# PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

## INVESTOR ADVISORY GROUP MEETING

Hamilton Crowne Plaza

1001 14th Street, NW

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[9:03 a.m.]

Welcome and Introductions

MR. HARRIS: Good morning. I'd like to welcome everybody to the 2nd Meeting of the PCAOB's Investor Advisory Group.

I want to thank all the members for participating and donating your time and expertise to this group. I especially want to thank SEC Chairman Mary Schapiro for attending and also Jim Kroeker, the Chief Accountant, and Mike Starr and Brian Croteau.

Chairman Schapiro, we all know how valuable your time is and your presence today means a tremendous amount to us. I know you will only be here, be able to stay until 11:45.

MS. SCHAPIRO: 11:15.

MR. HARRIS: 11:15, I'm sorry.

MS. SCHAPIRO: That's okay.

MR. HARRIS: First mistake.

MS. SCHAPIRO: My 12 o'clock appointment would not be happy.

MR. HARRIS: 11:10. But the fact that you would take time out to attend today's meeting in order to hear directly from this advisory group is a reminder that protecting the interests of investors is at the heart of everything the SEC and the Board do.

I also know that you have testified six times before Congress since February, including yesterday before the House Appropriations Committee on the SEC's budget, twice last week and three other times since mid-February, and that the Dodd-Frank Act mandates over a hundred rulemakings and requires you to conduct over 20 studies.

So, once again, thank you for coming and for your leadership of the SEC during these highly-challenging times, and at one point I think there was some forces here in town who wanted to do away with the SEC and you certainly won that battle. So congratulations.

Achieving the best results for investors often requires that the Board work closely with the Commission and particularly with Jim Kroeker and his office and we appreciate the cooperative relationship that has developed between our two organizations.

The auditors regulated by the Board have a clear mandate to protect investors which comes from the statutory franchise granted by Congress to the accounting profession in the 1930s to audit the financial statements of U.S. publicly-traded companies.

The United States Supreme Court reminded auditors that this "public watchdog function" demands that they maintain total independence from the client at all times and requires complete fidelity to the public trust, and I would stress that those words "totally independence" come right from the Supreme Court.

The Board, in turn, has an equally clear mandate which is stated in the very first words of the Sarbanes-Oxley Act of 2002, "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws," and the very first section of Title I of the Act states that "there is established the Public Company Accounting Oversight Board to oversee the audit of companies," once again, "to protect the interest of investors in the preparation of informative, accurate, and independent audit reports."

So hearing from this group and other investor representatives is vital to the Board and the auditing profession successfully fulfilling their statutory mandates.

In my opinion, Chairman Schapiro, you foresaw much of what is on our agenda today in your speech before the AICPA last year on December 6th, 2010, when you not only recognized the critical role played by accountants in our capital markets but you queried whether "questions could have been asked early on by preparers and auditors or if warning flags were simply ignored?" and you went on, "We wonder if the eventual losses to shareholders and investors were multiplied many times because material information was not made available in a timely fashion by people who should have been able to produce accurate disclosures."

Our Investor Advisory Group will be discussing those issues, among others, today.

Before turning to the schedule, I would like to recognize at the outset our new Chairman Jim Doty and then you, Chairman Schapiro, for any brief remarks you would each like to make and then I will recognize our former Chairman Dan Goelzer and our other new Board Members Lew Ferguson and Jay Hanson and afterwards I would like all members at the table to introduce themselves and then we will get on with the day's program.

Chairman Doty?

MR. DOTY: Thank you, Steve. First, let me thank you for the leadership you've shown in forming this group and getting us all together.

I also want to thank Jim Kroeker, Mike Starr, Brian Croteau, and staff of the Commission for the extraordinary support they've already shown us and the help they've given us on a number of areas, including getting out the China research that we've done earlier this week and it's been a great help, and, finally, Chairman Schapiro, I have watched Chairman Schapiro's career over a significant period of time and the lesson I have taken away from it is that everything she does and everything she touches, she gets involved in to make a difference.

She's made an enormous difference at every post she has held and it has taught me that you don't do something like this unless you intend to make a difference. It is our purpose in serving on this Board, and I speak, I know, for every board member, that we intend to make a difference, a positive difference in the grave issues that face us in our securities regime.

It is also something we hear a lot about at this time in terms of burnout and cynicism. Where I come from, there are a lot of people talking about burnout. Burnout is usually a product of cynicism and boredom and doubt that what you're doing does make a difference and I'm here to tell you that, among the staff members of the Public Company Accounting Oversight Board who line this wall and sit behind me, there is no burnout.

I have been to the offices, we are going to the offices of the Board. I'm impressed by the fact that there is tremendous incentive to do the job and get on with the job of the Board. There's tremendous commitment to the mission of the Board and enthusiasm about what they can do by way of making a difference.

With that said, I would just say we have a statement that is before you and is available and it underscores the fact that we think that a number of the issues we'll be talking about today are not remote academic projects of the Board. They are eminent interests. We want to hear from you about the role of auditors in the global financial crisis, what you think the perception of the audit profession, and what was done or not done in the audit profession during those events should signify to us.

We are going to be taking up imminently proposals about the role of the auditor in the process and the audit report, the form and content of the auditor's report. What auditors say about what they do is of great interest to us.

It is also clear that in a global firm, there are issues that are quite imminent. It is a matter of clear concern to us that often there is not appreciation of who does what work and what lies underneath the report of the auditor.

All these are areas in which I may say that I think the presence of the firms that are here today exhibit, among other things, a real recognition that these are issues and that we are not going to return to a regime in which they are simply ignored. I think the profession itself sees that imminent change is on the way, that it has to be significant, and that there must be things done to preserve the health of our financial reporting system.

In the global network we have issues abroad. We are very encouraged by the fact that we are going to be reinstituting inspections in the U.K. We believe that we are on the cusp of having entrance into other countries on the continent of Europe that will be meaningful and will give our investors an insight into the quality and the credibility of audits, and as you know, we are absolutely convinced that before the Chinese can hope to have the kind of credibility in their own financial system that investors expect long term, there must be a way of distinguishing among audits in that regime and at the present time there's no way of anyone knowing whether or not what comes out of a Chinese company is a good audit or a bad audit and that has to change.

So there are a number of issues, both domestic and international, that are before us and I can only tell you that they will be moving forward on an imminent schedule and not a remote schedule with the help and with the collaboration of the SEC and with that, I would turn it over to Chairman Schapiro.

MS. SCHAPIRO: Thank you. Good morning, everyone. It's a real pleasure for me to be here. I want to thank both Jim and Steve for your very kind words of introduction.

I'm particularly happy to be here today as you look at the lessons of the past and determine what role auditors ought to be playing in the global financial future, but I think I'm most happy to be here because it's the first time since the Supreme Court ended the uncertainty over the PCAOB's future that I've been able to be with all of you, and I think that the seating of Jim Doty and Board Members Lew Ferguson and Jay Hanson was really a very important event and not just for the organization but obviously for all investors. So I'm really thrilled to be here with all of you.

I also want to thank Steve Harris and Dan Goelzer for your tremendous leadership during what was clearly a time of uncertainty at a minimum but one where you kept the organization moving forward and I think we're all extremely grateful to both of you for your enormous efforts.

As you focus today on issues of importance to every investor, it's really comforting to me to know that the Board shares my commitment to ensuring that the information on which investors are making their decisions is accurate and in compliance with the federal securities laws.

I also want to thank the members of the Investor Advisory Group for the time and the energy and the commitment I know that you've put into your work here and into the effort to better inform and protect investors.

The recent financial crisis I think underscored the need for preparers, for boards, for auditors and regulators to be vigilant about performing their duties, particularly during times of stress, and it's critical that the SEC and the PCAOB learn from that crisis and determine ways to help prevent or at least to mitigate another one.

For example, we need to be asking such things as do financial reporting and audits provide investors with sufficient information for their investment decisions and can auditor performance under current standards be improved or do the standards themselves need to be revisited?

Suggestions for addressing these key issues in the wake of the financial crisis are being discussed all around the world today and I think that today's discussion will make a very important contribution to that larger debate.

We need to look ahead, though, as well as learning from the past and today, I think you'll consider two issues important to the future investors and auditors alike.

The first is what should go into the auditor's report?  Today, we would like to know what useful information you feel is missing from the auditor's report and areas where additional input from auditors could add useful transparency and we'd also like to hear your thoughts regarding who should provide this information, auditors through reports, management through additional disclosures, or the audit committee.

And second, we simply do not have all the information we need to evaluate audit quality, as Jim was just referencing, in some countries, despite the fact that companies from those countries are accessing the U.S. capital markets.

The SEC and the PCAOB are working with other regulators to resolve some of these issues and I am delighted that the PCAOB has reached an agreement with its U.K. counterpart to be able to resume inspections there and I do hope that this agreement will form the basis for future cooperation in the U.K. on oversight and enforcement and the basis for the PCAOB reaching similar agreements with other jurisdictions in the near term.

Today, I'd also be interested to hear your views as to what else can be done to further improve audit quality around the world. For example, are there particular insights into accounting firms that would be useful? If so, what are those insights and what is their relationship to audit quality and what specifically can the accounting and auditing profession do to increase auditor objectivity and to maintain and really foster and grow the public's trust and confidence?

Just let me conclude by saying that we all share this enormous commitment to investor protection and an interest in discussions like this. I completely agree with Jim. You don't do things like this unless you think you can make a difference and I think we're very much poised to do that and so while I won't be with you for the whole meeting today, I'll be here till 11:15, so I can get back to the office by noon, Jim Kroeker, our Chief Accountant, will be here and he'll participate all day in the discussions and so I will catch up with him later on anything that I might have missed, and I want to thank you again for letting me join you today and thank the advisory committee members and all of you for your commitment.

Thank you.

MR. HARRIS: Thank you, Chairman Schapiro. Dan?

MR. GOELZER: Thank you, Steve. First, I just want to join my colleagues in welcoming the members of the Investor Advisory Group to today's 2011 Meeting of the IAG.

As Steve noted in his comments, the Sarbanes-Oxley Act created the PCAOB to protect the interests of investors and further the public interests in the preparation of informative, fair, and independent audit reports and reliable financial reporting.

Despite that, integrating the needs and goals of investors into our work is sometimes a challenge. We often hear directly from accounting firms and from preparers of financial statements. However, we receive much less input from the intended beneficiaries, that is, investors. This advisory group is one of the ways that we try to rebalance the scales.

I also want to join Steve and Jim in thanking Chairman Schapiro and SEC Chief Accountant Jim Kroeker, Deputy Chief Accountant Mike Starr and Brian Croteau for being with us this morning.

The Board's role in furthering investor interest in reliable financial reporting is just a subset of the Commission's much broader investor protection mandate.

Chairman Schapiro, I know how great the demands are on your time and attention and I appreciate your support for the Board's work and certainly your support for this advisory committee's mission.

I think I would be remiss if I didn't also underscore that this meeting wouldn't be taking place if it weren't for Steve Harris's commitment to the success of the advisory group. Since joining the Board more than two years ago, Steve has made it a crusade to ensure that the Board does everything it can to make investor views part of our decision-making. The IAG is certainly one of the tangible results of Steve's efforts.

The three topics on the advisory committee's agenda today are the Audit-Related Lessons of the Financial Crisis, Possible Changes in the Nature and Scope of the Auditor's Report, and the Implications of Global Networks for Audit Firm Governance. Each of these raise key issues to the Board's work and can certainly occupy the entire day, probably more than that.

I'd just like to say that I'm especially interested in the group's views on changes to the reporting model; that is, whether we should be asking auditors to provide more information than appears in the traditional standardized audit opinion and, if so, how the auditor's communications with financial statement users should expand.

The Board has begun a project in this area and will be discussing it at a public board meeting next week.  There's certainly considerable investor hunger for more insight from the auditor regarding both the audit process and the qualitative aspects of company financial reporting.  However, going beyond the time-honored pass/fail audit report would raise some challenging issues.  It would potentially be a fundamental change in the auditor's role and could far-reaching implications for the nature and extent of the audit work performed underlying the report.

The advisory group's ideas about how we should go forward with this complex and important project will be, I think, particularly valuable.

Thank you, and I'm certainly looking forward to the discussion today.

MR. HARRIS: Thank you very much, Dan, and for the kind remarks.

Lew?

MR. FERGUSON: Well, thank you, Steve. I just want to say how delighted I am to be with you all here and that I feel very pleased and honored that all of you, Chairman Schapiro and the rest of you, would take your time to spend with us because this is very important. What you do for us, I think, is a tremendously important thing for the Public Company Accounting Oversight Board.

What's exciting about being on the Board right now is that this is a time of extraordinarily and really unprecedentedly rapid evolution in the financial system not just in the United States but in the world in financial accounting standards and in auditing standards and given the fact that our primary mission, as everyone up here has said, is the protection of investors, trying to find what is relevant and what is useful to investors in a new and changing environment is something that is one of our main focuses and this is what I certainly hope to learn from you all today.

What can we be doing? What should we be looking at that will be relevant to, useful, and helpful to investors, and how do we change these standards in ways that really make information more valuable to investors?

So I'm delighted to be here. Thank you, Steve.

MR. HANSON: Good morning, everyone. Also echo the comments from my fellow board members. I'm very pleased to be here and happy to have all of you here and happy to have Chairman Schapiro here, as well.

Clearly, we've heard the messages that you all have been reciting that you need more as investor representatives than what you're getting right now and to echo Chairman Schapiro's comments and questions about who is the best party to give you that information, I'm really kind of anxious to hear some of the thought process behind that and clearly the discussion about the role of the auditor, since I come from an auditor background, is really intriguing to me because I know what I grew up doing and how the firm structures are organized about what auditors do and if the role is evolving, then that's going to be significant behavioral changes that need to happen in the auditing profession which is going to be a significant challenge.

One of the perspectives that I bring to the Board from a career in public accounting is helping them understand that the needs of investors, sadly, is not necessarily in the constitution of an auditor because it's not really focused throughout an auditor's career. There's no doubt in my mind that the leaders of the firms have the needs of the investors in their minds and are trying to effectuate the changes in the firms but that's a long-term process.

And one of the personal reflections I have about the changes that I've come to realize in the last few years are necessary is most auditors throughout their careers don't hear from investors. They don't hear the passion behind the information that you need and why you need it and so I think there's a lot of outreach that all of you can help with the auditors and the firms to help them understand down to a fairly granular level and with the staff coming up through their careers so they can better keep it in mind that what they do matters to you.

That's the unfortunate loss of the line of sight to the ultimate user of the work of an auditor that is missed sometimes and so I think there's a lot of behavioral changes that we know we need to work on with the auditing profession and I think this is a really good start to help us understand better what your needs are and also I'll be curious, today might not be the forum for it, but we always talk about cost-benefit and it will be easy to measure the cost of additional work that auditors might do or report.

The benefit, it's a little more elusive to measure that benefit. So I'll be curious to hear your thoughts on the cost-benefit part of the challenges that we're facing, as well.

With that, Steve.

MR. HARRIS: And then, Norman, if we could start with you, maybe very, very briefly all the Investor Advisory Group members could introduce themselves and then we'll get started.

MR. HARRISON: Thank you, Steve. Yes. My name is Norman Harrison. First, congratulations, Chairman Doty and the new Board Members. Chairman Schapiro, always a great pleasure to be with you.

Very briefly, my entire career in one form or another has revolved around the capital markets as a corporate attorney, investment banker, more recently as a principal in the investment advisory firm of Reed and Partners where I've had responsibility for our compliance and oversight regulatory matters and I bring that variety of perspectives to this task.

It's a great pleasure to be here this morning. Thank you.

MR. SONDHI: I'm Tony Sondhi, and I run a financial consulting firm and all of my work involves financial accounting information. So I've always been interested in it from that perspective and I'm very happy to be here and welcome to the new members and the new Chair. It's good to see you.

MR. SPORKIN: I was with the Commission for 20 years and I've been on the bench for 14 years, and

I've always been interested in this field and I congratulate the PCAOB for having this and for Steve Harris, I think this is going to be very productive.

MR. SILVERS: I'm Damon Silvers. I'm the Policy Director and Special Counsel to the President of the AFL-CIO, and I'm very pleased to be here with all these people who do such great work.

Thank you.

MR. TURNER: Lynn Turner. I, too, was at the Commission, including a time when Chairman Schapiro was Commissioner Schapiro and a wonderful person to work with.

I currently serve on the Board of the Colorado Public Pension Fund.

MR. STARR: Mike Starr, Deputy Chief Accountant for Policy in the Office of Chief Accountant, and I'm also pleased to be here.

MR. TAROLA: Good morning. My name is Robert Tarola. What I bring to the group is experience as a public company auditor, a public company CFO, and now a public company director and audit committee member, both with a public operating company and with investment companies.

So I'm pleased to be here and look forward to the dialogue.

MR. CARCELLO: I'm Joe Carcello. I'm a Professor of Accounting at the University of Tennessee and Director of Research for our Corporate Governance Center, and, in addition to being on this group, I have the pleasure and honor of being on the SAG.

MS. ROPER: Hi. I'm Barb Roper with Consumer Federation of America, and I'm sure I'll be pleased to be here once I get another cup of coffee.

MR. BECKER: Brandon Becker, Executive Vice President and Chief Legal Officer of TIAA-Cref. I was formerly at the Commission and at WilmerHale after that. As you know, we rely upon financial statements and the information therein. So we welcome the efforts of the chairs and in particular Steve's efforts over these past many months to basically successfully herd cats.

So thank you very much.

MS. YERGER: Good morning. I'm Ann Yerger with the Counsel of Institutional Investors and I'll add my voice to the choir. I'm very happy to be here and we thank you for all the work you're doing on behalf of investors.

MR. KROEKER: Good morning. Jim Kroeker, SEC Chief Accountant. Special thanks to Chairman Doty and Steve for inviting us today. We're extremely excited about continuing our collaborative relationship with the Board and look forward to the discussion today.

I think there is much that can be done to improve the system that we operate in.

MR. SAUTERS: Good morning. I'm Gus Sauter. I'm Chief Investment Officer of the Vanguard Group. I'm excited to be a member of the IAG, representing 10 million investors for whom we invest money, and very interested in the outcome here because it's very important to us to be able to invest that money well.

MS. SIMPSON: Good morning. I'm Anne Simpson. I'm Senior Portfolio Manager at Calpers which is the largest public fund.

Thank you for inviting us to participate in this group. Calpers lost something in the order of $70 billion because of the crisis and those companies at the heart of it all had clean accounts and auditors' reports were almost identical and the price was rising of the audits and there were lots of initiatives to try to improve the quality.

So we really don't feel we've got to the bottom of this and it's very important that this group is willing to go right back to basics, look at some of the international debates and not just that we're tinkering around business as usual, this is terribly important, and to think about the impact of what went wrong.

For a fund like Calpers, the difference in the financial crisis was dropping from 75 cents on the dollar being paid to pensions after investment returns down to about 63 percent and when we're looking at how important it is that that money's there for people's, ordinary people's daily income, this isn't some technical debate for an ivory tower. It really affects ordinary people's lives and the performance of companies and their pension benefit securities.

So we think this work is extremely important.
Part of the trick will be to make what's technical be

a little more comprehensively but we're very glad to be part of the debate, and thank you for the invitation.

MR. HARRIS: Thank you, and let me give you a very brief update since our last meeting on May 4th.

Under the leadership of Acting Chairman Dan Goelzer, the Board has taken up, in close cooperation with the SEC, a number of recommendations made by you, the Investor Advisory Group, at that time.

You asked that the Board redouble its efforts to obtain access to foreign registered accounting firms for the purpose of conducting inspections and in January our efforts resulted in a cooperative agreement with the United Kingdom.

You also asked the Board to consider providing investors with the names of issuer clients of PCAOB-registered firms and jurisdictions where the PCAOB was denied access to conduct inspections and on May 18th, 2010, the PCAOB published such a list on its website.

You wanted the Board to issue timely guidance on hot issues for auditors and boards of directors and since the May meeting, the Board and it staff have published two Staff Audit Alerts, one on the Principal Auditor's Use of the Work of Foreign Auditors, particularly in the China Region, and one on the Audit Implications of Breakdowns in the Mortgage Foreclosure Process.

In addition, the Board adopted eight new auditing standards, proposed an additional auditing standard, issued a concept release on the failure to supervise provision of the Sarbanes-Oxley Act, and proposed two rules related to our new authority over audits of brokers and dealers.

You asked that the Board study and report on lessons learned from the financial crisis and in September of last year, we published such a report, a 4010 Report of the Lessons Learned from the Economic Crisis, and we will continue that discussion today, and you asked us to consider whether there should be changes to the auditor's report and under Dan's leadership and that of our Chief Auditor Marty Baughman, we have begun that effort in earnest and in fact, as shown in the standard-setting agenda found on our website, Chairman Doty, Marty and his staff are planning to update the Board on the results of their research by the end of this month, issue a concept release for public comment some time during the second quarter, hold a roundtable during the third quarter, and issue a proposed standard during the first quarter of 2012.

So clearly the recommendations of this group have made a difference and helped the Board to establish our priorities. That is also why the specific topics that will be discussed today have been identified by the advisory group members rather than by the PCAOB. These topics go directly to maintaining investor confidence in the reports issued by the PCAOB-registered auditors and we will be considering them in the following order.

First, The Auditor's Report and the Role of the Auditor; second, The Lessons Learned from the Financial Crisis; and, third, The Global Networks and the Audit Firm Governance.

These issues are particularly topical in light of the current debate taking place internationally, as, Ann, you referred. The current debate started in 2008 with the deliberations and recommendations of the United States Treasury Advisory Committee on the Auditing Profession with many of the issues being carried into subsequent studies and reports, such as the European Commission's Green Paper and the Financial Reporting Council's Report on Enhancing Corporate Reporting and Audits.

What virtually all parties to the debate agree upon is that the status quo is not an option for the auditing world. These identical words "The status quo is not an option" have been used both by leaders of the accounting and audit profession here in the United States and Michael Barnier, the Commissioner for the Internal Market and Services at the European Commission.

Each discussion today will begin with a presentation by the working group that has been researching and considering the topic. After the presentation, the working group will lead a discussion among all Investor Advisory Group members.

As I mentioned, unlike board meetings with other advisory groups, this group developed these discussion topics, not the PCAOB staff, and, as such, the members will present each topic. At the end of the day, there will be an opportunity for each member to bring up additional topics or issues that were not discussed during one of the day's panels.

Also, I would like to note that today's meeting is being webcast. Since we would like the open discussions to be informal and free-flowing, please do not feel as though you have to be recognized to speak. We would ask, however, that for the benefit of those listening to the webcast and for the transcript, you identify yourself the first time you speak and periodically throughout the day.

This meeting is open to the public and information connected with the working groups' presentations will be posted on the Board's website.

Now to start the program and knowing that some may be in and out during the course of the day, I would ask Barbara Roper and Lynn Turner to outline very briefly, taking five minutes or so, the topics they will be discussing later in the session and then we will go to the full presentation of the panel on the

Audit Report but before doing that, I will also want to recognize Damon Silvers for three minutes or so because I know, Damon, you've got an engagement at the White House this morning and you'll be testifying this afternoon on the Hill.

So we want to give you a little bit of time to give the overlay of what you would have to say. So with that, Barbara, why don't you open it up?

Introduction of Working Group Topic on Lessons Learned from the Financial Crisis and Working Group Topic on The Global Networks and Audit Firm Governance

MS. ROPER: Great. See, thanks to Brandon, I'm feeling better already.

My working group was devoted to the Lessons Learned from the Financial Crisis and if we had indeed focused on lessons learned as opposed to lessons that should have been learned, we'd have had a very narrow mandate, indeed, because two and a half years after dozens of the world's leading financial institutions failed or were prevented by failure from failing only by dint of a massive government intervention, we actually know very little about why these institutions failed without a hint on the financial statements that anything might be wrong.

Congress did not deal with these issues when it adopted the legislation, had the Dodd-Frank debate, which is probably just as well because, to the degree that they paid any attention to these issues, it was to undermine the independence of the accounting standard-setting process and to weaken protections against fraud at small public companies.

