impose burdensome costs to mutual funds, which would get directly passed onto shareholders. There's no products that mutual funds make where we can somehow build it into the cost of our goods sold or something like that.

The increase in cost is going to go directly to a diminished return to investors. It would likely be diminished in audit quality and an increase in the risk of errors or things not as well looked into, valuation issues not as carefully explored.

Plus, there's a very limited number of audit firms. We've talked about that. And I think that Bonnie Hill made that wonderful observation of timing. Well think how much more complicated it is for the mutual fund where you have a variety of investment pools with different year ends, one every month. I mean, now you're

-- now you've logarithmically leveraged the difficulty of moving from one audit firm to another. Because even a small group like the Forward Funds uses -- heavily uses two of the four firms that do 99 percent of the work in this area. And, well, there just are practical constraints on audit firm rotation.

But what I think is really special, and what I'd like to emphasize in my remarks, is to be very clear in thinking about the investment pool, which is the mutual fund and the management and administration companies that prepare the financial statements for the investment fund.

Investment companies are just the assets. It doesn't have employees. It really doesn't have operations. But it is a client of management firms, distribution firms and administration firms. And it pays those firms, it outsource to those firms for preparation of financial statements, among other things. Those firms, they have their own boards, their own shareholders, their own auditors. But for the pool of asset, there's a very independent board there, and independent audit committee and those individuals select the auditors that are going to review the financial statements prepared by the management firms and administration firms that the fund employs.

So there is already a separation of function that provides additional firewalls or insulations or -- or independence protection. And I -- I'm not sure that in the comments that I've read so far, in the comment letters that, that that has really come out as a -- as an excellent reason why mutual funds and similar entities need to be thought of differently.

The other issue that I want to point out, and maybe it's just a reminder, is that there are so many independent guarantees in the Investment Company Act and in the regulations. Not only is the pool separate and the board separate, but independent directors are exclusively in control of adding new independent directors. The ability of management to exert influence diminished quite a bit by statutory protections.

There also is, by required law, a compliance officer that looks at financial statement and accounting matters and reports to the board. And this is -- this is a staff person, if you want to think of it that way, that is an exclusive watchdog over the service organizations for the independent directors, then the financial expert and the other guarantees of quality and independence.

So this structure means that it's very difficult for -- it's like it's hard for me to envision any way in which the management companies or administration companies can -- can bias or lean on the audit firms with respect to the tough audit calls. I loved, I loved the analogy this morning of a good audit partner to the inch of marshmallow around the brick column, because that really is the ideal audit partner. And the -- the ability of -- of -- well, of being able to influence a tough call on valuation or how a security should be classified for purposes of valuation, or how a tax issue should be looked at, I think is -- it's very difficult to do in the fund industry.

I've probably used up my time, but there's another part of the Concept Release that I would like to address, and that is, despite the fact that I feel mutual funds are different and already have great audit integrity, I think there's always room to think about improvement. And it's healthy to think about ways that audit integrity can be improved. And in thinking about it, I have two observations to throw out to you.

One is, it would be expensive to mandatorily rotate audit firms, and it might be impossible even. But there's no reason why a concurring audit couldn't be done every -- I don't want to be like Bob Pozen and pull out an arbitrary number -- but every seven years, every eight years by another firm. A second audit, yes, there's a cost, but that's defrayed over a period of time. And that might also serve the benefit of a periodic RFP because it introduces another of the audit firm's to the board and to the audit committee in the primary role of auditor. So I think the concurring audit approach might be one you bed think about.

I also think if you want to start with areas where there are the most -- the most conflicts. In my experience, the most conflict-full situation is the situation where the audit firm that is auditing the pool of assets is also doing the primary audit or substantial non-audit work for one of the major administration, management or distribution companies. In other words, you've got the same firm working on both sides of the stem, either as primary auditor or as a substantial consultant.

There you've got some economic pressures. I don't want to say there's a conflict. But it might be in those situations that you would want to think about introducing additional, either PCAOB inspections or controls.

And with that, I'll turn the mic over to my colleague, Bill Baribault.

MR. BARIBAULT: Thank you very much. And thank you, Mr. Chairman and the board for traveling to California and giving us an opportunity to present to you.

I'm going to -- thank you for that introduction as well, so I'll skip that in my notes here. But it's important that we recognize that my views are not necessarily the views of other board and audit committee members of the American Funds and Capital Research and Management Investment Advisor, the investment advisor in our case.

I am an independent director and a trustee of the 16 of the fixed income American Funds. American Funds

Insurance Series, American Funds Portfolio Series, and American Funds Target Date Funds. Most importantly regarding my perspective, I am also a shareholder in the funds.

Based on the responsibilities and interests of an independent director and shareholder, I'm especially interested in audit independence and quality. I concur with the recommendation made last December by our American Funds audit committee chairpersons.

Their recommendation, and I quote, are, "Diverse backgrounds combined with our expertise, our experiences as audit committee chairpersons, lead us to the conclusion that mandatory audit firm rotation does not achieve a subjective."

Two comments, and you've heard of a lot of pros and cons during the day of -- of audit firm rotation, but two observations in our case. First, based on the size of our fund complex, we have two audit firms, which gives our boards a very great opportunity to review the work of two firms, to review their perspective on challenges, regulatory changes and all the issues that we face with our board of responsibility.

Second, and thank you to the PCAOB's most recent inspection, we were able to sit with one of our audit firms and go through the Part II report and deal in great detail with what had occurred, how they handled, and what immediate action they were taking, and basically a very open discussion and dialogue between that audit firm as a consequence of your inspection.

So while you hear many criticisms, this is an interesting opportunity to point out that we had a very lively exchange with an audit firm because of your inspection.

This panel discussion presents an opportunity to share ideas that contribute to the fundamental goal of auditor independence and quality. The following list of recommendations, I believe, facilitates auditor independence, skepticism, objectivity, audit quality, which leads to an increase in audit committee effectiveness.

First, it would be great if you were able to share individual inspection reports with the audit firm's clients, whose audits have been selected for review, in order to have transparency, promote discussion, and enhance the audit committee's review of the engagement.

Second, expand PCAOB's advisory network to include various industry representations. For example, investment fund audit committee members can add perspective issues and opportunities for quality improvement specific to their industry sector.

Third, consider sanctions and penalties that encourage audit firm rotation for material findings, such as undiscovered financial statement fraud from the lack of professional skepticism.

Four, review all auditing standards and practices adopted by the PCAOB since its inception to determine their impact on quality and independence.

Five, compile and publish a list of best practices from the database of inspections to share with all audit committees to facilitate their learning and review of audit firm performance.

Six, recommend guidelines for audit committees to consider audit firm rotation based on calendar, event or partner change, for example.

Seven, compile in a systematic manner the circumstances that gave rise to the lack of professional skepticism, and share those with audit committee.

There is a running theme here, and you've heard a bunch of it earlier today, is to the extent that there's more transparency, more communication, and better education for audit committee members, the results will be that much more positive.

I appreciate the opportunity today to discuss the issues on auditor independence.

MR. CVENGROS: Thank you. And I second the remarks about comes to the west coast. Very helpful to meet the people and person face-to-face as well.

My name is Bill Cvengros, and I am an independent trustee and director of the Janus funds, and chair of the audit committee. I think some of my background here, it might be helpful, and I just want to just highlight a few things in terms of this -- this discussion.

I've been a CEO of a public company and reported audit results to analysts and other investors as well. I'm the director of three other public companies, and each of those I've been a member and a chair of the audit committee at some point in that cycle.

It's interesting to note, as I look back, that this has taken place over the span of about 25 years. I'm not as young as Andy Bailey, but -- so I've had the '80s and '90s and about 2000s and so on. I think it's relevant in that it's been an opportunity to observe the progression that's taken place for oversight and regulatory issues over this period of time, as well as the improvement and the best practices, I think, of audit committees.

Like others, I can't speak for my colleagues at Janus, but I can say that the trustees of the Janus funds have a very strong view on the issue of independence in terms of the trustees themselves, as well as the audit firm. We view that as fundamental and critical to our mission of representing the shareholders of our funds. And in this regard we have a couple of points I'd like to point out.

In contrast to some funds who merely have -- who have requirements to have, I think, three-quarters independent directors, we have 100 percent of our trustees are independent. There's no management from the advisor. It's totally independent, including the audit committee, of course.

We have a board practice of, including all the trustees in the audit committee meetings, even though they're not members of the audit committee, they think it's such an important thing to be part of those meetings, so hear what the auditor has to say, and also to be part of the executive session that takes place with the auditor. And it's also true that the audit firm is separate on the funds from the auditing firm that's the chief firm for the advisor, Janus Capital.

So my views are in -- not in favor of mandatory audit rotation, and I have several reasons. I'll go over some of them. A major reason, frankly, is what happened with the PCAOB since the creation of its, you know, authorization with SOX. You have made numerous and wide-ranging improvements, proposals and standards, some might say prodigious. These have been focusing, in many cases, on audit quality and independence of auditing firms. You certainly have been very busy. So, you know, hats off to you.

And I've observed over the last 25 years, as I've said, a true progression of these requirements in best practices. And I think overall the audit process and the oversight has improved drastically. Not to say we haven't had mistakes, but the bar has certainly been raised. And, you know, you've been leading the effort in that regard.

I think two things really stand out to me, and one is the audit partner rotation which does bring a new set of eyes, often from a different part of the country, a different part of the firm, and as well as as the PCAOB review of the audit firm's audit process. There is no audit partner in the country that was excited about the fact that the PCAOB was going to review them.

I also think as a result of all this there's been fewer, not more, audit failures and misstatements of a material nature. And this is all in the context of a world that is much more complex, particularly in the mutual fund business, much more complicated instruments, as well as a world that's been under a lot of stress economically in terms of the financial markets.

Another reason I'm not in favor is, that many have talked about, the increased costs, the proposal process, the transition, the sales and marketing efforts, and these would be, in fact, borne by the shareholders of the funds. There's just nobody else there to bear it. And on top of that, there's -- beyond the mutual fund business, there's also the already-increased requirements that are costing public companies more and more money to be public, particularly small and mid-sized companies.

There's one thing about the sales and marketing, if there were different persons involved in that process, you might hear fewer accountant jokes because of the nature of the marketers, but -- strike that from the record -- but anyway.

I'm very concerned about the disruption at the time of change, the orientation period. Many have talked about that. There is a window there for increased risk in audit failure. I think there's a general sense here by many that shorter-term engagements that are forced by mandatory change would be introducing another level of risk.

In the case of the Janus funds, as other funds, mutual fund companies are a special breed. The `40 Act is very complicated, specialized, et cetera, we all know that. And it is very essential to have the leaders in the industry that are on top of the '40 Act in terms of the auditing firms. And there aren't that many. I think the -- we use like, Julie mentioned, two of the four firms already. And I think the audit committees and the clients are best served if, in fact, they are able to find the best and retain the best, if they still think they are the best.

Finally, I have a concern about unintended consequences about something like this. It may encourage different business model changes at the auditing firms. This could increase the already extensive travel. One impact may be on women in the profession because of the increased travel of partners and managers on audits, they may not be as interested as being a partner, if that's going to be the case. And there probably might be some other locational issues as well.

That being said, is there room for improvement; I think so. But the question is how. And others have given their views. My view would be to focus on making the existing oversight standards as effective as possible to allow a period of continued digestion and evaluation of the impact of the numerous changes and proposals that have been made over the last few years.

But there is one thing I think would be a major improvement right now within the context of those standards, and that would be share the non-public information of the PCAOB reviews with the audit committee. And I can assure you that, you know, a well-intentioned independent audit committee is going to take those to heart very seriously. And if they are of the nature that it dictates that they are taking the proper skepticism, independence, and competence, than there would be a review and re-tendering of that audit assignment.

So, if after further review and research, the PCAOB thinks there should be something more done in this area besides what's in place now, I could see a step in the direction of having a mandatory re-tendering of the audit firm assignment after a long tenure. Maybe it's 10 years or more. If they would open up the process and still allow the audit committee to have the authority and control to retain the firm that they think is the best or hire a new one. So, thank you very much.

CHAIRMAN DOTY: Well, thank you all. And we have some question time. And we're going to start with Steve.

Once again, Steve Harris.

MEMBER HARRIS: Well, Ms. Allecta, I can't resist the temptation, because you worked for two legends and you cited them. As you just cited one as well.

Putting the mutual fund complex aside, with respect to the entire rest of the universe, because I think you had mentioned Bob Pozen has written about mandatory re-tendering under limited circumstances, but he's editorialized on that. And then Chairman Pitt has indicated in highly limited circumstances -- and I don't want to get in cross purposes with Chairman Pitt -- but in highly limited circumstances, were there very deficiencies in audit quality, he would support some form of mandatory rotation.

Are there any circumstances at all that you would support mandatory re-tendering or mandatory rotation?

MS. ALLECTA: Are you asking with respect to operating companies? Yes, I think that's correct.

MEMBER HARRIS: Yes. Yes.

MS. ALLECTA: And I think the answer is yes. I think there are circumstances that were actually highlighted very nicely by the panel that preceded this one. There are circumstances where there's enough -- financial statements are really -- the integrity of the financial statements can't be overstated.

And where there is evidence that the accounting firm has been sloppy, has been lazy or perhaps more culpable in producing financial statements that are just erroneous or perhaps even fraudulent in some respect, misleading, certainly that is, you know, a call for replacement.

But mandatory replacement for -- just because the clock is ticking, there may be industries where there are so many subjective issues, where GAAP is so unclear or allows a variety of interpretations, there may be industries just as special in those respects as mutual funds are in our respects, that require that fresh set of eyes and that disciplined change. So I would never say no. I suppose the answer is yes, but I'm not knowledgeable enough about which industries might, might really benefit from a mandatory audit firm rotation.

Did I dodge the question well enough? Good.

MEMBER HARRIS: No. And Mr. Baribault?

MR. BARIBAULT: I think I established in my bullet point a theme that would be applicable to -- to all business sectors. If there's a material misstatement or an issue with a financial statement, an audit committee has a responsibility to challenge the audit firm, revisit the question, possibly look outside for help in evaluating what that was. PCAOB, in a case of an inspection report, might raise something to that level. And I think there is a responsibility. And I think it should be encouraged.

I think, again, what I'm focused on most clearly here is the concept of a calendar replacing a process. I think responsible audit committees are well-prepared, well-trained. I heard a comment earlier today about encouraging retired partners from audit firms to participate. We in fact do have that in our structure. We have people from the regulatory side. So our attempt is to create an audit committee and a board that's very responsive to current issues and current engagements. And we would be very suspect of a finding that would rise to that level.

CHAIRMAN DOTY: Lew? Lewis?

MEMBER FERGUSON: First I just want to ask a quick question, but I don't want this to count as my real question. An information question. It's a half question. And this is to Mr. Baribault.

You mentioned that one of your audit firms had shared with you what we call part two of our inspection report, which is the sort of confidential part of the audit report that deals with the firm's quality control. Did you happen to know whether that part had already been made public by the firm -- or by us for a failure to remediate, or were they shared that with you which they can do, during the period while we still have no ability to make it public? Because that's a very important question to me. Do you know?

MR. BARIBAULT: The answer's somewhat -- it overlapped during that period of time. But we became directly involved after it was public.

MEMBER FERGUSON: Okay.

MR. BARIBAULT: But we did understand there might be -- or probability that it would be made public. What I'm encouraging the board to consider is, it would enhance the process if audit committees would automatically receive that information. It would create for a much sooner, spirited discussion, an open dialogue, and the information would be helpful.

MEMBER FERGUSON: You could get that by -- if you mandated it or put into your agreement with the auditor that that part -- that that be made available to you even during the period when it's confident. But we can't make it -- we have no ability to make it available during the confidential, but the auditor can.

MR. BARIBAULT: But what the request is that, could you consider for the particular firm that's been audited, the client relationship, making that report public, I think that's something that we would like the PCAOB to consider.

MEMBER FERGUSON: My real question to all of you is a different kind of question.

As trustees of these mutual funds, you're shareholders; you also act as shareholders of enterprises. And, frankly, shareholders with a lot of clout. Do you ever think of, or would it be an advisable thing to use your voting power as shareholders -- not necessarily to push for mandatory rotation, but just to use your power as shareholders to suggest to firms that perhaps they want to consider auditor rotation.

Particularly in cases, for example -- I used the example of the financial industry recently when not a single major bank in this country had a going concern opinion, and shortly after some of these financial statements were issued in 2007 and 2008, massive bailouts had to be undertaken by the federal government. Is that a case where perhaps people like you all, holders in large of shares should have suggested to these firms that maybe they wanted to consider auditor rotation in that case?

MR. CVENGROS: Well, my view is, the shareholders should speak up in those instances. The large institutional investors try to do that at times, and sometimes it makes a dent and moves the dial. And in our case, I'm not sure we control enough of the, you know, investment assets in a hundred billion dollar complex in the case of Janus to really move that dial that way.

MR. BARIBAULT: I would submit, in our environment, our proxy committee has some very healthy debates on voting and what the issues will be, and decisions and recommendations. So it does come under great scrutiny in our -- in our complex.

MS. ALLECTA: Even in our small fund group, we take our proxy voting very seriously. But there is -- there's very little influence beside billion dollars spread around can do, so. But it's a -- but all of us together have a lot of influence. And firms like Glass Lewis are very helpful in providing guidance to us.

And increasingly, I think, there's more willingness -- now I'm just speaking generally -- there's more willingness to take mutual fund proxy voting seriously. It used to be that we voted with our feet. If you didn't like a company, you sold it. That was -- or, regardless of whether you liked it or not, if you thought the price was going to go up, you bought it or held it. Now, I think there's much more consideration about ethics and issues like that within the proxy voting, rules and procedures and protocols that all fund groups have. So, yes, there's a movement in that direction, low-hill trend.