The FCIC, the Financial Crisis Inquiry Commission, report does actually have a fair amount of very interesting information in it that deals with the lack of transparency on financial institution balance sheets, but it is focused more on problems with the financial reporting by these institutions than on the auditor's role in that financial reporting, and as Steve indicated, the PCAOB has done some initial and very useful study of some of the problems that occurred with audits that may have contributed to those failures but it has looked more at, you know, sort of a broad look at what went wrong rather than a focused look at why they went wrong, why things went wrong and what we might want to do about it.

So we haven't seen in this area of the financial reporting and the audits of these financial institutions the kind of detailed accounting that we would like to see of why the auditors, frankly, failed so miserably to fulfill their public watchdog function.

You know, nearly a decade ago Congress passed sweeping legislation, the Sarbanes-Oxley Act, that was supposed to solve this problem. You know, it was supposed to make auditors more independent. It was supposed to make them more responsive to shareholders. It was supposed to raise the standards of the audits. It was supposed to hold auditors accountable for doing better audits. It was supposed to fix the very problems that we've just been dealing with in the financial crisis and so, as I say, the question that we have is why?

You know, why, after all of that effort went in to reforming this process, are we still back in a situation where financial statements told investors nothing that they wanted to know about the true health of these financial institutions and where auditors have shown every sign in this crisis that they continue to view themselves as working for management and that they continue to see their job as finding a way to get comfortable with management's numbers rather than ensuring that shareholders, investors get a full and fair picture of the financial state of the public companies.

You know, auditors tell us that this is an expectations gap. Investors ask if this is really the best we can expect, is the audit even relevant anymore? So as I say, our group focused on this question of the need to get a better sense of what went wrong in the crisis.

There are doubtless many answers to that and the EU and U.K. have started to look at some detail about at those issues but in this country, at least so far, we have not seen that kind of detailed examination and so our first recommendation to the Board is that it really needs to undertake this job. It needs to conduct a detailed transparent indepth examination of the role of auditors in the financial crisis and that that needs to look at what went wrong with the audits of these major financial institutions, why the problems occurred, and what can and should be done about it, and, you know, we have ideas about some of the areas that the Board would look at, but rather than sort of predetermine what that study should look at, we think it really needs to be thought through in a fairly comprehensive way as we go forward.

And then beyond that, you know, that's sort of for where we are now but we also think this is a process that the Board needs to institutionalize. In other words, this examination of audit failures needs to be something that the Board does on an ongoing basis in the future so that you create a process in which you have a very timely mechanism for looking at where the weaknesses in the system are and correcting them.

So that, in a nutshell, is our --

MR. HARRIS: Well, Barbara, we look forward to the whole presentation a little bit later on.

Lynn, why don't you go ahead now and give an overview of what you'll be presenting later on?

MR. TURNER: Thank you, Steve. Certainly the performance of audits has added to the credibility of the information coming out. The auditing profession did seem to have hit a low point coming out of the corporate scandals of the Enrons and WorldComs, Adelphias of the world, if you will, and seemed to be making some progress coming out of that and with the establishment of the PCAOB to improve their audit quality and I think the Board deserves some credit with respect to their inspections in that regards.

But in recent years, it seems that instead of moving forward, the profession seems to be moving backwards in a number of areas. We see the type of things that Barbara talked about in terms of lack of red flags, perhaps lack of credible reports on controls. We see the firms once again growing their consulting practices all over again and we've seen in the past how, when that happens, the tail seems to become the dog in terms of driving the mentality within the profession.

And there's three of us around the table here and you've heard Damon and myself who spent over a year working on the U.S. Treasury Committee Report on the Auditing Profession which included a number of hearings, public hearings, quite a substantial public comment period, public comment, a couple exposure drafts, and it included a wide variety of people on that board, investors, people from the firms, representatives from the business community, regulators, etcetera, and it's now been two and a half years since that report came out.

Some of their recommendations, such as improvements to the communication between the auditors and investors, were not necessarily new. Those same type of recommendations were made back in the '70s and, unfortunately, weren't acted upon and if they had been acted upon in a timely manner and perhaps if some of the recommendations in the Treasury Committee report had been in place prior to when we went into this crisis, perhaps investors and hopefully investors would have gotten red flags that they could have acted upon and clearly the markets are only efficient and can only be efficient if they get adequate information.

As we've seen in recent years, they haven't gotten the information and as a result the markets have been woefully inadequate. Our own fund went from, our members in our fund, about a half a million people in Colorado, about 15 percent of the population watched as their investment accounts went from an aggregate of about 44 billion down to about 26 billion during this crisis which had significant impact on them as well as our taxpayers.

So it is a very significant issue.  At the same time many people watched as their 401(k)s at Vanguard or Fidelity or whatever go through exactly the same type of crisis.

So we do think in our subcommittee, and there's a memo that we've prepared that's in your materials that give you greater detail, that it is time to finally act upon all those recommendations of the Treasury Committee report.  This was an esteemed group of people led by former SEC Chairman Arthur Leavitt and former SEC Chief Accountant Don Nicholiason, but some of those recommendations included in the area of transparency and governance which we've all embraced for public companies around the globe.  We've embraced for greater transparency in government agencies, as well.

The one place that we don't seem to be able to get it is in these large accounting firms and we've seen the benefits of it in the operations and efficiency of other organizations and one has to ask why is it that this one group seems to be isolated from the benefits of that that other organizations have seen.

So certainly it's time for them to become much more transparent in terms of their financials, in terms of their governance. It's time for, as Dan Goelzer has most appropriately called for, greater transparency at the PCAOB with respect to the investigations and that entire process, taking it back to what the SEC adopted, quite frankly, Chairman Schapiro, while you were there as a commissioner when the Commission voted to make public all the 102(e) proceedings and as I recall briefing with you on that, you're a very positive supporter of that.

There's also the issue with the increasing slide back into the consulting with respect to the independence of the audit firms and the coziness of these firms we've seen in a number of these cases, the audit firm had been with that company for decades. GAO report has also pointed out that that relationship has gone on for decades at other organizations and in light of some of the situations we've seen reported in the press, it just raises the question as to whether still in the mind of the auditor, keeping those audit fees were more important than getting the right answer out, something we also saw with respect to the credit rating agencies. So it's not something that just afflicted the auditors but as we made changes with the credit rating agencies, it seems that it's time to make change and a fundamental change.

We discussed this during the course of the ACAP Report of the Treasury Committee. In fact, Paul Volker was a very strong proponent of doing and acting on something like this. The chairs had chosen, after discussions with the firms, not to act on that but I think it is now time to act on that and I think it's time to revisit the whole issue of mandatory rotation and I think using a reasonable period for rotation, the time for that is past due now and that was very key to some members on our subcommittee.

Global audit quality. You've mentioned the problems with the Chinese audits. I think Chairman Doty is absolutely direct on target with that. Business has become much more global. If you look at the financial reports of companies, such as IBM, Coca-Cola, and General Electric, the majority of their operations and their revenues come from outside the U.S. Those audits of those numbers are conducted by firms, affiliates outside the U.S. They're separate legal entities from the firm here, yet over the years, as that globalization has occurred, we have not changed fundamentally how we supervise and oversee those portions of the audits.

For many years, the firms have relied upon credentialing where essentially if you had an affiliate and the partner was credentialed over in his own country, they pretty much went and did that portion of the audit without the type of supervision that you'd see being conducted here in the U.S. on the U.S. portion of the audit.

I think it's time to revisit credentialing. I think it's time to revisit the supervision and how that is done. We certainly have seen problems with that with respect to Chinese audits and I think it's past due time to revisit it in its totality here and reconsider those standards.

Chairman Schapiro, in her opening remarks, noted that perhaps it's time to redo standards. I think this is one standard that it's more than past due time to reconsider and change.

MR. HARRIS: Lynn, I'm going to have to cut you off because I want to watch the clock very carefully and we've got your full presentation a little bit later.

MR. TURNER: That's fine, Steve.

MR. HARRIS: And I know, Damon, you know, can't understand why we don't preempt the White House and the Hill, but since clearly we don't in your mind, why don't you take your three minutes or so and then we'll excuse you?

MR. SILVERS: Well, Steve, thank you. I was going to say something to the effect of, you know, there are very few powers on this earth that would take me away from this committee but you named two of them and I hope it will hearten folks around the table that one of the things that I'm doing on the Hill, testifying with respect to the changes, proposed changes to Dodd-Frank, some of which I think go right to the issues we're discussing here today.

I'll try to be very brief here and, first, thank you for allowing me a chance to speak a little bit out of turn.

As I said before, I'm Damon Silvers. I'm the Policy Director of the AFL-CIO. I am here because of the interaction between our capital markets, our system of public accounting/public auditing, and the retirement security of working Americans.

I think it's fair to say that our country is in a profound long-term retirement security crisis. The problems we've had in our financial markets over the last decade are more repeated bubbles, repeated sort of crises in governance, disclosure, enforcement, regulation, are not the cause of our retirement security crisis but they've exacerbated it profoundly and we've heard, I think, from a number of other people in this room about the specific numbers, specific plans in terms of losses.

I think that people in this room, Chairman Schapiro, Chairman Doty, you all are in the position of having, and for different reasons and in different ways, having to rebuild and restore both the strength and the public confidence in our financial regulatory institutions and it's a great honor to be here with you because of the work.

I know that, Jim, you're just beginning and I know we've talked about it and I have great confidence in where you're taking the Board and the great work, Mary, that you have done.

But these are profound challenges and this meeting today, you've heard, I think, the presentations from my colleagues on, I think, these two very sort of overarching issues for this group and for the PCAOB.

The question of both understanding and there being some accountability for the events of the last several years in the financial markets and I think it's important to emphasize those events are continuing. This is not a matter that is over.  It is as present as this week's headlines about irregularities in the mortgage markets, all of which have implications for the work of this Board.

This question of accountability (1) and the question (2) of the set of issues around the future -- around the current present performance and future of the auditing profession that Lynn alluded to.

Now, I just want to say before I have to leave that I'm extremely impressed and supportive of both the presentations that you'll see later in detail that you just heard summarized and I want to say a word or two about this issue of understanding and accounting for in a sense the financial crisis and the role of the audit process of public company auditors in respect to that crisis.

The PCAOB, despite being in a very awkward position as a result of the Supreme Court litigation, is one of the very few institutions, other than those that were specifically ordered to do so, like the FCIC, one of the very few institutions in our government, around our government that has tried to do some kind of inquiry and report on what happened in relation to its obligations in the financial crisis.

But I think -- and so the Board and the staff deserve a lot of credit but I think fundamentally the question that got asked got it backwards. The key issue is not the impact of the crisis on audits, although that's not a non-issue. The real issue is the question of the impact of the audits on the crisis and there are -- and there, there's a profound conundrum.

I'm going to quote to you from a little piece of the presentation you're going to hear. The Center for Audit Quality which I respect greatly, many friends have worked there and are involved in that body, said that "we believe that auditors generally carried out their role effectively during the crisis and appropriately reached audit opinions within the context of the applicable accounting and auditing frameworks."

I don't have enough information to judge whether that statement is true or not but it seems to me it's almost equally disturbing if it's true than if it's false because the question is how could that possibly -- how can we possibly say that we have an adequate auditing framework if that outcome could occur and so I think that that question is the question that the PCAOB really needs to dig into and dig into deeply, and I think there are a couple of also further questions.

I'll note that, some of you may know this, I serve as Vice Chair of the Congressional Oversight Panel for TARP. That body is issuing its final report today and we go out of business, leaving me more time for the PCAOB and other things, but in the context of that work, it's become apparent to me, and I've raised this issue repeatedly here at the SAG, that there are just basic unanswered questions, such as, and I'll just mention two of them, what were auditors supposed to have done around the question of going concern during the financial crisis and, in particular, what were they supposed to have done around firms who would have had a going concern problem but for government guarantees, particularly implicit ones?

I think we know something about the GSEs, for example, but what about Citigroup and Bank of America and Goldman Sachs?

Secondly, and I've alluded to this earlier, there are these continuing and profound issues about the valuation, accounting, and auditing of mortgage-related assets. Our oversight panel could not divine what an appropriate valuation was of troubled assets more than a year into the TARP Program because the financial accounting for those assets was so opaque and auditors signed off on all those statements. This is in our August 2009 Oversight Report.

That problem seems pretty significant but it's now been compounded by, I think, all the issues associated with the mortgage processing irregularities that are on the front pages this week.

These are enormous questions and no one has answered them. The Board will have before it and will have before it this afternoon, you will have before it this afternoon as a result of my colleagues' work, detailed presentations on these issues and they completely reflect my views and concerns.

And I'll finally say and close that, as a result of the work of the Treasury Committee that Lynn talked about, there is a menu of suggestions for how to, at what I think are sort of minimum levels because they don't reflect the events of the last 36 months, a set of basic ideas for how to improve the independence and accountability and transparency of the public company audit process, items like audited financial statements for audit firms, potentially outside directors, auditor rotation and the like.

I can't resist, in the context of Jay Hanson's comment, that auditors don't hear from investors enough, that one thing that's been sitting in front of the PCAOB for awhile that might help that is for an actual human being to sign the audit statement. It would be much easier for that person to hear from investors if investors knew who that person was and so with that, I'll close and I thank you for the opportunity to say a word or two.

MR. HARRIS: And now, Joe, we'll get on with our first presentation which relates to possible revisions to the auditor's report and an examination of the role of the auditor in today's securities markets.

The Working Group looking at these issues is led by Professor Joe Carcello and includes Brandon Becker, Norman Harrison, Pete Nachtwey, Gus Sauter, Ann Yerger, and others participating with this group included Anne Simpson, Bonnie Hill, and Mike Head, and while Pete, Bonnie, and Mike could not be here, it's my understanding that their views and those of Eric Vincent are incorporated in Joe's presentation.

So, Joe, take it away.

Report from the Working Group on:

Auditor's Report and the Role of the Auditor

MR. CARCELLO: Thanks, Steve, and let me thank again the Board for convening this group and Chairman Schapiro and Jim and Mike and Brian. Brian, there's a seat over here, if you want to -- no? Okay. For being here, for the involvement of the SEC I think sends a real important signal.

One of the things we've done that we'll talk about is we actually did a survey to gather data on what investors value. So it's not just our opinion. So let me go ahead and hand out the actual survey so that when we get to that -- watch me tripping -- you'll have that in front of you and then I think there probably is enough copies, if not for everybody in the room, close to everybody in the room, and then we also have a pdf of the question by question results, so you can have that in front of you, as well.

All right. So our charge -- and Jim or Jay, if I am blocking you, just let me know -- to look at the auditor's report and we have a subgroup of the IAG, in addition to myself, Norman Harrison is going to be involved from Breeden in presenting, Gus Sauter from Vanguard, and Ann Yerger from the Council of Institutional Investors.

In addition, Brandon Becker from TIAA-Cref was involved in our subgroup and Anne Simpson from Calpers was involved in our subgroup from the people who are here today and then some people who aren't here.

The first known written U.S. corporate audit report was a report by the Baltimore and Ohio Railroad Company in 1827 and it talks about essentially just an audit of receipts and disbursements and talks about the accounts being correct. So you can see we've gone a long way in the last 170 years or so.

As the audit report has evolved over the years, the first audit report, as I said, simply stated, the findings of an account examinations, cash in essentially, cash out. In the early 1900s, audit reports were very detailed and descriptive, provided a comprehensive examination of what the auditors did. The audit report was seen as a certification as to the accuracy of the numbers and there wasn't a standard audit report until 1917 when there was a Federal Reserve Bulletin on the topic.

Over the years there's been a lot of interest in this topic and different commissions that have examined the topic. So the Cohen Commission back in 1978 looked at this, recommended that the auditor's work should be clearly described and their findings should be clearly described without using technical terminology, describe the audit function unambiguously, state the limitations of the audit function, and use standardized alternative phrases rather than a single standard report form.

More recently, the CFA Institute has done surveys similar to what we've done on what investors want. Based on the CFA survey, they want more specific information about how auditors reach their opinion, more information about key risk areas, about significant changes in those risk areas, and about areas that require judgment and involve uncertainty.

Earlier today, we've heard from Barbara and Lynn and Damon about the ACAP Committee. The ACAP Committee made a number of recommendations. One would be to clarify the auditor's role and limitations in detecting fraud, consider mandating the partner signature on the auditor's report, and consider making the report more descriptive.

So let's look at the world in 1990 and the world today. Why did I pick 1990? The last time there were any degree of substantive change to the audit report, at least by the profession, was as part of the expectation gap standards, okay, and so you go back and you read SAS-58 and SAS-59, you know, those fun pieces of literature and that was really the most recent change and I'll leave it to people who are more familiar with this in the audience as to whether that was significant change or not.

It was a change, whether or not it was really substantive, it's debatable, but it was a change. So let's pick 1990 and let's pick today and let's look at our world, okay, and so I have technology products up there and they've changed a lot, right? There are whole new industries that exist today that didn't exist 20 years ago.

The accounting profession has changed. Arguably, the firms' organizational structure has changed more than their product and countries have changed. The largest country in the world, at least in terms of land size, 20 years ago has now been split into smaller pieces.

So let's see how the product we care about, the auditor's report, has changed in the last 20 years. So what I have up here is an audit report and you have these slides in front of you, so you probably can't read this, but you have the slides in front of you, issued in February of 1996 by Ernst & Young on the B.F. Goodrich Company. Okay?

Audit Report issued by Ernst & Young on the B.F. Goodrich Company today. Okay? Now what I've highlighted here for you is the same company, so we've held the company constant. The only thing that's changed in 15 years is highlighted. So there's now a reference to the standards of view, the PCAOB, and there's a reference to the 404 audit. Those changes were mandated by the United States Congress.

So short of changes mandated by the United States Congress, arguably, we would have seen exactly the same audit report 15 years later. So I think it's reasonable to make a supposition, right? Given the lack of change in the product, customers, i.e., investors because if investors aren't the customer, why do you exist, must love the product.

Norman will provide empirical evidence on the truth of that supposition later.

Okay. So when we came together as a group, again the group is Brandon from TIAA-Cref, me, Norman from Breedon, Mike Head from TDAmeritrade, Bonnie Hill who's on a bunch of corporate audit committees, IcahnBlue, Pete Nachtwey who's the CFO at Legg-Mason, Gus from Vanguard, Anne Simpson from Calpers, Eric Vincent who's the hedge fund manager at Osprale, and Ann Yerger at the Council, we came together and one of the decisions we made very early is we did not want this to be the opinion of however many people there, six wise men and women. We wanted it to be more broadly than that.

We also wanted it to be driven not just by, quote unquote, investor advocates but by people who every day are buying and selling equity and debt securities, trillions of dollars of equity and debt securities.

So we made an effort to reach out to investors and we were fortunate and we had some help from Blackrock, which is the largest money management firm in the United States. We also wanted this to be as mainline corporate America as possible to insulate against any criticism that we were driven by special interests, and we also had good help from Capital Group.

So let's think about what we have here. The largest money manager in the country, Vanguard, the largest mutual fund in the country, Capital Group, the third largest mutual fund in the country. I'll say more about that in a little while.

We also developed -- so the people on the subgroup, we put together the survey with a lot of involvement from the people on the subgroup. I asked those individuals to get three to five people inside their organizations who buy and sell daily to fill out the questionnaire and then we also developed a mailing list of 300 large investment banks, hedge funds, private equity funds, mutual funds, pension funds, and endowments, and we mailed to them.

So we have a mix of kind of a choice base sample and a random sample because we just wanted as much feedback as we could get. We had respondents, included CEOs of some of these organizations, presidents, managing directors, CFOs, chief investment officers, equity analysts, portfolio managers, controllers, and credit analysts. So that's kind of a sense of who responded.

The survey, as you can see, it's in front of you, we started off with just project background and instructions. We had some baseline information on the current use of the audit report and the value that users feel they get from the audit report and potential changes that they would like to see.

Then we broke the actual body of the survey into three sections. One would be what additional information, if any, do investors want about the audit process itself? Why did the auditor do? We asked them if they wanted additional information about what the auditor found and then we asked them if they wanted the form of the report itself, structure of the report to change, and then we tried to gather basic demographic information on the employer and the title of the person.

So the responses were received. It's hard to get people's attention in today's world but we got 73 respondents and we did receive multiple responses from Blackrock seven, and as I said, $3.6 trillion of assets under management, Vanguard six and 1.4, Capital Group, TIAA-Cref, Legg-Mason, Breeden Capital.

Just those groups alone represent more than $7 trillion of assets under management and, in addition, we had responses, this is just a sampling, Highbridge Capital Management, Pershing Square, Osprale, the Virginia Retirement System, the Florida State Board of Administration, Calpers, and a number of others. So that's a little bit about how we went about this, how we gathered, what the survey looks like, what the respondents looks like, and Norman, who's in back of me, is going to take it to our next section.

MR. HARRISON: The first set of questions we asked were designed to set some parameters. I think when you're surveying the population, in this case the population that are using the financial statements about possible changes to the format of the auditor's report, the first question you ought to ask is whether the users are satisfied with the status quo. Does the current report give you sufficient information? Do you find it a valuable tool? So that's the first question we ask and, not surprisingly, perhaps most of our responders told us that they do not believe that the current format of the audit report provides valuable information to them in their work as investors.

It's important to understand as you read these results you have the detailed survey results in front of you but for purposes of summarizing the responses, we have included or attributed percentages only to the population of the respondents who actually expressed a point of view. There are five potential responses to each question, as you see. You could strongly disagree, disagree, be neutral, express no view, or agree or strongly agree. So the percentages we show here are only for the portions of the respondents in each case who expressed an opinion.

So here, for example, 45 percent of the respondents told us they believe that the survey doesn't -- that the current audit report does not provide valuable information to facilitate their understanding of the financial statements. It's important to understand, though, however, that only 68 percent of the people who responded to this question had an opinion one way or the other. The rest were neutral or hadn't reflected on the issue.

So of those who had a view, well over two-thirds wrote the view that the current format of the audit report is not helpful to them in their work. Seventy-three percent told us they skimmed the report quickly and I hear this all the time in my work and in discussions with colleagues and discussions with clients and in former lives with colleagues in the investment industry. You know, many are of the view that even calling this four-paragraph letter a report is a bit of an over -- glorifies it beyond what it really is, that it's nothing more than a transmittal letter or a check of a box and it doesn't provide really any insight to investors as to what they're going to find in the financial statements that follow.

We get a sense of that through some of the narrative commentary which was very helpful. I think one of the very useful features of this survey that Joe principally designed is it provided our respondents a chance to give us not only a graded answer to a question but narrative input. A lot of the comments are very, very helpful and shed some further light on these issues.

The comments here in each case by a portfolio manager or an investment professional at a large institution, a money manager, tell us what we all hear a lot, I think what I certainly do in my dealings with investment professionals, and that is, the audit report really is nothing but boilerplate. It's canned language. I sometimes count the paragraphs. If it's the right number of paragraphs, I keep going. If there's no -- if I don't see the words "going concern" jumping off the page at me, then that's really all that it does which, from an investment professional standpoint, very, very often means very little. It's a pass/fail model. It's binary, yes/no, and that's it.

Interestingly, however, there's another category of respondents that had a somewhat different view. We received responses in some cases from individuals who sit on the audit committees of mutual funds and in this case, you see a different point of view expressed. Audit committee members in general tended to take the view that, well, yes, the auditor's report is one of the tiles in this mosaic that we look at and consider when we're getting comfort with the disclosures that our fund is providing and it's interesting that those who have more of an actual relationship with the auditor, people who are responsible for retaining and overseeing the work of and regularly interacting with the auditor attach greater significance to the auditor's report than the investment professionals who are actually on the frontlines using the financial statements as raw data for the analytical investment process.

We may talk about this more later in the Q&A session. There are other areas in which there are somewhat significant disparities and responses to our survey between investment professionals, people who actually go to work each day, crunch numbers, make investment decisions or recommend investment decisions, the investment committees of their funds, on the one hand, and people like audit committee members who are more involved in oversight and governance functions.

There are some interesting departures and disparities in responses that we may take a minute to reflect on.

Far and away the area in which our respondents most overwhelmingly agreed that further disclosure or some form of disclosure in the audit report would be very helpful in the investment process comes in the area of disclosure for risks, which again intuitively makes sense, because if you think about it, what all of us do who are in the investment business is we analyze financial information and assign and attribute risks to the quality of the reporting, to the projections, to management's own disclosures, to the models we built, to assign a value to a company, project future results and choosing appropriate discount rate, a range of discount rates to apply to those earnings to try to derive some sense of a current value to determine whether a stock we believe is perhaps undervalued in the market.

All of those functions, those day to day investment functions involve assigning, attributing levels of risk, attracting risk into the investment process, the analytical process behind investment decision-making.

So here our respondents most overwhelmingly said if the auditor's report in some manner provided a narrative description of those areas of disclosure, those areas in the financial statements where the auditor saw relatively greater levels of risk, we would find that type of disclosure to be important. We would also like to know for those areas of greater risk in the presentation of financial results what additional resources did the auditor apply? Was there an expansion in the scope of the audit, an assignment of specialist resources to the audit? What did the auditor do in response to perceived areas of relatively high risk or significant risk in the issuer's financial reports?

The next question was a question of disclosure around the allocation of audit firm resources to different aspects of the audit and we asked specifically whether investors would find it useful to know the number of hours and the allocation of hours spent by the audit team on certain categories of the financial statements or accounts and for the most part the answer here was no, not really. Some expressed the view that it would be interesting to know that it would, you know, perhaps be beneficial in some respects but I think the consensus of the responses here was that allocation of individuals and the tallying of hours spent on various elements of the financial disclosure doesn't necessarily correlate with those areas of greatest risk or substantive significance. The labor-intensive nature of an audit task is not necessarily correlated with risk.

Another area, however, where there was

significant agreement among our audit respondents was in the category of potential disclosure by the auditor of the materiality thresholds that the audit firm applied in its review of the financial statements.

Again, 56 percent expressed a positive view here but we received, other than a neutral response to this question from 73 percent of the people who answered the question, so 56 percent is actually a substantial majority of those who took a view one way or the other.

There was a lot of discussion around this. I think this is an area where the narrative discussions will shed some further light on the issue. Interestingly, one of the participants, an investment professional for one of the mutual funds we surveyed, actually didn't take issue with the concept of the composition that there should be more disclosure around the issue of materiality thresholds, both quantitative and qualitative, but rather than have it be a matter of disclosure on an audit by audit basis or firm by firm basis, believe that should it be the subject of a more broad-based standard-setting initiative perhaps by the

SEC or the FASB.

Next category in terms of overall sort of background presentation that we asked about was whether investors would find it useful to know the nature of, the extent of work performed by firms, other than the audit firms signing the audit report, and again here we had a fairly overwhelming response. It wasn't one of the questions where everyone had a view. Sixty-seven percent of the respondents said yes or no to some degree, but of those that responded, 47 percentage points or 70 percent of the total respondents to this question said that they would find it useful to know of situations in which other audit firms, including non-U.S. member firms, of U.S. firms signing the opinion, were participants in the audit.

I think the issue here is one of level of confidence in the overall audit process and at least wanting to know, again from a risk measurement standpoint, evaluating risks associated with the audit, whether there was substantial participation by firms or affiliates of firms who were beyond the scope of PCAOB and SEC oversight.

So those were the threshold questions and again just to summarize briefly, far and away, the two areas which our surveyor respondents told us they would find it extremely useful to have substantive narrative disclosure or discussion by the auditor pertains to the areas of risk, identification of areas of risk in the issuer's financial statements, where the greatest levels of risk appear, and knowing something more about what the audit firm did to audit and test and evaluate those risks, and, secondly, some definition around both the qualitative and the quantitative measures of materiality that were used with respect to particular items or elements of financial statement disclosure.

Again, there was also a high level of interest in knowing more about participation by other audit firms who were not the firms signing the opinion and the only area in which there was relatively little interest compared to the other areas is on the question of disclosure of allocation of resources and hours spent on the various elements of the audit.  So that again these are the threshold areas.

We move on now to the discussion of the

survey, portions of the survey which questioned our respondents on what they would like, what more they would like to know about how the audit was conducted and what more they would like to see in terms of manner of disclosure of the findings, the results of the audit, and Gus and Ann will take you through those two areas.

MR. HARRIS: Gus, for the record, why don't you say at the outset how much Vanguard has under management?

MR. SAUTERS: I'm Gus Sauter from Vanguard and Joe was close. We have about $1.7 trillion under management around the world, about 1.6 trillion in U.S. mutual funds.

So I'm going to discuss -- I'll be discussing what the auditors found. Norman just talked about what the auditors did.

The first question we asked in this section was the evaluation of significant estimates and judgments and here 79 percent, an overwhelming super majority of respondents believe that the auditors should discuss significant estimates and judgments made by the management, and I personally strongly agree with this.

I would liken this to the difference between a physicist and a statistician. A physicist is very hard mathematics believe in single point estimate and I'd distinguish that from a statistician who believes there's a distribution of outcomes.

When we look at financial statements, we get a single point estimate. We get the physicist view of what the world looks like. Unfortunately, we recognize that many of these numbers have a broad band around them, that they are in fact estimates and so I believe that we need information that a statistician would look at here, and so including this in an audit report, the fact that there are estimates and judgments and what those estimates and judgments are is very important.

I would note that there is a comment here that that is the job of management. I don't disagree that that's the job of management and it's perhaps not fair to debate somebody who's not here, but I find I'm more successful in debates that way.

But I do believe that the financial

statements and the audit report are created for the benefit of investors, not for management. They're really not -- they're useful statements for management certainly to help them better manage the company but ultimately they are created for investors and this is, I think, very valuable information that we would love to have.

The second question we asked in this section was about evaluation of accounting policies and practices and again a large majority of investors or of the respondents indicated that they believe the auditor should discuss the quality of the accounting policies and the practices, not just the acceptability.

So we know there are many ways to create financial statements within the auspices of GAAP accounting, but some of them may better reflect what's really going on in the company than others, and so it's important for the accounting report, the audit report to indicate how well the types of policies chosen by management to represent the company really do represent the financials of the company and how consistently those were applied.

Another, for me, very important question is the sensitivity analysis performed by the audit engagement team. So 65 percent, another again, there was strong agreement throughout this entire section of questions, 65 percent would like the auditor to include the results of sensitivity analysis in significant areas of judgment.

This ties into one of the questions that Norman was talking about, talking about the risk of the audit. What parts of the audit represent greater risk than others? What can we learn from doing sensitivity analysis? You know, I think, actually, there's a very good example with the global financial crisis that transparency actually can lead to higher valuations of stocks rather than lower, that this doesn't represent risk to management or to the company, that it actually can represent value to management and certainly value to investors.

You know, I would just point to the stress tests that were done on the banks. Those stress tests came out, I believe, in April of 2009. The market bottomed in March of 2009 and it largely bottomed with the knowledge that these stress tests were going quite well and would be quite positive. So, in fact, stress tests, in the case of the banking system, really proved to be a very positive thing and valuations started to rise from there. So removing uncertainty is a very important principal with investing.

Next question was disclose unusual transactions in restatements and other significant changes, and yet again 67 percent believe that the auditor should disclose unusual transactions in restatements and significant changes.

The comment says that management should do all of this and much of this should be done by management but I think it's important, the way I think of the auditor's report is to me, it's an executive summary or an abstract and to me it should be giving us a little bit of a roadmap as investors as to what we should be focusing on. What are key areas that we should know about and look for inside the financials? So this would be important information to know that there was something unusual, something to not ignore, something to track down.

And then I believe the final question here is disclose the key issues discussed in the summary audit memorandum and here, 54 percent believe that the auditor should discuss key issues in the summary audit memorandum, and 18 percent did disagree.

If I were to rank all of the things that we surveyed here, quite honestly, I'd be giving you my candid opinion, I pretty much agree with the top of the comment here, only if issues were not resolved.

So yes, it would be important if there are issues that are not resolved, but discussing, in my personal view and that of Vanguard, to discuss issues that were resolved and that the auditor felt comfortable with would be of less importance to me. I recognize that we can't -- that in fact if we put everything into an audit report that we're surveying here, the audit report would be as thick as the prospectus and we know that very few investors read a prospectus which is the advantage of a summary prospectus.

So really observing the principle of parsimony, I think this one, to me, falls down a little bit lower on my list of priorities, but here is a summary of all of the questions in this particular section and you can see large agreement in most of these questions, very, very strong agreement, most significant being the assessment of the issuer's estimates and judgments, second -- and actually, again representing Vanguard's views and my personal views, I would say that is the most important thing to me that should be included in the auditor's report.

The second question was discussion of unusual transactions in the restatements and to me, if I were ranking these myself, that would be third for me, so very important. Again, assessment of quality of issuer's accounting policies and practices, strong agreement there.

My second favorite would be the next one, the discussion of sensitivity analyses, as I've mentioned before, doing stress tests, and then, finally, on the positive side, the discussion of key issues included in the summary audit memorandum.

But there were a couple of questions that I did not cover here that were in the survey where really the respondents were somewhat ambivalent toward. The first one was disclosure of all audit adjustments discussed with management and there, it was 50/50 whether or not people favored that or opposed it, and, similarly, grading the issuer's aggressiveness or conservatism in creating the financial statements on 1-to-10-point scale and again this was a 50/50 tossup.

So that's it for this next section and I will turn to Ann to present the final section.

MS. YERGER: Good morning, everyone. Given that we're sort of running out of time, I'm going to blow through my slides a bit.

I was charged with -- oh, no. This is why my husband never gives me the remote control. Can I touch a button to get rid of the -- sorry. I don't want to touch anything now. I won't touch it.

Well, let me start. My task is to summarize the survey responses relative to the form of the audit report. Okay. Let me just skip there really quick. Apologies, everyone.

I'm just going to roll through it. I think everyone's got it. It's going to be up on the website.

First of all, in terms of the form of the report, the survey did find that there was strong support for reform to the report. First, two-thirds of the respondents that had an opinion suggested and strongly supported expanding the assurance language in the current auditor's report to expressly state that that assurance in terms of whether there's a possible risk, a material risk to the financial statements as to a misstatement address whether that's caused by an error or fraud, and I know there's been a lot of debate over the years about what's the auditor's role in terms of detecting fraud and one of the comments on the slide sort of, I think, says it all, which is that auditors should state that they at least looked for material fraud.

Second issue was regarding the auditor partner's signature and slightly less than 60 percent of the respondents that had an opinion on that issue believe that the audit engagement partner should sign the report.

In terms of how should this additional information be presented to investors, I think somewhat north of 70 percent of the respondents that had an opinion on that believe that there should be a separate auditor discussion and analysis section. So there should not be an expansion of the current report but instead an additional report that would be provided in the 10-K.

Regarding whether there should be disclosure in that report of information provided to the audit committees, again somewhere north of 70 percent of those that had an opinion on that issue believed that, indeed, the report should include at least some narrative summary of issues that have been communicated by the audit firm to the audit committee.

Two issues that I'm not going to talk about but where we found there was sort of less support, first and foremost was this issue of whether that binary nature, that pass/fail nature of the current report should be changed to be more gradated, whether there should be the allowance for seeing reports or different grades in the middle, and there actually was a real split within the respondents. So I don't think we saw -- we didn't find strong support for changing the current kind of pass/fail model of the existing report.

And there was also, I think, more opposition, although still support, for the concept of greater disclosure about the roles of management versus the audit, the auditor in terms of identifying, detecting, and preventing fraud.

So I think the key takeaways from the survey are that status quo is no longer appropriate. It's real strong support within the respondents that there should be changes and expansion of the information provided to investors and I think our view, stepping back, is that this is the role of the auditor and there's a lot of questions about what's the auditor's role here in terms of costs and benefits and perhaps we'll talk about that more in the Q&A Section, but our belief is that what the survey respondents said they wanted is work that the audit firms are already doing.

The question here and the issue is providing more information to investors so that they can do a better job analyzing the quality of the reported financials, understanding where the risks may be with those financial statements, and helping them make a better investment decision.

So if I identified the top four issues that came out of the survey, there's this broad support for greater disclosure on the auditor's assessment of management's estimates and judgments and the process that the auditor used to reach that assessment.

Second, areas of high-risk to the financial statements and our concern here isn't operational risk, it's concern that the financials may be materially problematic.

Third, greater disclosure about unusual transactions, restatements, and other really significant changes, and, finally, the quality of the issuer's accounting practices and policies.

I think in conclusion regarding next steps, and I'm only speaking for Joe, Gus, and Norm, and Brandon, we weren't able to talk to you before this, so I don't want to put words in your mouth, but we would very much like to urge the Board to methodically but aggressively address this issue and resolve this issue.

It's been debated now for now 40+ years.

It's under debate around the globe. The fact is that our markets are known for having the highest standards in terms of transparency and quality of information to investors and we believe there's an opportunity and an important role for the U.S. to lead this discussion of how these reports should be changed.

Thank you.

Auditors Report and The Role of the Auditor

Open Discussion

MR. HARRIS: Well, Joe, Norman, and Gus, and Ann, thank you very much. That clearly showed a terrific amount of work and effort.

I will save my questions till last and reserve myself five minutes, if I may, and open it up to Chairman Schapiro, Chairman Doty for any words that they'd like and then we'll just open it up for questions.

MS. SCHAPIRO: Let me just -- I'm anxious to hear the discussion. I actually think this was a first-rate presentation and I agree with Steve, clearly an enormous amount of work and thought went into it and I think it will inform the discussion incredibly well.

So I really thank you so much for it.

MR. DOTY: Joe, first, a technical point and it's important, I think, for the Board.

I think you all adjusted your responses to focus on the people in these organizations who are actually investing the money and away from the individuals who might be giving multiple responses who are involved in other functions, is that true?

MR. CARCELLO: Yes, that's true.

MR. DOTY: So the preferences, the point being the preferences that you're summarizing here for us are the ones of the investor decision-makers.

MR. CARCELLO: As Jim said and I was able to give Jim an advance look at this yesterday, as we were thinking about this a little bit deeper, although we contacted only investor organizations, once the questionnaire got there, we had no control over who filled it out and so we had CFOs, we had controllers, we had board members, we had audit committee members, and not that their opinions don't matter, but I thought it might be interesting to see if only those who are in an investment function, who actually are buying and selling would evaluate these things differently, and the answer, Jim, is yes, very much so on every single question.

How often do you find that? Every single question, the investors evaluated the need for change higher than did the overall respondents. So what I've done here is I've taken the issue, you know, summarized it in, you know, just a couple of words on the far left column and then the overall mean in the next column, that's the old respondents, and then the investor-only and then the difference, and what you see, Jim, is that on some things there's a pretty big difference. They may say, oh, .37, .36, .34 is not that big a difference. It's a five-point scale and so some of these differences are pretty noticeable and so I think two takeaways again are there that, in general, investors want change more than the overall population and if you look at, you know, the ones that I have in bold are the ones where there was a big change and there seemed to be meaningful support.

I define meaningful support as a mean of 3.5 or higher, so materiality disclosure, risk disclosure.

Look at that risk disclosure number, 4.32. That's on a five-point scale. That's very, very high number. Unusual transactions, 4.1, 4, significant estimates and judgments, sensitivity analyses, quality of accounting policies and practices.

The numbers were high when we had the overall respondents. When you limit it, Jim, just to investment professionals, the numbers even go higher.

MR. DOTY: And to go back to Ann's recommendation to the Board, which I take it is the recommendation of the whole committee which is that we address it methodically but high-priority right away, and I may have missed this in Gus's presentation, but how do you all rank the priorities of the matters you'd like to see discussed in light of what you just put up?

Where, for example, do sensitivity analyses, discussion of what the auditor did, and what they performed by way of tests, where does that rate in relationship to some of the other issues, and then some kind of overall statement about where the auditor looked for misapplication fraud?

MR. CARCELLO: The four items that Ann

finished with, Jim, that last slide, those were the four items on the questionnaire that had the greatest support, both from investors and from all respondents, and we assessed greatest support in two ways: the highest percentage of people who said they wanted this information, either agreed or strongly agreed that additional information in those areas would be helpful, as well as the biggest difference between those who supported that information and those who didn't think it would be helpful.

So we basically took those who agreed or strongly agreed, compared it to those who disagreed and strongly disagreed, and looked for magnitude of difference.

MR. DOTY: I don't want this to appear rehearsed. You said we talked yesterday. This is not a rehearsed discussion. I do think I take away from what you have said, from what you have all said that the interest in the investor group is to get the information, to get it in a format that does not cloud or render ambiguous what's been the standard format of the report, the basic structure of what has been the audit report, and that how this information is delivered in your minds does not require or does not -- is not determined by any effort to enhance auditor private civil liability.

In other words, you all would be happy with a solution that reaches the results of the Treasury report and the results that your survey rendered given on the Treasury report, if it could be done in a way that did not enhance private civil liability audit firm, is that fair?

MR. CARCELLO: We've talked about this and Ann may want to jump in here in a minute because Ann and I have in particular talked about this at some length, and the sense that we have is our subgroup certainly and even some of the feedback we got from the questionnaire, this is not an attempt, certainly not by the four of us, in any way to reach for auditors' wallets.

This is purely an attempt to have better information and to the extent it can be done in a way that doesn't increase their legal liability, I think we would all be supportive of that.

MR. SPORKIN: Has anybody ever thought about making some of this interactive, have a day where you ask the auditor, maybe part of the annual meeting or something, where the auditor can be facing the investors and responding to questions, you know, so there could be something more direct rather than having to get some -- just do everything on paper? Is there anything -- any of this ever been done? Is there a reason not to do it?

MS. SIMPSON: Anne Simpson, Senior Portfolio Manager, Calpers.

In my experience, auditors do attend the annual meeting and we were at the week before last at the Apple Annual General Meeting and the question about the report to the auditors was why didn't they use iPads? So, you know, I don't think that forum is being used to grill the auditors.

Just while my section of the system is the microphone on, I want to say how strongly we support this, even though we were just on the sidelines, how important these recommendations are, and if anyone was in any doubt, we thought it would be interesting to look at the audit report in just one of the many companies that were big recipients of TARP and systemically connected to the mortgage crisis.

So we chose Bank of America. Here's the audit report from 2008 and that cost a 119 million. Here's the report in 2009, word for word exactly the same, and by now the price has gone up to a 193 million. This is the 2010 report, word for word exactly the same.

So with that as the backdrop, I think it really gives a sense of the urgency of tackling this issue and we very much like the idea circulating in Europe, and I think it was touched on by Ann, that instead of trying to do something with this particular document, we might think about the idea of an auditor's discussion and analysis which would be a different setting and allow for narrative reporting and something which would be actually useful.

I should also say that during this whole period, we didn't find an auditor with less than a 95 percent vote in favor of their reappointment. So I suggest the whole thing at the moment is being treated as a rubber stamp and I doubt anybody reads it because even though it's getting more and more expensive, it's not going to give you anything you didn't have several years ago.

You know, the auditor in this case has been auditing this company for decades. So that's what was done. Any improvement much appreciated.

MR. FERGUSON: This is Lew Ferguson. As you looked at this, did you think about the consequences, for example, if these reports are made more subjective and more analytic, what the consequences for comparability among reports would be and among, for example, among audit firms, that whether they might use different standards that would be difficult to compare, and how does one address that?

I mean, one of the few advantages of a binary report is that presumably the language is both formulaic and it's either on or it's off and they're comparable, but as you get to a more analytic report, obviously there's much more subjectivity in it.

How do we deal then? How do investors deal with that for purposes of preparing reports?

MR. CARCELLO: Let me take a first shot, Lew. A couple of responses.

One, I think the sense that we have from our respondents is that they would prefer to keep the audit report as is, binary on or off, as you said, and then supplement it with an AD&A and that may also get to Jim's concern about legal liability. There's ways to do that. That may help on that front. So it would be in an AD&A.

Now you still have the same issue. The AD&A may not be comparable. So it just translates to a different document.

There's a couple of ways to potentially deal with that. One is presumably if the Board did move forward on this and did require an AD&A, they would put some standards around it, right? So that's a challenge for Marty and his team, but I think they could take that on. So there would be some guidance on how auditors do this. So it wouldn't just be completely free form.

Secondly, you do have an inspection and an enforcement function and so if auditors don't apply some degree of consistent standards in doing this, you get at that through inspection and enforcement, but there's also a third way and that is the market, right?

You know, Gus has a lot of smart people working at Vanguard and that what they'll find is if these disclosures are not transparent, are not good, and if over time the disclosures of things like risks and uncertainties and judgments don't map to subsequent realizations, when Vanguard casts their vote on whether KPMG or Ernst or Deloitte or whoever, Grant, is reappointed, maybe they won't vote for them and maybe it won't be 95 percent anymore.

So more information generally makes markets work better.

MS. YERGER: One observation is, I mean, I think the biggest risk obviously with any request for more disclosure is that we end up with boilerplate disclosure. So I think there would be an expectation that certain companies would have different disclosures.

You would hope the reports would not be the same because they're different entities, I think with the different approaches, different tones at the top, and I have to second what Joe says. If we can develop -- if you can develop a format that provides meaningful non-boilerplate types of disclosures to investors, I think actually there will be pressure from the marketplace to increase the standards.

It will be a great way of compare what the firms are doing and I think ultimately it's going to be in the best interests of the marketplace at large.

MR. HARRISON: Could I weigh in? First, I agree violently with everything that Joe and Ann just said, but I wanted to relate your responses back to Jim's question a minute ago about the perhaps in some respects overarching issue here of auditor liability and, you know, that is a concern I hear in a lot of discussions I've had.

There's a flavor of it, I think, in the survey results but certainly people I talk with about this issue, you always hear the concern expressed that if there are new disclosure and reporting standards imposed on auditors, it will devolve into lawyer-drafted boilerplate, much as the current auditor's report is, for that very concern.

So there is a tension here but I also think an opportunity to strike a balance, which, as Ann very rightly says, I think, that it may be appropriate to prescribe a format in which the enhanced auditor disclosure will occur but permit it to occur in a way that it is necessary that in order to comply, there be a substantive narrative discussion and disclosure of these important categories of issues in a way that invites comparison among companies and gives investors actual meaningful information, meaningful intelligence to inform their investment decision.

That, I think, is the key balance to be struck here and in any new rules going forward.

MR. HARRIS: Why don't we recognize Barbara, Gus, Lynn, and then, Jim, if or Mike have anything that you want to either ask or engage, the Chairman's got to get out of here at 11:10, I want to save three minutes for myself for question, but why don't we go in that order and if there's additional time, we can recognize others.

Barbara?

MS. ROPER: Thanks. First of all, Joe, great presentation. Everybody, that was really terrific.

So as I look at these issues, it strikes me that there ought to be two goals coming out of this. One is that you focused on extensively which is giving investors better, more useful information, but the other is, at least as I think about it, how do we drive the behavior that we want in the audits, and I think ever since I started on the SAG, I've heard someone at every meeting, so I'll be the one at this meeting who says you manage what you measure.

To the degree that we require some of this information to be brought out in the open and I would say make auditors accountable for how they present this information, you know, I think it has an opportunity (1) to help in this, you know, really huge challenge we're facing as to how do we ever get auditors to think of themselves as working for investors.

This, I think, is helpful in making them sort of think about how they're communicating with investors, talking to investors, rather than just rubber stamping a management document, and if they have to report on some of these issues about risks and whatnot, maybe they'll think a little more seriously about them when they do that, and I think that would be useful in some of this helping to change the culture, but, you know, I have to say this issue of liability drives me a little crazy because it would be hard for me to imagine how it would be more difficult in this country at this point to sue auditors after PSLRA and after all of the court decisions that we've been through.

It is this immunity from liability that I think has contributed to a culture in which auditors don't feel like they have to be responsive to shareholders, do find their way to get comfortable with management's numbers, and don't serve their public watchdog function.

So while I recognize that the threat of liability is used as an excuse to present boilerplate information and I think that's a threat in this area, that we will end up with boilerplate, somebody needs to be prodding them from the other side and saying, look, it's not going to pass muster and that strikes me as the responsibility of the Board.