CHAIRMAN DOTY: Jeanette Franzel?

MEMBER FRANZEL: I want to make sure I understand the unique structure that you cited that would maybe make a mandatory firm rotation requirement inappropriate for the mutual fund industry.

You talked about the pool of assets and then the management and administration company that prepares the financial statements. And the, I guess the safeguards that were there. If you could elaborate on that a little bit.

And then each of you mentioned you were using two audit firms. And I wanted to just follow up to ask if those firms were doing, were both doing audit work, or one was the consulting firm and one was the audit firm.

MS. ALLECTA: I'll answer the second question, because it's a quick answer. With the exception of the American Funds, I think it's fair to say that most fund groups have one firm that does the primary audit. But because of the nature of the securities that are held in these investment pools, and because of the tax issues and tax issues in India and foreign countries, and a variety of complex issues like that, there usually is a second firm that is brought in for consulting purposes in that area. And there may be other non-audit work that's done by a second firm that has to do with the tax evaluation issues.

And Bill can elaborate as to what Janus uses its second auditor firm. But one primary firm.

The second -- or on the first question, I think the point that I was trying to make is that -- I'm going it use an example not at this table. I'm going to use the Franklin Funds. At Franklin resources, you have a public company. You've got a board of directors. You've got shareholders who own money in that public company. You've got an auditor that audits those financial statements. And people buy and sell that stock in reliance on financial statements. They haven't -- may have a penny -- not a penny invested in a Franklin fund.

Over on the funds side, you've got a separate group of shareholders who are the investors in the pool of money that Franklin resources employees have decided should be in that pool. And you've got a separate board, and you've got a separate audit committee. And there's more independence on that side than on the Franklin resources side.

Management of Franklin resources, quite frankly, has impact on the composition of its board of directors, on what happens in the audit committee, and what happens in the preparation of financial statements for itself and in the selection of auditors. It has less impact, less ability to influence the selection of auditors and the work of the auditors and the integrity of the audit on the side of the funds where there's this other structure, other board in charge.

I don't know if that makes it any clearer, but hopefully it does.

MEMBER FRANZEL: Yes, thank you.

MR. CVENGROS: And in our case, we use the -- we have a primary audit firm. And then the other one that we use is there for a non-required, but we think best practice to have a SAS 16 for all of our major service providers. So it gives us checks on the controls of those service providers.

MR. BARIBAULT: In the case of our funds, we have two audit firms, each one basically auditing different parts of the complex. So they are, they're equals in a sense. They're not one subservient to the other.

What I think makes that situation work well for us, is it gives us the ability each year, when we are reviewing the engagement for an upcoming period, do we have the kind of criticism we're expecting, do we have the skepticism, the curiosity to really chase issues that are important to us as a board. And by having two different audit firms basically, as we have, really facilitates the process, because you'll find different nuances coming from one, and the other enables us to spend time with each of them, and really almost get the best practices from -- from each.

The other information that's, I think, relevant to this is, we, unlike any other -- you might say public company boards -- we not the board of the investment advisor. We're not the same as a public company. We're not looking at compensation of officers of the company. We are really there to look critically at two activities. One, the audit process engagement for the public accounting firm. We also have the same two of four that everybody kind of refers to.

But equally important; on an annual basis, we actually renew the engagement for the investment advisor. We discuss fees. We discuss performance. But where our firewall on that other side of not trying to run the investment advisor or the management company. And that gives this board a tremendous increase in its independence, the scope and breadth of what it looks to.

And I think there's a risk element that's different in the fund business. The books get closed every day. Everything is market to market at the closing of a day. So I listened to one of your earlier panels and there was a discussion of fair valuation. Well, we do it every single day. And one of the audit firm's primary responsibilities is to really validate that process, make certain its accurate and look for variations or anything that might be a challenge.

So there's a great intensity on what is important to our investor. And our investor is our shareholder. And we view that we have the responsibility, I think the supreme court somewhere along the way made a reference that we are the watchdogs on behalf of the stockholder, investor.

MEMBER HARRIS: I want to follow up on a couple points you've made about expertise of the audit firm in the mutual fund area in this '40 Act. And the drawback to a format like this where you're talking to us is, you don't get a chance to sit face-to-face with the people that have the opposite view, and actually have a debate about some of the issues. And so this is my way of creating the debate about that expertise issue.

We've heard in other round-tables, other forums, in fact from some speakers this morning that, you know, audit firms, they might not have an expertise in something, but they will never claim they can't do the work, and they will always figure it out and get it done. And looked at what happened when Andersen failed, that lots of firms jumped in and got the work done. And so this expertise argument is way overblown, way overrated. There's plenty of firms that you could pick from, the big four and any one of the top hundred firms could do the work.

So if I were the cynic in your face saying that's an overblown excuse, what's your response?

MR. CVENGROS: My response would be that the market sort of tells you, you know, which firms in a way are showing their expertise and they become the leaders in that field. And the other ones that never made it or didn't last, they didn't have the expertise to keep up with the myriad of regulations and rules and so on that go on with the Investment Company Act of '40. And they don't have the staff to keep up with the number one thing, which Bill mentioned, which is valuing the securities daily.

And not every one of them is liquid, you know, with a real active market. So you have to have other checks and balances to make sure that your level two and your level three valuations are put in place properly. And then you get into some of the things in terms of international funds, and they have their own particular rules which a local, a very reputable local firm, you know, a regional firm, you know, may be capable. But when they start to go internationally for funds, well, that's a different thing, you know. You get in a different world.

MS. ALLECTA: And let me start by saying I think the word expertise might not be quite the right word.

In the beginning, life was simple. We invested primarily in publicly-traded stock exchange listed securities, and there were excellent boutique '40 Act accounting firms, as well as numerous larger firms. Life got more complicated, particularly in the valuation area.

And now with the need to have independent valuation verification, the audit firms that can do mutual funds -- and by the way, we're not a huge industry segment. So if you're making a decision to specialize in this area and to build in the technology, you've got to have enough market out there to support it. They have to spend an incredible amount of money, energy and resource on developing valuation sophistication. Smaller firms can't make this investment. So smaller firms, the better ones, have been absorbed by the larger firms. Just because the world's become more complicated, you need a much higher degree of technical support for that.

It's also true on the tax side. The tax side of mutual fund investing has become much more complicated, because we now own Slovenian-defaulted debt. We now own securities in Sri Lanka through different entities, because you can't have direct non-local ownership, et cetera. So there are -- there have come into existence huge areas of complexity that smaller firms simply can't support the investment.

It's not that they don't have the expertise, they just don't have the capital. There's been a capital hurdle that they can't overcome.

MR. BARIBAULT: My personal response on the concept of specialization is to easily summarize as -- in the context of the audit partner, and are there enough audit partners who are around to have these expertise. There may be. But it goes far beyond that.

When we see the audit partners rotating, when we see new, young aspiring partners in this growth mode of learning this particular industry or specialization, when we see the people supporting them, it's clear that, as you comment, the investment that's involved, but it's also the resolve and commitment to aggregate and pull together that talent into one firm.

And that's very difficult to outsource to other resources. Because it is a career. It's a point of specialization. And we've been able to see -- I've been able to see specifically the growth of young people in a firm, and one day will make partner, and one day maybe be, you know, partner assigned to our assignment, and all the breadth and depths that they've had as real experience would be hard to duplicate on the outside.

MEMBER HARRIS: What's the universe that we're talking about with respect to the audit firms that have the appropriate level of expertise of what we're talking about here? Because you take a look at the various industry figures in terms of concentration. Are we talking about a handful, a half a dozen? Or what's, in terms of the audit firms that are capable of auditing a mutual fund complex, what --

MS. ALLECTA: I don't want to get into trouble here. There are the big four. And among the big four, there are probably three that are -- that enjoy a little bit better reputation. Although that varies a little bit. Hedge funds and funds that are more on that side might see it differently.

There's one that is dominant among the big four, but perhaps not hugely dominant. And there are a few smaller firms that are competent, but they couldn't -- they couldn't handle a company of Forward Fund's size, which is quite modest, five billion. But they certainly could handle smaller pools and have some degree of sophistication, provided the instruments in those pools weren't too difficult to value.

And I believe in the Independent Directors Council letter, they pointed out that 99 percent of the assets of the industry are in fact audited by these four firms. So that tells you something about the concentration.

MEMBER HARRIS: I'm just wondering why partners at these firms, for example, wouldn't set up a boutique firm.

MS. ALLECTA: Well, many of the best partners at those firms were in boutique firms. One was them was McGladrey & Pullen. They could not afford to invest in the technology to do the independent valuation work necessary to independently value the securities held in the portfolios of a Janus international fund or a Forward alternatives fund.

So it was just a question of the world becoming more complicated and demanding more technology than a small audit firm with a few number of partners could afford to take on.

MEMBER HARRIS: So are we essentially saying that this is a natural oligopoly?

MS. ALLECTA: It has -- yes, it has. And I was intrigued by the way in the immediate past panel, CalSTRS went from a regional provider to a national provider. I don't know why, but I just made a note. Here's another case we've gone the oligopolistic path.

And I think it's something important for the PCAOB to look at, is whether the demands we make on the integrity and quality of the audit are such that firms that want to play in the audit business for big companies or for companies like mutual funds that have complex instruments have to make such significant capital investments that you're promoting natural oligopolies.

MR. BARIBAULT: I think it was presented at an earlier session, that by going to the top 10, there was a significant cost increase, and the belief there was, that that was in the best interest of independence and maybe accuracy.

It's our perspective, with the two people -- the two firms that we use that we have that bit of competition in-house already. We have the kind of due diligence that we have pursued.

And if we then begin to compare costs and the alternatives, we would be spending our shareholders' money, then that becomes, as an independent director and a shareholder and not with the audit firm or with the investment management company, it really is all about the shareholder. So we're very focused on that balance between quality, independence, skepticism and cost. That's why you find us concerned about cost.

MEMBER FERGUSON: I have a question that, you know, I'm intrigued by the fact that you have the benefits of watching two audit firms do the same thing essentially. And we've had various -- or heard of various proposals at different times about -- for example, you may have heard the panel early today where one of the panelists suggested rotating in a manager from a different firm. We've had people suggest to us that periodically the concurring partner come from a different firm. Or that sometimes, perhaps periodically there should be a concurring audit. I think you suggested this is a second audit.

Based on your own experiences, the experiences of any of you with seeing two audit firms work at once where you see that, do you think a proposal like that makes sense where audit committees should periodically have a second person, kind of a second firm or second individuals in the team or from outside it is firm take a look at what the auditor is doing to give the board of directors and the audit committee a broader perspective on the -- or particularly where the relationship is a long one between the auditor and the company?

MR. BARIBAULT: I do not support that. The cost associated versus what's really occurring in the marketplace -- so my question would be, what evidence, what's happened in this marketplace to create the interest and the need? What are the metrics?

There was some conversation earlier about understanding of the research. If PCAOB were to share with us best practices and share with us maybe without naming parties, the information that's contained in those examinations, then I think you'd be achieving the same thing. You'd be achieving the challenge that's appropriate, and yet the audit committee would still maintain its primary responsibility to the shareholder, and in one of those roles under the '40s Act selection of the audit firm.

MS. ALLECTA: I suggested it because, in part because -- I and hope this is not a violation of attorney-client privilege, but at one point I had the honor of being counsel to the American Funds, and I saw this practice, and in my mind it created some very healthy benefits, not the least of which was the ability to negotiate contract terms.

For somebody like the Forward Funds, trying to put in a clause like we want to be able to see part two of any PCAOB -- I mean that would be like going onto iTunes and clicking don't agree and then expecting to get something. I mean, there's no negotiating leverage that any fund group under $20 billion has with an audit firm.

So two audit firms does enrich the experience, just the way going out on an RFP enriches the experience. And it's a cost. And so I think one needs to do the cost benefit analysis carefully. You don't want to do it casually. You don't want to invite people to come in and -- I don't like the RFP suggestion, because that's kind of like saying we're really inclined to keep the guys we have but we feel like, you know, we got to have a beauty contest.

I like it because we're saying, "We're paying you for a real service. You're going it come in and do an audit." And in the meantime, we get to see a whole new approach, a whole new way of doing things. And as an audit committee chair, it gets me thinking. And so I think it could be a healthy process, and I think the cost could be made reasonable.

Do I think it's necessary? No. I mean, my bottom line is, I think it's an unnecessary additional assurance right now. But if you find that you need additional assurances from mutual funds, I think that's an idea that I'd like to hear other people comment on.

MR. BARIBAULT: I have one additional thought. There could be an assumption -- and I'm adverse to it -- that there's an opinion-shopping process going on that could be introduced into the process unintentionally, but still there. So I revert back to having a highly disciplined audit committee with good information who's well-educated, is committed to continuing education, and asks all the right questions. And by you pointing that out to us, helping us in that forum will make us much more effective.

MR. CVENGROS: And I would just add that not all mutual fund complexes are in a position, really, to have two auditing firms. I mean, if you're -- if there's many trusts, separates trusts and funds as maybe American Funds, it gives you that opportunity to do it because there's a scale there that you can operate with each of these auditing firms.

But to segment smaller number of funds and have two auditors in with the advisors working with them is -- it would be cumbersome and additional costs to the shareholders. But I think it's a great idea that American can do that.

CHAIRMAN DOTY: We are scheduled for a break, a five-minute break. But I want to thank this panel, because all of your comments, of course, and your papers go into the record. We have the record to look back on and to be able to rely on all of your thoughts.

You have made a very thoughtful presentation of some very important distinctions between the mutual fund industry in the operating company universe, and they're, all of them, very useful to us in evaluating what we have to do, especially with regard to the specific proposals that Bill Baribault made, and that you each in our own way have indicated in your materials. So thank you.

And we'll break briefly. And we'll be back here at, let's say 3:50.

(Whereupon, the above-entitled matter went off the record at 3:44 p.m. and resumed at 3:50 p.m.)

CHAIRMAN DOTY: Well, I'm sure the preparers feel that it's been a long day, and that we're late getting to the preparers. But we're now -- that's where we are now.

Ken Goldman, Senior Vice President and Chief Financial Officer, Fortinet, Inc., a provider of unified threat management solutions. He served as senior vice president, finance and administration and chief financial officer of Siebel Systems, Inc., the software solutions and services giant acquired by Oracle in January 2006. Prior to August 2000, he served as senior vice president of finance, chief financial officer of Excite@Home Corporation and Sybase. He served as chief financial officer at Cypress Semiconductor and VLSI Technology. Named among America's 15 most connected capitalists for 2010 by Forbes Magazine. We're going to have to talk about that, Ken Goldman. And served on the board --

numerous boards of public companies, and he was a member of the Treasury Advisory Committee on the auditing profession. And previously served on the FASB's primary Advisory Group, the Financial Accounting Standards Advisory Council.

Welcome, Kenneth Goldman. You bring a lot to this discussion. And we do want to know -- we do want to know what you had to do to be connected; whether it was electronic or virtual is going to be very important.

Richard Levy. Rich Levy is Executive Vice President and Controller of Wells Fargo. Joined Wells Fargo as controller in 2002. Has over 30 years of public accounting and financial services industry experience. Before joining the company, he was senior vice president and controller for New York Life. Previously a partner with Coopers & Lybrand where he headed the firm's national tax practice for financial institutions. And before his experience at Coopers & Lybrand, he was a senior VP at Mid-Atlantic, a New Jersey-based regional bank holding company. Began his career with Deloitte & Touche. Welcome, Rich Levy. Good to have you.

Kevin McBride, External Reporting and Treasury

Accounting Controller of Intel Corporation. Mr. McBride is the -- is responsible in Intel for leading Intel's treasury accounting and SEC reporting activities. He joined Intel in 2000 as an accounting policy manager. In 2005, he completed a two-year fellowship at the Financial Accounting Standards Board. Mr. McBride has led and managed Intel's technical accounting activities through 2009. And prior to joining Intel, he was an audit manager at KPMG in Portland, Oregon. He's participated in numerous professional initiatives, including the FBI's annual current financial reporting issues, the AICPA National Convention, and the SEC Institute Conference on Fair Value Measurements. He is a member of the Center for Audit Quality SEC Regulations Committee. Welcome, Kevin, McBride.

Welcome to all of you. Thank you. And we'll start, Ken Goldman, with you.

MR. GOLDMAN: How's that? Starting now? Okay.

So, anyway, thank you, Chairman Doty, and other members for inviting myself and others, and frankly for coming out here to the west coast and getting our thoughts.

I do plan on, very quickly, talking about my background relative to this committee. Some things I've done to prepare for this panel, my sense of pros and cons related to the mandatory auditor rotation, and honestly some other alternatives that I think would help improve auditor effectiveness to this committee.

You are correct, by way of background, I am a CFO of Fortinet. I have been actually CFO over a number of public companies that you note. Actually, 30 years going on being a CFO of public -- primarily public companies. Over 25 years, actually, of public. On a number of public boards and private boards. Actually, well over 20 over the last few years.

Currently chairman of the audit committee of NXP Semiconductor, on the -- also Infinera, and was chairman of the audit committee of Juniper, Starent and Legato. So I've been in a variety of things. Plus I'm on the -- I still remain on the board of Cornell University, and I'm going to come back to that in a while.

In terms of preparing for today, I did review my experiences, my experience on the FASAC board of 1999/2003, the Advisory Committee on the Auditing

Profession that you mentioned, and you said a number of the recommendations that we came up with, sort of unfortunately that report, you may note, came out in October of 2008, very timely, and I think now sits in a museum, all 12 binders of such. But I will come back to some of the comments and recommendations there, because I think they -- they bear on today.