MR. SAUTERS: At the risk of piling on, I'd say that we recognize what we're reading in a financial statement is an estimate and a best estimate perhaps and that there's subjectivity around that, but I think we would argue that more information is better than less and even if an auditor gives us a range that isn't accurate, at least it's probably a more informed view than we can do on our own independently because obviously they're much closer to the action than we are.

Over time, as I think Joe and Ann indicated, we do think that those estimates will become better. We will have an idea, just developing our own time series, of successive estimates from a given auditor and we'll know how to calibrate those.

So I think we would certainly err on the side of more information, not less.

MR. DOTY: Steve, one brief interjection to Barbara's point.

There are, of course, cases making their way along which come out of the financial crisis. We don't, for reasons that Dan discussed earlier, we don't discuss our investigations and our litigation, but we wouldn't want -- taking Barbara's point, we would not want the group assembled to assume that we are simply quiescent and oblivious.

MR. TURNER: In fact, Jim, based upon conversations I've had with the Defense Bar, it seems like you guys are really stepping it up on the enforcement stuff which is good to hear, knowing that that won't come out for a long time.

But I do have comments along two lines. One, the legal liability issue that Barbara mentioned, which we did discuss on the ACAP report, and then some of the other issues that have been teed up in the presentation.

First, on the legal liability issue, the ACAP did request from the firms and the Center for Audit Quality a fair amount of data on the cases so we could go in and look at the cases and see what the cases actually involved and whether or not these were legitimate cases or not.

The firms refused to provide us that data, quite frankly, which was somewhat disturbing when you compare it to available data, if you looked at the Stanford Clearinghouse, Cornerstone Research, Neerie.

On average, for the last five years, notwithstanding the fact that that time frame encompasses when there's literally been hundreds, thousands of restatements, thousands of restatements, when there's been a subprime financial crisis, we have averaged just six cases being filed against the entire auditing profession on securities matters involving federal securities law, just six a year on average for the last six years.

It goes to Barbara's point, that with the Dura Pharmaceutical case, which upped the bar phenomenally with respect to loss causation, and with respect to Tell Apps, it has made it almost impossible to sue the auditor today.

So unless the auditor is going out and in one of these statements, expanded statements making misstatements that they knowingly know or recklessly made, there's no risk of litigating that. Now someone may sue them but those cases aren't even getting past the motion to dismiss these days.

So despite the fact that the firms like to always take us back to the '80s and early '90s, pre-SLRA, when there was a lot of litigation, that times have changed. That's just not the case today and legal liability, unless the firms are willing to come forward and make public what those cases are and demonstrate that they are -- you know, there's a legitimate concern over some of these things, that's something that just shouldn't be done.

I recall when we were doing the auditor independence rules. The firms all came in and said if we did those rules, we'd destroy the profession, they couldn't hire anyone, kids wouldn't want to join on. They met with Commissioner Hunn at the time. He wrote them a letter saying, well, give me the data and the firms again refused to provide him the data. So they said you can't go forward with the rulemaking without the data but we won't give you the data and it seems like that's what we've got. It's certainly what we saw with the ACAP Committee.

So I think the litigation issue is a huge red herring and I think if you go back and read the results in the ACAP report, you'll see that there's discussion about just that in that report in light of what they wouldn't give us.

On some of the issues that are up here in front, I understand the SEC's going to hold hearings this summer, as was mentioned, on financial reporting and auditing, and I think that is fantastic. I think that's a very good proactive move. I think there are some serious issues out there.

But I think, as I look at this, it reminds me a lot of the earnings management initiative that we did and we broke that up and between the auditing groups, the accounting standards-setting group, and the piece to the SEC, and I see a lot the same here, here people are asking the auditor to say tell us about the unusual transactions.

Well, that was a recommendation in the 1978 Manny Cohen report saying the FASB ought to turn around and require disclosure of all unusual transactions. The FASB, unfortunately, never acted on that. If we'd had of had that, when Cohen so aptly recommended it, we wouldn't have had some of these problems, but I think that is really a FASB -- something in the FASB arena rather than in your arena or the auditor and I'd say the O'Malley panel in 2000 recommended that the FASB put out something on going concern. That's 11 years ago now, coming up on 11 years ago. That, I think, O'Malley had it right. That's in the FASB arena and they've been slow, extremely slow.

Our standard-setters at times are slower than the seven-year itch on acting on some of these, you know. Eleven years, probably someone ought to be able to write that standard.

MR. HARRIS: Lynn, I don't want to do it to you again, but I think I have to because the Chairman's going to get out of here in 10 minutes. Tony's got his card up. Brandon's got his card up. I want to give Jim an opportunity and I'll cede my time, unfortunately, although if there is any time, --

MR. TURNER: Just a second, Steve. Just a second.

MR. HARRIS: -- for one second, but hold -- no, no. Hold on for one second. I want to get to any benefit-cost analysis you've done with respect to your one or two top recommendations. So take another minute, let's see if we can wrap up in 10 minutes, and go ahead, Lynn.

MR. TURNER: Yeah. So I'd come back and I'd say you can split some of this up. I think some goes to the FASB, some is in the purview of the PCAOB, and you ought to sit down with the three of you and divvy it up, who's going to do which pieces.

On the risk-management piece, you'll recall the big six firms at the time, big eight, I guess, came to the Commission and with a very good proposal on what should be done with respect to disclosures on risk management and I think that's worth -- I think what the firms had put together was very good and it's worth going back and revisiting that again, as well, because I think they had some good ideas then that people poo-poo'd and I think in hindsight what the firms had recommended probably people should have given more thought to.

MR. BECKER: A quick word for incrementalism. I think people should speak truthfully and it would be helpful if we had a more robust discussion and analysis by the accountants, but if I could get there by sacrificing, redoing the litigation reform debate, and if I could get there quickly rather than try and make sure that I get a fully robust discussion, I'd rather break the dam, as it were, and get that discussion and analysis and then fight another day about legal liability and the robustness of that discussion.

MR. SONDHI: I just wanted to say that, based on the last 11 years of being a standard-setter and many more years of working with different standard-setting bodies, the cost to standards of the issue of legal liability for auditors has been enormous and it continues to weigh on us.

They're always invoking it. They're always -- it always affects the standards that we have and I think it's time that we did something about that.

MR. HARRIS: Jim, would you like to make any comments, or Mike?

MR. KROEKER: Sure. One, I think thanks. You've made a compelling case that when your customer says they want more, the status quo isn't acceptable, and I think the case is compelling for that.

Lynn, I think, actually addressed my biggest question was whether this is just an issue about auditing standards, in some cases, estimates or judgments. I'm really interested in if that's a cry for we're not getting what we want out of accounting standards and if we're not getting it there, is there more to be done on the audit front and so I think you're pretty clear that a holistic approach, if something's broke in the accounting standards, let's focus there, but if there's any more on that, I'd really be interested, as well.

MR. CARCELLO: The only thing I would add quickly to that is, and this is only a couple of anecdotes, a couple of investors told me this when I talked to them via phone, is they said, you know, the FASB has become so prolific in disclosures that some would argue there's disclosure overload and so that there's issue of the quality but there's also the issue of the quantity.

One of the things they like about the auditor giving some opinions in these areas or additional color around these areas is that the best management is biased. Even if they're honest, they're still biased because they see the world through their own lens.

And the second problem is you've got to wade through that and they felt that it would be both more objective and much more efficient and they really estimated -- they really emphasized the limitations on their time if the auditors would succinctly in an AD&A talk about some of these things.

Now again, we didn't ask that specifically. So that's only a couple of people who told me that via phone but that's at least one counter argument to just relying on the notes for the disclosure.

MR. KROEKER: I appreciate the point on objectivity which is a passion of mine. I think it will come up throughout the rest of the day, as well, is are there things -- if we're going to increase the reliance on auditors for providing additional information beyond pass/fail, what additionally do we need to do about objectivity?

MR. TURNER: Yeah. Jim, I think you raise exactly the issue and I hope you'll take this up in the roundtables, but the bottom line is to actually you and Joe make good points.

There's data with respect to estimates that auditors probably aren't on top of it as management is, so that should be in the footnotes, and I think, yes, investors have been clamoring for more in the footnotes with respect to estimates. You can look at FASB projects over the last three decades and one after another investors have clamored for that from the FASB and the FASB doesn't give it to them. So it's no surprise we are where we are today.

I personally think there is just a serious deficiency in that process.

On the other hand, it is clear that investors I've talked to, while they want to get the information from management, they also want to get the investor's perspective and the audit firms have been saying, well, let the audit committee provide that, but the audit committee, and I've served on three, four of these, the audit committee doesn't have the same perspective because they're not out there doing the audit.

So we also want to hear from the auditor their color commentary on that data and so what you're really looking for is a wholesome product that gives you both better disclosures and information that rightly should come from and be the responsibility and obligation, quite frankly the liability of management, and then this color commentary from the auditor on that information and that takes kind of a joint work of all three of you, quite frankly, to get it done right.

So I think you're dead on target with what you were suggesting there.

MR. HARRIS: Joe, could you just answer my question and that is, with respect to the benefit-cost analysis of your top two recommendations, have you thought about it? How costly is this going to be versus how beneficial it will be?

MR. CARCELLO: This is obviously opinion. We don't have any data on this, but if you look at our top two recommendations, more information about the auditor's assessment of risk, Steve, and more information about the auditor's assessment of estimates and judgments.

If the auditor hasn't gathered that

information, it's not a GAAS audit. You can't do a GAAS audit without assessing risk. You can't do a GAAS audit without assessing estimates and judgments. So clearly they have the data.

We're not talking about -- this is not 404(b) revisited. Okay. This is data that exists in the workpapers. So any incremental cost, and I don't want to, you know, start the hornet's nest again, but any incremental costs would only really be reflective if firms feel that, as a result of disclosing that, their liability goes up and they try to price that.

Beyond that, I don't see where the incremental cost really is coming from cause the data exists.

MR. HARRIS: Okay. Bob you've got the last word.

MR. TAROLA: Steve, I just wanted to mention that the auditor's already providing this kind of sensitivity analysis to the audit committee by virtue of required disclosures to audit committees. I think what our group is suggesting is that that gets translated in a meaningful way to investors, not just audit committees.

MR. HARRIS: Thank you very much. Thank you, Joe, for all the work. Thank you very much to the group. Chairman Schapiro, thank you, first and foremost, for spending the time. We know your busy schedule and, as I said, we really appreciate your coming. Thank you.

Why don't we take a 15-minute break and get back here -- well, 11:30.

Thank you.

[Recess.]

MR. HARRIS: Barbara, thanks a lot. Our next presentation is by the Working Group that has been examining the Lessons Learned for the Auditing Profession, that may be learned by the Auditing Profession, that may be learned from the Recent Financial Crisis.

The Working Group, led by Barbara Roper, includes Michael head, Damon Silvers, Anne Simpson, and Tony Sondhi. I understand that Brandon and Pete Nachtwey also made contributions to this presentation.

When the Investor Advisory Group discussed this topic at its last meeting, it was combined with a discussion of the possible creation of an antifraud center at the PCAOB and some members suggested such a center could examine not only instances of possible fraud but also systemic risk to financial reporting beyond fraud.

The center then could publish information in anonemized form that might assist auditors and others to look forward to find where the next fraud or significant market event might occur.

The Board is continuing to consider the formation of such a center and with that introduction, Barbara, I turn it over to you and thank you very much.

Report from the Working Group on:
Lessons Learned from the Financial Crisis

MS. ROPER: Great. And thanks to all of my Working Group members for their help in putting this together.

I'm not going to repeat at length what I said earlier this morning but I would like to run through and highlight some points, just basic introduction to the issues that we were trying to address as part of this working group.

Our basic assumption is that auditors or perhaps it's fair to say audits failed to perform their basic public watchdog function in the financial crisis and we believe that there's a need to figure out why they failed to perform that function and what can be done to fix that problem.

We thought we fixed it when we passed Sarbanes-Oxley Act. We made auditors -- we sought to make auditors more independent and to give audit committees more control over the audit with the idea that that would make auditors more willing to stand up to management in their review of financial reports.

We created the Public Accounting Oversight Board to raise the standards for auditors and hold auditors accountable for meeting those standards in the hopes that that would improve the quality of audits and that together these would give investors financial statements that they could rely on to give them the information they were looking for when they invested in public companies.

The recent financial crisis, in essence, provided the first major massive test of the effectiveness of those Sarbanes-Oxley Act reforms and, you know, by any objective measure, at least from the point of view of investors, they failed that test.

This is just a sampling of the financial institutions, major global financial institutions that failed or were sold in fire sales or were prevented from failing by virtue of massive government intervention, all of which had received unqualified audit opinions within months of the failure, and as you see, all of the audit firms represented with clients on that list, and I think the point that Damon made earlier is exactly the right one.

If the auditors were performing as they should and this is the result we get, then there's a problem with the system that says that's an appropriate audit.  It may not be a problem with the auditor. That's why I said earlier, it may be fair to say that audits rather than auditors failed to perform their function, but I think it's impossible to look at that list and not at least raise questions about whether auditors didn't play a fairly significant role in the financial crisis.

Some of the obvious areas: did their failure to adequately test valuations help companies to hide significant information their deteriorating financial condition from investors? PCAOB inspectors found that auditors in some cases were not adequately testing valuations. How did that play into the financial crisis?

Did they allow companies inappropriately to hide risks off balance sheet? Again, PCAOB inspectors found that in some cases they were not adequately testing whether it was appropriate for those to be treated as off balance sheet assets. So, you know, what role did that play in causing the financial crisis?

Did they agree to or perhaps even help to design transactions whose sole purpose was to hide from investors the degree of leverage that companies were taking on, and if the answer to those questions is yes, and many have suggested that the answer to those questions is yes, it, at the very least, raises concerns that, as the U.K. Financial Services Authority said, they showed a worrying lack of professional skepticism, but if the answer to those questions is yes, it may not only have deprived shareholders of information but contributed to a situation which lack of transparency helped to freeze the credit markets and really worsened the financial crisis.

So this is a significant issue that needs to be addressed.

As I said earlier, we're told that part of the problem here is an expectations gap. Investors have unreasonable expectations about what they can expect from the audits of public companies. I provided -- I'm not going to read them but I provided some -- and you have in your packets some of the things that have been written by independent observers which express a high degree of frustration, anger, cynicism that's really troubling, you know, as is the statement about the lack of investor confidence in financial reporting and auditors' financial reports and even raise questions about whether the audit itself, if it can't do a better job, has become irrelevant.

Contrast that with the statements from some of the audit firms themselves which express less concerns, shall we say, and in fact, in some cases, seem to express a degree of complacency about the current situation and if this is, indeed, the best we can expect from audits, it does really raise significant questions about what the value to its shareholders is, investors is of, you know, the audited financial statements.

For the most part, at least in this country, the auditors have sort of escaped repercussions. They haven't gotten a lot of attention from Congress which, as I say, has largely proved to be a good thing, given what Congress chose to do in this area, and the Financial Crisis Inquiry Commission, you know, had sort of its hands full with all of the issues it was supposed to address.

There is actually, if you look for it, quite a bit of information in the Financial Crisis Inquiry Commission report that is interesting. If your concern is about lack of transparency on financial reports, if your concern is about some of the relationships that appear to have existed between auditors and some of the companies in the role of this, and in the slides I've highlighted a few of the cases.

The report gives most attention to the issue of AIG, Goldman Sachs, and PricewaterhouseCoopers which was auditor to both of those firms, and there's some sort of interesting and at least to me kind of shocking things that you come across if you dig into that report, like the fact that at the point when Goldman Sachs started pushing AIG for collateral, AIG Financial Products didn't have a model or otherwise try to value the CDO portfolio that it guaranteed through credit default swaps.

So the company had an exposure of $79 billion and the parent company's, you know, total reported capital is $95.8 billion. They don't have a model for valuing that exposure and that seemed to be fine. They got no questions apparently from their auditor about that problem and in fact their auditor, like many of the executives at the company, didn't even know that there were collateral provisions in these contracts.

So, you know, this huge risk that ultimately brought down the company that isn't apparently on anybody's radar screen that would seem to be relevant information, and then the other sort of event specific to this audit that was highlighted in that report is that the auditor, to its credit, had started raising some serious questions about the risk management practices, the valuation practices at AIG.

They had concluded that -- they had serious problems with value that AIG had reported to shareholders in December about taking a negative basis adjustment to reduce from 5.1 billion to 1.5 billion their loss estimate from their CDOs, but they let that disclosure go out to investors in December.

It wasn't until February that they brought it up with the Board and, you know, I have to ask, along with the FCIC, you know, why the auditors waited so long to make this pronouncement that there was a material weakness in their controls. It's unclear, particularly given that PWC had known about the adjustment in November. So November to February, they know about it, they're concerned about the controls, but they let that information go out to shareholders. So those -- you know, so as I say, there's some things that have come out.

Then there's another in the report, they also -- not in the report itself but on the website, there's a document with regard to Citigroup that raises some serious questions about the role of the auditor, given that a week after Citigroup had gotten a report from the OCC that their controls were a mess, they put out a financial statement that said everything's fine and the auditor signed it and attested to the quality of controls.

That strikes me as another area we could stand to get, you know, better insight into. How common were those practices? Why? I mean that's the big question in all of this, I think. Why does that happen?

So then, as I said, the PCAOB has done its own report and actually, you know, it is a useful document. It provides some very beneficial information, you know, insights into some of the problems that occurred that logically one might expect played a role in the financial crisis, the problems that the inspectors found with regard to fair value measurement and off balance structures being sort of at the top of the list of seeming-like areas that deserve more study.

But that report is just a starting point in our view. There are a couple of reasons. Its focus is on the effect of the financial crisis on audits rather than the role of audits in the financial crisis. It presents its information in very generalized terms and, most importantly, it identifies where auditors fail to perform up to standards but it does not attempt to analyze why those failures occurred or what needs to be done to prevent or minimize the chances of a recurrence.

So, as I say, it provides a valuable starting point for the kind of further review that we think is necessary but a starting point only.

So, as I said, in this country, there's been relatively little attention to these issues up to this point. You have to sort of dig for the nuggets in other documents but we think a more indepth study needs to be done.

Ann is going to talk a little bit about

what's going on in the EU and the U.K. where they have begun to look much more extensively about some of these issues that we think should be delved into in this country, as well.

MS. SIMPSON: Thanks very much, Barbara. Well, thank you to the whole of this group. We had some very good discussions and I must say, Barbara, thank you very much for leading it because it was not an easy crowd to get together and an almost impossible task.

You know, what went wrong, why did it go wrong, what should the PCAOB be doing about it? So I think Barbara set the scene very well for what our concerns are.

My task, at Steve Harris's suggestion, is to take a look at what's being done internationally, give you some of the highlights, and we hope this presents a menu of ideas for the PCAOB because these big questions about why the watchdogs didn't bark, these questions are being asked in other jurisdictions, but the U.S. is the largest capital market in the world. It's the market where the home market for the big four audit firms, and it's just phenomenally important that the PCAOB takes this agenda up.

So, you know, our congratulations to the appointment to the new board members. We really think this is an important issue.

So in just a few minutes, what I'd like to do is give you a flavor for the different initiatives that are there. We've put together a six-inch file of these various projects that are going on internationally and for that, I'd like to thank Mary Morris and her team at Calpers for doing the background work but if anyone is interested in the projects that I'm going to refer to, please let me know. I'd be delighted to send you the links.

So the first thing I want to say is that there are at least a dozen different inquiries that have been launched in different countries and I'm only going to talk about Europe. So all due respect to Asia, Latin America and other parts of the world, this really is a European discussion.

I just want to read off the titles of some of the to give you a sense of the scope. So the Financial

Reporting Council, their project Enhancing Corporate Reporting and Audit, a separate report on Auditor Skepticism, the Auditing Practices Board Ethical Standards for Auditors, again the FRC Audit Committees and Non-Audit Services, and then an Audit Firm Governance Code issued by the Institute of Chartered Accountants in England and Wales which is really trying to get at this whole agenda of the governance of the audit networks without having to wait for some global legislative initiative.

So there's been a very wide and diverse range of activity but I think the key inquiry is being led by the European Commission which has issued a green paper towards the end of last year which was framed on the theme of Lessons Learned from the Financial Crisis - Audit Policy, and I just want to give you the full quote which Steve touched on earlier which Michael Barnier, the European Commissioner, who's responsible for this, conveyed a real sense of urgency when this -- in February, just last month, when this project had an open meeting on all the submissions they gathered so far, and this is what he said.

The title of his speech was Audit 2011 and in French the title was Lanee du Lévesque, which I think loosely translates into the audit as audacity, but he sees this, I would say, as a loose translation as time to get on with it and no holds barred. This is an opportunity for a root and branch, fresh look at what's going on on the audit.

So this is how the paper is framed. He says, and this was what Steve mentioned earlier, "The status quo is not an option for the auditing world. It's not about changing for the sake of change but to reply to the very real needs which we can no longer ignore."

So there's a discussion which will seem very familiar to the United States about what went wrong and how shocking it was that nothing was mentioned in audit reports. However, I think what's interesting about this project and maybe for the PCAOB worth looking at, our investor group would certainly encourage you to go in this direction, is how broadly they're framing their questions.

So let me give you some examples, certainly the ones that caught my eye. On the audit industry, first question. This isn't their language in the question. Please understand this is me giving you highlights. I'm sure they do have a far more subtle way of putting it. This is my take as an investor of what they're asking.

So, first of all, how have the global big four firms become a systemic risk in themselves? And the question that follows from that: do we need to take measures to introduce the equivalent of living wills or measures too big to fail, which obviously have been preoccupying reform initiatives around financial institutions?

And in that regard, they're interested in this idea of living wills, what would that look like for another collapse of an audit firm, and transitional support, for example, through joint audits or a move to audit consortia? So that to me is a very eye-popping thought and something really worth thinking about.

The second big question, which is about the way audit firms are currently organized, has the partnership model reached its limit? Is it time for both restructuring and also downsizings? Another part of addressing their concerns about systemic risk with the big four, and that would also be an opportunity, they think, for us to consider allowing new corporate forums to be developed, raise capital, and help with entry for new players.

Third big issue that they put on the table: is the supervisory system truly independent of the audit firms? Parts of the standard-setting world receive funding directly from and also have representative seats for members of the audit profession and they would really like to look at that again and see whether it compromises independence.

Another fundamental question: should auditing ever be provided alongside other commercial services? Should auditing even be a commercial service? They posed the question in certain circumstances, should the audit actually be conducted by a non-commercial body? Should it be a regulatory or supervisory body that goes in to do the audit, for example, of systemically-important financial institutions?

So we cannot criticize Barnier for being timid. This is no shrinking violent there in Brussels, but there's more.

Let's turn now to what they're asking about the role of the auditor, sort of taking the whole industry. There's a whole section of the inquiry about the industry itself.

The next thing about the role of the auditor and here are a few highlights from the questions that they're asking. So have we got to a situation where the reasonable assurance provided by auditors is less concerned with risk, which is what it was meant to have been concerned with, and more concerned with simple conformity to standards, and have we gone -- we've lost substance over form, an issue that was touched on earlier.

Secondly, should the audit methodology be communicated to stakeholders? Note, interesting as this is Europe, it's not shareholders, it's stakeholders, and, in particular, and I think this is very interesting, thinking about Damon's comment about valuations on -- you know, around mortgages and mortgage securitization and derivatives, products run from those, should we in particular have substantive verification of the balance sheet, which is part of a bigger question they're asking about getting audit -- should we be thinking about audit going, as they put it, back to basics rather than focusing on processes which perhaps are more properly the task of management? So that's answering the question that they're asking it.

They also have a section on auditor behavior. This is sort of auditor anthropology, I suppose. What could be done to foster professional skepticism and part of that obviously is independence and objectivity which we've touched on, part of it is training, part of it is reward and incentives, but it is a behavioral question. It's not something that you can define easily.