Let me take -- let me actually do -- talk about some of the progress. And I think people forget this, and I did hear some other panelists talk about that today. So since Sarbanes-Oxley in 2002, we now have CEOs' and CFOs' certifications. We have mandatory five-year partner rotations. We have SOX for internal controls. We have auditor services independence requirements. We have the audit committee response overseeing the auditors. We have a more robust private regulatory regime, thankfully under yourselves. We have audit committees composed of expert members. We have more frequent mandatory filing reviews by the SEC and a whole host of other changes.

So actually you have to step back, and before you want to make some changes, think about some of the progress that has been made. And I also thought that back to -- because I remember the period well in the late '90s, in like 1990s, and there were a few bad apples, so to speak, and I would sometimes remind people not to take too much from some bad folks when most folks do -- and I would say the CFOs and audit committees that I know take this job -- and auditors take this job very, very seriously.

And I did note, I was looking at some of the data, that audit restatements are down 80 percent from 2005. Class action lawsuits down by over half in that time frame. So let me now address mandatory auditor rotation, which I am not in favor of, which you can probably expect.

For those with short memories, I would remind you, we used to have eight firms. Through misplaced consolidation, in my judgment, and elimination of Arthur Andersen, we're now down to four. And I think I just actually heard the prior panelist note that these four firms now audit 98 percent of the market capitalization of U.S. public companies. That's actually comparable for other major capital markets.

In practice, we use, I use other firms for various other non-audit services, which now, by the way -- and our own financials, our own auditors, and as well as the others, you know, our non-audit service from our own firm is down to like 20 percent from 50 percent that it was back in 2002. And in many cases, you may have other auditors as your customers. So it makes it very, very hard.

Other industries you find constraints relative to industry experience by geographic presence that severely limits the alternatives. And ironically and perversely, changing auditors many times has a negative connotation for investors. Either an existing auditor prefers not to work for the company or vice versa, and hard to really -- it's hard to understand fully the rationale for the auditor change by investors.

In a related situation, I was on a -- I'm actually still on the Cornell University board, a number of years ago, we actually did put up our audit for a competitive bid. And we did change from an existing auditor to a new auditor, not for cost, which was incidentally -- which ended up becoming more competitive then our prior firm, but because the new firm uniquely possessed relevant industry experience auditing the very top university similar to our size, and could field a team for us in Ithaca, which is no easy task.

I also mentioned we never really looked at a non-big four firm. And so -- and this firm also -- so when you look at it, actually it's interesting. For example, the four firms -- we did move from the existing firm in this case, and it was really one firm that really had what we considered to be not only the relevant experience, but in this case, geographic presence both in Ithaca and actually coming out of Syracuse.

So I -- I've broken up my general recommendations into two parts here just to sort of make it easier to digest, and some more relate to mandatory auditor rotation, and then others some other general suggestions.

I would actually require large companies to bid out the audit every 10 to 15 years, some flexibility in that time frame. And if they choose to keep their existing firm, explain why. Additionally, all public company audit changes and reasons must be disclosed. Auditing firms must notify the PCAOB of premature auditor

-- premature engagement partner changes at audit clients.

You know, in thinking of this, I actually was thinking about last study results of companies that have changed auditors relative to audit quality. Is there a link between audit quality and changing auditors? Do negative perceptions exist regarding auditor changes? What is the fundamental reason and benefit or problem were trying to fix via audit rotation? And so think about all of those in terms of making a change.

Two, I like Arthur Levitt's suggestion of when a mandatory audit change may need to be addressed. For example, when there are restatements, non-audit services become too high, and so forth.

Three -- you're going to like this one -- require both engagement partner and reviewing partner to sign the opinion, either a 10-K or the proxy. Span scope of audit committee reporting proxy relating to auditor independence, objectivity and professional judgment. I would more formalize the role of the reviewing partner. I find the reviewing partner, even though it's a very important aspect, is not totally clear sometimes.

Five, publicize and issue best practices and learning developed through the PCAOB reviews of company audits and make these more public to the companies involved. Continue to publicize and replicate improvements made in firm audit methodologies. Audit firms to discuss inspection results more fully with the company audit committees.

Controversially, perhaps, increase the mandatory -- contrary to what you -- what everybody was talking about -- increase the mandatory partner rotation from five years back to seven. In reality, the first two years -- I see this over and over -- are training and learning the account.

There are a couple of good years in the middle, about three years maybe, and then year five is when rotation. So before you get into changing, you know, the five years, the first couple of years the new person -- the new partner's getting onboard, you know two or three years where they're fully onboard, and then all of a sudden you're back into a partner rotation. It just seems like every -- I'm going through this constantly in terms of partner rotation.

And you know something, it's all about the people. I would focus on ensuring appropriate human capital steps to ensure trained and competent auditors at all levels. And I certainly hope we don't suggest a mandatory CFO rotation.

Let me just take -- you know, one more minute, and I'll talk about some other suggestions that I thought of. One, PCAOB consider developing and disclosing key indicators of audit quality, disclose such indicators and monitor them. PCAOB to ensure -- to issue constructive recommendations based on its findings relative to audit quality.

All public companies adopt annual shareholder ratification of public company auditors. One of the things we did address a lot in the treasury was the ensuring of viability and preservation of four firms I would hate to see if we went lower. So large auditing firms produce a public annual report with audited GAAP financials, including key indicators of audit quality, effectiveness, and also consider adding independent board members.

Four, recognize many of the restatements result from recently issued and complex pronouncements such as those relating to complex financial instruments, fair value accounting and so forth. Let's work to balance accounting theoretical accuracy with practical implementation implications.

Five, provide training and develop -- and promulgate best practices in terms of running audit committees. Provide training of audit committee members and audit committee expertise.

I would add that we've gone from a period where we used to have four to six meetings a year to 10, 12 and more audit committee meetings.

And six, align standard certifications for audit firm and employees between federal, state and other related bodies. It's interesting how you have different standards between states and federal and so forth. And consolidate the rules of various oversight bodies such as the SEC, PCAOB and AICPA regarding independence requirements among public company auditors free of conflicts of interest.

And the very last one, my last comment, there is really no substitution for reasoned professional judgment and possessing a good ethical compass. And remembering, as I was told early in my very first job, disclosure is my friend, is shining a light on transparency.

So with that, I leave it to Richard.

CHAIRMAN DOTY: Ken, are your comments written? Can you -- you're leaving us a manuscript, I hope.

MR. GOLDMAN: I could leave this if you want, yes.

CHAIRMAN DOTY: It would be very helpful.

MR. GOLDMAN: Yes.

CHAIRMAN DOTY: All right.

MR. LEVY: Chairman Doty, members of the PCAOB and observers, thank you for inviting me to participate in this public meeting to address the very important topic of audit firm rotation and auditor independence.

Auditor independence is critical to ensuring audit quality. However, existing professional standards and practices, including additional safeguards established pursuant to the Sarbanes-Oxley Act of 2002 already effectively ensure that auditors remain independent in both fact and appearance.

While the intentions of the PCAOB proposal to promote and improve audit quality are laudable, we do not believe there is sufficient evidence to support the underlying assertion that lack of auditor independence is a pervasive problem or a primary cause of audit failures. Our audit committee is best qualified to determine when external auditors should be replaced. In order to credibly challenge both management and the external auditors, the audit committee must retain full oversight responsibility.

When in the judgment of the audit committee the performance of management or the quality of the audit is adversely impacted by a perceived or actual lack of auditor independence, it is the fundamental responsibility of the audit committee to determine whether a change in the external auditor is necessary. That responsibility should not be undermined by regulatory intervention.

Audit inspections performed by the PCAOB have not yielded a significant number of deficient audits. Several years after the implementation of Sarbanes-Oxley, the PCAOB has acknowledged that audit quality has improved. Neither academic studies nor the use of inspection activities, which typically target higher-risk audits have indicated correlation between audit failures and a lack of auditor independence.

Effective and comprehensive quality control measures that ensure and enhance auditor independence exists today, and we directly experience the effectiveness of these measures as our auditors continuously adopt their audit procedures as a result of feedback from the PCAOB.

Audit firms are subject to onerous internal and external quality control measures, including measures enacted under Sarbanes-Oxley to improve auditor independence. Audit firms are required to communicate the description of all client relationships, the audit firm's quality control procedures, and material findings from peer or internal reviews and PCAOB inspection activities. Other rules place limitations on hiring audit firm personnel, prohibit performance of certain non-audit services, and limit the tenure of the audit engagement partners.

Meaningful distinctions also exist to ensure quality control measures are adhered to, including the signaling of potential audit failures in public SEC filings, the assessment of financial penalties, employment actions, or more severe sanctions. It is not reasonable to assume incumbent auditors would audit any more rigorously simply because they would be subject to mandatory rotation.

There's a practical limit to the number of viable replacement audit firm candidates. Large, complex multinational companies are realistically limited to using -- to using one of the big four accounting firms. However, given the unique market, operational and technical accounting perspectives of the financial services industry, we believe only two of the big four accounting firms would be viable candidates for our company and our large bank peers.

The field of viable audit firm candidates is also limited by existing rules meant to enhance auditor independence by prohibiting the performance of certain non-audit services, a portion of which is typically divided among the remaining big four firms. Non-audit service frequently represent significant complex multi-year projects, and it is not feasible to expect that such projects could be completed or transferred to a replacement firm in a timely manner without significant cost or interruption -- or disruption.

When potential replacement firms do not have adequate expertise or resources, audit firms may have no other choice but to hire resources from the incumbent audit firms. For similar reasons, we are concerned that audit or non-audit service may be awarded to less-qualified audit firms.

Each of these reasonably possible scenarios will counteract the perceived benefit of mandatory rotation while bidding up the cost of industry expertise. The potential incremental cost of mandatory audit rotation will be significant, with some estimates increasing first-year audit costs by 20 percent.

However, this assessment does not contemplate the implemental costs associated with reporting requirements imposed by post Sarbanes-Oxley legislation, and pending new regulations under the Dodd-Frank Act, the increased leverage that audit firms may have in setting fees, and the audit inefficiencies and learning-curve costs a replacement firm will incur examining complex registrants.

Lastly, there are potentially significant unquantifiable costs related to audit-detection risks after a rotation. We are troubled that the PCAOB has not performed a meaningful study to determine if the incremental cost of mandatory auditor rotation are justified.

Although we do not support mandatory auditor rotation, we do believe there are opportunities to enhance audit quality and promote auditor objectivity that would be more effective and less disruptive than mandatory auditor rotation. We recommend that the PCAOB consider enhancing required communications and information available to audit committee by sharing with them the results of its inspections of registrants' auditors, as well as publishing the results of its overall inspection program in a format specifically tailored for the use by audit committees.

Revisiting the requirements for qualifying as a financial expert of the audit committee to ensure audit committee financial experts have the requested financial reporting expertise to effectively perform the oversight responsibility over the auditor relationship is another suggestion.

And finally, enhancing auditor training requirements to specifically address audit quality concerns identified by the PCAOB inspections, as well as assessing the adequacy of existing training programs at auditing firms, with appropriate emphasis on professional skepticism training.

In closing, we believe existing safeguards provide -- provided by professional standards and practices, combined with the oversight provided by audit committees have been effective in ensuring and promoting auditor independence. Mandatory auditor rotation will increase audit risk, subject reporting entities to substantial incremental costs, create conflicts of interest among potential replacement audit firms, and limit competition due to the concentration of industry expertise and geographical reach.

We believe mandatory auditor rotation will replace a perceived audit risk with tangible and more serious audit risks which could severely damage audit quality. Therefore, we strongly encourage the PCAOB to review other alternatives to enhance audit quality and promote auditor objectivity.

CHAIRMAN DOTY: Kevin McBride.

MR. McBRIDE: Good afternoon. Thank you for the opportunity to provide Intel's views on auditor independence and rotation. The Board has conducted extensive research and outreach on this topic, and in my opinion certainly has demonstrated its commitment to protect investors and fulfill its mission.

I am Kevin McBride, and as mentioned in my introduction, I serve as Intel's external reporting and treasury and accounting controller. My responsibilities include ensuring that our finances comply with SEC rules and regulations, and that our process in developing and preparing our financial statements are transparent to management, the auditors and the audit committee.

I'd like to spend just a few moments summarizing Intel's position and make a couple of additional comments on ideas that have been shared during the Board's outreach.

Auditor skepticism and objectivity are essential to high audit quality. I think the question is, how to enhance skepticism and objectivity. With respect to skepticism, I believe that there are two critical components, deep subject matter knowledge and the desire to get to the right answer. Let me take the first component, which is the deep subject matter knowledge.

Intel's annual revenue for 2011 was approximately 54 billion with over 80 percent of that revenue generated outside the United States. We also manufacture, test, and assemble products in six countries outside of the U.S. So in addition to our consolidated reports filed with the SEC, we file over 150 statutory reports around the world, and in fact in over 40 countries.

Our business model and geographic dispersion require deep knowledge of our business, as well as domestic and international rules and regulations. So in order to file those high-quality reports with the relevant jurisdictions, we develop and train a highly skilled workforce. It takes us about four to six years to develop our technical staff, and another four to six years to develop an individual with the skills necessary to manage that staff, and our controllers with oversight over those managers generally have about 20 years experience.

And we enhance that experience through periodic rotations to ensure that our managers, as well as our controllers have broad experience necessary to deal with the complexity of our business. And we need that deep expertise to be matched by our auditors.

Which brings me to my first objection with mandatory firm rotation. I don't believe that a fresh set of eyes will have the deep subject matter expertise in the early years of the new audit relationship to demonstrate the skepticism that the Board desires and the companies need.

So when I look at the cost benefit equation associated with audit rotation, I see three costs. One in an increase in fees, which has already been talked about. Second is the cost associated with taking management time to help the auditors understand the people, the processes and the systems that translate the business into meaningful financial information.

And third is the cost associated with rotating service providers for the non-audit related services that companies like Intel procure from the other big four audit firms. In fact, that steep learning curve makes the auditors acutely reliant upon management, which I think is the very thing that auditor rotation is trying to avoid.

In applying auditor rotation in the largest companies exacerbates these issues, given the complexity of those companies. Further, it undermines the company's ability to select a big four firm that is best suited to provide the relevant non-audit service. So when I think of the cost benefit equation, I believe mandatory rotation will not produce the desired outcome in the early years of the new audit.

The other component of skepticism in my mind is the desire to get to the right answer. That means looking at reasonable alternatives and understanding the relevant merits of those alternatives. I believe this is an important attribute. But it's consistently demonstrated by our auditors. Perhaps more can be done to share that information with the audit committee to give them visibility into the -- into our auditors' passion for getting to the right answer.

The other necessary trait is objectivity. To address this concern, I've heard of the insurance-based alternative to existing client-payee model. I believe the notion is that the auditors cannot be objective if they're paid directly by the company. But the changes set forth in Sarbanes-Oxley Act make a marked improvement in numerous areas, including requiring that the auditors work for the audit committee and requiring that the audit committee is comprised of individuals independent of the company.

Let's put that fact aside for a moment and talk about the insurance model. And I'm selecting this model because I think it's particularly illuminating with respect to a potential way forward.

The insurance-based model presumes that the auditors are more objective if paid by the insurance company rather than the audit committee. But I think there's more to it than that. First, the company, the audit insurance company would need more insight into audit failure. The model presumes that a subpar audit could lead to an increase in the insurer's claims, and thus a decrease in revenue to the offending firm.

I think there's an important element missing from that equation, and that is information. In order to properly risk adjust insurance premiums and value the services provided by the firm, the insurer would need to understand the nature of the audit issues. Was the issue systematic or was it isolated. Was it a matter of a failed procedure, a lack of independence, lack of good judgment, lack of education? Was it something related just to the audit team? Is it the office or is it the entire firm.

The insurance provider could then use that information and model and appropriately extrapolate the issue. Also, the insurance provider would need immediate feedback about audit failure. It couldn't wait months or even years to learn about audit failures. In order to understand the quality of the audit, I believe audit committees require no less timely and thorough information. And armed with that type of timely and thorough information, an audit committee can make a more informed decision about auditor retention.

So to be clear, I oppose mandatory auditor rotation. However, I clearly recognize that auditor rotation is an appropriate solution in certain circumstances. But I believe it's the audit committee's duty to make that determination, and audit committees would benefit by understanding the results of PCAOB's inspections. Thank you.

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

MEMBER HANSON: Thanks. Good comments from all of you.

This morning, we heard from a couple of our opening panels make assertions about audit committees; that effectively, they're not up to the job of policing auditor independence, objectivity and skepticism. You're in the position of having -- having felt the brunt of what auditors are going through in terms of reform from our inspections and new standards over the last 10 years, and I -- and I think probably more acutely in the last three or four years. And you're also in the position of having to answer to the audit committees in terms of what they're asking you more acutely about, you know, today, from what we're hearing and saying.

So I would ask of each of you to share a bit of personal experience about how things are different now in even just the last couple of years compared to the pre Sarbanes-Oxley era, both in terms of your interaction with the auditors, as well as interactions with the audit committee. So that's my main question.

And then -- and then for Rich and Kenneth, I want to follow up on something that Kevin just said about -- about advocating that -- or supporting the idea that we should be able to give -- or it would be desirable for us to give audit committees more timely, direct, specific feedback on what we've seen in audits of your -- of your businesses. And whether as preparers you would find that troubling or if you would support that. So, two questions wrapped into my time.

MR. GOLDMAN: Yes, well, I guess -- I think the -- you know, in terms of the committee -- you know, in terms of committees and how we see it, I mean, I think -- I'm trying to understand your first question in terms of what really --

MEMBER HANSON: The question, it's really what has changed in how you interact with both the audit committee and the auditors in the last -- the last few years that --

MR. GOLDMAN: Well, I think that the number one change actually starts with a comment I made is, instead of having four or five meetings a year, you literally have, you know, 10, 12. And let me just explain how to really works in practice, and maybe you don't know this.