And also they spend some time asking questions which we have touched on here about how do we move away from an up or down, yes/no answer with the audit opinion, and they do actually ask some interesting questions about if you did have an auditor's discussion and analysis, you don't want a lot of fluff. You do want something useful. You don't want to stray into being vague again. So there's some real discussion around that.

And finally, they do flag up should auditors also be opining on material, environmental and social risks, and I think we've seen companies, you know, even in the U.S., where the risks being run on environmental issues are -- have proven to be material. So that does, of course, pose a question about what the auditors might be doing about that.

So let me just finish with the wrap-up questions which, if we could find a group of ideas or issues for the PCAOB to tackle, I suggest it would be captured in these less than a dozen questions.

So, first, do you believe the audits should provide comfort on the financial health of companies and audits fit for such a purpose? So to bridge the expectation gap and in order to clarify the role of audit, should the audit methodology employed be better explained to users?

Thirdly, should professional skepticism be reinforced and how could this be achieved?

Fourth, should the negative perception attached to qualification in audit reports be reconsidered and, if so, how?

Is there adequate and regular dialogue between the external/internal auditors and the audit committee? We touched on that in Ann's discussion. If not, how can it be improved?

Do you think auditors should play a role in ensuring the reliability of information companies are reporting in the field of corporate social responsibility?

Should there be more regular communication by the auditor to the stakeholders and should the time gap between the year-end and the date of the audit opinion be reduced?

And then my favorite which I think will keep everyone occupied for a very long. What other measures could be envisaged to enhance the value of audits which I'd be fascinated when they do publish their comments to see what else people came up with.

So I think I would recommend this particular initiative at the European Commission to the PCAOB

Board for consideration. Chunks of it are not relevant. They're about how do people in Finland go and audit companies in Germany and, you know, all manner of things very particular to Europe, but I think what I find valuable is the willingness to put everything on the table, even if they don't have the answers, and to have a very broad-ranging inquiry to see what might come back.

They're planning to come back with proposals later this year, but I certainly think we might -- I'm sure you're already in touch with your counterparts in the European Commission on these issues, but I'm sure they'd find it valuable to, you know, be helping shape the agenda that the PCAOB will take.

Thank you.

MR. HARRIS: Thank you, Ann. Tony?

MR. SONDHI: I've been tasked with giving you a sense of the recommendations from our working group, but I wanted to make two points before I get into that.

Barbara, in her excellent job earlier, was talking about the AIG reported capital and she mentioned that 80 percent of it was so and so. I wonder how many people are aware that of the AIG Financial Products Unit, the unit that actually imploded, roughly 80 percent of its capital actually came from the deferred compensation of the CEO of that unit. How much comfort do you think an investor derives from the fact that 80 percent of the capital that stands behind the company comes from the deferred compensation of the CEO?

The second point that I want to make is that if you think about disclosures and what's happening with them, recognition and measurement today is insufficient to provide an adequate picture. So the numbers that you see in the set of financial statements, the only way to understand them, I think, is to be able to read the footnotes and understand what they're talking about.

So if you have footnotes that are boilerplate and you have footnotes that are not being audited, there's an extraordinary amount of a gap in there. That deficiency, I think, is rather significant.

I think I've mentioned this before here when I first went to the IETF at the FASB, I made a comment that in coming up to the building I had seen a sign outside that said that accounting is not discussed after 4 p.m. on Fridays and below it, it said that disclosure, however, cannot be discussed before 4:30 p.m. on Fridays.

I wonder what that similar sign is for the auditors. Does it mention when or whether they even talk about disclosures? I want to be very clear. I'm not talking about the people from the accounting firms who serve on the IETF or go on to serve on the FASB. I know they are aware of disclosures. I'm talking about the field auditors. What are the processes that they follow with respect to disclosures, with respect to auditing those, and I think that's where we're finding some of the problems.

Now to the recommendations. Our first recommendation is that the PCAOB launch an indepth study into the role of the auditors and the audit, as you've clarified, in the financial crisis, as enablers maybe of the financial crisis.

I think the objective or we feel, I'm sorry, the objective should be that we need to identify the causes of the pervasive audit failures and then propose and in a timely fashion implement remedies to those.

The working group also recommends that the PCAOB make this indepth analysis an ongoing part of your process.

Another set of recommendations or thoughts, I think it's time to revisit SOP-94-6 on disclosures of significant risks and uncertainties. I think if you think about the fact that that particular disclosure requirement didn't really help us very much with this last crisis, maybe we need to update that and take a look at it.

I think, for example, if you look at, as Lynn had mentioned, Enron, WorldCom, and some of the other companies that were part of or responsible for the crisis, earlier crisis, I should say, those disclosures did tell you a fair amount, but you had to go through them, you had to read them, but they did not, no matter how well you analyzed those, they did not give you the full scale of the problems. So I think we need to do something about 94-6.

I think we need to reconsider the audit

procedures as they relate to liquidity, financial flexibility, and off balance sheet financial statement assets and liabilities.  So I'm expanding it from risks, not just the off balance sheet risks, and this again with respect to financial flexibility, the off balance sheet.

I remember organizing a conference about off balance sheet risks in 1984 and Lynn had pointed out earlier that one hopes that seven years would be sufficient, but I've actually done an analysis, Lynn, if it takes the FASB seven and a half years, they normally don't reach a conclusion.

One outlier on that is control and consolidations which they quit after 23 and a half years.  So I think that we need to look at those.  By the way, I'm not making these numbers up.  You can actually look them up, if you want.

And then, finally, I think another point that has been made before and specifically by Lynn, and that is, we need to be very, very clear about where and what the responsibilities of the PCAOB, for example, are when inspections turn up problems with the application of the accounting standards.

We need to be very, very clear because that's one of the most difficult areas. Is the problem with the way the standard was written? Is the problem with the way it's being implemented? Or is it an issue of audits? I'm not suggesting that it's always going to be straightforward and that may be one of the most difficult recommendations to consider, but I think it's critical, and I certainly will be happy to answer any questions.

MR. BECKER: Just two small points. We were well aware that the Board, like any organization, has its own resource limitations and we're not privy to the internal investigations that the Board is undertaking, but despite the potential breadth of the postmortem that we described, we do think it's critical that we undertake such an inquiry, not with a view toward necessarily assigning blame but literally with a view toward trying to learn what we need to do to change things on a going forward basis, so that to the extent the Board feels it's necessary to skinny down or otherwise target the breadth of what we've described, we do think that that inquiry is worthwhile or otherwise it will just drift into dust, but we recognize that there will be resource limitations. We don't think that duplication is appropriate.

Second. We debated, as Tony's careful remarks highlighted, what we recognized to be the potential boundary issues between standard-setting and implementation.

We think, if anything, those boundary issues argue for this inquiry because when you have a split between standard-setters and enforcers, as you will, there is enormous potential for gaps to develop. The standard-setters may or may not appreciate what the enforcers are finding and the enforcers may feel limited in their ability to make recommendations regarding standard-setting.

So, if anything, we thought that that split argues for taking a very careful assessment of what did happen on the ground, potentially with a view toward either making recommendations with respect to standard-setting or enhancing the coordination between standard-setters and fact-finders.

So that rather than be a limitation on such an inquiry, we see it as an opportunity to enhance the flow of information between and the benefits from coordination between standard-setters and fact-finders.

MR. HARRIS: Well, Barbara and Ann, Tony and Brandon, I think that was extraordinarily helpful.

Why don't I turn it over to Mr. Chairman, to you or others that have questions and I'll have some of my own, as well?

Lessons Learned from the Financial Crisis

Open Discussion

MR. DOTY: Thank you, Steve. To go to the last one first, I think it's important and useful to know that we do re-evaluate the forms, the inspection forms and the materials we employ in inspections, and I take it that one of the things that may be useful is if you're suggesting in the basic formatting of an inspection, if some careful attention be given to areas where the inspection team finds what it thinks may have been an issue, an issue of standard application or misinterpretation of the statute, of the standard.

I think that's something that the people behind me are giving a lot of thought to now, but with respect to the first one, the big one of the ongoing study, I very much appreciate the focus you've given it, Brandon and Tony.

Is it the group's sense that we ought to hit certain of the instances -- for example, mention was made of the Citicorp letter from the OCC. I mean not to seize on that but is it your suggestion that we take some of the major examples and when you say determine what happened on the ground try to go into this from an audit inspection review of an audit issue? Is that your recommendation?

MS. ROPER: Yes. I mean, I think that would have to be a part of what would happen, to pick a few examples and really dig into find out, and I think, I mean, we're assuming that some of what you will find will have to do with things that aren't directly within the purview of the PCAOB. For example, you may find that in some areas what you see is a problem, you know, a fundamental problem with the accounting standards, but I would say, you know, similar to what Brandon was saying, that rather than just sort of set that aside as not in your purview, one of the things I would hope that this Board would look at is whether the standards are not auditable.

But to your main point, yes, I would think focusing in on, you know, maybe, what, half a dozen or whatever, you know, cases to see what happened, you know, really dig into the details of, you know, what went wrong or what, you know, didn't go wrong but nonetheless led to the conclusion that it did, but also to look, you know, sort of more big picture in some of the ways that the Europeans are doing at some of these issues about culture and incentives and independence and skepticism and, you know, that are broader than the individual case analysis.

But I think one of the reasons we've called for a specific indepth study is that we think we know some things about what went wrong but we don't know what we don't know and we don't know a lot about why and so I think that's -- so those are some of the answers we'd like to get to.

MR. DOTY:  And in the process, we may find examples.  There may be information that comes to us that indicates a breakdown of basic governance models that we all agree on, a tipping point when communications cease to go to the audit committee, a studied diversion of attention from what the activities of the subsidiary were or what a unit were. Those are things we would normally bring to the attention of the Commission and I guess what you're suggesting is that if we do have a study like that, that might be the way to give appropriate publicity and attention to them.

21-A reports, I think, are still done at the Commission and that might lead -- we might -- you're urging us to keep, as we go into these situations case by case, to keep the blinders off and think about what might make the appropriate substance of a Commission 21-A report on a broader front and I think that's a very helpful thing.

I did want to get back to Ann's emphasis on the green paper and I appreciate the irony of your remarks about they're not being modest, they're being ambitious. Not to describe them as either Utopian or Willian, it did seem to me that as you went through the list, you went through issues that were being raised by them that had a particularly continental flavor to them and as you got more specific, you got more into the areas in which we could, as a Board, proceed, as you said earlier, effectively and efficiently, and I want to be sure that that's the consensus that I'm discerning from what you're saying, that in fact appreciating the boldness of raising the question of whether firms are too big to fail and whether they ought to be broken up and whether someone ought to do the audit besides private firms, all of which are on the list, is it a matter of recognition that we, that our role should get to how we effect the conduct of auditors in this financial crisis where they may be seeing or perceived to have suspended skepticism or where they may have interpreted their rules on the application of GAAP as not to require a broader horizon on what was going on and therefore dealing with the audit -- dealing with what the auditor's report is, dealing with what can be audited under the standards and what we do audit, dealing how the audit firm relationship works with the audit committee, are we, in your view, going down the right track by hitting those issues and not dealing with whether firms should be corporations, whether they should be broken up by an economic regulatory authority?

MS. SIMPSON: Well, that's difficult because you want to be practical, but I think if we don't have some space to actually talk about the structure of the audit industry, we won't actually be able to grapple with issues like independence. It's very tough.

It may be that one way to go here is that if the European Commission has actually set the debate running about -- because they've got the same big four. I mean, it's the same big four that the European Commission are looking at, the same big four that would be here.

So it may be that one decision your group could take is to say let's see what the Commission comes out with later in 2011. We might return to that question of the structure of the audit industry, meanwhile we can get on with some very specific work that related to the U.S. market and make progress, but I think to -- I think these are inter-connected.

MR. DOTY: You believe they're inter-connected?

MS. SIMPSON: I believe they are, yes.

MS. ROPER: Can I add one point on that? You know, I guess what I would assume, I'm generally comfortable with what you're saying about what you think the focus should be.

If, as a result of your fact-finding, you discover that there are certain things about the structures and governance and whatnot of the audit firms that's directly related to the reasons we're having problems with lack of professional skepticism or lack of independence, then I think those issues come back, you know, into play.

I also think it's a separate issue perhaps, but I don't know whether the audit firms are a systemic risk. They are clearly too big to fail and what does that mean in terms of the willingness or ability to take, you know, tough enforcement actions against them, and does that play into an environment when the audit firms feel that they are sort of insulated from accountability when they do fail?

So I think to the degree that you look at some of those bigger structural issues, it ought to be driven by what you find once you go in and do the spade work and find out what went wrong.

MR. DOTY: I think that's very wise and I take it to heart. I'm fond of asking whether anybody can give me an example of a major firm that failed through private civil enforcement -- through regulatory civil enforcement action. I mean, it seems to me that our job is not to worry about the collateral effects of regulatory civil enforcement but to decide what has to be enforced, but I think these are all -- these are very stimulating and well-put.

MR. HANSON: Tony, I wanted to circle back. This is Jay Hanson. Circle back to one of the things you said and you mentioned this arcane reference to SOP-94-6, which was the translation for the non-accountants in the room, is this a standard that was issued back in 1994 that effectively said companies should disclose more about the risks and uncertainties of their operations and the estimates in the financial statements and your point about does that need to be revisited, that's another fundamental question of, well, is there something wrong with the standard or is there something wrong with the application?

Another poster child example that my chairman, Mr. Doty, and I have talked about and Mr. Kroeker's been on the stump talking about this, is disclosure about litigation, that there's a principle that's been out there since FASB Number 5, so back in the early '70s, has been out there that says if you've got litigation exposure or contingency exposure that has not been accrued for in the financial statements, I don't remember the exact words, but it's effectively disclosed some stuff about it that will give the reader some idea of how big an issue it could be.

The FASB's taken a couple different bites at an apple of trying to say, well, it's not working right now today with disclose some stuff and so here's 10 pages of granular things to disclose and well-meaning lawyers, like Mr. Mercer and Mr. Doty, say no, no, no, you can't do that because that will compromise the case and everything else and, Jim, I think the current discussions at some of the recent conferences and communications to the issuers are you need to disclose more stuff, we'll back off on the standard for now, but if we have to put in the standard to be more granular, we'll do that, but it's kind of a poster child example of the challenge of trying to mandate exactly what a company should disclose and you get what we have today which was hundreds of pages of footnotes that investors have a hard time wading through to figure out, well, what's important here.

It can't all be of equal importance and it might actually comply with the requirements but it really doesn't tell the story and that's one of the challenges that issuers face and auditors face and we face as we're inspecting to say do the financial statements really tell the story and there's a lot of players involved in fixing that problem and I'm not sure that we can do it by ourselves but, Tony, maybe the question that I want to frame up here.

Do you think there's really a problem with the standards?  Is it really an application of the standards on some of these softer areas that the investors clearly want more information?

MR. SONDHI:  Jay, I do believe that there are areas where there's a problem with the standards. I also agree with you with respect to 94-6 on the disclosure of significant risks and uncertainties.

I think that standard, and I remember spending a lot of time when it was being developed and working with some people on it, as well, and it had all the signs and indicators of being a good standard. It has, unfortunately, not resulted in the kind of information that we would need.

So that one clearly appears to be an issue of how it's applied and what we're missing in the implementation, but, on the other hand, I don't think that -- I'm not ready to say that there isn't an issue to look at in terms of how audits are performed and so on and what I wanted to also mention, FAS-5, also, by the way, is an excellent example because if you read it and what it says about the probability of when you have to provide disclosures and how it's actually applied, you see two different worlds, and I don't care who's responsible for making those two worlds the way they are.

The problem is that -- which is why I said I don't. My point is that as an investor, I always find that I get information about liabilities and those kinds of risks later than I would want it.

To go back to one more just brief comment that, Jim, you had asked a question that Barbara and Ann have certainly responded to very well, but I just wanted to point out that I cannot think of a more critical study where the design is going to be more important.

So when you were talking about how one should go about it, I think it's the design that's going to be fundamentally critical to how this gets done, and I think what Jay has been saying contributes to that. So I think it's critical that we're very careful about how this is designed and the questions you ask yourself as you proceed through this particular study.

The other thing that I want to be very clear about is I see a lot of studies, I see a lot of announcements. Unfortunately, the follow-through is rarely something worth writing home about. For example, Europeans have looked at their banks, but I think that if, you know, you just simply look at the amount of information that's missing in the stress tests, it's unfortunate because I don't think it gives you -- as an investor, it does not help me and does not make me comfortable with respect to the banks in France and Germany when they tell me that their own regulators are permitting them not to provide and, by the way, I don't mean to single out those, we do the same thing around here in different -- at different levels.

The point, though, is that I think the study needs to be designed carefully and carried through very, very carefully, as well.

MR. TURNER: I'd like to come back to something that Barbara said about the firms and too big to fail.

I would hope that this Board would never view these firms as too big to fail, that in fact if the firms had got in trouble in the marketplace and weren't living up to their obligations and, as a result, faced a dilemma that would cause the demise of one, I do think you ought to let the private sector work then and let the firm fail. I think it's very wrongful for the government to support inefficient and ineffective organizations and so I would hope that people wouldn't on this Board view these as too big to fail.

I would also hope that the Board would not wait for the EC to do something. I would hope that this Board would be very proactive and try to get ahead of the ballgame rather than just following what the EC has done. The EC at times over the years has talked a great story at the beginning and then not really delivered and if you're waiting for that, I think you'd be wasting and getting behind time.

On the professional skepticism issue, I've been in this profession for three and a half decades now and every single decade, there's been some event occur or a number of events occur where questions of -- given rise to the question of why weren't the auditors more skeptical. It certainly gives rise to the question of whether or not the fundamental issue is not whether they were skeptical but whether they were really truly independent, and I think we'll talk about that after lunch today.

But besides dealing with the independence issue which I think you have to deal with, I think you also have to understand that the Number 1 vehicle for dealing with the lack of skepticism is to hold the auditor accountable and that is done through your enforcement arm and I know we have to wait to see what happens but we've been waiting nine years now to see what happens and I think that's long enough.

I think it's fair for the public now to actually see something come out but I think nothing would influence auditors in the field more than seeing some auditors who didn't live up to their professional obligations hit with some steep penalties, if you will, and I think that degree of accountability needs to be forthcoming.

If you continue and if the public continues to see coming out of this Board a lack of meaningful enforcement actions, a real watchdog with teeth, then I think it's realistic to expect that auditors will behave accordingly and view the watchdog agency not so much as a watchdog but as a lapdog. It's just the way people behave. So I think a lot of that is up to the Board to drive the behavior and what happens there.

On the issue of the standards, first of all, there is a piece of this that falls into the three plates between the FASB, the SEC, and the PCAOB, but having said that, though, I don't think the PCAOB should be sitting there and saying we got to wait for the other people before we can do anything. I think you divide the three pieces up but then once the pieces are determined, then I think the PCAOB should move independently and aggressively, timely, quite frankly, to do something.

We know, as we've talked about, the FASB -- you know, we've been waiting since 1978 for that standard on unusual transactions. You know, we could all be dead before we ever see anything out of that Board the way they operate and likewise on 94-6, that is truly a standard problem. I don't think anyone really thought that standard was going to work when initially was put out by ECSEC.

If you look at the original exposure draft, it had a very good disclosure and a much lower benchmark for having to disclose risk and uncertainties and then when the business community came in and vehemently opposed that and, of course, there were hardly any investors on ECSEC at the time, ECSEC totally folded the tent, watered it way down, created a benchmark for disclosure that you'd almost have to have a nuclear plant gone burning up before you'd have to disclose it and so in fact in that standard, it is a deficiency in the standard. People have known about that deficiency for a long time and yet again this is a standard where we've known about it and no one's ever acted on it. Now we've had a meltdown and it's unfortunately that, you know, members in my fund have had to go through that exposure and the damage to their retirement accounts because some regulators couldn't get out of their way and get something done.

So I'd certainly urge that the PCAOB move forward actively on their piece of the project and not wait for the other people to go do their stuff or, you know, we may be going through another meltdown before we ever see anything happen.

MR. HARRIS: Bob, why don't we go from you right the way around the table to the cards that are up and then if anybody has anymore, we ought to be mindful and break for lunch no later than 12:45?

MR. TAROLA: Thanks, Steve. Bob Tarola speaking.

Barbara, you said some things that really struck me, the notion that auditors could be part of the systemic risk, too big to fail. The auditing profession globally has a public franchise that is unique and it seems to me has to be more transparent about how it does business, how it's organized, how it conducts its professional responsibility, and I wanted to go back to what Jay was mentioning about these various arcane ways that accountants deal with issues.

But much of what we do is trying to assess the degree to which something out of our control will affect the numbers that are being published and whether you're accounting for those numbers or auditing those numbers, it's largely factors that are outside of your control that you're trying to address, and what I'm hearing from those who represent investors more directly than I is that you want to know how you make those judgments and that's a fair question and in some way, in the reporting framework and maybe it's an auditor discussion and analysis, those sort of questions can be addressed.

But I agree with my colleagues here that this is -- despite the fact that the auditors seem to escape repercussions, the could have and maybe should have been the group in the financial reporting supply chain that raised these issues along the way.

MR. HARRISON: Steve, thank you. This is Norman Harrison. I'll be very brief. Just also a follow-up to a comment that Barbara made when she was responding to a question about the proposed scope of the study that the working group has recommended when she made the observation that one of the issues here is we don't know what we don't know.

It occurred to me that one of the questions that has troubled me as we've read the various postmortems on the subprime meltdown and all of the failures around those incidents is I think there's a fair question to be asked in some cases, did the auditors not know what they didn't know, and what I mean by that is, you know, in your -- any study you undertake in your ongoing examination activities, I think it's important to focus on what mechanisms the firms have in place to ensure that they have requisite subject matter expertise.

I mean, everyone at this table is one form or another an observer or a participant in the capital markets. I think the subprime issues are perhaps a vivid illustration of the complexity with which financial products are structured these days and accounted for, the speed with which they move and the number of parties involved and the complex structured transactions, and I often wonder whether in many cases the auditors, you know, to give the benefit of the doubt, may have been asking good questions or the right questions but did they have the subject matter expertise inhouse to evaluate the credibility of the responses they were receiving from the issuer and so I think that's an aspect of this that can't be overlooked as we look for lessons learned or perhaps, you know, guidance to provide going forward about how to try to ensure that things like this don't happen again.

MR. SAUTERS: Brief comment about what Norman just said.

Unfortunately, we all base a lot of our

judgments on what we've learned from the past and we know what we know from the past but we don't know what we know about the future and it's very possible that an estimate for a particular firm could have been a good estimate, yet they were financially crumbling underneath. We just don't know that.

There were plenty of people before the crisis meltdown that were saying there is trouble ahead. You know, there's a disaster. At the same time, there were plenty of people that said it's smooth sailing. So we are subject to not knowing what we don’t know but I think giving more information to more people, i.e., investors, certainly helps more people process that.

The AIG case to me is really quite interesting. It points to several difficulties. One is accounting standards themselves. You know, perhaps better discussion about off balance sheet financing, perhaps better discussion about fair value pricing. Those would certainly help information. It certainly sounds like there was a breakdown in applying auditing principles in the case of AIG.

But even if everything were done correctly in

2008 or even 2007, it wasn't going to stop the global financial crisis freight train that was coming at us. That was well in place and ultimately there were a lot of loans that basically defaulted.

I think one way we might have been able to have at least mitigated some of the damage was greater information to investors throughout the entire process, if we had greater disclosures. We knew that there were greater risks associated with balance sheets perhaps as early as 2003 and 4. We look back now and it's quite clear that there was rot building in the system as early as 2003.

If we had known that, the marketplace itself can send very strong signals and could have started to address some of these things before the bubble got to be the size that it did in real estate and so again I go back to disclosure to investors, the audit report, whether it's the AD&A. I think that would be a significant help in the whole process.

MR. BECKER: For purposes of the reassessment, I would urge the Board to use its scarce fact-finding resources where those fact-finding resources can contribute to the debate in a meaningful manner. So that while I recognize the importance of some of the broader structural and other issues that have been raised on the continent, where I would hope that the Board would focus on is trying, as Tony highlights, to design a study that can speak specifically to a process where we learn something at the end of the day.