I mean, you obviously have a meeting to review before the earnings -- before the earnings come out, you have a meeting to review the relevant Q or K. When I'm -- and I'm talking about when I'm on the -- when I'm on the audit committee, you know, I tend to have a couple extra meetings to go over special subjects, and so easily have 10 to 12 meetings a year. It is -- I'd say before we had this, it used to be four or five.

I would also say, I sort of -- I probably talked fast before -- you know, when I thought about, you know, pre Sarbanes, it's interesting a lot of people in the Valley are pretty down on Sarbanes, and you'll hear a lot of negatives, and I actually think there's a lot of good that came out of it. So I'll probably get some lashings when I get back home. But the reality is, the fact that you now need, you know, independent members of the audit committee, they need to be relevant -- understanding of the -- have the relevant experience and understanding accounting.

I mean, I can think of several firms that got into, quote/unquote, trouble in financial services, which were composed of audit committee members which weren't related to the industry, didn't have the appropriate accounting expertise. And so I think the -- all of us, whether I look at myself as a preparer, I look at myself as an audit committee member, because I do both, you know, we all -- or at least the people I know, take the job very, very seriously. The requirements are much more extreme.

And -- and so the point that I made is, the thing I asked for -- I actually have a meeting with a KPMG case with -- because I've asked them to give me what you're saying is best practices for audit committees. Because one of the things is, it's hard to get really a sense of what are other people doing, and so I was up to risk now and so forth. But what I'm trying to say is what's really -- what's new in the last year or two years or three years. So I've asked this case, KPMG meeting to provide the audit committee of NXP, what is the -- what are the best practices you are seeing relative to audit committees.

But the last point I make relative to the question you asked is, I think in terms of the PCAOB, I think -- I think there's a mix, if I could say. I think the auditors feel a little bit of, certainly lashings that they're getting. Some of it I think they feel is deserve; some of it they may feel is undeserved.

But I think it's -- we all would benefit just sort of -- and you could find a way to parse that out and say, you know -- and the comment to that is here are the general comments that we think could be helpful in terms of things you're seeing across the board, not unique, but across the board that would be helpful for us as preparers, and our committee members, that we should be on the lookout for. I mean, I think that would be very, very helpful to have better -- and the other thing is they have it more current. And so to have findings that are a year old and not two or three years old in terms of what you're seeing when you do your -- your audits. So that would be my first comment.

MR. LEVY: Just to weigh in also on the impact of Sarbanes-Oxley, I actually can understate this, I think it was a very profound impact on both the audit profession, and quite frankly, on registrants. It's not just about the financial statements as they've been rendered, but also the control environment. And so we spend a considerable amount of time not just talking about what the results are, but what the control environment is, and what could be a material weakness, significant deficiency, or even a deficiency.

So it's not just something that would emerge in a period or an issue in the period, but something that you're processing your -- your whole infrastructure could -- infrastructure could potentially not detect and allow to be ultimately a financial statement issue, or a misstatement. So I think that the auditors themselves, as well as the registrants have really had to lift the game up as a result of the whole SOX process.

In addition, I think that, you know, you guys have actually played a meaningful role, because typically in the relationship with a registrant and its auditor prior to Sarbanes-Oxley, prior to the advent of the PCAOB, there really would be the constructive tension around the SEC, maybe in a financial institution in terms -- well, from a common letter perspective and their oversight, from a financial institutional perspective, obviously the bank regulators play a continual role with their presence, and that actually can impact financial results.

But now, quite frankly, you are coming in and doing your targeted reviews and inspections, and when you see an issue, it may not be at a Wells Fargo, it might be at another large bank peer, you are raising that issue, and you're raising that issue with the firms, you're raising that issue with the SEC. A good example is the Level 2 market valuations, and that was a concerted effort that we -- we certainly felt as an industry. And at Wells Fargo obviously demonstrating to our auditor that we in fact had a good sense on our, you know, Level 2 provided market values.

And so the process has actually morphed to the better. Yes, that might entail more audit work from the firm and more hours and more costs, but quite frankly, I can tell you that there is -- there is a constructive tension that exists in the current environment with regards to our audit committees. I would also say that they've benefited from the Sarbanes-Oxley Act. Clearly having financial expertise is very important on the committee.

And, again, having that skepticism really has to start from that top. You know, in terms of a well-controlled organization, it's the tone and tenor from the top that you will always say is one of the global controls that you want to look for. Well, I would -- I would second that at the audit committee level. That tone, tenor, attention to detail being an activist board. All right?

And I would tell you that the level of activity and engagement that I've seen at, not only Wells Fargo, but quite frankly, in what I'll call my prior life, has really been elevated. So to the extent that there's an opportunity here, it's to continue to increase and elevate that engagement by the firm by the audit committee. And quite frankly, ensuring that it's not just the large registrants that are able to attract talent to their audit committees, and the -- and the required subject matter expertise, but that actually you -- we want to make sure that all public registrants have a good quality audit committee.

MR. McBRIDE: I think there's four notable changes that I see post Sarbanes-Oxley.

Well, the first one is the ongoing management of technical issues that arise each quarter. What we do, as a matter of process is, as the quarter develops, we identify those issues that are going to be important to the quarter, and we have a meeting with management, talk about the relevant views on that and the alternatives, and I we present that -- those issues to the auditor. We actively manage that list throughout the quarter. And at the end of the quarter, once the issues are resolved, then we select the items that we need to talk to the audit committee about. And that's, that's something that's new post Sarbanes-Oxley.

I think another one is the -- I think Rich touched on this -- is the identification of things that are occurring, either new accounting standards or, you know, issues coming out of the SEC inspections, or PCAOB inspections; that we meet every quarter with our auditors and have a conversation with senior management about those issues. It's an opportunity for our auditors, as well as they bring in the national office -- an office expert to talk about those issues and the firm's views with respect to those issues. And we get an opportunity to ask questions and really understand where auditor -- where our auditors are coming from.

The third -- and Rich did hit on this one absolutely -- is a discussion of control deficiencies. The discussions we have with respect to control deficiencies is really trying to get to what went wrong, what's the root cause. One of the things we see -- and this is actually very relevant to the comment I made with respect to audit quality in the earlier years of -- of an audit rotation, is what we see when people rotate in jobs at our company, is that we have to provide quite a bit more oversight and review on particular desks when people rotate, because of the risk of a person immersing themselves in a new process with new issues that they're not familiar with.

And so issues arise out of that, and we talk about those every quarter in our -- in our quarterly controls review. So that's new since Sarbanes-Oxley.

The other point I wanted to make is with respect to auditor rotation. When -- we've had, within the last three years, a new lead audit partner that came in and questioned some of our critical accounting estimates, so some of the things we did was we prepared a kind of report out on our accounting process, our key estimates, our judgments.

We walked their lead partner through those -- those items, as well as he brought in -- this is on an issue related to fair value in particular that I'm thinking of -- they brought in the national partner in charge of valuation. They brought in valuation experts. They had staff, and senior and other partners in that meeting. We brought in our relevant experts that are involved in valuation and the process, and we walked through the issues. And it's an opportunity for them to get educated, as well as for us to get educated on the latest views of these issues.

So I think those are some of the things that I noticed, some of the changes that we've seen since the start of Sarbanes-Oxley.

MEMBER FERGUSON: One of the things that I think each of you mentioned -- and you're sort of not unique in this; it's been mentioned throughout the day by panelists, has to do with one of the problems with mandatory rotation. And it would be -- it might just be with rotation in general -- is the fact that to the extent that large enterprises use non-audit services from other big four firms under the independence rules you're very limited. So if you had to rotate, either that would limit your choice of those service providers, or, you know, might -- if you had to rotate in a very short-term basis, might preclude certain people from being your auditors at all.

It strikes me in many ways that this is a problem of the firm's own creation. They have chosen to go into these businesses. And frankly, the most rapidly-growing parts of the business of the big audit firms are the advisory service, growing much more rapidly than the -- than the audit business.

Does this argue for strict limitations on the kinds of non-audit services that audit firms should be able to provide, including going so far as to having audit-only firms, a proposal that's being considered by the European community right now?

But, I mean, you know, these problems which I think we realize or recognize are very real in today's environment, are problems created by the firms themselves. They have created this universe. I mean, you haven't. So what's your reaction to that?

MR. GOLDMAN: Well, it sounds good in principle. The problem in practice, and it comes back to the 98 percent which some of us talked about, if you want good tax advice that you can't use your own firm for, the reality is, you know -- and I looked at, yes, I don't want to be negative on some of the firms you'll be seeing on session 10 here, but the reality is there aren't many firms that could provide that.

And so if you want the best service that can do these questions you have, you've got to look for the best folks. And so you have to find -- how do you find a way to have other firms provide those services. So in our case, we use Ernst & Young for tax services when our auditor is Deloitte. I mean, I don't know -- I mean, I could look -- you know -- so you're saying how do you use a non-big four, so to speak, and I don't think the others have nearly the competency that we want to see in terms of some of the structures that we're looking at right now.

So, you know, you're right, we didn't create the problem. I would argue the problem was created when we collectively allowed eight to go to four, and we are where we are.

The other problem I have is, there are a lot of firms I ask for, you know, to provide tax, probably the most relevant one that I think all of us will agree we use the firms for. And there's a lot of firms that just don't have the people and capability to provide that service. And so that is, I think, heart of the issue.

MR. LEVY: And just to jump on -- first of all, if you were to go down that direction, clearly you would need to have a respectable time frame for transition, because you certainly wouldn't the want disruption between a firm that was engaged, to then have to exit before finishing a project. But that's it.

I'm really not a supporter. I think this is a bad proposal. It's really kind of creating just a, if you will, the high priest of audit. We just had audit purists. I think it's been a debate that's -- that's been kicked around and seems to be recycling. I think there's a tremendous amount of benefits that the firms actually are able to provide -- to pick up on where Ken was going -- by virtue of their experience. So when -- when you bring together the accounting knowledge, the tax knowledge, the consulting knowledge, it actually creates quite a powerful capability and skill set that actually is lacking in the marketplace without that synergy.

So, you know, there is a real benefit to users of service like tax or consulting, because when there's new legislation like Dodd-Frank, and there's an aspect of -- of complexity, living will, how do you interpret, who do you implement, those are all items that even large sophisticated financial institutions would like to get the best and brightest minds' input on. And I think that you want to have that capability at its -- at a high level. So just a couple thoughts.

MR. McBRIDE: My concern is where do you draw the line there. In particular, we enter into a complex business arrangements, and oftentimes the firm can draw on transaction services to help and work through the accounting issues relevant to that transaction. Or it could be a valuation issue, where they can draw on their valuation services practice to help review particular accounting issues.

So, you know, right now I know that those areas serve as a resource to the audit team, and in some cases to the company in working through technical matters. So, you know, my concern is where do we draw the line. Where would you draw the line if we were going to go down that road?

MR. GOLDMAN: I would add, one of the things that's interesting enough that we learn when we're on the treasury committee, and you can ask this question later, but the -- and we had all the CEOs of the various -- or most of the firms below the top four, and interestingly enough -- if I could paraphrase most of them had no desire to get much bigger. They actually like the spot they were in. They were under the radar. They liked the less, quote/unquote, legal liability they thought they had.

And so the idea of having them -- I mean, I'm sure you're probably looking at whether you get any of those to become a big -- a five or six -- the reality is, the sense we had in the committee, none of them wanted to go there. They were actually very happy with where they were. So the practicality of having that expertise to the next level, you know, is really a very different level.

MEMBER HARRIS: Mr. Goldman, when you said that disclosure is my best friend, what did you have in mind in terms of improving audit quality and independence objectivity?

MR. GOLDMAN: Well, you know, that's funny, I learned that -- I literally heard that from an audit partner at E&Y, and you can tell it struck with me ever since -- stuck with me ever since. And it was a very simple comment, is when it doubt, disclose everything to your auditors. When it doubt, disclose it in your footnotes.

And so -- and then you shine a light on everything and then everyone can make their own assessment as to, you know, the issue, if you will. And so it's something I've lived with, you know, if you will, since I've been doing this, is, you know, disclosure. It's a simple comment, disclosure is my friend. If it's disclosed, everyone can see it, and you find a lot of the issues.

Then you -- you may have disagreements as to it, but at least it's all out there, and it's understood. And so that's something I've used forever. And it's a when in doubt, to me, put it in the footnotes, put more than -- more than you need in there, disclose everything to the auditors, and -- and then you -- then you may have to arm wrestle them some things, but at least everyone knows what it is. And you make, hopefully, professional, reasonable judgments. So that's the way I've lived in terms of my job.

MEMBER HARRIS: In terms of the disclosure to investors, what would that mean? How does that translate?

MR. GOLDMAN: Well, I mean, I think -- you know, again, it's the same concept. I mean, the thing is you asked that question -- because I do IR as well -- I mean, the thing you have to be a little careful about is what metrics do you want disclosed, because, you know, you find once you disclose a metric you have to consistently disclose it.

But it's the same comment, if you -- if you --

any of you -- you know, you'd probably get bored silly -- but if you listen to what we provide at Fortinet, yes, we probably go -- I go about 25 minutes discussing my -- you know, results of the quarters, we were one of the very first companies -- and actually auditors didn't want me to do this -- but we actually provided pro forma comments, you know, obviously back to the GAAP numbers in our filings, because that was one of the things the SEC asked for or suggested to make the numbers -- you know, make your communications very consistent between what you provide the investors and what you provide the -- in your filings. And we did that.

And, you know, my auditor said, geez, you know, it's not GAAP - blah-blah-blah -- and we said I'm going to do it anyway because the SEC wants it, and we're going to make sure it's consistent, we're going to make sure we do the reconciliations, which we do. And you're probably going to be now looking at my numbers.

But -- but I think, again, it's the idea of show it there, let everyone see the numbers, see how -- see how the public and the investors see our numbers. And so, again, I look very carefully at what's required. And obviously if -- if we hadn't -- if that I hadn't encouraged it, I wouldn't have done it. But I actually think that's good, as an example.

MEMBER FRANZEL: I want to follow-up a little bit on Jay's question about what has changed. And you all indicated that things have certainly gotten better since the Sarbanes-Oxley Act.

But I'd like you to elaborate on how this played out during the financial crisis in terms of increased auditor skepticism, if you saw such a thing, as well as audit committee oversight.

MR. LEVY: Well, given it's a financial crisis question, I think we've -- we are living through it. And I would tell you that there was a lot of focus around almost all things financial, probably starting with the valuation of financial instruments during a time frame where the market had ceased. And so what was the right valuation from a fair value perspective.

A lot of -- a lot of discussion, a lot of inquiry, a lot of justification to provide on our part, and actually good dialogue all the way through and up to the audit committee on the allowance for loan loss and the adequacy of the allowance for loan loss, especially in a time frame where, you know, linear trends no longer were working, where there were step functions and values of underlying collateral that wasn't thought would be secured loans becoming, essentially, unsecured loans.

The value of the, let's say, a second lien, home equity lien where the, the value of the house no longer supports it. You know, what is the adequacy of the -- of the allowance. Or, in essence, what's the right estimate of the loss content. That skepticism actually has continued in terms of -- I think -- I call it constructive tension.

Because even to this point when we still see that the GSCs are putting back more and more of the mortgages that were sold, that they, they are looking at having repurchased. And so that process, as you look to anyone in the service, mortgage servicing space will attest and it's clear in the financial statements continues to be an evolving area, what is the amount of the probable and estimable repurchase obligation.

So I would tell you that across the board on almost all of -- in fact, all of the critical accounting policy areas, more, more in-depth examination, in essence, fortified, lots more time spent, and also during acquisitions because we happened to be in the position to acquire and merge with Wachovia, Wachovia had a -- has a wonderful franchise, but in 2008 it also had a pretty significant level of loans that would be classified as purchase credit impaired loans. What is a purchase credit impaired loan? How did you determine it? What was the amount of the loss content that has to be set up in terms of the SOP 03-3?

So very technical, very deep dive. And quite frankly, if I'm on your side of the table I want to make sure that the examiners, the firm is actually up to those -- those tasks. Again, I came back to my opening remarks, at the level that we're at and our other large bank peers, there's really two firms that -- that really audit those.

So it's not even a four-firm oligopoly. But that's very critical to have, if you want to continue using my term constructive tension, it's very important to have the best, most capable firm doing that examination.

MR. McBRIDE: And I'd add to that. And we have an investment portfolio that includes an equity kind of a venture capitalist arm. So we have -- excuse me -- we had valuation issues. It sounds like Rich's were much more complicated -- but we had a number of valuation issues in the investment portfolio.

But it went beyond that. We're, you know, quite a few intangible assets on our balance sheets, so we were getting into the valuation of businesses and tangible assets, etcetera, and there's quite a bit of scrutiny placed on, you know, the future cash loans associated with the businesses and recoverability good will, as well as the intangible sites.

And then you have to look at, you know, the tax side of all those issues, whether, you know, you could recover some of the deferred tax assets associated with the things that are on our balance sheets. So valuation up and down the balance sheet was really the key to that year-end audit.

CHAIRMAN DOTY: Intel has substantial foreign operations, as you noted earlier, Kevin. What are you doing about the emerging pattern, the patchwork of tenure and rotation requirements that are emerging around the world, different parts of the world? How are you dealing with that?

MR. McBRIDE: So is the question -- just to make sure I understand the question -- is the question: Are we concerned about what would happen if, say, in Europe, they do move to mandatory rotations and how that could impact?

CHAIRMAN DOTY: Yes, that's of interest also. What kinds of plans are you making for the rotation regimes that are already in effect in certain countries? And certainly the proposal that looks as if it's moving forward in the UK of tenure, if you don't re-tender you must explain? There are a number of variants of this that we've been talking about through the day that are sort of gaining steam in their different levels in different parts of the world. And it seems to me that you all would be thinking about that.

MR. McBRIDE: You're right. We do file -- like I said, we file in 150 different jurisdictions. What I'm not sure of with respect to those proposals, is whether or not those impact listed companies, because we're only listed in the U.S., or whether it relates to the statutory audits.

And if it does relate to the statutory audits -- right now we have an integrated audit, and that's very important to us, because we get the efficiencies, because having one firm throughout the world that understands our practices gives us the ability to, you know, leverage the practices, the understanding of that institutional knowledge that both we and the auditors have.

But I'm not familiar enough with respect to those proposals to understand whether they do impact the statutory requirements. And if they do impact the statutory requirements, then that's something we need to get.

CHAIRMAN DOTY: Well, that's fair enough. I think we've exhausted time. Are there any other questions from anyone on the staff or the Board?

If not, it remains to thank you for having done this. This was a very informative presentation, and we look forward to seeing you again.

MR. GOLDMAN: Thank you. I just had one more comment actually. Just to give you a sense the importance. I think all the -- both our company and all the committees I have been on, what you see today is the CEOs will now attend audit committees. And just showing how important and how substantive and fundamental the work that's being done is, you find CEOs now -- it's almost obligatory, but, you know, but -- because they're not on the committee, as you know, but they do now attend.

I don't know if they're your companies, but. So it's one of the things you have seen over the last 10 years since Sarbanes, and maybe even before that started, but the CEOs now attend these meetings. And again, the business aspects that are reviewed in these committee meetings are much more substantive, again, than they were back, say in the '80s or '90s.

So I -- again, just showing how -- how the audit committee has sort of become much more profound as a committee relative to running the company.

CHAIRMAN DOTY: Do you see any change increment in the attempts of the CEO to determine the membership, the constitution or control the general tenure of the audit committee? There's a concern that many people have raised that as the audit committees become more important, as it is in fact the centerpiece of Sarbanes-Oxley, that management in the form of the CEO does take a lot of care in trying to be sure who's on that committee.

MR. GOLDMAN: I think in a positive way, actually. And I'm not sure what direction you were going. But, I mean, I think the CEO actually, you know, does want to make sure that we have, you know, good audit committee members that do add value. So, whereas I think in the past they may have thought just another committee, I don't need to go to it, you know. It's sort of interesting, but now they actually care who is on the committee because they attend the committee.

And they, you know, I think they want to make sure it's people that they can -- you know, make sure that it's people that they can understand that they find helpful to them running the business, and know the business.

CHAIRMAN DOTY: But you don't think there's been an impairment of independence of the audit committee in that circumstance?

MR. GOLDMAN: I don't think so. I don't, you know --

MR. McBRIDE: I mean, the CEO is certifying financial statements along with the CFO, and it's important for them to understand the issues that are being discussed at that level. So yes, I mean, I echo the comments.

MR. LEVY: I just want to second what Ken is saying. I think the -- the objective of the CEO would be to have the best quality members who actually can understand, because accounting has become very sophisticated, and the audit resulting. And quite frankly, also, the risk focus that the committee has to examine, even outside of just the financials, has become such critical elements of making sure a company's well run, that it is really a focus that has enhanced the independence and enhanced the caliber of the members on the committee.

CHAIRMAN DOTY: With tenure of CEOs and CFOs becoming predictable, as you pointed out, Rich, it is an ironic result that sort of occurs. And of course what we've heard during the day, that in fact the audit firm that is not rotated every 10 years or that goes for 30, 40, 50, 70 years, that firm really becomes more in control of the corporate accounting enterprise than the CEO or the CFO perhaps.

Is there any -- is there any thought that if CFO or CEO terms are becoming subject to this kind of a rotation that it becomes very important, as Ken Goldman says, that at least every 15 years, that there be a tender and if you retained you explain?

In other words, does the tenure issue talked about on the management side reinforce the necessity of having a having a fresh look at the audit relationship at least every 15 years?

MR. LEVY: It's probably a worthwhile item to consider. I mean, I think there are opportunities for enhancing the existing structure. I think that the fundamental issue in the accounting space is, is actually the chief accountant, quite frankly. And in fact, also having accounting or, you know, chief accountants, CFOs and/or former partners on the committee, that is very helpful to that constructive tension. Because I don't think it matters if the CFO is there for 10 years or a year, or the CEO for that matter. I think it's really the governance and the infrastructure and what has been laid in terms of the foundation.

So if a mandatory re-bid is helpful to the process, that's fine. I find, I find that there's still a very steep learning curve at any organization. And it's hard enough -- to the point where Kevin was making -- for our own staff to come up to speed. And I think that is a very big -- a factor that the decision-makers, the committee would have to consider.

CHAIRMAN DOTY: Yes. But we may have the burden. It's very interesting that in this complex world, accounting becoming complex, the operations scattered, the necessity of having at least many affiliate firms involved, even some non-affiliates, the 900 plus member of the audit team scattered worldwide, the audit team rotating, many of the issues of management are there if you don't reexamine your audit relationship, it would seem to me. There are many, many of the retraining issues that you're going to have without regard to whether there's a new audit team coming in. Think about it.

You've done a great job. Thank you for being such a great panel.

Yes, we'll go to the next panel. we have two regulators; two regulators from a foreign -- a non-U.S. jurisdiction.

We have David Gerald, Founder, President and Chief Executive Officer of the Securities Investors Association of Singapore. He founded the association in 1999 to contest the freeze of new shares owned by 172,000 Singapore investors and Malaysian companies by the Malaysian government. They now have 70,000 investor members. They are the voice of retail investors in Singapore. They are supported by the OECD and the Accounting and Corporate Regulatory Authority of Singapore, the Singapore Exchange. Mr. Gerald was appointed in 2010 by the Monetary Authority of Singapore to be a Singapore -- to the Singapore Corporate Governance Council Task to review the Corporate Governance Code to promote high standards. And he has been in private practice in his career, a legal career spanning 30 years.

Kiochiro Kuramochi is the Deputy Chief Accountant for Internal Accounting and Auditing and Disclosure Division of the Financial Services Agency of Japan, a very close collaborator with our own PCAOB and Audit Inspection Cross-Border Board Oversight, and a member of IFIAR, appearing here for the first time before the Vice Chairman of IFIAR.

We welcome you both and look forward to hearing what you have to tell us about your own regimes and what you see in these concepts.

MR. GERALD: Thank you. Thank you Chairman and members of the PCAOB. Thank you very much very inviting me to share my views as an investor on auditor independence, objectivity, professional skepticism.

You are seeking public comment on how this could be enhanced on mandatory audit firm -- especially mandatory audit firm rotation. At the outset, I wish to say, sir, the views expressed in my opening remarks are entirely my own and do not necessarily reflect those of Singapore or the Securities Investors Association, Singapore. I am neither an accountant nor an auditor. As you have said, I'm a lawyer with -- in practice for many years, but only recently my involvement with auditors; a simple-minded investor, sir, so please do accept my apology if I reflect the ignorance of the practice of auditors as understood by this honorable Board.

With markets opening up in Asia and the liberalization of investing rules, it is now easier for investors to do cross-border investing. Corporate governance and accounting standards are not well developed, especially in countries like China and India. Shareholder activism is also not prevalent in Asia.

Auditor independence is the key to investor confidence in financial statements. The fact that the financial statements are audited gives them a level of comfort when placing reliance on the auditor's statements for investing in the public listed company. But the current method of appointing and remunerating auditors have raised doubts in the minds of some investors on the independence of auditors. This is exacerbated by instances of failure on the part of auditors like Andersen and Enron. Central to this issue is a question whether there are sufficient safeguards and effective supervision of auditors in place to minimize failures.

Some investors in Singapore are of the view that since it is the audit client who pays the auditor's fee, they doubt the complete independence of auditors. Such a situation, according to them, threatens the auditor's independence. But they are in the minority.

Whilst some clamor for third-party appointment of auditors and payment, canvassing that would be the answer to their worries, I take the considered view that so long as there are sufficient and effective safeguards to protect investors and sufficient sanctions put in place, together with stringent oversight by independent regulators, the call for independent third-party appointment and payment may not be necessary now. One should continue to place faith in qualified and regulated auditors as professionals capable of exercising integrity and independence.

Not to do so may affect the future of the profession adversely. Unless statistics support such a drastic move, status quo should be preferred. Such a move would also, I am advised, require Congressional approval here. One should not paint the entire audit profession with the same brush used to paint those few who have failed. Every profession, sir, has had its fair share of shame brought by recalcitrant members. After all, to err is only human. One can never stop audit failures completely as long as humans are involved.

To date, in Singapore, there has not been a call from investors for a change in the mode of appointment and payment of auditors, because they have lost confidence in the integrity of the audit profession. In fact, on the value that external auditors bring to shareholders, ACCA and SIAS in Singapore conducted a survey in 2010 dealing mainly with the perspectives of educated and savvy investors. We surveyed 30,000 investors, and the findings are as follows:

Overall, 90 percent of the respondents felt that the external audit in its current form and scope bring value to them. Only a minority felt it had very little or no value to them because of the historical nature of financial statements on which the audit opinion was formed.

Eighty percent of respondents felt that audited financia statements were important to them in making investment decisions.

More than 85 percent of the respondents felt that the provision of non-financial information such as corporate governance practices and corporate social responsibility issues would serve their decision-making purposes.

Independent audit oversight, the question investors have asked for many years, who audits the auditors. Expectation of investors have been met in some Asian countries. Supervision of audit quality and auditors now in place, but not in China, India, Hong Kong and a few others. On auditing the audit firm, Singapore, Malaysia, Thailand and South Korea have implemented independent audit oversight by audit regulators. Application of International Standards Quality Controls 1, ensuring certain systems and quality controls are also in place in these countries.

Investors in some of the above-mentioned countries are becoming aware of the function of audit regulator, and therefore the comfort level is increasing. Investors' understanding of audit committee, however, especially in Asia, needs improvement. They need to understand the role of audit committees better, and need to engage the audit chairman at meetings to ensure that the committee has discharged its role adequately. Singapore Companies Act 201B subsection (5) outlines the functions of the audit committee, which is to review the audit.

Firstly, the audit plan; secondly, the evaluation of the system of internal accountancy controls; thirdly is audit report; fourthly, the assistance given by the company's officers to the auditor, et cetera. Investors need to question the audit chairman on these matters at meetings.

Investor confidence in audit work could be boosted through with greater education, awareness about audit quality, the independent audit regulator's rule of auditing the auditors. This helps to ensure that auditors follow standards and perform well in key areas like professional skepticism, which helps ensure that the corporate governance system works as it stands -- as it should.

On mandatory rotation of auditors, the arguments in favor and against mandatory rotation are well documented, publicized and will therefore not be canvassed here by me. Currently, to avoid too much familiarity between auditors and their client, the Stock Exchange in Singapore listing rules, and many other jurisdictions require the audit partner to be rotated every five years. The International Federation of Accountants also requires rotation of audit partners every seven years. Quality control reviews are also undertaken by a second partner of the audit firm carrying out the audit.

It is sufficient to say that the current practice of rotation should continue with enhanced and effective safeguards, and allow the PCAOB and other regulators around the world to monitor the effectiveness of the current practice of rotation of auditors every five years.

Moreover, the measures introduced by Sarbanes-Oxley, pursuant to the Enron debacle, does provide important and useful safeguards. The shifting of responsibility to the audit committee from the management to hire auditors and oversee the engagement and the prohibition of certain non-audit services to clients should give further assurance to investors. But more importantly, the establishment of the independent oversight of the auditing profession by PCAOB in the U.S. and equivalent bodies ACRA in Singapore should increase the level of assurance to investors. The Accountants Act also in Singapore is similar to those in the west, prohibits auditors from providing certain services, including internal audit services to clients. There are regulations under the Act governing independence and ethics applicable to auditors, breach of which will attract sanctions.

In view of the above, it is sufficient to leave it to the audit committee and the shareholders of the company at annual meetings to decide on the appointment of suitable auditors for the company, and it is for the board to decide on the auditors appropriate remuneration.

It must also be noted that it is the shareholders who appoint the auditors at the annual general meeting proposed by the board of directors. Shareholders need to be active at meetings and query the board on the basis for the recommendation of the auditor to be voted on, the quantum of payment recommended and the length of the engagement of the issues that will be addressed by the auditors to justify quantum.

Shareholder activism is necessary to ensure that the right auditors are appointed and paid correctly. Should the shareholders be active on these issues, in my view, the likelihood of auditors and the management of the listed companies acting in cahoots will be further minimized.

I would like to make very quickly three recommendations.

Mandate full time internal auditor. Perhaps to enhance not only vigilance against fraud and criminal activity, but also professional skepticism and quality of audit, public listed companies should be mandated to appoint full-time internal auditors. A full-time internal auditor, though engaged by the company through the audit committee, should report directly to the audit committee, the chairman and the board, and not the CEO. He should report to the CEO only on operational and administrative matters.

The advantage of this suggestion is that it will give the necessary assurance investors are looking for in avoiding a situation like Enron, and will also minimize mistakes. As demonstrated by Cynthia Cooper in the WorldCom case, an internal auditor can act quickly to bring misconduct to justice. The internal auditor could be the watchdog for the investors and the stakeholders of the company. In my view, this will also enhance the independence of external auditors. It will also help in the appointment and remuneration of external auditors. It will make the issue of mandatory rotation a moot point. This way the management will be kept in check. Internal auditors presence will help external auditor to shorten time to understand the company's culture, besides minimizing fraud within.

Second recommendation would be that we should enhance board's responsibility. The most effective fraud prevention is to have an effective board that is responsible for risk governance and internal controls. The board is now required to play a more proactive role under these new and tough rules issued by the Singapore Exchange, effective on 29 September, 2011, the 2012 Code of Corporate Governance issued by the Monetary Authority of Singapore on 2nd May 2012, and the Risk Governance Guidance for Listed Boards Guidelines issued by Corporate

Governance Council on 10th May, 2012.

The board must identify risk areas, set risk tolerance strategies, and oversee implementation of risk management. On an ongoing basis, the board needs to continually monitor and assess the adequacy of the risk management managers it has put in place, oversee the system of internal controls, and ensure that management takes appropriate steps to mitigate risks.

Thirdly, transparency. There must be transparency of independent oversight work. I support the view that the independent oversight regulator's work should be made public so that investors will be in the know. It will enable the investors as shareholders to make an informed decision on the appointment of auditors.

In conclusion, it is the enhancement of safeguards, and not changing the current model of appointment of auditors and payment to them is what is needed. Thank you, sir.

CHAIRMAN DOTY: Thank you for that thoughtful view of Singapore and law and the markets.

And Koichiro?

MR. KURAMOCHI: Chairman Doty, members and staff of the PCAOB, thank you very much for this opportunity to participate in this discussion of auditor independence, objectivity and professional skepticism. Please be reminded that at the outset that the views I express this afternoon are my own remarks and are not necessarily representing those of Japan or the Financial Services Agency.

With respect to the enhancement of the audit quality, we have also had many discussions in Japan for decades and have made a series of reforms to our systems and auditing standards. The steps we have taken on auditor independence, objectivity and professional skepticism include the following:

The Certified Public Accountants Act, our legislation governing CPAs and auditor activities, stipulates principles such as independence, and further prescribes specific requirements for independence. For example, lead audit engagement partners and audit reviewing partners are subject to five-year rotation requirements with a five-year cooling-off period, similar to the United States. And all the other audit partners are subject to a seven-year rotation requirement with a two-year cooling-off period.

Other examples include stringent restrictions on non-audit services. In addition, the Certified Public Accountants and Auditing Oversight Board, which is called CPAAOB was established as an independent body in the ambit of the FSA in 2004, and it has been conducting CPA examinations, as well as inspections of the audit firms. The Japanese auditing standards as set by the Business Accounting Council, which is established under the FSA.

Furthermore, we are currently engaged in revising the Japanese auditing standards to enhance auditors' professional skepticism, as well as auditors' response to accounting frauds. Audit committee of the Business Accounting Council started deliberation on this topic in May 2012, aiming at concluding the discussion in about one year. I personally expect the following matters would be covered in the deliberation.

One, reaffirming the importance of professional skepticism.

Two, clarifying auditors' response to accounting frauds.

Three, how the firm-level involvement should be articulated.

Four, enhancing auditors' report by including additional information.

Five, improving education and training to deal with accounting frauds.

Six, how audit evidence should be evaluated.

Seven, how auditors should modify auditor -- audit planning to address a revised assessment of risk of material misstatement or an identification of fraud risk factor.

The PCAOB's Concept Release discusses audit firm rotation from various aspects. We also debated over potential audit firm rotation six years ago. At that time, there was an accounting fraud incident committed by a large listed company and the company's auditor issued a clean opinion, although the auditor's audit partners had knowledge of the fraud.

In response to the incident, we deliberated on how auditor independence should be enhanced. After a thorough deliberation, the stringent partner rotation I mentioned earlier, rather than audit firm rotation, was introduced, because of the following reasons.

One, disruption of the auditor's accumulation of knowledge and experiences.

Two, costs associated with the change in auditors, on the auditors' as well as issuers' sides.

Three, the fact that mandatory audit firm rotation had not been put in place in major developed countries.

Four, practical difficulties in audit firm rotation due to limited number of large audit firms.

As a result of the financial crisis, we understand that various debates are in progress in -- with regards to audits in the United States, as well as Europe, although direct effects of the financial crisis were relatively limited in our country compared with the situations in the United States and in Europe.

Japan also experienced the burst of the bubble economy in the 1990s, and subsequent collapse of large companies. Prompted by such incidents, we have debated over the role of audits for decades and implemented various changes in our systems. We consider that the measures responding to accounting frauds should evolve, as accounting frauds become increasingly scheming and complicated. At the same time, we believe that exercising professional skepticism should be the foundation for the financial statement audit.