So purely as a thought example, not to suggest anything on a micro level, if you take Damon's observation from this morning about the extraordinary difficulty of valuing mortgage-backed securities, mortgage-related securities, and you took some of the examples Barbara gave and you looked across, say, three firms, three different accounting firms, and then you looked at a firm that actually is viewed as successfully navigating the crisis, it would be an interesting question.

How did four different auditing firms deal with that? You could come up with some comparables. You could look at how those comparables then played out through successive firm failures. You could compare and contrast that with facts on the ground about how the audits of successful firms dealt with that. My suspicion, my hypothesis going in is that you would find that much of it was driven by the quality of the managements of those companies, much more so than the quality of the audits of those companies, but then you would develop a factual predicate that you could actually make some decisions on and we would be smarter 18 months from now than where we are today because otherwise I think that the facts will drift into the realm of competing mythologies and narratives by people with various stories to tell and positions to advance and that the Board has unique opportunity to set a baseline for some factual assessments and then I would use what are very limited resources to try and answer questions where, at the end of your study, you might actually know something more than when you went into your study as opposed to repeating more broadly-based structural debates that will produce multiple white papers.

MR. HARRIS: Judge?

MR. SPORKIN: The interesting thing here is that, yeah, while we had, say, General Motors and Chrysler, I think you could understand what happened there, but look at the -- what you had, you had all these financial institutions that had the problems. It was the financial institution meltdown. Now that ought to tell you something and I think what you looked and you can see the type of security that was involved, the securitized security.

It tells us that we had what I referred to as the smartest guys on the block are inventing things and nobody knows how to deal with them. We got things that are exploding without an antidote as to how to deal with them when they go bad. We're creating viruses in the system and it seems to me that we can -- there's a lot that we can tell just from how to deal with this thing.

I mean, the critical thing is to find out how to prevent it from happening in the future and the failures, the oversights and whatnot, but there obviously is something in the -- that's created in the financial institutions that's causing or that caused the auditors of those financial institutions difficulty in being able to grasp that problem, what it was, and to be able to deal with it. In other words, if it's like a disease or something, you could isolate the germ and you ought to be able to isolate it here. We ought to be able to -- I mean, we know that we have a lot of cowboys around. We know we have a lot of lawyers around that are every day creating, you know, -- you have somebody creating something called synthetic securities. What the hell are we talking about? How do you have synthetic securities? Where, and, you know, somebody's got to be saying, hey, you know, that can't happen.

In my day, if we had some broker in Utah, in Salt Lake City, creating a synthetic security, you know where that person would have been? I mean, so there's certain things here that we can deal with, it seems to me, and to come and say, hey, wait a second, folks, before we start creating these things that are going to destroy us, we ought to be able to test them to see what you need to be able to cope with them when they go out of control and I think it's -- I mean, I really think a lot of the effort should have been -- should be paid on how do we prevent this from happening.

We keep looking to say, hey, what were the lessons learned, yeah, but the lessons learned, it seems to me, that we're not a bunch of dummies. I think we can figure out what some of these were.

MR. HARRIS: Barbara, did you want to get a word in and then the Chairman and then we'll break for lunch?

MS. ROPER: Yeah. I just wanted to make two final points.

One, you know, on the design of the study, I would encourage you to think of yourself as the average three-year-old, you know. Why? Why? Why? I mean, what is part of the problem but why is, you know, what we need to know if we're going to fix it.

And the other thing, as Brandon has said and rightly so, is referred several times to the very limited resources. I would urge the SEC to approve a budget for this Board that gives you more than very limited resources for this kind of inquiry.

MR. DOTY: Steve, thank you. These are extremely thoughtful comments, very helpful. I wanted to leave one question for you all to think about over lunch. It's sort of the yang to Lynn's ying about not being fixed on too big to fail or on some of these other issues.

Let us suppose we do a well-designed focused study and we do come up with some structural or very significant changes in the practice of the audit, the audit profession, the industry, the way in which they can be addressed, and let's suppose also they are changes that have been around for awhile and have been discussed over decades but have never been -- the devil never having been worked out because it didn't have to be, the devil of the details, and let us suppose they're extremely expensive.

Does it affect the view of this Investor Advisory Group that in fact if the right things to do to restore objectivity and to enhance credibility in the audit and to make it something that investors can get meaningful information from and get comfort about what stands behind it as in a test function, that that is very expensive.

Does it bother you or where do you come out in terms of the valuation of what we do, the priorities, if we do things which make it much more expensive with the result that there are some companies or some aspirant issuers that can't do IPOs, can't afford the audit, and are essentially priced out of becoming public companies?

Now you may say, well, that's a Draconian result, but let us suppose that the best changes are expensive changes. If you'll indulge that hypothesis with us, where do you come out on the value of or how we go about doing that?

I'm sort of going back to something Gus said about the tipping point. To avoid the tipping point in AIG is a big issue in the minds of this Board. So how do we balance those competing costs of excellence, value for the investor, and cost to the registrant?

MR. HARRIS: And then I'd like to leave you with the thought for the afternoon and, Lynn, for your group potentially to think about and getting recommendations on what steps, if any, do you believe the PCAOB should take to (1) improve auditor objectivity, improve and boost the transparency of auditor skepticism, monitor conflicts of interest, Gus, which I know you spoke about at some length, you know, at the last session, and police auditor independence, and so with that, I think we got enough to think about after lunch, and we'll look forward to reconvening at quarter of 2.

[Whereupon, at 12:49 p.m., the meeting was recessed for lunch, to reconvene this same day at 1:45 p.m.]

AFTERNOON SESSION

[1:49 p.m.]

MR. HARRIS: Okay. The third presentation and discussion this afternoon expands the discussion to include The Global Networks and Audit Firm Governance.

Shortly after arriving at the PCAOB, I was struck by a statement I read by the then head of the International Forum of Independent Audit Regulators, by Paul Boyle. Discussing the audit regulatory environment, he said, "The first regulatory gap is at the firms which manage the international audit networks are currently not subject to regulation or oversight. As a first step, we should consider improving our knowledge of the structure, operations, and governance of the networks."

Ever since, I have shared Mr. Boyle's concerns about this issue. In light of the fact that the largest public accounting firms, including their foreign affiliates, audit the vast majority of the global market capitalization, the influence over the audit process is served by those running their international networks is clearly important to the smooth functioning of the world's capital markets.

While those regulators representing foreign nations, we certainly have the power and the right to disagree, it would seem that we have the common goal of high-quality audits performed by independent and competent professionals for the benefit of investors. That common goal should allow us to come together to close this regulatory gap and resolve inspection and other issues.

Lynn Turner has been leading the working group looking at measures that would provide a minimum level of worldwide audit quality and how regulators across the globe can come together to improve and monitor international firms' governance and performance.

With Lynn on the working group are Bonnie Hill and Kelvin Blake, who unfortunately can't be here but are represented, Judge Sporkin, Bob Tarola, and Meredith Williams.

So, Lynn, with that, why don't you start?

Report from the Working Group on:

The Global Networks and Audit Firm Governance

MR. TURNER: We had six in our group. Steve mentioned Bonnie, Meredith Williams both have board meetings this week, so, unfortunately, couldn't join us today, and Kelvin Blake had a hearing that he had to be at come up yesterday, so he's unable to join us, as well, but all three of them helped us out with the ideas and contributing to the memo.

There is a memo in your materials that provides greater detail and support behind what you're going to turn around and see in the slides.

These are global entities but they're not a single entity. I think this taken from the Deloitte website, and I don't mean to single out Deloitte, you can find the same type of information out at the website of any of the other firms, but it highlights how they are in fact independent, separate groups serving the companies they audit in each individual country and that obviously creates some issues with respect to regulation, with respect to transparency.

While they go to market as a single united firm, whenever there's a problem in a firm in one particular country, the firms in the other countries seem to not know those guys anymore.

It's interesting over the last few decades, we've found that transparency and governance are key to good corporate results, good corporate performance. We've had an increase obviously in the quality of the governance and independence of the governance at public companies as well as push for transparency in governments and regulators. We've seen the same with respect to transparency, improved disclosures and all.

Each of the large firms in fact have their own governance consulting group that goes out and consults with these public companies, discussing how important this governance, the quality of independent governance, the quality of independent oversight, and the importance of transparency is, but when we turn around and look at these firms, none of them practice what they preach.

It's amazing. As we did the ACAP report and took testimony, we found in fact that none of the large firms were even providing GAAP basis financial statements to their very own partners. So it raised a question, quite frankly, if you can't get that type of information, how do you know if the firm's even financially stable or not, and how can you say litigation will bring you down because no one can get the financial information? When we in fact requested that financial information at ACAP, the firms were unwilling to provide it back to us.

In Europe, we're starting to see more transparency because of the directive. It's probably best described as a good first step. Some would say it's more than a good first step but when you look at the reports, it is providing additional information. The firms, though, still lack the basic independence governance that most institutions have. The ACAP did recommend the transparency through the annual reports and also recommended improving governance.

There was an issue, a debate at ACAP about whether the financial statement part of the report should be public or not. The two co-chairmen supported making them public. Other members, including the accounting firms on the committee, opposed making that information public. They were afraid that it might be used in litigation against them. However, as we've seen from many of the court cases, juries get that, courts get that information anyway. So regardless of whether it's going to be made public through the PCAOB or some other body, if there's litigation involved, people are going to get that information anyway.

We did as a group support an annual report being filed with the PCAOB, just as the ACAP recommended. It's tough to understand, especially given what we've gone through in the last couple years, all the discussion about systemic risk, and I don't know how that I'd put one of these firms in the same category as systemic risk, but, quite frankly, if one of these firms were to go down, people are going to go come back and ask the PCAOB what'd you know about it and if you don't even get the financial statements, it's a legitimate question as to how you really are regulating and overseeing and obviously, as the memo points out, Congress did give you the authority to go get that financial information.

We also support the notion of improving the governance, getting some type of governing board on these firms. Richard Breeden supported that as part of SOX. It didn't make it into SOX, but I think the time for that, as ACAP recommended it, has come.

We also, in the sake of transparency, back to the good steps that Board Member Goelzer took in urging Congress to make the whole investigative process public, we do support that, bringing that out in public. I think one will speed up those investigations but will have an impact on how these firms operate and behave.

Bob Tarola will come back and I'll get Bob in a few minutes to expand on that.

On the independence of the firms that we talked about, the coziness, and we've just been talking about the objectivity and is it skepticism or is it just a lack of objectivity, I think quite often it has been just a lack of objectivity. At the end of the day, it isn't skepticism, it's just people really in their own mind weren't independent of that management team. We hoped when we passed SOX that we'd get a better result with the audit committee picking these people but, quite frankly, the audit committee financial expert rules got watered way down and so there hasn't been that much of a change in the audit committees in this regard. So it probably hasn't had the impact.

So we have this coziness issue. It's a very key issue to some of the members on our firms and as we saw from a GAO report a few years back, these firms, and as we heard earlier with B of A and others, these firms, the audit firms have been with these companies auditing them for a long, long time.

Five years back you had a large column in that one to two years because that represented all the changes from Anderson, over about a fifth of them. We did have the big five, now the big four, and so about a fifth of them did make the change at that point in time, but outside that you can see some fairly, you know, three-four decades of being with that same company.

However, after the Anderson thing, we went through a phenomenal change. Over the next four years, 6,500 auditor changes, only 2,300 of those from

Anderson. People talked about the GAO did a study at the time and the GAO went out and surveyed the big four accounting firms and they surveyed CFOs, saying would you like to do mandatory rotation, you know. I don't think there was any surprise what the answer was going to come back from that type of survey. In fact, former Comptroller of GAO said it was one of the worst studies that the GAO ever issued, but it said, you know, with that, we don't want to do it because of the cost and obviously people do think about the cost and yet, notwithstanding that cost, you had over 4,000 companies on their own decide to make a change in auditor. They decided that the cost wasn't so great that they wouldn't go through it and we had CFOs going ahead and making the decision to make that change which indicates that the findings in the GAO report really weren't valid.

As a result, and to get to the basic issue, the basic fundamental issue that we'll continue to have with auditors, and I don't think we'll fix this problem until we are willing to take on this elephant in the room, is to go break that tide between the mindset of the auditor of trying to keep that company and the fees coming in from them, not unlike what we saw with the credit rating agencies, and making a clean break and getting them focused on making sure they get the job done right, and I think to do that, we've got to come back to the issue of mandatory rotation.

Will there be costs? There will be some costs associated with it, but as we've seen, the costs aren't so high that a lot of thousands of companies haven't done it.

Do you have the issue of getting smart in the first year that you do an audit and getting up to speed and knowing what you're auditing? Absolutely. No question about that. But we also know from Enron and WorldCom, Adelphia, Tyco, HealthSouth, all these companies that Lehman had auditors on them for decades and yet, despite all that supposed knowledge base from all those decades, they couldn't find multibillion dollar errors or they found them and didn't say anything to the public which turns around and raises the issue of objectivity again, and I think, as we heard, if we can't get past the objectivity issue, with all the digitalization that's going on today, I would predict that in two decades out, we're going to see accountants going the same route of journalism, that the digitalization will make them no longer relevant because you'll be able to get the information and enough quality information about the data from databases, run your own models, and we won't need the audit.

When we at Glass Lewis could go through those databases and find errors in restatements that the auditors onsite couldn't, it gives you an indication that that's the direction that we're heading into and so now we do start to hear more and more about is it worth paying, you know, a 100-200 million for an audit when in fact we get four paragraphs that doesn't give us any information. Can I run the data and the databases, especially with the tagged information, and do that myself now, and I think within the next two decades, we'll get to the point that if the auditors can't provide useful information, if they can't really remain objective, then they're going to go the route of journalists.

If you wonder what's going on with journalism, you just have to ask some of the people who are journalists over here.

So, anyway, strong believers that you need to do mandatory rotation. During that rotation, also make it to where you can't fire the auditor, so we don't get into opinion-shopping. I think former SEC Chairman Breeden first suggested that, put those together. You'll have to do something in that first year to make sure that people can go through the transition and get up to speed, but I think it can be done.

I've never seen auditor who did an audit in the first year ever issue an audit report that says I didn't get enough information, I didn't know what I was doing, and I assume in the PCAOB inspections of audits in the first year, you guys never came out and issued a report that said the auditor didn’t find enough data or do enough. Certainly, we haven't seen that in the public reports. So it doesn't appear to be a problem.

On global audit quality, as we talked about earlier, if you look at IBM, GE, and Coca-Cola, they derive a majority of their revenues, in some cases a significant majority of their revenues from outside the U.S., and with what we've seen with the problems with the PCAOB being able to get inspecting countries, like in the past the U.K., France, Germany, Italy, most of the EU, let's be real, China, this has been a problem because, while people think the PCAOB is ensuring the quality of the audits, the majority of those audits haven't been inspected. So we really don't know whether the quality is good or not.

What we do know is we see the reports on China and see some very suspect audits coming out of that particular country and for those of us who are investing, it is very important that we be able to invest in some of these countries and rely on the numbers. Those countries are having growing GDP. With that growing GDP, there's better opportunities for us to be able to get the rates of return that we need to earn the retirement benefits that people need to have to live in a respectable fashion and so as a result, we need to be able to do that.

If, on the other hand, we can't get those returns there, that'll be a problem for us. So global audits are very important to us, but, as I mentioned earlier today, the firm still uses the method of what you might call credentialing. They basically rely on that affiliate that is a separate legal entity angst to itself.

As we saw in the first slide over in that foreign country, the lead partner may go to some of the countries and look at the work but we're not seeing the type of inspection, the type of probing and supervision that you would see here in the U.S. Some of the PCAOB's own inspection reports highlight that. There's a couple of those inspection reports cited in the memo itself where the PCAOB has found that lack of supervision of international audits.

So we do think you need to do something with that and it's probably going to take a change, a move away from credentialing and to a much stronger standard on supervision. This is one of the examples of one of those reports where there were material waived adjustments in a foreign country and the local U.S. country didn't even -- auditor didn't even know of it, wasn't even made aware of it. It's amazing. Good inspection report, by the way.

We've talked about the problems with China. So with respect to global audit quality, going back to the first part in the annual report, getting us the information of the quality control, how the firm actually operates, some certifications around that from the executives of the firm, deal with this issue of credentialing and supervision of the foreign audits, and where you cannot get into those countries, China, France and Germany, and inspect those audits, we'd like to see the audit report flat out come out and state that this portion of the assets and revenues were audited by a firm that hasn't been inspected by the PCAOB. Let the investors know what they're dealing with, what their risks are.

Last. Some of our members were very keen on improving these audits through forensic audit procedures. This was key to a couple of them. I think it applies both to U.S. and international aspects.

This was a recommendation made 10 years, 11 years ago now almost by what was known as the Panel on Audit Effectiveness or the O'Malley Panel. It recommended that we beef it up and start doing a better job. As we know from data that's provided by the Association of Certified Fraud Examiners, external audits just don't find it. That's all you can say. They just don't find it and this gets back to the relevance issue.

You've got only 4.6 percent of the frauds are identified by external audits. If that's all you're going to find and you're not going to find the multi-billion dollar errors, why would I want to turn around and pay tens of millions or hundreds of millions in audit fees? It just isn't worth it and yet what's amazing, most amazing about it, if you look at your own auditing standards, they don't require the auditor to get an understanding about the whistleblower and the tip line which is the Number 1 way you do find it.

My experience has been on audit committees that the auditors, unfortunately at times, don’t know enough, sometimes have been literally clueless, about what we had or did not have with respect to working whistleblower hotlines and with us going to Facebook and social media, the hot tips aren't going to be coming in through the companies' hotlines because if you do that, you ostracize yourself and you become very public, might lose your job and certainly can't get the next job, but you certainly can go to WikiLeaks, remain totally confidential, and so we're going to have to deal with this. The world is changing and that's going to become a bigger and bigger thing.

The last thing we want is WikiLeaks finding out about these problems and the auditor clueless and yet the auditors aren't getting their hands around it. It's just an example of one thing that really needs to be taken a look at by the auditors and the auditing process.

The O'Malley Panel, again in August of 2000, recommended that there be a forensic-type of phase of the audit work, that it be embedded in the auditing standards. There were some changes made but because of pushback by industry, we didn't get the full flavor of what O'Malley was looking for put into the standard and we think that needs to be beefed up.

So with that, I'll turn it over to Bob. Bob will talk to you about the governance transparency and then Stan's going to talk about his views on forensics work.

Thank you.

MR. TAROLA: Thanks, Lynn. Bob Tarola speaking.

I just want to embellish on a few things that Lynn mentioned and I'll go back to a statement I made earlier today about the major auditing firms having a public franchise, yet not having the requirement of public transparency that any public institution has, whether it's a publicly-traded company or even a nonprofit enterprise institution that has to make information public through various IRS disclosures and otherwise. Yet the profession, the auditing profession has managed to avoid that.

I was part of that auditing profession and I don't think that's right anymore. There's too much at risk, as mentioned by other task force that worked within our committee. To say what Lynn said, in the event that one of the firms is unable to handle its obligations, it would put the Board in a very awkward position.

I want to talk a bit about the global networks. As an audit committee member of a global company, this has been a struggle. Our two audit committees I serve on both involve global networks and we rely pretty much on the trust me principle, that the U.S. firm will make good on all the work of the international network and take responsibility for it, and, in theory, that's the way it's supposed to work, but the legal structure doesn't promote that.

In fact, it promotes a segmentation of work liability and that's bad for directors and certainly bad for investors.

I don't have the answer to that. I don't know how we bridge the legal structure of our global economy to solve that, but for the most part, I would say that audit committees are buying the marketing message more so than the legal fine print and somehow we have to bridge that gap.

Rotation is an interesting question. I was the CFO of a company who had auditors for over a hundred years, same firm. That had some interesting issues associated with it. Board rooms are private places and boards would be reluctant to share everything, if you will, outside of that board room nor should they because some of them should remain private.

The investment community, though, needs to know that the relevant information with respect to financial matters is being shared with them and rotation has a way of promoting that. In that, the privacy of that board room changes a bit if there's an understanding that there's going to be a new person there every so often to hear that message, assess the message, and have some obligation to convey that message.

And lastly, this issue, the issue of transparency and good governance, I think could go a long way to closing some of the expectation gap just by taking away the concern that investors have currently, I think directors also have to some degree, of how these firms actually operate, how they manage their affairs, whether or not they are healthy, can actually back their work with financial resources, and how in fact problems would be resolved among this federation enterprise when they in fact do occur.

MR. SPORKIN: I'm here to tell you a good story about an accounting firm with an outstanding fellow heading it who some three years ago allowed me to test a theory that I had and the theory was the concept of forensic in the audit.

We all know that all the accounting firms have good forensic groups, but generally they're being used for people other than their own clients and my thought was why don't we use them for the firm's own clients.

So along with a former associate of mine Gene Goldman and Scott Taub, who was what, acting chief accountant, we came up with this concept of forensic in the audit.

Now how do you -- you don't have it in every audit, right? So you gotta say how you're going to select which audits you wanted it and what we did was we would have at the beginning risk assessment. We would look at the client. The auditor would look at the client. Where do they do business? What types of risks do they have? Do they do business in areas where the countries are on the lists of transparency international, of having the possibility of a lot of FCPA and other issues?

Once you get to the first issue of the risk assessment and it's determined that the client is in an area where they have these problems, then what you do is you incorporate the forensic with the financial auditor.

Now, why? I mean, why can't the financial auditor do this? Why do you need a forensic? What's the reason for it? Well, the reason is simple. The financial auditor's talking about materiality. He's up here. The forensic auditor usually comes in at the low level. He's looking at petty cash. He's going to be looking at things that the financial auditor is not going to look at and so you have to combine the two together and the forensic auditor, as he goes into the K looks and sees if there are agents, looks and sees how they're expensing some of these, how they're treating officials in the countries where the client operates, and so you have this blending and this and you have the two working side by side.

Now there are problems there because the financial auditor usually looks down at the forensic auditor who may not be a CPA. He could be an investigator of some kind. He could be a lawyer even and so you have to get that blend in and if it works.

So rather than just come up with this concept on a theoretical basis with this outstanding leader of this accounting firm, he said, well, let's try it and so for three years now, we've had a test case and it works. He's come back to say, and we've tested it. I've been there with Gene and Scott. We've tested it for three years. It's not perfect. There's still problems and yet it will work. There's no question.

Now one of the big issues was who's going to pay for this. You know, is the accountant going to have to -- the accountant absorbed it for the test period but what I learned recently is you make money because the client needs the assurance that they're not violating these provisions of the law, the money laundering and the FCPA. So, yes, he's willing to pay that money now, so that he doesn't have to go through an investigation whereas in one case, what, they had over a billion dollars in costs and legal fees.

So what was thought was going to be a problem in getting someone to pay for it is no problem at all and so the system works and they will be testing it, I think, one more time and hopefully they'll roll it out but the beauty of it is that in an era and among a profession where it's always thought that there was a lack of innovation and a willingness to be creative, it is tremendous that you find someone now who's willing to try something and doing with the -- really thinks the concept is good and he's willing to back it. So that's where we are.

Now is this going to be the -- should this be the standard? I hope that at some point we'll come to the PCAOB and roll it out and, you know, I think there should be no reason why we shouldn't meet the expectations of investors.

I mean, up until just a short while ago, accounting firms have disowned fraud, have said we're not interested, we can't find it, we're not -- can't find it, we're not going to look for it. I think the profession now realizes they can't get -- that doesn't work anymore and they've got to do something more and while this system that we've been perfecting might not be the 100 percent answer, there are problems of dealing with third parties, of how you're getting access to agents' books and records and things of that kind, but we'll work it out over time.

We're going to have to get new kinds of auditing standards to be able to deal with these emerging issues as they arise, but I think you're going to see something that you're going to like because I think it's really pushing the ball forward and I think it's going to be a boon to investors.

MR. TURNER: Steve, let me just follow up with what my two fellow panelists had to say and maybe come back to the question that Chairman Doty raised at the end of the last session about costs.