We understand that institutional measures such as audit firm rotation are debated when audit failure occurs, as we also have similar experiences. However, when revising the established system, we believe that it is important to have cool-headed discussions, carefully exploring whether or not the possible change would truly have positive effects on professional skepticism or accumulation of knowledge/experiences of auditors.

Given the globalization of corporate activities, audit systems are getting increasingly prone to global influence, and PCAOB's decision could have certain effects on Japanese companies and Japanese audit firms.

I appreciate this opportunity to express my views today, and I hope that PCAOB gives due consideration to various views and reaches an appropriate decision at the end.

Thank you very much.

CHAIRMAN DOTY: Thank you both.

I have to say before asking any of my colleagues whether they have questions, that, on behalf of the PCAOB, I know that you know that we value very much the relationship we have with each of your governments on cross-border oversight. It's meant a great deal to us to know that where there are issues of inspection that can be troubling, that you -- we've always found a very helpful, cooperative attitude in both of your regimes, both of your countries toward our inspections. And we think it's worked to our mutual benefit. And we look forward to continuing to do it.

I hear David's comments on some of the regimes -- on some of the states in his region that are not accessible and that are not transparent, and I know that in your own -- in Japan, it's been a special benefit, we think, that we've been able to conduct inspections and reach the point at which in the last year we achieved as absolute -- an actual formal protocol on it.

With that, and not knowing how much our board members want to get into foreign law, I will nonetheless ask Steve Harris, any thoughts?

MEMBER HARRIS: I do have a question. But I want to defer it to our Vice Chairman.

CHAIRMAN DOTY: All right. Lewis, anything?

MEMBER FERGUSON: I have a question. It's kind of one that puts you on the spot here. This has nothing to do with the auditor rotation. As you know, the -- you may or may not know, the PCAOB has over 900 non-U.S. audit firms registered with us, including 100 in China, 50 in the People's Republic of China and roughly 50 in Hong Kong. We're not able to inspect those firms. We've been negotiating with China, but we're not able to inspect those firms. I don't know if we will be able to.

Those firms audit registrants and companies that are registered in the United States that actually have billions of dollars of market capitalization in this country held by U.S. shareholders.

What's your advice to us? What do we do? How do you advise -- I mean, you all live in Asia, you know the market there, you know the climate there. What do you suggest we do with these, with these audits?

MR. GERALD: These are companies that are listed NASDAQ or --

MEMBER FERGUSON: The New York Stock Exchange, yes.

MR. GERALD: Oh, the New York Stock Exchange. And these companies have -- and we have the same problem as Singapore, they are listed in Singapore but they are operating in China, management in China, monies are kept in China, and they have two people sitting in an office in Singapore.

And we've had -- on my return, I'm having a dialogue session with the shareholders of a company called China Sky. They are refusing to comply with the listing rules, and challenging the Exchange, taking the Exchange to court, but they're all in China; they won't come to Singapore. So I think the regulators have to now really think about how to deal with foreign listings, because foreign listings are becoming a liability to the shareholders.

What do we do with them? If they're listed in Singapore, I'm suggesting to the exchange that they ought to provide a bond, a bank, you know, bond, or they must provide some sort of safety net for the investors in Singapore before taking the monies outside Singapore. From Singapore, if you want to transfer it to China, you ought to have the safeguards.

I'm asking the Exchange can we look at the safeguard. This is not about a Singapore company doing something wrong to Singapore investors; we can take them to court. But this is about the foreign company which runs away and cannot subject themselves -- do not want to subject themselves to the jurisdiction of Singapore or United States.

So you've got to ask these people, if they want to come to the United States or Singapore and raise funds from the public, from our citizens, they have to give some assurance that they will not deal with the citizens wrongly; they will not do the things that, you know, that the others have done. Because I'm sorry, all have to be treated equally. You've got a constitutional issue there.

But in Singapore we are thinking of putting pressure on the, you know, on the regulators to ask if they would put safeguards in place, either requiring independent directors or the auditors of the companies to certify that the monies are being transferred for genuine bona fide reasons and that it should not be transferred like they did in one case, because I know in one case 80 million was transferred.

And do you know what, I spoke to the chairman through an interpreter on the phone, and he said all the monies are safe, 80 million. And the next day, the independent -- the executive directors made the statement that we are only 17 million. And then the following day, another person makes a statement saying that we are not going to give you any more.

So, you see, if foreign listings are coming to the United States or to our country, we need to put safeguards in place. That's my reply to your question.

MR. KURAMOCHI: Thank you for the question. This is a very difficult question. At the same time, what I can say here is, I think we have to continue the discussion so that they realize, international corporations really provide the mutual benefit.

Actually, I am also working for IOSCO. IOSCO is the International Corporation for the Security Regulator, and I'm working on the Accounting and Disclosure Committee, which is a standing committee, and China has a representative on that committee. And we have a lot of dialogue. And this kind of continued dialogue actually, you know, changed the perception.

What I can say is, we have to continue the dialogue. And having seen the globalization over the capital market, it is kind of impossible to isolate one country from other countries. So I think the continued dialogue could open the door. Thank you.

MR. GERALD: Chairman, if I may add a few more comments. From my experience, the Chinese government does not want to cooperate with the foreign exchanges, because the Chinese -- they do not like Chinese companies listing elsewhere. They said they have not gone through us. I went to see the Chinese ambassador in Singapore, and they appointed a very senior officer to see me, and he said that we will do everything we can, but never got back to me. When I got back to them, the answer is there's nothing we can really do.

There isn't an extradition treaty between Singapore and China to bring those culprits back. And I do not know about the United States, but they are refusing to everyone. So it's going to be very difficult to enforce. So investors are being asked to look at these companies very carefully by us before they embark on investing or parting with their precious dollars. And I think there must be this reckoning by investors, that if you invest in a foreign company where everything is outside, you're not going to get -- trace or track your money -- you may not be able to track your dollar; that's the bottom line. So you've got to be very, very careful.

Having said that, there are also very enlightening Chinese companies in Singapore who follow proper governance and who are interested in, you know, working with us. So these are the -- we've got about 14 companies that have gone astray. But the rest of the 156, you know, we find many of them are realizing that they need to, if they come to Singapore, they need to work with us, they need to work with our regulators' Exchange on corporate governance.

MEMBER HARRIS: Well, Mr. Gerald, I just want to express my appreciation for your testimony in Busan, South Korea in terms of the importance of establishing independent audit regimes in the Asia community, which is not currently the case in a number of jurisdictions.

MR. GERALD: Yes.

MEMBER HARRIS: I thought that was very powerful testimony. And we realize you traveled quite a bit to get here today, and very much appreciate your testimony today.

MR. GERALD: Thank you, sir. Thank you very much for inviting me. I'm always available to improve the situation for shareholders.

MEMBER HARRIS: And then, Mr. Kuramochi, it's -- once again, we very much appreciate your being a member of the Investor Working Group of IFIAR, and your participation has been very helpful, and we look forward to that continued assistance in London.

MR. KURAMOCHI: Thank you very much.

MEMBER HARRIS: I note that, that you indicate here that there's other audit partner rotations and team rotations subject to a seven-year rotation requirement in Japan. If you could either send us some background in terms of how you reached the seven-year team rotation and why that's important in Japan and how that came about, that would be appreciated, or if you know the answer right now.

Others have talked about not only engagement partner rotation, which we have under Sarbanes-Oxley, but people have recommended team rotation. And if you care to comment, why does Japan think it's important to have seven-year team rotation?

MR. KURAMOCHI: Okay. And so first I have to clarify. So we have a like two-tier partner rotation system. The engagement partner, I mean the lead engagement partner has to be rotated by five years. And the rest of the partners or lead partners have to be rotated by seven years.

The reason why we think all the partners have to be subject to the, you know, this rotation requirement is, you know, there's interaction between management and the partners, and in certain periods we have to change, you know, all the partners. And I think this is very important to keep the independence of the audit firm to change all the partners.

MEMBER HARRIS: Thank you.

CHAIRMAN DOTY: We have about less than 10 seconds left on time.

Brian, yes, go.

MR. CROTEAU: Thank you very much. My question I think is a quick question for David, and it relates to what I think -- and you might correct me if I'm wrong, or if you're able to talk about this that would be helpful -- but I think there was a requirement for rotation of firms, at least for banks in Singapore, that was lifted in 2008 but had been implemented before that. I'm not sure if it ever took effect, but I think in 2008 there were concerns over disruption. It was lifted. But I wondered if you could just say a few words about that and provide a little background about that.

MR. GERALD: Yes, you've got me there. But the reason is I think that Singapore is also grappling with bringing in little island, institutions, financial institutions, listing companies, and companies to list in Singapore, and there had been some feedback on the disruption is costly to the banking industry, and therefore there was a review.

But those methods are still under review, and I do not know -- I'm not a part of the regulators, you know, in business. But I think as we go along, new rules will evolve to make it easier for banks to do business.

If I may ask, Mr. Chairman, any reaction to the suggestion that you should mandate internal auditors as a full-time officer in the, in the public listed companies? We are trying to do that in Singapore now. I mean, our association is pushing for that.

CHAIRMAN DOTY: U.S. public companies routinely now have full-time internal audit services. It's not something the PCAOB would normally do under our authority. Our authority is over registered firms, not over corporate governance structures or the management structure of a business corporation. I think the SEC disclosure regime gets very clearly to us. So a company that did not have an internal audit function would have to say something about that. That would be something I think that would make it very difficult. Marty?

MR. BAUMANN: Thanks. I have a question for Koichiro.

Many who have talked here today talked about the fact that it would be very hard to change auditors in the United States because there's only four firms auditing 98 percent of the market cap or whatever it is. And for Japanese listed companies, do you have essentially the same thing? Is your market dominated by just four firms for the Japanese-listed companies in Japan?

MR. KURAMOCHI: The situation is very similar, especially for the large listed companies. Most of the large listed companies are audited by four audit firms, the four accounting firms. Because large listed companies have subsidiaries all over the world, and they have to get audited, and their international network is very, very essential. So that is why, you know, concentration situation in Japan is very similar to the United States. Thank you.

CHAIRMAN DOTY: I guess I should also say that our communications with auditor committee standards would, David Gerald, it would require the auditor to talk to the audit committee about their assessment of the strength of internal audits, whether or not it was adequate, and whether or not they were reliable. So we get at -- there are two disclosure channels into the existence of being a full-time internal audit.

I think it's for me to say thank you all again for coming a long way and for being good partners in cross-border oversight.

MR. GERALD: Thank you.

MR. KURAMOCHI: Thank you very much.

CHAIRMAN DOTY: And we now are going to the firms.

David Follett. Dave Follett is the Chief Practice Officer of Moss Adams, LLP. He's practiced public accounting since 1992. He's been a partner since 2001. In October 2011, he was appointed Chief Practice Officer of Moss Adams. In this roll, he has full responsibility for client service, oversight of industry service groups, and responsibility for the firm's business development functions. Extensive experience working with larger middle-market companies, public and private. Past chair of the firm's SEC corporate finance group. Co-chair of the International Services Group. Continues to serve as the reviewing partner on audits of public companies. Professional accounting fellow with the Division of Corporation and Finance of the SEC. Welcome to Dave Follett. And other professional qualifications that are in his resume.

Tom Gard joined Armanino & McKenna, LLP as an audit partner in 1996. Became partner in charge of the audit practice, 2005. Seven years with KPMG, became an audit senior manager, and served as CFO and COO for a regional and commercial insurance brokerage. He's been a certified public accountant since 1984, member of the AICPA. In 2002, received his accreditation from the AICPA in Business Valuation. Been qualified as an expert witness in various jurisdictions. Extremely involved with clientele on the distribution of financial services and technology sections, has deep experience with publicly-traded clientele and the rules and regs of the SEC. Welcome Tom Gard, and to Dave Follett.

Paul Regan, Chairman of Hemming Morse. Mr. Regan is chairman. Has been a certified public accountant for more than 40 years. His work in the accounting profession includes experience as an auditor and a consultant. As an auditor, he served as an engagement partner, supervised audits of public and private companies. As an accounting expert, he has testified in more than 100 trials and arbitrations and in more than 200 depositions, and has worked on more than 750 complex litigation matters, many of these involving extensive analysis and determination of GAAP, our own auditing standards, and SEC reporting. His testimony has been on behalf of companies, as well as for various state and federal agencies. He has undergraduate and graduate degrees in accounting. Designated by the American -- by the AICPA as a Certified Financial Forensics, a CFF. He is a past chair of the California Society of Certified Public Accountants, and is a current member of its council. Also past member of the AICPA's governing council.

Gilbert Vasquez, Managing Partner, Vasquez & Company. He has managed and directed a successful practice in public accounting, auditing, taxation, and financial consulting since 1967. Recognized as a prominent CPA, community leader and entrepreneur. Past president of the California Board of Accountancy. Many honors, including the Mexican-American Legal Defense and Education Fund Achievement Award, the Coca Cola Golden Hammer Award, Citizen of the Year by the Northeast Chapter of the American Red Cross. And there are other awards here that go on and on. Holds a Bachelor of Science in Business Administration and a major in accounting from Cal State Los Angeles, and is a credentialed professor of accounting.

Welcome to all of you. You bring a very

important segment of all of this issue of the independence and objectivity to this Board, and we thank you for being here.

Dave Follett.

MR. FOLLETT: All right. Thank you, Chairman Doty, members of the PCAOB, and observers.

I am David Follett, the Chief Practice Officer from Moss Adams. Moss Adams is the largest accounting firm based in the western United States, and we are the auditor of many middle-market and smaller public companies. In addition, we serve privately-held and other pubic interest entities, including those who plan to seek capital in the U.S. equity markets in the future. We have been inspected by the PCAOB three times, including our initial inspection six years ago.

My firm appreciates the opportunity to participate in this public meeting on auditor independence and audit firm rotation, to further discussion on ways to enhance auditor independence, objectivity and professional skepticism. We are committed to the ongoing efforts to continue to improve audit quality in our firm and in the profession.

We believe SOX has had a positive impact on audit quality. The creation of the PCAOB and the strengthening of the role of the audit committee have built a solid foundation for enhancing investor protection. I personally served as the signing engagement partner on the audits of issuers, and believe in and have witnessed improvement in audit quality since the enactment of Sarbanes-Oxley in 2002. This includes the enhanced oversight and participation of audit committees.

Auditor objectivity and professional skepticism are at the root of audit quality. The PCAOB and the profession should continue to seek ways to improve objectivity and skepticism. Actions taken for improvement by the PCAOB should be supported by objective evidence of the cost to implement, and more important, the achievement of the benefit of improved audit quality. As I will discuss further, we do not believe mandatory firm rotation achieves the objectives of improving audit objectivity, and therefore we, along with the majority of stakeholders who have commented on this Concept Release, are opposed to the PCAOB's proposal.

We believe mandate of firm rotation would undermine the authority of the audit committee whose role has been enhanced by the implementation of SOX. Audit committees are essential to maintaining an appropriate oversight of the issuer-auditor relationship. Mandatory firm rotation inappropriately prohibits an entity's ability to continue with an existing auditor even if the audit committee determines it's in the best interest of the entities shareholders.

And I would insert that while there's been some comments on the activities and the role that the audit committees play, I can comment in the smaller and middle-market companies. I'm pleased to say that what we see is a very robust activity and communications in dialogue with those committees, and they're very engaged in the company's operations and their role. Further, research does not support audit firm longevity as a root cause for audit failures or a lack of objectivity or skepticism. Mandatory rotation would cause significant disruption and an increase in costs. We believe there would be a disproportionate burden on middle-market and smaller public companies as a result of mandatory rotation.

SOX has improved audit quality in many ways. In response to the increased responsibility placed on management to assess and report on internal controls of financial reporting, SEC issuers have been more responsive to improving upon internal control deficiencies. Audit committees have also become more involved in the understanding of the internal control deficiencies identified by management and the auditor, and more insistent in requiring changes be implemented to address these deficiencies.

In addition, requiring audit committees to be responsible for the hiring, retention and termination decisions of the independent registered accounting firm has created a better oversight to the relationship between management and the auditor. Finally, the PCAOB inspection process has helped firms identify areas to improve audit quality. Overall, these areas create foundations and opportunities for continued improvement.

As noted in many of the comment letters received by the PCAOB, there are alternatives to mandatory firm rotation that involve less risk and less cost. We recommend that PCAOB focus its efforts on constructive dialogue with stakeholders to determine alternative approaches to mandatory firm rotation that will have a positive impact on auditor independence, objectivity and professional skepticism, such as the following.

Engaging with audit committees to improve their corporate governance practices, including the training, evaluation of auditor performance, and the sharing of best practices.

Performing root cause analysis of audit deficiencies identified during internal and PCAOB inspections, and providing more open collaboration between the PCAOB and the profession on steps to be taken in response to these findings.

Third, increasing transparency between auditor and audit committees, including the communication inspection findings, and enhancing audit firm quality control and training with a focus on continued improvement of objectivity, skepticism and audit performance.

The profession has come a long ways over these last 10 years, but we also recognize that continued improvement is necessary. Moss Adams looks forward to the opportunity to participate in the efforts to improve audit quality. We appreciate the opportunity to participate in these important round-tables and look forward to the discussion today.

MR. GARD: Thank you. On behalf of Armanino McKenna, I appreciate the opportunity to participate in this panel to express our views on various means to enhance auditor independence, objectivity and professional skepticism.

I'd like to take this opportunity to give the Board a brief overview of our firm. Over the past 50 years, Armanino McKenna has become largest California-based accounting firm with over 350 professionals located in the San Francisco Bay Area and throughout the west coast. We provide audit, tax and consulting services to a diversified client base operating in multiple industries. Our audit clients are both privately held and publicly traded, and include many with either national or international operations.

Typically, these accounts are headquartered in the Bay Area, with multiple locations either across the country or around the globe. We have provided services to registrants for nearly 20 years, including services in connection with various offerings.

Quality is the cornerstone of our firm's audit service approach. We are proud that the results of our peer reviews and periodic inspections demonstrate the quality with which we approach our work. The primary goal of our profession has to be to develop and preserve investor and creditor confidence in financial information. Anything less than that is not acceptable. I think most of us could agree on this objective. If we do not enhance investor and creditor confidence in the client's financial statements, we must question the value of the services we are providing.

The pursuit of audit quality is a major objective for standard-setting organizations around the world. In December of 2011, various audit reform proposals were advanced in the European Union, including mandatory rotation of audit firms with defined cooling-off periods and prohibition from providing non-audit services to public interest entities. Similar requirements are being evaluated around the globe to determine their effect on audit effectiveness. We applaud all actions towards the goal of increasing audit effectiveness.

Audit firm rotation is a significant consideration. Since the adoption of the Sarbanes-Oxley Act, engagement partner rotation has been required after five years. If audit firm rotation is to be implemented, the ramifications of such a change will need to be fully evaluated. The costs and benefits of such change must be carefully weighed and balanced. Requiring rotation of the audit firm will have some negative consequences. These have been discussed repeatedly in prior public meetings and comment letters. I will not repeat all of these possible consequences here.

However, a main ramification is the disruption caused by any change and the additional time and effort required to bring a new audit firm up to speed with the company being audited. No matter how well-coordinated the transition is, a change does involve significant time and effort of both registrant and audit firm personnel.

It is also my experience that it may take an audit firm at least one audit cycle, if not more, to fully acquaint themselves with the company being audited, to be able to design and implement the most effective audit they can plan. Thus, audit firm rotation may actually decrease audit effectiveness in the early years of the rotation.

This statement in no way implies that the first-year audit is in some way deficient, that it's just not planned with the same level of understanding of company operations that is obtained after going through the entire audit process. Subsequent audits benefit from this understanding, and the efficiency and effectiveness of subsequent years audit improve.

The main driver for audit firm rotation is to prevent complacency in the auditor by introducing new perspectives at regular intervals. However, I'm not aware of strong evidence showing a direct correlation between auditor tenure and audit deficiencies, much less the amount of time before complacency begins to occur. The PCAOB in its Concept Release stated preliminary analysis appears to show no correlation between auditor tenure and number of comments in PCAOB inspection reports. Thus, are we considering a remedy to audit deficiencies that will not be effective?

In any respect, doesn't the rotation of the engagement partner already make significant strides toward preventing such complacency? Certainly, a new perspective and a fresh re-questioning of audit approach in past decisions is inherently healthy in the audit process. Thus, are we really obtaining diminishing returns on improving audit effectiveness by requiring audit firm rotation in lieu of the current audit partner rotation? In other words, are the costs incurred to rotate the audit firm worth the incremental benefits?

We do see one potential benefit of audit firm rotation that should not to be understated. In a marketplace with many viable audit firms vying for a company's business, there should be inherently healthy competition. A company can typically choose its audit firm from firms of varying size, skill sets and demographics, and with certain differences in audit approach. However, for registrants, the overwhelming audit service providers are national firms, and of national firms, very markedly, the big four firms.

Thus the competitive landscape in selecting an audit firm for public companies is very different from the landscape enjoyed by private companies. Preference for national firms is dictated by several factors, some very valid, and other reasons, perhaps legacies from common practice.

Certainly, very large public registrants may require the largest public accounting firms to benefit from the audit firm's geographical diversity and locations. However, many registrants are not as geographically spread and could benefit from the service approach that smaller firms provide. We believe there are many registrants that a regional firm like ours can service in a more responsive manner, where we are just a better match of resources to the company's primary needs.

However, given the current competitive landscape, the frequency of registrants looking beyond the national firms is relatively low. Underwriters, private equity firms and financial institutions with long business relationships with various national firms help perpetuate this marketplace. Again, sometimes are warranted for the size and geographical footprint of the company in question, but many times not.

Requiring audit firm rotation could assist in changing the competitive landscape for audit services to registrants. As the vast majority of registrants are audited by the big four accounting firms, requiring audit firm rotation would make for some interesting decisions for registrants. Many times consideration of other big four firms is not feasible as many may be conflicted given other services provided to the registrant. It's not uncommon for a registrant to utilize other firms to perform tax provision, internal audit, internal control, IT and valuation services. Thus the registrant's choices upon firm rotation may be few, if they solely look to the national firms, and more particularly the big four firms.

With fewer alternatives, perhaps the registrant will be more inclined to consider regional audit firms. More likely, other large firms will make the investment to become stronger national and/or global firms to increase the alternatives available to large registrants. Competition generally leads to new solutions and providers. I do not believe we should be afraid of increasing competition because the pool of large audit firms now appears small. If the opportunity is strong, other providers will position themselves to fill this need, especially given lead time to prepare.

Requiring audit firm rotation could lead to a more interactive and participatory market for audit services. This increased marketplace will provide more options to the registrant, and thereby will enable the registrant to find the firm that best fits the registrant's particular needs and circumstances. Long-term increased audit quality of course cannot be compromised; however, competition generally leads to innovation and improvement, results that investors and creditors will value. The benefits and costs of mandatory audit firm rotation are difficult to quantify with precision, but must be obviously carefully weighed.

I want to express my appreciation to the PCAOB for the opportunity to participate in this panel. I look forward to continued dialogue and evaluation of this issue.

CHAIRMAN DOTY: Paul Regan.

MR. REGAN: Good afternoon, Mr. Chairman, and thank you for giving me the opportunity to make comments on the audit firm rotation issue. And thank you to the Board as well.

I'll try not to read my comments. I understand you have my comments in front of you. There's a couple of paragraphs that I might read to make particular points. You do have an understanding that my background, a couple of particular points that really provide the basis for my comments. And the basis for my comments are my individual experience. They're not the views of my firm. They're not the views of organizations that I am associated with.

I have been audit chair of a public company. I have been on audit committees of public companies and I have and continue to be on audit committees of non-profit companies.

The experience that particularly, is particularly relevant to my comments here today is in my investigation of significant audit failures since the early 1980s. You'll see I've listed in item 4 on page 1 of my comments some companies that I have investigated and I have testified on. And they include the Sunbeam Corporation, Enron Corporation, Xerox Corporation, Parmalat which is an Italian entity, and Mini-Scribe which was one of the, one of the early audit failures that I was associated with, the bricks that were disguised as 20 and 40 megabyte hard drives.

My work has principally been for the Securities and Exchange Commission, testifying as an expert on both GAAP and GAAS, as well as the FDIC, but certainly the Resolution Trust Corporation in the '80s got me involved in this process, mostly in financial institutions in Texas, Oklahoma, Florida, New York, California, Colorado. And I also assist the PCAOB, and I have testified for the PCAOB with respect to audit failure issues.

My work has involved investigations around the world. They have involved auditors that are big eight, big six, big five, big four, medium-sized companies, medium-sized firms, as well as small firms. I have done and reviewed audits that were performed in the United States, Europe, Canada, Asia, South and Central America, as well as India.

As a consequence, my comments on mandatory firm rotation come principally from that experience and that environment. And when I read the Concept Release, there were some statements in that Release that I'm very familiar with, and I witnessed and I've seen and I think are troubling. On page 2 of my comments, you'll see that I've identified five that I think are particularly important.

I think that the annual inspections, you've commented in the Concept Release, the inspections now are approximately 2,800, and that you've discovered and analyzed several hundred cases involving what they deem to be audit failures. In assessing that, I find that very troubling. It's a significant number, and it's concerning to me and it's concerning to, I think, a lot of other users of audited financial statements.

What's perhaps even more troubling is, included in the concept statement, is that although your, your results on the 2010 inspections are not complete, you do observe that you're identifying more issues now than in prior years. And that in some instances, you're looking at entities again, and there is repetition of past identified significant deficiencies. And that is, in addition, very troubling.

The last three points, rather than repeating them, are very similar to what I consistently have seen in my work; that is, an absence of professional skepticism and acceptance of client representations without the application of appropriate auditing procedures, and an absence of objectivity. And in many instances, even activity that borders on advocacy rather than independence and professional skepticism.

In the cases that I've worked on, what I have seen, and what I apply a filter of, if there had been an audit rotation, is it likely that the defects in the underlying financial statements, the material departures from GAAP, would they have been detected. I think it's likely that they would have been, certainly would have been detected sooner, either because of the concern by the existing engagement team, that a new team would be replacing them in the near future from a new firm, or, in the absence of the new firm, having caution because of that concern of being replaced by another firm with a new, fresh set of eyes, then the new firm might not be willing to accept the improprieties which were in place causing a material misstatement of financial statements.

I've certainly read a lot of the comments that you folks have been reading and hearing. I also see the comment about partner rotation, and in the cases that I worked on, partner rotation has proven to be very ineffective. And there are two principal reasons for it being ineffective.

And that is, that the partner who is rotated in is typically self-selected by the firm. And in some instances, selected with influence by the client. Self selection by the firm tends to select someone who is already familiar with the issues and/or familiar with the improprieties which are eventually disclosed.

In addition, even if the new partner comes in from -- and not having a vested interest in prior engagements, if the new partner witnesses a circumstance where there is a material misstatement of previously-issued financial statements, that new partner is subjected to monumental pressures. Because with a restatement brings massive costs to the accounting firm, massive costs to the client, probably loss of the client, massive costs of litigation, and potentially the loss of an ability to continue to practice. And some new partners are very -- well they in fact have been reluctant to bring that onslaught of cost and difficulty on them.

I've got a couple of comments which I think may be particularly helpful. I see a number of comments that have been made about the enormous cost of changing the auditors, but I also, in my experience, have seen changes in auditors where the costs have been reduced; the fees are less by the new auditor than the old auditor.

A suggestion with respect to cost reductions and quality enhancement that I would encourage you to consider. If there is rotation, the firms need help in being efficient and effective in rotation. And I think a very good source of that help is requiring the predecessor auditor to provide access, not only to certain working papers, but certainly the risk assessments and the audit work papers relating to key areas of risk with respect to the financial statements. Cooperation from the predecessor auditor would help the new auditor plan and perform an audit on a more cost-effective basis and more effective auditing procedures.

Finally, with respect to implementation, you certainly can't require that everyone change in seven years or five years. This is something that does need to be staggered in your implementation plan. Thank you.

CHAIRMAN DOTY: Gilbert Vasquez.

MR. VASQUEZ: Thank you, Chairman Doty, members of the panel, and other guests.

I've been managing partner of a firm since its inception almost -- more than 40 years ago. I'm very proud to say that in that time period, we've never been sued, we've never had any complaints issued against our firm. Our firm will always be probably classified as a minority firm.

In addition to being past president of the California Board of Accountancy, I'm also the founder of ALPFA, which used to be Latino CPAs, and from an idea to -- I understand that our next conference which will be in August we're going to have more than 20,000 members -- I feel pretty good about that. And I started that organization because I wanted to have Latinos be represented in the accounting profession.

I have the distinction of serving on more than 10 private companies and more than 20 non-profit companies. Of the private companies I've been involved in, five have been publicly traded. I currently sit on two boards, and on the two boards since I've been chair, we've changed the auditors. In both instances the fees went down fairly significantly. There's always a learning curve, but the learning curve with smaller companies; I don't think it's as great as it is with large companies.

Our firm has a choice of registered PCAOB, we have a small SEC practice, but mostly we do a lot of governmental clients, a lot of non-profit clients, small private companies, tax consulting work like many other firms do. And so my experience in doing this, kind of makes me look at auditor rotation/firm rotation slightly differently than perhaps some of the other presenters.

One of the things that I've always felt is that the incumbent firm has a relationship with clients that will span decades, that there's a lot of pressure on that partner to be -- to make sure that that client doesn't leave that firm. And therefore, sometimes it can have an effect on independence, as well as perception.

And so when it comes to both firm rotation and auditor rotation, my perception is different. And aside from performing audits under the PCAOB standards, because\ we do so many governmental clients, we do work under, under GAGAS, and then we do a lot of work under Circular AB-134.

And so in this industry there's a lot of RFPs that are going off. There's a lot of firm rotation. We get used to bidding consistently in our -- for these engagements. And obviously we always have to be competitive. The proposals are very extensive. They're very detailed because we're providing, really, the basis of how we're going to perform the audit. Some of our engagements have been in excess of $2 million, so we're talking about pretty good fees.

In the prior testimonies that, that you received, one of the ones that I read, 52 percent of the public companies voluntarily changed auditors between 2003 and 2006. So in a sense we have firm rotation taking place now. The European Commission's Green Paper talks about joint audits. In especially the government audit area, we do joint audits all the time. We're subcontractors, we're joint ventures. The process is seamless. The larger the entity, the more reason to have a firm like ours involved and other smaller firms.

So I don't maybe have the bias that others might have when they look at either firm rotation and working at auditing, because, again, where I've seen that it's going to be cost prohibitive or it's ineffective and it doesn't work well, when you've been doing it as long as I have for 25 years with some of the big four firms and other firms, it's worked very, very well.

So my recommendation, based on 45 years of experience, and again coming from a slightly different environment is, I would be in favor of certainly mandatory rotation of accounting firms after a predetermined period. And if not mandatory, certainly a mandatory RFP period. Because that way, the firm that is doing the audit I think understands that somebody else may be looking over their shoulder, and there's a bit of complacency.

When I was working in federal, I was onboard 19 years, we had the same audit firm from the inception until we sold out. So for years we had the same audit. And of course there was no PCAOB, there was no partner rotation, but there was a sense of, you know, we didn't need to go out to bid. This company sold in 1995, so a little bit before, you know, our time period here for this issue.

In addition to that, I believe that if you do have mandatory rotation, that you'd be looking at multiple-year audit opportunity. And of course you're bidding it out hopefully with firms that would have an audit team in place. I think the audit team also gives the lead firm a reason to be a little more conscious about how they do work.

As it relates to publicly-traded companies, I think that the CPA firms that have been found in violation of SEC or PCAOB should at least be prohibited from doing work for that company for three years, until after the violations have been cleared up.

And finally, as it relates to policies that you see with federal contracting opportunities, the National Football League recruited minority coaches, minority firms should be given an opportunity to be joint members of audit teams that are bidding for services, especially in the private sector. We're kind of locked out of a lot of these opportunities, especially the larger ones.

And again, we're talking about industries. And here in California, we have large utilities. I believe that those are, again, both size, I think, and industry, are easier in a sense of trying to implement either mandatory rotation or at least an RFP after a certain period of time. I think you see it will affect your cost. I think it will make more people a little more efficient. I think they'll be more conscious.

Thank you very much for allowing me the opportunity to present my views, and I look forward to our discussion.

CHAIRMAN DOTY: Thank you, all.

Jeanette?

MEMBER FRANZEL: Well, I think it's very appropriate that we have this panel as our final panel, because you all presented all of the dilemmas and the various viewpoints that we have been hearing and that we need to weigh.

On the other hand, we hear that Sarbanes-Oxley Act actually has increased audit quality, and therefore maybe we don't need to, to take further steps. We hear we've got a difficult competitive landscape out there, and maybe rotation could help with that, serious fraud cases that could have potentially been discovered earlier with rotation, and then the government non-profit experience with very commonly -- where they commonly use teams of audits to do joint audits and regular rotation, and that market seems to have adjusted to that just fine. So I think we've got a lot to think about here.

I am curious about the Sarbanes-Oxley Act increasing audit quality. And maybe to the extent that all of you can speak to this, what specifically have you seen that you can say has increased audit quality in your experience? And I would ask all of the panelists to address that question.

MR. FOLLETT: Well, I'll go ahead and start us off. You know, I've seen it on almost every level. Starting, first and foremost, the relationship that we have as the audit firm with the audit committee, and specifically the chair of that audit committee is just dramatically different than it was.

And, you know, the companies that we typically deal with are in the range of the, you know, market capitalizations of 30 to 40 million all the way up to north of a billion dollars in market cap, so there's some diversity there.

But what we've seen in, in pretty much most cases, and it took some of those companies the first early years of SOX to evolve and to see how the new world was, but the level of dialogue that we have with those audit committees is, is very similar to what you heard from the presenters from the larger companies. I mean, dialogue with committee chairs on a routine basis. I'm talking about, not just the, the quarterly issues that you run into, but looking at prospective matters that may be facing the company, how they're evaluating risk, where we're seeing new areas of audit risks. And just the changing nature of the companies.

And the one thing that you have with companies of this size is they're, I'll use the term volatile. And what I mean by that, there's usually something going on. They could be evaluating a transaction; they, sometimes they get acquired; numerous things go on in this space. And just the level of dialogue we have with the committees, that's the starting point.

And then that trickles down to the relationship we have with management. And certainly the interaction, our approach to our internal inspections and what the,

the dialogue we have with the PCAOB inspectors, it certainly, you know, did not exist pre- SOX. It's just, it's just dramatically changing in all respects.

And maybe I'll turn it over to you, Tom, at this point.

MR. GARD: Yes, I think I'd echo what was just said as far as the engagement of the audit committees. The market cap -- the companies that we audit, their market cap is very similar to what, what was just indicated that Moss Adams handles as well. But the, the engagement of the audit committee has improved dramatically. Clarifying or maybe emphasizing their role and their responsibilities has really led to active engagement on their part.

I think a couple other thoughts too, is requiring the certification of statements by the CFO and CEO. In some cases, perhaps that is focus the CEO a little more clearly that he's signing off as well, that he needs to know what's happening in some of those areas in some of those key decisions, the fact that they're looking at, I think increased internal control awareness, just the whole -- whether it's tested or attested to by the auditors or not, the companies having to go through and make sure that their internal control systems are in place and functioning on a quarterly basis I think has led to some great improvements in that area.