When you talk about costs, our pension fund saw tens of billions of dollars disappear in value during the Enron scandals' loss on investments. In the last subprime, as I mentioned, we saw 44 billion go down to 26 billion and Ann mentioned similar-type numbers and percentages. In fact, all investors, and that's not to blame the whole thing on the auditors because that would be sorely misplaced.

I think ultimately the people who were doing these bad loans deserve the brunt of the complaint, but nonetheless the gatekeepers did have a finger in the pie here and when you look at costs, when you raise the question of cost, I think you need to -- rather than start with the cost to a public company, I've never seen investors say we weren't willing to pay the cost to get good high-quality information with integrity. I've never heard an investor say they weren't willing to pay for that.

But what we don't hear in this town -- in this town when people start talking about cost, it's always it's a vehicle to avoid doing something. It's never people starting off the equation with what does this cost investors and I'd urge the PCAOB to reverse that paradigm for once and start off with what was the cost to investors of what we've seen transpire in the last 10-12 years and when you look at those numbers and you look at any additional costs to having the auditor go ahead and do the work to provide additional information, and I think most of the information is available, it'll get QC'd to death, but most of that information does exist in those topside memos, quite frankly, and that are required by your own standards.

I do agree with Joe on that but also understand the QC'ing that will go on, but those costs are but a drop in the bucket to what the hundred million Americans in this country have suffered in losses. They pale by comparison. So that's my view, Jim, on the cost side.

On the forensic side, I think Stanley made some very good points. When we came out of Enron, for those of us serving on audit committees at the time, we did see the audit firms starting to put forensic people on every audit, certainly any major significant audit, and that really benefited us in the audit committee in terms of what they could bring and also their ability to turn around and challenge the auditors to think out of the box. The forensic people do a different audit. They think differently and I think that out-of-the-box thinking is very important. It was very useful.

Unfortunately, what we've seen in recent years is a cost-saving measure. As the firms have turned around and once again started to cut their fees, they've pulled those forensic auditors off of almost all those audits, once again leaving us without the real indepth type of assessment, expert assessment of fraud risk that you ought to have on the audits, and why was it done? It was done to save costs and keep the partners' draws and salaries up, and I think someone needs to turn around and take a look at why it was that the firms saw fit to go do it, and I think rightfully so, but then all of a sudden degraded the quality audits around the globe in that respect.

On the objectivity issue, probably the best example I can think of involves one of the companies that's been discussed a lot today, AIG. Of course, in 2004, Elliot Spitzer did his investigation of AIG and started to bring his action against them for the transactions that they'd engaged in, including with Jenri.

As part of those negotiations in the settlement, Spitzer was very concerned about the objectivity of the auditors, PWC had been their auditor for a long time, and eventually -- initially, Spitzer wanted them to rotate. The chairman of the board was able to talk him into just letting them go out for a proposal and they did. They went out for a proposal and brought KPMG and Deloitte and Touche into that process and in November of 2007, I think I got the right year, they had a bake-off between those three firms and they decided to keep PWC on.

Within days of that announcement, PWC came out and announced that there were problems with the numbers, problems and issues with the company, and court documents have shown PWC was concerned about the valuation models by the time the second quarter Q was being worked on.

If there was ever an example of where there was a serious question about the objectivity of the firm that cost investors a lot of money, that cost taxpayers one of the largest bailouts we've ever had, that is it, and if you look at the, you know, 100 to 200 billion that we had to put into that thing, the cost rotation, the rotating auditors on that, would have been a drop in the bucket, so small a drop you couldn't even see it compared to what we've paid in taxpayer bailouts.

So from that perspective, I don't think there's a cost-benefit issue. I think it is very clear. This is an issue of does this Board have the courage to take on what will be a very tough controversial project, one that we debated in this profession for a good five decades but we've always danced around it, and as a result of dancing around it, we never got the basic fundamental issues solved, and I think this is a time that this Board can show courage, can show leadership, can show vision, and really separate itself as being a board who did the right thing.

The Global Networks and Audit Firm Governance

Open Discussion

MR. HARRIS: Thanks, Lynn. Mike?

MR. STARR: As these meetings go, it's always interesting.

First of all, I'd like to acknowledge all the good work that went in by the three working groups. I thought the studies were very thorough. I thought the comments were very good and I think this could lead to what Lynn said. It's an opportunity to really do something significant.

One of the things that struck me, though, is sitting at lunch, you know, the conversation at lunch frequently at these types of gatherings is actually better than the discussion around this table, fascinating how that happens, and one of the things that came up -- this really went to something Barbara said.

Barbara said in her report that with Sarbanes-Oxley, we set out to strengthen independence, improve audit quality, and that it appears that we fell short of the mark in that regard, and I thought about that and what struck me is that we made a mechanical change and it was a good change, one that I support, but what we didn't do is we didn't change behavior that has grown over decades.

So what we set out to do, we didn't really accomplish and that was to change behavior. If you'd step back and listen to the three reports, I think the thing that has really been discussed is Lynn's elephant in the room, objectivity. I think objectivity goes a long way to strengthening objectivity, goes a long way to addressing many of the problems that we discussed, and my question -- I have two questions for this group.

The first question is do auditors view investors as their clients, and you don't have to answer that because I think most of you would say no, they don't. Jay Hanson actually alluded to that in his opening remarks.

So if that’s the case, then how do we change that behavior? How do we change behavior so that we strengthen objectivity?

So my second question really is would this group, this Investor Advisory Group be supportive of tackling that issue, objectivity, in a meaningful substantive way and really looking for it, not just taking Lynn's suggestion but looking at a range of possible solutions because one of the things that's interesting about audit quality is it's a little bit like a balloon. Sometimes when you push down over here, it pops up over here. So you have to be really careful about what you change and what levers you pull to make sure that you achieve the intended result without any disasters, negative, unintended consequences.

So the question I have again is would this Investor Advisory Group support really looking, doing what Anne Simpson suggested, taking on a big project and looking at objectivity and how it's strengthened?

MR. HARRIS: I don't think any one individual speaks for the Investor Advisory Group but we certainly welcome the input of all here. I mean, certainly with respect to myself and speaking for nobody but myself, I would, of course, welcome that. I wouldn't welcome it to the exclusion of other issues that investors have laid out on the table but I don't see how you can divorce what we're discussing in terms of what I've mentioned, improving auditor objectivity, boosting transparency of auditor skepticism, monitoring conflicts of interest, and policing auditor independence.

I think improving auditor objectivity is extraordinarily important. So once again, you asked the question of the Investor Advisory Group. I filibustered, you know, on my personal views on it, giving people the opportunity to think it through. So now it's open season to, you know, whoever would want to answer the question.

I don't know. Barbara, you had your tent up, but --

MS. ROPER: Yeah. I was going to talk about that anyway. So well played.

MR. STARR: I'll take the check after the meeting, Barbara.

MS. ROPER: One of the issues that I work on that has nothing to do with auditors is fiduciary duty for brokers but it's that same issue of objectivity and I've had occasion as a result to listen to a number of presentations by behavioral economists who basically say however bad you think conflicts of interest are, however negative you think the effects of conflicts of interest are on behavior, they're much, much worse.

You cannot solve the problem of professional skepticism without looking at the issue of objectivity and, you know, I actually, as I recall, took some heat at the time Sarbanes-Oxley Act was passed for suggesting that it didn't do nearly enough on that issue of independence, that it was in fact on that one issue a fairly modest set of proposals and that all of the really significant proposals that had been put forward to try and address that issue had, for political reasons, been taken off the table and so, you know, in an attempt to look objective in presenting my earlier report, I didn't try to presuppose that I know the answers to all of the questions that you might find if you do a study but I do think a lot of what you find when you get back to, you know, sort of dig in and look at the details is that objectivity -- issues around objectivity are going to be at the heart of a lot of the problems that we've seen.

And then just briefly on the issue of costs, I sort of have two ways of answering that question. One sounds a lot like Lynn's, you know, $11 trillion in household assets gone in this latest crisis, not all of which, of course, is attributable to the auditors, as Lynn said, but you can afford to pay a fair amount of money in that kind of environment if you deliver significant meaningful improvements that would reduce those losses.

On the other hand, I also -- you know, there's a political answer to this question, which is that anything that you propose that raises costs will be opposed on exactly the grounds that you said. You know, you are inhibiting capital formation by making it too expensive for small companies to come to market.

The point I would make about that is they're going to say that whatever you do. You know, that is -- I mean, I could just put it on a tape. I can't tell you how many times I've heard it. It is used with no factual basis or with the slimmest most manipulated statistics in order to back it up and anything you do that looks to force meaningful change and produces business restriction will -- you know, resistance will be met with that argument.

So you might as well just sort of take it as a given and take it with a grain of salt.

MR. HARRIS: You've had yours up and then I don't know what the order was, so I lost track.

MR. CARCELLO: That's fine. I'm always happy to defer to Barbara.

On the question that Mike teed up, I think if you can meaningfully improve objectivity, a lot of the other problems in the profession kind of take care of themselves. I think that's a root cause of a lot of other things that we see. So I think, to the extent that you can deal with that, it eliminates or at a minimum mitigates a lot of other problems.

But the comment I wanted to make is, I guess, a question to Lynn and his group and for the benefit of obviously the Board and the SEC people.

Lynn, one of your recommendations is that there be independent members on firm boards or advisory boards and no less than three and I certainly support that, but I had a couple of questions for you and, as I said, for the benefit of the others in the room.

To the extent that this is not something that the firms have done voluntarily, there's always the risk that when you impose things on people that they don't want to do, they look for ways to comply with the letter but not the spirit of the law.

So some of the things that I guess I would ask is (1) I think to do this well, there would have to be carefully-drafted rules that would preclude firms from narrowly tailoring or limiting the mandate. I could create an advisory board with no real power, no real authority. I mean, if you look back to the history of audit committees, audit committees have existed for long times and we saw audit committees that never met. We saw audit committees that had one or two people on them and they weren't independent and, you know, obviously over time those have become tightened up, but limiting the mandate would be a problem, putting friends and family on firm advisory boards and I use those terms broadly when I say friends and family.

Some of that is prohibited in the corporate sector obviously by SEC rule and stock exchange listing standards, but even with that, we see corporations because social ties are not outlawed and so we still see this being an issue, and, you know, obviously the Chairman's gone, Jim, but I think one of the things that motivated her proxy access proposal was this very issue and so to the extent that you're not going to have something comparable for accounting firms because they're private partnerships, I think it's careful -- I think it would be important for the Board, if they put this in place, that they look to make sure that who are put on those firm advisory boards are in fact really independent, they're not shills.

And then the last thing, the Institute of -- somebody this morning talked about the U.K. Governance Code which is now in effect and I've talked to some people in the United Kingdom and the firms are doing it very differently.

As I understand it, Ernst and Young now has independent members on the advisory board for the whole global network, is what I've been told, and some others have done it across Europe and some others have done it country by country. So it will be interesting to see how that plays out.

But I think one of the things that's important there, one of the requirements that these independent firm board members are charged with is being the liaison between the accounting firm and the investor community and we've talked a lot today about the need for greater involvement of investors with the audit process.

So to the extent that the Board did something like this in the United States, I think that's a useful feature that we've seen in Europe. So your comments on it, Lynn, would be appreciated.

MS. SIMPSON: Yeah. I would agree with you, Joe. I think on this particular Board, you've got Chairman Doty who's been a wonderful counselor to corporates and corporate boards and I think between Jim and Lew and Dan, they should be able to draft a credible governance policy. I hope they would.

I have no doubt they could and with Jay's help, Jay's been a partner in one of the firms and knows the firms inside and out, and I would think that between those four, they could do an excellent job of crafting something, but I think the points you make, Joe, in fact, every single one of those points you make, perhaps especially the friends and family, --

MR. HARRIS: Hey, Lynn, thanks for excluding me.

MR. TURNER: That was actually intentional. Well, hopefully, you know, you did the stuff on the audit committees on SOX, so at any rate, but, no, I think Joe's points are all very good points and things people should consider, but I think this Board has got the talent to turn around and go accomplish that.

MR. SONDHI: I think that two comments with respect to the task force's benefit and the capital formation.

I think the cost versus benefit argument, as several people have pointed out, have always been used and they will always be thrown at us. When we talk about accounting standards, we talk about disclosures, everybody talks about how expensive the disclosures are. Then they go ahead and produce those, you know, and simply copy them over and over.

It's too bad that wherever the central location is where they get that disclosure, they don't have to pay them royalties because all the firms use the same thing over and over, but that's one aspect of it.

The other point I wanted to make was about the capital formation issue. That's another red herring that gets thrown at us all the time. I really don’t see any empirical evidence, no studies that show me that capital formation has been impeded. In fact, as started this morning, it was pointed out that the first audits were issued in 1897 or something. I don't recall anybody requiring that, but companies decided that with the railroads, decided that it would make sense. Railroads decided almost 36 years before the 1933 Act's required those audits.

Subway systems in New York City were going out and getting audits because they felt that would actually help get -- they may have been cynical for all I know, but the point is that people went out and got these audits, incurred these costs in order to facilitate rather than impede capital formation.

The other point I wanted to make was in response to Mike. As he said, sometimes the conversations during breaks and lunches are quite interesting or maybe even more so, and I think what we were talking about and what the day has shown me is that this is not a simple single direction or unidirectional problem or anything. That's why I said earlier the study that we think you must undertake is something that you will have to plan carefully and you'll have to keep your eyes open as you go through it because it will suggest directions to go in, but it has to be done with a great deal of care.

I think it also has to be done because, as investors, we've paid a lot for this already in terms of losses that have been listed by Barbara and by Lynn, not to mention, you know, a whole host of other places and studies that would show you how much it has cost investors, and, in fact, the other point is not just the investors, I think the real question is how much has it cost the economy not having substantive system in place.

MR. HARRIS: Actually, Mr. Chairman, please, at any time interrupt or ask any questions you'd like.

MR. DOTY: Well, I don't have the sense of the group that the suggestion that doing the things that have been put forward as recommendations should wait on the study.

In other words, I think, I think what I'm hearing is the group believes that there are recommendations coming out here that are ripe for consideration and some kind of addressing handling by the Board while the study goes on, and at the end, a question or two on a couple of them comes up, but, Norman, you go ahead.

MR. HARRISON: Thank you, Mr. Chairman. I wanted to get back to -- I think Mike Starr made both a very astute observation and asked a very important question and I think it underlies actually a lot of what we talked about today.

I have no doubt that if there was a fourth side to our tables here today and the four vice chairs of audit from the big four firms were sitting there, we'd have a vigorous discussion about whether there's sufficient objectivity in the audit process today and probably a lot of disagreement around that question.

Ironically, as I thought about it, as I heard Mike discuss the issue, it occurred to me that in some respects an assessment or a formation of a view about whether an audit or an audit process involves sufficient degree of objectivity is in many respects a subjective determination.

Reasonable minds will disagree because at the end of the day it comes down to behavior, it's human conduct, and as with most things involving human conduct, what determines it is incentive structures. So I think where you come at the end of the day is to the question, among others, of whether there are consistent and uniform and sufficient incentives in place to ensure the kind of behaviors you want to see occurring regularly in an audit process and that is the willingness to engage in a rigorous scrutiny, to ask difficult questions, to demand candid and forthright answers, and to communicate results of all kinds, good, bad, and indifferent, and that in turn goes to a whole host of issues around audit, the structure of the profession, the structure of the firms, transparency, range of service offerings, transparency of the audit process, which we discussed earlier today, and a lot of the other issues that have been on the table today.

So I think it is a vitally-important question and I think one that underscores a lot of what we have talked about and what I suspect the Board will want to consider going forward, but at the end of the day, it is a profession and professions involve people and people are creatures whose behavior is determined in large part by incentives and I think that's something that we and the Board should always keep in mind as we talk about how to improve the audit process and bring what I think everyone would agree is a very desirable goal of increased scrutiny and objectivity to that process.

MR. SAUTERS: This is Gus Sauter. It may not surprise anyone that the representative from Vanguard would say costs do matter.

You know, I think any undertakings should consider cost-benefit and I think the benefits are substantial. Joe mentioned earlier that some of this really wouldn't be very costly. You know, a lot of the analysis is being done by auditors already. Better disclosure really isn't -- shouldn't be that costly, but I wouldn't throw cost considerations away.

There have been studies done since the implementation of Sarbanes-Oxley, which is very costly legislation, that show a secular decline in IPO activity and at the same time an increase in privatization. So, you know, there are some costs that could be hitting economic growth because of significant regulation.

Nevertheless, I think there is a huge conflict of interest. When management selects an auditor, first management is selecting the auditor. Management is paying the auditor, but management is using the investors' checkbook to write the check on.

So, consequently, we have this situation where the auditor isn't tied to the investor, they're tied to management, and I wonder if there isn't a way to figure out how to tie the auditor to the investor and could that be -- you know, I don't know if Joe was literally suggesting this. Could that be setting up an investor group? I'm thinking something different from independent board members but an investor group whose sole function would be to hire auditors.

It's perhaps dangerous to try to think of these things on the fly but I think that it would be important to somehow culturally align the auditors with investors and again hopefully that wouldn't be overly expensive.

So while I do agree with most of the comments here, you know, there is a cost at which you say no, a trillion dollars worth of extra cost probably is not worth it. I'd be so bold as to say it's not worth it. But hopefully there are ways to make significant changes without incurring overly-burdensome costs.

MR. DOTY: Before it goes back to the end, I did have a question about Robert Turner's notion about firm financials.

This is an area that keeps coming up and to what -- I think you did indicate that one of the uses of firm financials would be creditworthiness, whether there was something behind the attestation.

To what extent does that really induce to a run on the bank-type situation? Is it appropriate for the Board to be attentive to that? We are veering away in our philosophical orientation in this country from too big to fail. Does the use -- does the receipt and use of firm financials tend to pull the regulator more into a too big to fail analysis?

I just ask these as questions and I think that one of the things I am sensitive to is that there are very few public institutions that don't have audited financials. I mean, there are some, but universities have them, labor unions may or may not, but the fact is what use would be the appropriate use of the firm financial?

MR. TAROLA: Chairman Doty, the direct answer is yes, but in a qualifying way. When boards hire auditors and, Gus, the audit committee's responsible for that hiring activity, I know people have said management and maybe that's an indication that people around the room think management and the board are the same thing and maybe that's, you know, true in some cases, but when you hire an auditor, you don't have that information. It's really the trust me model that the financial wherewithal stands behind the firm.

Now because I was a partner with a firm, I know that most of the cash is distributed out on an annual basis. So the creditworthiness is really around cash flow and should that be interrupted, problems will arise, I believe.

So I think it is relevant to the system overall, to the financial reporting system and the quality of the markets to have some indication that those who are rendering opinions over the quality of reporting have the wherewithal to stand behind those opinions.

MR. DOTY: Whether it would have mattered to Robert Tarola's CFO to know whether the firm had more or less cash flow capital than someone else you were considering would be a question.

In other words, would it matter to you that firm A had more than firm B or would there be other ways firm B could show you that they would deliver a better audit? These are things I think we will eventually hit. You don't have to opine on these today.

And I guess the other thing is what difference does it make in terms of that issue of the quality of the audit if in fact people are looking at what is really a distributable cash flow statement at year-end? How does it factor into your assessment of whether the audit's good?

MR. TAROLA: Actually, it's not in my view a factor into whether or not one firm will deliver a better audit than the other. I think that that's more -- that that consideration and judgment is more around the expertise of the firm and/or the people involved with your audit.

I think from the standpoint of representing a company, however, if you thought one of the prospects for performing your audit did not have the wherewithal to stand behind their work that would be a consideration. I think that's in degrees. So it's not absolute.

MR. HARRIS: Lynn, I know that this was a recommendation of ACAP and one that you feel strongly about. So if you could take a minute and just indicate how you think investors will benefit from individual firms providing annual financial statements prepared in accordance with GAAP, I'd appreciate your getting that into the record, and then we'll turn to Board Member Hanson.

MR. TURNER: Yeah. Like I share the thoughts that Bob had, having been a partner, as well, at one of these firms.

I do think any time you're starting to make your financial statements public and put information out there that very well may have an impact on how you behave. You asked the question about how this ties to audit quality which is a fair question from your perspective. I know there's been some diversity in views in the Board about whether or not you should be a regulator of just audit quality or go beyond that.

What I would tell you is ultimately at the end of the day, audit quality gets back to the people that you can attract just like the quality of a law practice gets back to the quality of the attorneys you have in the law practice and your ability to attract the very best and brightest and pay the most for those. I mean, it just goes hand in hand.

You can't make an assessment about that, unless you're able to see how these firms are performing. All of these firms are highly leveraged, extremely highly leveraged, thin capital, because of what Bob said, you distribute most of the money out each year because you not only want to put out the earnings but you got to put out enough money to pay the taxes on it. So for the most part, they operate and their capital is provided by the banks that turn around and support them with their annual revolving lines of credit.

Given the fact that they're thinly capitalized, that they're highly leveraged, they all have a call on their partners, because that, quite frankly, is where perhaps the biggest assets lie off balance sheet, it would seem to me if I was trying to oversee that company, I'd want to know just how lever and how close they are to the edge and I'd also like to know what they're doing in the way of investing in their people, you know.

Is the payroll of one firm running 40 percent of revenues, another one running 45 percent of revenues?  Are they investing enough?  Are they investing enough in technology?  Quite frankly, are they generating sufficient margins to allow to make those investments and still return enough money to the partners to entice the partners to stay there and do a very good job?

You can't get that type of information unless you're getting those financial statements and for those of us who vote on reappointment of the auditors, that's a very valid piece of information.  You talk about the run on the bank, you know, is it important to me to know that a bank has 10 percent capital versus three percent capital? Yeah. It is.

MR. DOTY: That would be an argument about making it available to the audit committee hiring them but not publicly available perhaps.

MR. TURNER: No, because I'm being asked and in fact ACAP recommended that every public company give its shareholders a vote on the auditors. That is important information to me. When I turn around and vote on the auditor, I shouldn't be doing that in the dark. I should be doing it from an informed position.

So why wouldn't I want to know the financial stability and viability of an audit firm I'm voting for and know that it's making the reasonable investments in its people? I think it's common sense that you'd want to turn around and have that information and actually I had this discussion with the partner of a large regional firm that audits many public companies about two months ago about the financials. Do you put them out or not?

His biggest concern and what this person, very good partner, very good auditor, but what his concern was was that because the firms are so capitalized, thinly capitalized, and because they have such a huge OPEB liability, their exposure, their financial stability isn't around the liability issue for litigation because that's dropped off the cliff at this point in time because of court cases, their biggest exposure is the liability to their retired partners for healthcare and retirement and at ACAP, despite the fact we pleaded with them to give us financial information and they refused to, the limited data that they did give us indicated that perhaps one or two of these, if you did a GAAP basis set of financials, because of the OPEB liability, would actually have negative capital and yet you're sitting here as five board members today and you don't know, given the significant leverage of these companies, whether one of them does have negative capital or not.

How can you regulate such a significant public franchise if you can't even tell one of the companies, one of the four that audits most of these public companies is sitting there with negative capital and you can't know unless you get that information.

If it ever blows up, there won't be any place for you to run and hide because the public will be coming back and saying why weren't you getting this, why didn't you know it, and there's no answer to that question. That'll be on the front page of the New York Times and there's just no answer. There's no rock you can go and hide under when that one pops. So just a thought.

MR. HANSON: Board Member Hanson speaking. Question I want to frame for a number of you.

I've heard a couple different comments about the use of various specialists that auditors need to use. Lynn, you mentioned forensics, forensic auditors. Judge Sporkin mentioned the same thing. One of the most difficult areas in the audits of the big banks is the valuation of the complex financial instruments, that you need the top people on earth to help value those, and there are other examples, as well.

Norman, I think you had mentioned the need for subject matter experts in the firms to be involved and another area this comes up is in income taxes, that the line auditor has a really difficult time with income tax. They need the help of the specialists in that area. In the IT area, that's another example. Actuaries are another example.