MR. REGAN: I would agree that both the strengthening of the audit committee and the certifications have enhanced awareness and the importance of accurate financial reporting. I think the strength of the individuals on the audit committee has been improved. My own personal practice and chair of the audit committee of a public company is, I very much wanted the engagement partner and the concurring partner to have my home phone number, my work phone number, my email address, and I got calls at night, I got calls on Sundays to discuss anything that was concerning the audit partner.

However, in the audit frauds that I've looked at, the auditor and management have been very careful to not include the audit committee members in an understanding and an awareness of the matters which eventually turn to restatement and were found to be improper GAAP reporting. So the audit committees are walled off in those circumstances. And unfortunately I see circumstances where people are dishonest. And so I have a distorted perspective and a bad sample size.

That's why when I look at your sample size, it's 2,800, and when I see that you too are experiencing hundreds of the significant deficiencies, I'm wondering how bad my sample size is. My sample size for significant audit failure is probably less then a hundred, but it's getting close to a hundred.

MR. VASQUEZ: Well, I happen to sit on both sides of the fence as an audit committee chair. I can see that the firms are better versed on all the issues that our clients seem to have, at least I think on the organizations and companies that I sit on; more frequent communication.

I think on our firm side, the big difference is auditor skepticism. I think, I think that in the old days you just kind of presumed that things were okay. Now you come in and you take a look, you're always concerned about internal controls, you're always concerned about -- you do a background check on people. So you really are better trained, more willing to ask the tougher questions, required to ask the tougher questions, and understanding that at any point in time you can get sued. And so that certainly makes you want to do a better job, and I think that's why we do a better job as well.

MR. REGAN: In my prior answer, I don't mean to imply that the auditor was dishonest. The fraud resided with, principally within management. Parmalat may have been a different situation. There are some situations where perhaps the auditor was involved in the fraud. The auditors tend to have a lack of professional, professional skepticism and acceptance of client representations, and a failure to gather persuasive evidence. And when you got a dishonest client, that's not going to lead to a good result many times.

MEMBER HARRIS: Do you have any wrap-up thoughts in terms of how the profession or the PCAOB can further enhance investor confidence in the audit?

MR. REGAN: Well, I think the database of solution probably resides within your 2,800 inspections. It preceded 2010. On that, I think you've got to analyze those failures that occurred, and those failures that are repeating.

And within that analysis, you have to make a very difficult decision of whether things like audit firm rotation is, you know, the balance of -- is it going to be costly. Certainly it's going to be disruptive in the public accounting world and in the client world. But you're going to have to -- you're armed with that information, and you're going to have to make that assessment.

Again, in my experience, firm rotation would likely have shortened the period of time or precluded many of the frauds that I've seen. So that -- and you're doing that. And this is not an easy task, I'm sure, because the comment letters that I read are not very favorable toward this, but I believe it would improve audit quality and significantly.

MR. GARD: I think the step has to be, in some respects, me as an auditor, I'm looking for causation and analyzing the results of your inspections, and being able to -- right now we're saying there is no direct correlation, or you haven't found a direct correlation between audit tenure and audit deficiencies. I think that causes a lot of problems for people, seeing that this could be a solution, mandatory audit rotation.

Somehow, better analysis of that data, and being able to extract root cause for significant deficiencies or audit failure I think is the step that needs to be done.

MR. VASQUEZ: One other note. You mentioned auditor-only firms. I think that that would cause more opportunities for more CPA firms. Clearly, if you have auditor rotation, that's also going to expand the number of firms that can grow in expertise. Right now you have the vast majority of registrants are with four firms. I think that's never a good policy. That's never a good business for America. So this is maybe another item to think about.

MR. FOLLETT: I'll just add that when listening to testimony, including our own panel, it seems to me that the issue tends to go back to two fundamental questions or issues. And that is, the first is, again, this fresh eyes argument. Getting a different group of people, whether it's a different firm, just different individuals to look at the issues at a company in both an audit and accounting perspective.

And, you know, I would argue that what we have seen with the audit, the audit partner required rotation, the concurring partner rotation, and then the other limitations on other partners involved with the engagement, you have a natural evolution of teams and the people who are involved. You don't have the same staff accountant working on engagements year after year, because obviously they progressed in their career. So when you look back on the history of tenures, you have different people involved.

And in addition, you also have different people involved with the company, managements change, internal auditors come in. And so I think we're getting fresh eyes today under the current system that we have. I think we just need to identify where are those areas that, that within that construct, need to be addressed, where maybe there isn't the level of skepticism that we need to have.

The other issue has to do with the issue of pay model. And I do think that you do need to take a look at -- the firms need to take a look at, is there any one client or a series of clients that individually, you know, for the firm, for an office, for a partner, is significant to the level you would certainly, from an independent standpoint, question whether or not someone could be objective if, you know -- an extreme example, you have one audit firm that has one audit client that represents a hundred percent of their fees, there would certainly be an issue there.

I think that what you find, and certainly I can speak for my own firm, is that any one client represents such a small fraction of one percent of certainly the firm's revenue's, or even an office's percent of revenues, that, you know, it just doesn't -- it intuitively does not make sense why a firm would risk it all, from a litigation, regulatory risk, a reputation risk, to make -- to be inclined to make decisions that would put it all on the table for such a small percentage of the -- of the revenues of the firm.

So again, I think that looking at the underlying causes of deficiencies, of the magnitude of those deficiencies that the inspectors are finding, and the cause of audit failures, is really the focus. And, you know, that's my thoughts.

MEMBER FERGUSON: And one of the things that's been mentioned by panels today, including, I believe on yours, although everything is sort of beginning to run together for me now, but was that it would be helpful, in an alternative to rotation, it would be helpful if audit committees had a better understanding of sort of the PCAOB inspection process and how it works and what it means.

And one of the ways -- you know, because we do have a lot of knowledge about audit firms, and it's very detailed knowledge -- one of the things is that, you know, part of our inspection reports are not public.

As people who are inspected by the PCAOB, would you be willing to, and what do you think about sharing the non-public portion of your PCAOB inspection reports with, with your audit clients as their evaluating auditor? Because you can do that. We can't share it, but you can. What do you think about that?

MR. FOLLETT: Well, I guess maybe I'll start. I think that, you know, certainly my firm would be open to that. And we have the dialogues with audit committees of what we're seeing, whether it's inspection questions that are raised by the inspectors during their work at our firm, or trends that we're seeing. You know, when we started seeing the trends with the level two, level three issues that were coming out within the inspections, is that having that level of dialogue with audit committees, proactively letting them know where we're seeing areas of risk, how we're modifying our audit accordingly to address those matters, you know, is important.

I would suggest that -- I don't want to get myself in trouble -- but I think it would be beneficial as to the inspection process, because as you know there's sometimes a very significant time lag between the inspection and the posting of the report, is that maybe there's an interim step where the inspectors can come back with, you know, early indications of areas to focus on, or things that they're seeing in terms of best practices at the other firms, or early indications from the findings without having to wait; which, you know, many times is more than a year from the inspection until the posting of the report. So the firms can more quickly react, have those communications with audit committees and address risk, you know, further in advance than they can today.

MR. GARD: I think actually our firm would be very happy to share that information. We actually do discuss that with our clients. We've had the luxury of having -- we've been through three inspections as well, and our results have been very good. We do a lot of private companies as well, and certainly people are always asking about our peer review results and any comments and things like that. And that's something that we routinely share with prospects or clients and so forth. I think it's important information for them to know the quality of the firm that they're dealing with.

MEMBER FERGUSON: What about sharing also to the extent that you had a finding, or a part two finding, sharing your experience in the remediation process and keeping your clients up to date in terms of that, how's the remediation going, what are you doing in terms of remediation, what about that?

MR. GARD: Well, I think that would be important. That would probably be the second step. If you had a finding, I logically would want to say, here's what we're doing about it, and here's why we believe we've addressed that issue, here's the things that we put in place to address it, and how it will be prevented in the future and so forth.

So again, just, I think, open dialogue about that information, any findings that might be there and steps being taken, is part of a very positive, healthy relationship between the client and the auditor.

MR. FOLLETT: Well, I would add that once you start to raise inspection findings, you're almost forced to then discuss the remediation effort the firm is taking, you know, and how you reacted to that by its nature.

MR. VASQUEZ: Our firm's been through three PCAOB inspections as well, and I would echo everybody else's comments. Also, as chair of the audit committee, I would definitely want to know what is going on when there is a remediation.

MR. REGAN: Speaking as an audit committee member or chair, I would like to be informed and have that be as transparent a process as possible, and I would like the communication to start as early as possible. I mean, waiting until a year after is something that I would really like to avoid. I'd like to be aware of the issues soon as possible. And I would like to understand the remediation that is, that is going on. I think it's a very important communication.

MEMBER HANSON: Your firms, you've described, have significant practices in companies that are not subject to our oversight, non-public companies and public sector clients. One of the challenges that I would like you to just tell me if you find it a challenge and how you're dealing with it.

On the plane here yesterday, I was dutifully reading my Journal of Accountancy and I think you're all members of the AICPA, and I am too, and the Journal of Accountancy generally is full of really insightful articles about ways for CPAs to provide more services to their clients. It's really about client service from the perspective of serving the needs of management. And we've had a lot of discussion here today about serving the needs of the investors. And Steve Harris is real good about asking who the client is, and we've had a discussion about that, that in public company audit, the auditor's client is really the investors.

How do you balance that messaging that your professionals are often presented with that the profession is about growing services and selling services to clients, and the client is defined as management versus what we're finding challenges with, is resetting that so that auditors and public companies really think first about the needs of the investor, not about the person sitting across the table from them, that they're debating a particular accounting issue?

And you don't all need to respond to that, but I'll just pick on Tom and Dave for reactions.

MR. GARD: Okay. It is a challenge. Within our firm we probably do about 80 percent of our audit work is for privately-held companies versus about 20 percent publicly traded. I would say, I guess, first of all, we started -- our audit process is very similar. Our risk assessment and everything, really we address the risks in the same manner. But there's always a keen awareness, well, who is, who is the client, who is the reader of the financials. And it might not be the client, it might be a financial institution, is the main reader of those financials for a bank loan or whatever. But who, who is the ultimate reader of those financials, and what's important to them.

That helps us dictate some of our materiality considerations in different ways that we look at different things, whether it's a per share calculation, whether it's measure of equity, whether it's a variety of different things, much so that is a very, very important step in our risk assessment.

But I think having said that, still, and I guess it -- while it's not universally true, most of the people that work on our publicly-traded clients primarily work in publicly-traded clients, mostly because of their knowledge about the different regulations of the SEC and the different forms and filings and so forth. Although it's not universally true, they still do some private work. But I think that helps. Since they're primarily centered in that market, they're typically, as they're going through the risk assessment, thinking about its investor and its per share information is important in a variety of different aspects in that respect.

Ultimately, the goal is the same: getting the right answer. Applying the appropriate test work in the various areas to make sure that you've minimized audit risk and gotten to the right answer. But we have planning meetings, interactive planning meetings on every engagement with the audit partner manager, the entire team to do brainstorming, obviously, and a variety of different techniques and thought processes. And one of those is very, very definitely centered on who's the ultimate reader here, who's the client, who's the reader, let's design our procedures in an appropriate manner.

MR. FOLLETT: Well, I guess my comments would echo Tom's. You know, it's interesting when you have a client base like ours, where you're going to, you know, have to audit the Port Authority, to benefit plans, there's a number of, you know, things that we are involved with that, they're not a listed public company, but they're in the public interest.

And so from a tone at the top, whether it comes to, you know, our approach to the audit, assessment of risk, who are the users of the financial statements, and, you know, who's investing in this company, I mean, it could even be a private equity firm or a hedge fund of that nature, you know, we do start with the same, the same starting point. But akin to Tom, for those of us who have chosen in our careers to, to be a public company auditor, you know, there is obviously the heightened level of -- everything with independence rules, and, you know, we don't, we don't delve into gray areas.

I mean, there's certainly the prohibited services that, that have been outlined, but you'd be pleased, there's many times we get into conversations about a particular service or something that's being requested, and we say, you know, let's just not go there, because it's just, we don't even want to even get close to that line. So, you know, there's differences with what I guess on some level once you start getting down to, you know, a particular service or the needs of the client, and certainly some of the smaller companies we deal with, the private ones are less sophisticated, and we can use our services in different ways. But there's a line. But I would say the tone at the top is really the key on, on everything that we do from an assurance perspective.

MR. GURBUTT: Thanks. I guess I have a question that's specifically related to a remark that Mr. Follett made in his opening remarks, but I'd also be interested in the views of the rest of the panel.

You said in your statement that there would be a disproportionate burden on middle markets and smaller public companies as a result of mandatory rotation. And I guess I just wanted to understand that a little bit more. And I think my immediate question would be: Why is it that smaller companies change their auditors more frequently than larger companies, if that's the case?

MR. FOLLETT: Well, I think the comment's alluding to the fact that -- well, and I do understand -- and some of the previous panelists do have limitations, given the industry and the size and complexity of their international business, they have certain limitations on the ability to rotate. But in terms of the cost, the teams involved, sometimes there's geographic location, there's a number of other factors that affect the smaller to middle-size, mid-market type companies that also have an implication.

And again, where some of the larger ones aren't likely to have a transaction, I mean, I could foresee a situation. I mean, I'm often in conversations with these companies about, you know, are they going to do a private transaction? Are they going to do an acquisition? Are they going to be acquired by another company? Well, you could see situations where they're coming up to the mandatory period and being forced to change due to regulation when they are in the midst of doing something that could, you know, materially change their company. And you see more of those types of transactions that, you know, that have huge impacts on the companies, I think, in the space that we operate in.

MR. VASQUEZ: I think it's easier for small- and mid-market companies to change, because if you're unhappy with a partner, it's a lot easier to change if you're smaller and the firm's smaller.

Cost, I've noticed, always seems to be a factor. It seems like all the smaller companies I've sat on, when we change auditors, rarely does the cost go up. And the costs have a way of creeping up just slowly but surely the longer you're there. It's just like salaries of individuals that work for companies for a long time; one day you look up and you say, gee, how did this happen? And so I think that's part of the reason as well.

MR. REGAN: I think at some point, in terms of a company's size, particularly -- not merely its total assets or sales, but how many countries is it in and its geographic dispersion, they may be asking themselves: are we too big to rotate? And I think that's -- that may be a practical and important question, but some of those companies may need to rotate. And they may be forced -- they may never rotate unless forced to.

CHAIRMAN DOTY: Brian Croteau.

MR. CROTEAU: Just quickly, and it may be somewhat rhetorical, and it may be a question for David, picking up on a loose point. And I'm asking you because you said it most recently, but I've heard it from other firms, and so I thought I would raise it.

The point about more timely inspection reports is a good one. I know it's a point that the PCAOB has focused on, as well as thinking about other ways to get broadly more information about inspections out sooner. But at the same time, don't firms have an opportunity, relative to inspection comment forms and sort of at the end of inspection field work, and results of internal inspections, to really make use of that information much sooner than the time when an inspection report is issued?

MR. FOLLETT: Yes, absolutely. I mean, we do have the dialogue during the inspection period. But you understand when you have the time lag, you know, it's better to have more information, I guess, sooner. And so I think, even if it wasn't the issuance of the report sooner, but just to even have the opportunity for a more robust exit interview process than I think we're currently afforded under the inspection regime, I think is just, you know, an option for you.

CHAIRMAN DOTY: Other Board questions? Marty?

MR. BAUMANN: Just one more question. In discussion a number of times today, should audit committee members get copies of part two, should you discuss part two with them? I'm just interested in your view.

Do you think the audit committee members have a -- would get value out of part two in the sense that -- would they understand it, have context, maybe they'll -- does part two indicate a certain type of deficiency in your firm? Do they have the ability to put that into context as to: how important is that in your firm? How is it in relation to other firms? So would that, in fact, be useful?

MR. GARD: Well, I think some of the comments made earlier, that the more transparent, probably the better. And I think discussing the comment, we would be able to supply the context. We would have to fully explain what was the origin of that finding, that comment? Does it have a bigger root cause? What's the remediation? -- and so forth.

So, yes, I don't see any real issue as far as us being able to -- I think it would be incumbent upon us to provide context to help in the understanding of where that comment came from.

MR. FOLLETT: And I would add that I do think that something that has been raised by other panelists, you know, something to really consider, and that is getting audit committee members that have prior audit experience. The CFOs are wonderful, and ex-CEOs. But there's nothing better for me than to have an audit committee member who's a former auditor. So when we're discussing areas of risk, fraud risk factors, things that are changing, I mean, it's certainly very helpful to do that, and I think that's something that we can certainly encourage.

And I have encouraged the boards that I've worked with to consider that when they have vacancies, as an alternative. And I think that's something that we have an opportunity, and that would facilitate a more robust dialogue about inspection findings. And even beyond that, just areas of emerging risk.

MR. VASQUEZ: I might add, it also helps when you're trying to negotiate fees.

CHAIRMAN DOTY: This may be an appropriate place to leave it. You represent a segment -- a section of the audit profession that we are very interested, keenly interested in hearing from, understanding and knowing more about. We don't have the chance often to see you in Washington. So one thing that this trip has accomplished is it's given us the chance to sit down and have this discussion with you.

It's, I think, extremely significant that Dave Follett's citing to what Sarbanes-Oxley has done by way of improving audit quality focuses on the internal control of financial reporting, the ICFR certification by management, and the report by the auditors. We will be interested in seeing what the JOBS Act does to that.

Your views here on what the JOBS Act has done or will do to audit quality and to the benefits of Sarbanes-Oxley, as we go through the process, are going to be very interesting and very important to us. So you've made a difference today. It's been a great privilege and a pleasure to hear from you. And we hope to do more of that in the future. Thank you.

With that, I think we can adjourn the meeting.

(Whereupon, the above-entitled matter went off 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 true and accurate record of the proceedings.

Neal R Gross

Court Reporter