It's been my personal experience that being counter auditor types like me kind of like doing that for a living. Folks that are highly specialized in areas of financial instruments and income taxes, they don't like being an auditor, otherwise they'd be an auditor. They like doing their craft.

So one of the challenges is they have to be able to do their craft to stay current as well as have the skills to help the auditors. So that's one of the areas where I'm just kind of curious as to your thoughts about how you reconcile the need that the auditors have to have those kind of people readily at hand to help them do their job in these most complex areas, yet the cry is coming out that with the split of the audit practices and the other consulting services, things like that, the arguments that were coming up 10 years ago are front and center in the table now.

I'm just kind of curious as to the connection between those two, that if the firms do not have ready access to those people that are the best, how are they going to accomplish what we're identifying as a really, really significant need for those people to be involved in the audits?

MR. TURNER: Jay, and you're right, that did come up a lot during the discussion over the auditor independence back in 2000. The problem was that, for the most part, the auditors and those experts just don't get along in the firms and so you didn't have that exchange of information going from the consulting side, if you will, into the audit side, and the firms all still to this day still have the consulting practices and they're growing. They just don't do it for the very same companies that they audit.

So in that context, it shouldn't be an issue because the expertise is there and should be available. The real question is why isn't that, as we had talked about with the forensic people, why isn't that expertise inside the firm being brought into the audit, and I think that's a legitimate question.

The other thing is when you use outside

experts, either in the actuarial area or others, all too often the auditors just take that report, plop it in the workpapers, tie it out and don't really do what the standard requires them to do with respect to that report. There's a fairly decent standard, I think, from the old Auditing Standards Board in that regard and I think in that area, I think more than a standard issue. It's a performance and enforcement issue, but it really ultimately gets down to either internally or externally are the auditors putting the experts that they really should be on those audits?

MR. HANSON: And, Lynn, I agree that historically it's been a challenge of the auditors and the consultants playing nice together and I think it's gotten a lot better. I think the larger engagement teams use the specialists. They have no choice because they know they need them to understand the complex topics.

MR. TURNER: You know, I'm not sure I'd agree with that, Jay, because if you look back over the large banks and the valuation issues that were there at Lehman and at Citigroup and the likes, I would turn it around and raise a serious question. AIG is another prime example. I would raise a serious question as to whether or not there was really an independent unbiased view that came into the pricing of those assets. I think history tells us that there was serious deficiencies there.

MR. HANSON: I'm not saying it's perfect. I'm just saying directionally it's better than it had been from my direct experience as well as experience talking to a lot of the other firms and my concern, to restate it, is if we go down this road, as some are calling for, to split the firms into being audit-only firms, that's only going to exacerbate that problem of having the best expertise available to the auditors.

MR. TURNER: You know, Paul Volker has been a big fan and vocal proponent of that and I value Paul's counsel tremendously. I'm not sure that's true. I'm not sure I would agree with you. I think you could go get that expertise and what you'd have to weigh is would you get a more thorough robust audit because it was a firm that was very focused on the public franchise but had to go get outside experts and bring them in or would you have a better audit where there were conflicts internally and maybe less subjectivity on the part of the auditor as a result of that? You know, it's a good idea, good question. I'm not sure but what Paul isn't right about it.

It comes back to the question that someone raised. Oh, I know. It was Mike. Mike raised the very first question. Who do you view as your client? If you go back and look at that initial slide that I put up from Deloitte and Touche from their international headquarters on their website, they give you the answer to that question. It is not investors. They talk about their clients. It's the businesses.

As long as you have that mentality, then I think Volker may absolutely be right and Paul isn't a pure audit firm. He has no problem with bringing in some expertise and having that resident but when you've got the mentality that these firms have demonstrated and then they're telling you who their client is, they aren't asking, they're telling you, that raises a very significant issue.

And back to Mike's question about overall issue of a real serious look at how do you come up with the remedy here, you know, most people have talked about mandatory rotation. They've talked about perhaps having the stock exchanges through some type of fee arrangement, pick them and all. I think what Gus mentioned is the key. You've got to build that link between the investors somehow and the audit firm.

I personally believe that if you take the ACAP recommendation and the SEC adopts requiring companies to have the listing requirements that auditors appoint the auditor and then you go with the mandatory rotation, I think that's the easiest, most cost-effective way to do it that there is, and we've studied this thing for 50 years.

I agree with Chairman Doty, another study is wasted time, you know, at this point in time. We've studied this thing to death. If people can't figure out, given all the studies, how to do it at this point in time, then we're probably a lost cause and 20 years down the road, the digitalization will take care of that, but I think the real key thing is the answer has to come back to what Gus said and there has to be that link. That first slide has to change. That first slide has to be transformed into when they're talking about clients, they're talking about investors.

MR. HARRIS: Brandon, we haven't heard from you for awhile, so why don't we go over to you?

MR. BECKER: Just a small point. I thought Board Member Hanson's description of the problem was correct and it's an ongoing one.

The only thing I was going to add was it's not unique to the accounting firms in the sense that regulators have that in a routine basis. We have that when you're trying to build a risk team that's going to evaluate what your traders are doing. Broker dealers or old broker dealers had it when they'd lose traders to hedge funds.

Unfortunately, in answer, at least in our experience, is you've got to pay people the right amount of money and you've got to create a career path and you can't do it overnight.

Whether or not structural division is the way to get it, I'm not sure. I wouldn't opine on whether structural division ensures that, but I am confident that if you don't have a career path and you don't have the right amount of money that you're paying them, you're not going to get the talent that you need in parallel because then you've got to try and create a culture where they're on a par and willing to talk seriously to people and be listened to.

MR. HANSON: Well said. That was my point.

MR. HARRIS: Mike?

MR. STARR: I just want to correct one thing when I asked my question. What I envisioned was not a study. What I envisioned was a study with a call to action. So I don't want another study that just sits on the shelf some place and gathers dust.

I wanted to share two things, a couple thoughts from lunch. Tony and I had discussion about the importance of words and there are two examples I want to share with you that underscore the importance of words and both of them come from a speech that Jim Kroeker gave at the SEC.

The first is that it's responsive to the question do auditors consider investors their clients? When you look at the auditing literature, in fact look at the literature of the PCAOB, it refers to the client meaning the businesses that are audited, and I would simply submit, as Jim submitted at the SEC conference, that we should change that phrasing to talk about the companies that auditors audit and not refer to them as clients. So that's the first example.

The second example, let me take you back a step. The Code of Conduct for AICPAs has four key phrases that are either words or phrases. They are integrity, objectivity, due professional care, and public interest.

Several times today, in referring to my profession, if I can call it that, people have talked about the accounting industry. If you really believe in that Code of Conduct as I do and you really believe that auditors have a duty to the public, then I think it's more appropriate to refer to the accounting profession as a profession, not an industry, because I don't think an industry has a duty of care to the public.

Thank you.

MR. HARRIS: Well, Mike, how do you bring it back to becoming a profession when so many people now are associating it as an industry?

MR. STARR: You lead. You lead. That's how.

MR. HARRIS: Speaking for myself, once again, I think you put your finger right on it and Jim did, as well, and the Chairman and that is, I think that a lot more attention has to be paid to the fact that auditors should view their investors as their clients. I don't think that's the case right now and I think that does have to be changed.

Jim?

MR. KROEKER: I just want to follow up for Lynn. I think (1) Lynn, Robert, Judge Sporkin, great presentation, and I think great thoughts.

The one area I wanted to follow up on was particularly as it relates to the issue of transparency, whether the group gave any thought to greater transparency around the inspections and the findings, whether that's Part 1 to the company under audits, so for their audit committees, is there enough transparency there, and then Part 2, of course, is non-public but nothing precludes a firm from making that information public and, of course, somebody with a public responsibility and a public interest could go that further step of making that Part 2 quality control questions and concerns and criticisms public and, of course, that could drive greater accountability on the part of the firm for responding to those concerns.

So I don't know if the group thought about that.

MR. TURNER: Actually, in the very first phone call, one of our members who serves on a number of audit committees raised the concern that in that capacity, they had a very difficult time getting information regarding what the quality of the audit was on a global basis. It was almost impossible to get. That was some comment that was made in the very first phone call and having served on and chairing an audit committee of a global company like that, I would agree with that. So I think that's a very valid point. We don't have it in the recommendations obviously.

I would turn around and say that when the reports first started coming out, there were discussions amongst audit committee members about trying to get these and I believe actually at the very beginning, one or two of these reports actually got turned over to an audit committee, as I recall, but then it seemed like the big four got together and squelched that and so since then, they haven't been forthcoming.

There's no question that there is nothing that precludes a big four firm, if they really want to be transparent here, if they want to walk the talk, so to speak, that they could in fact go allow that and give it to audit committee members, but they have chosen not to which is unfortunate. It's why you got to be -- you know, when they talk about everyone being transparent, it seems like everyone needs to be transparent but them.

It would be great if they would change that view and start to be thinking out of the box and becoming more open and transparent. I just think these are animals that, by the nature of how they're operated and run and how they pick their leadership, the chance of that are not high and I think that's -- I think Steve knows this, well, that's a point that myself and former SEC Commissioner Goldsmith have been very focal on that we think these ought to be made public. You need to change the legislation.

MR. HARRIS: Tony, and then I indicated to a number of people here that we'd wrap up at 3:30 or close to it. So why don't we begin to wrap up.

MR. SONDHI: I'll be brief. I just wanted to mention that when I said that costs don't matter as much, what I meant was relative to the benefits they don't.

The second point I'd like to make is in response to something Gus said, that there's been a secular decline in IPOs. I think part of that -- I don't know if I saw the same studies but I've seen some and I left those studies with a feeling that they could have been written and actually designed a lot better because they did not acknowledge or include the change in private equity acquisitions that took place. They did not take into account the change in any activity in the same period and they did not take into account a very common thing on the West Coast where a lot of private companies are being gobbled up by the companies that they are doing little bits and pieces of work for.

So I don't know that there has been -- I'm not sure about the relationship there between causality and correlation between the advent of SOX and, you know, whether there actually has been a decline.

Jay Hanson had asked about or mentioned about different experts and Brandon responded to it and I think the point there is that these companies, the audit firms need those experts. They need to use them. That's the cost of those experts, whether they are acquired through a career path or whether they're rented by the hour or something like that, I don't mean to be offensive by using the term "rented," but I'm just saying that if you do it that way, I don't care. The point is that it's part of the cost of the audit and it ought to be included.

If they're not using them and the only thing -- the only way that they seem to be able to survive is by having a separate consulting firm, then I think, you know, this goes back to Lynn, to the idea of 0021, and now to 081, I think somebody's not doing separation and allocation correctly and, you know, that's all I would say with respect to that.

I think it's absolutely critical that they have these different expertise that you listed and it should be part of the cost of doing the audit.

MS. ROPER:  My tent actually went back up when the Chairman was asking questions and I will resist the temptation to comment on all the other issues that have come up since then.

Contrary to what Lynn said, I'm pretty sure you didn't say you thought a study was a waste of time, but I think you did ask whether you needed to wait for a study before you acted, and I think there are two separate sets of issues.

There are issues that have been studied to death.  The ACAP report has a number of recommendations that were based on extensive study and so there's no need to go back and restudy the things that we've studied in order to justify acting on things that have been well researched and thought out.

There are, I think, another set of issues that where we don't know, you know, everything that we need to know to know what the recommendations would be and that's where, you know, I think it would be wise to start with some analysis.

On the issue of financial statements, one of the things that we should have learned from the financial crisis and this relates -- perhaps this is a less colorful way of saying something that Lynn said, is we do not want to discover that these firms are too big to fail when they're at the point of failure and right now, you're flying blind. You know, you're very much in the position that you could find yourself where things are falling apart and you're dealing with a firm that's, you know, coming apart and you didn't know because you didn't have adequate transparency and so, you know, I think there's an incontrovertible case for the regulator having access to that information, but I also think Lynn is right.

You know, if the sort of continuing theme here is that we want investors to be the ones who are being reported to, if we want them to take more ownership of this process, part of that is getting them more involved in these decisions about hiring and firing the auditor and part of that requires having greater transparency about the financial condition of the auditor.

MR. HARRIS: Brandon, I thought that you and Tony and Barbara, your group was recommending in terms of the study, a study of what went wrong, and essentially I think your words, Brandon, although I don't have them in front of me, but you wanted to have, when you first brought it up at the first meeting, an autopsy and that's essentially what you're talking about. A selective autopsy of what went wrong. Am I correct in that? I think that maybe the Chairman may have a question on this in terms of between Tony and Brandon and Barbara. I think we may need some help on this.

MR. DOTY: I think I understand. I'd take a clear message away that what's wanted is a well-designed focused study on why auditors in major financial institutions that had these problems in this particular era felt that they could issue clean audit opinions and had none of the constraints to going and calling, sounding a warning to a toxin to the audit committee, and that that has to be structured, and I do not want this discussion, as elevated and I think as illuminating as it has been, to end on the issue of the auditor financial statements, but, Barbara, if we are going to be what I will call a stringent regulator, a regulator who is insisting on accountability, if you violate rigidly-imposed standards, one would say we do not -- if you have this simple mission idea that one takes away from the SEC, for example, one would say we do not want to be petitioned by a company that is doing the wrong thing and taking in audit clients by the argument that we cannot pull the plug, that we cannot sanction that client, we can't end their ability to take clients because they -- it's going to be -- this is going to be the one network member of the firm that pulls the whole firm down.

We don't want to be seen to be thinking primarily about whether this firm can take another $1 million penalty. That seems to me to be the dilemma here. In other words, I do think that there is intense competition in the audit profession. I don't think we know where that's going to lead and I would like to be where I think Arthur Levitt and the Commission and others were when the competition was between, by analogy here, the automated market of NASDAQ and the institutional auction market of the NYSE and Brandon and the team at that time were very careful not to put their thumb on the scale and determine that outcome, you see, and I am concerned that -- this is an area I think demands a lot of further exploration among wise heads because I'm concerned that the question would -- that you're posing about why didn't you do something has a simple answer now and that is, it isn't our business. We're not the business model renovators of an accounting firm, an auditing firm.

I'm concerned that that answer then is complicated if in fact there was something which the firm asked us to do that involves suspension of standards, suspension of accountability. That's the dilemma.

I think the moral -- we do not now have as a board a moral hazard in regulating audit firms. What concerns me about the financial statement question is that it implies inserting ourselves into a moral hazard position. That's philosophically the way it reads, and

I do hear, though, what Robert Tarola says about the fact that, you know, that people might want to know if you're in a negative capital position, if you're the audit committee chairman, whether they hire you.

My impression is not that -- that's not the way audit committees make those decisions. That's just to explain why I find this to be a difficult, a very difficult subject.

MS. ROPER: Right. Can I just -- a couple of points. One, I agree. I don't want you making decisions about disciplining firms based on their financial condition.

My point is you will be asked to make those decisions and it came up in the KPMG tax shelter case. There were press reports of people saying, well, we can't discipline KPMG because, you know, we can't afford to lose another audit firm. So that issue arises regardless of whether there's transparency or not.

If there's transparency and you know what's going on, you're actually in a position to make the audit firms do some things to get in a better financial condition, including one of the ideas that's floated around, the living will notion, but I do think -- I mean, I think -- and I don't mean this to be disrespectful, but I think you're kidding yourself if you think you don't have a moral hazard now because the issue will present itself when it's presented itself and it won't matter that there was a logic behind the position that you took at the time.

MR. DOTY: That's a telling point. This is a discussion we're going to have to continue. I do think that we answered it. We spoke to this at the top of the meeting in a sense, that in fact I do not know of a single regulatory civil action that ever sunk a major accounting firm, see.

On the other hand, if you're telling me that if looking at an accounting firm that I think is shaky, that Jay Hanson tells me is shaky, we should send its clients elsewhere, we should go and ask the Treasury to provide financing -- this, by the way, is, I think, what Mr. Barnier has in mind, that the government would provide sort of a cushion, so that audit clients of KPMG in Germany would go over to firms, a consortium of local firms in Germany that would audit, I think these are ideas that are not well conceived, but I acknowledge to you we will have an argument at that time. If that happens, we will have an argument.

I do not believe that we're in a position right now to structure an orderly plan of liquidation for a global accounting firm. It's just it seems to me to be beyond the kin of any regulatory institution and, in fact, I think one of the great disappointments that has come out of this financial crisis by the American public is that we have demonstrated the incapacity of the Fed to do this for banking institutions.

The Fed has lost credibility over this, but this is to tell you why I find the issue difficult. It's not to foreclose further discussion on the issue.

MR. HARRIS: And I wanted to ask a question along those lines and, first of all, I share, Barbara, your concern and, Lynn, your concern on this subject and I think it is an extremely difficult issue.

I don't want to end the day without discussing or getting any ideas as to whether or not anybody here has any concerns about the issue of concentration in the public company audit market. It's been a very hot topic. It's raised repeatedly by the European Commission. We have a highly-concentrated profession.

BDO, for example, in its response to the European Green Paper recommended, among other things, the outlawing of all artificial intervention by third parties, e.g., lenders, and the appointment of statutory auditors through restrictive clauses or lending processes which discriminate in favor of borrowers appointing particular audit firms or members of a particular group of audit firms and Grant Thornton and others had similar concerns as did others who responded to the European Union.

I'm wondering whether anybody here shares those concerns and has any ideas whatsoever in terms of how to promote competition.

MS. ROPER: You know me, I always have opinions, so I'll just jump in.

I actually see this issue differently and perhaps in part because I've spent a lot of time in the last 18 months working on credit rating agency issues.

Competition, increased competition without increased independence is likely to occur on terms that are not beneficial to investors.  If auditors are -- if there's more competition for business and it's competition to win management's favor, we're not going to be happy with the results.

So while I do have concerns about the degree of concentration that exists, including for this issue that I think there is, has been, and I've been very encouraged by the Chairman's comments, I think there has been a reluctance to discipline the big audit firms because of the sense that they're too big to fail, I think you need to think very carefully about what happens when you get competition and it promotes a race to the bottom.

MS. YERGER:  I would just quickly second Barbara's comments and I do want to note that I think from the Council's perspective, one area that we have concerns that may actually further concentrate the industry is the issue of convergence of accounting standards and the simple fact is I'm not certain that the mid- and small-cap companies have the capabilities to move in that direction, at least rapidly, and I think it gives really a competitive advantage to the big four which could further sort of exacerbate, I think, the perception that there's far too much concentration in the industry or profession, Mike.

MR. TURNER: I think you have to give people the information you need to -- in the marketplace so that they can force the firms to compete on quality.

Currently, that information is just not out there and so they're competing on fees at this point in time, and I think if you go to some type of mandatory rotation tied to forcing an auditor to tie into the investors once again, as Gus mentioned, and in that annual report, you start requiring disclosure with respect to information, so people can differentiate on a quality basis, then I think you'll start to have greater competition around the right issues which would mean you'd have to provide that information out there and the quality control factors as were proposed to the ACAP to be disclosed.

Absent that, there is nothing you're going to do to change the current environment of the big four and then probably the next couple of firms. There's just such a huge magnitude difference and so much capital or volume and size advantages to those four that the others just literally cannot, will not, never will have a chance of catching up with them.

General Discussion

MR. HARRIS: Well, to begin to wrap up, we said when we scheduled this that we'd give each member an opportunity in closing to put any issues on the table before us or make any closing comments.

So, Joe, first of all, thank you very much for that superlative presentation earlier on. I thought you did a terrific job and you and your group certainly spent a ton of time at it and it's very much appreciated.

I think maybe the best way to summarize the discussion is with the question at the last. I think maybe, Lynn, you told us Warren Buffet used to ask when he was on the company's audit committee and that is, what is it that the auditors know that if they were investing in this company they as investors would want to know and have out there publicly? I think that was a telling comment, and I think that you addressed a number of those issues in your presentation.

I want to go around the table and we'll finish up.

MR. CARCELLO: Yeah. I think this was an extremely good meeting, like our first meeting, Steve. I think the only comment I'd make, and this is really for you and the rest of the Board, is I think these get-togethers -- this is a very unique group, not leaving myself out. I don't want to give myself credit, but I think it's a very good group. I think we have a very good perspective.

I think the involvement today from the SEC was very helpful and I would just encourage you to have a more regular schedule now that there's a full slate of board members in place.

MR. TAROLA: Robert Tarola here. I also think this was a very informative meeting and it was good to hear the views of the board members as we focused on these various topics.

I think you have an opportunity to improve the system as well as improve the profession, not just the quality of it but the financial benefits of it, because I think you could move toward a relevance model that is to their benefit as well as to investor benefit and I think that you can create a win-win.

MR. HARRIS: Mike, and I want to say that, Jim and Brian and to you, thank you very much for participating today. We look forward to our ongoing relationship with you and if you have any comments, we'd welcome them.

MR. STARR: Nothing to add, other than to thank you, Steve, for having us here and I agree with you. I look forward to ongoing discussions. Thank you.

MR. TURNER: Steve, I'd say the interaction with the Board this week or today has been great. In the past the Board hasn't been as active in questioning and all. So I've very much so enjoyed the interaction and thought it was good and hope we'll have the same type interaction at next week's SAG. But with that, I think you know what the issues are. I think you got a good handle around what the issues are and I'll look forward to seeing what the Board does.

MR. SPORKIN: I do congratulate you again for an outstanding meeting. Maybe we ought to consider the next time hearing from the auditors.

MR. HARRIS: Judge, I believe deeply in transparency and so we'll take that, I think, under advisement at the Board but I have no problem whatsoever at any time not only hearing from investors in an open meeting but from the profession in an equally open meeting.

MR. SONDHI: As Mike said, we were talking about words and I'll use one right now, Mike. Given all the praise for this committee, we're bordering on heliographing now and I am not into idol worship, so I won't take it over there, but it has been a good meeting. I appreciate the opportunity to do this and I'm certainly more than happy to continue and help in any way possible.

Thank you for the opportunity.

MR. HARRISON: Steve, nothing further on the substance of today's discussions which have been wonderful. It is great to see all five chairs occupied and occupied by men of such skill and obvious interest in all that we're doing.

I want to thank you, Steve, for your stewardship of this process. I've been a member of other advisory boards and groups in the past and too often the model is you meet two or three times a year and everyone comes and there's a lot of energy and enthusiasm and then it sort of goes flatline until the next time you meet and there's energy and enthusiasm and it kind of falls off again.

That doesn't happen here and that's a tribute, I think, to you and your work. I was very pleased both last year as these things occurred but to hear your recap this morning of the significant work that was done in the immediate aftermath of our meeting last year to follow up on the issues that were discussed there and I am optimistic that the same will be true here, that you'll not hesitate to certainly call on us for further input as the Board moves forward and do hope that we'll be having occasion to gather together again the not-too-distant future.

Thank you.

MR. SAUTERS: I'd like to thank you for the opportunity to participate today. I very much enjoyed the comments from the Board, from all the members, as well, and really I'm excited about the prospects that we can get better information for investors. I think that's what it's all about.

MR. KROEKER: Steve, just wanted to thank you again. I think there's a lot to report back to the Chairman. When she left, she said she wanted to hear back. There's a lot to report back and really look forward to working constructively as you take leadership in this area.

MS. YERGER: Just want to thank the PCAOB Board and staff and the SEC staff for spending the time today. You both have -- both agencies have the important mission of protecting the interests of investors and I do think that investor voices too frequently are not maybe articulated, perhaps we're not vocal enough or visible enough on some of these policy debates. So I think this committee is very special, that this is a group of investors trying to propose reforms reflecting the needs of investors.

So, Norm, I'm going to follow your comments and not only am I looking -- I think I just want to urge the Board to act on those issues that I think have been studied for many, many years, in some cases decades. Let's make sure that we're taking the lead here in the U.S. as opposed to waiting for other regulators to act and to methodically but I think aggressively study those issues that need to be studied and I very much look forward to hearing the progress report at the next meeting.

MS. ROPER: Yeah. Hi. Barb Roper. I second everything everyone said. I mean, I really do appreciate the time all of the PCAOB board members have taken and the attention of the SEC staffers to spend essentially a full day listening to us express our views.

I have almost a second career as an Investor Advisory Board member, feels at times as if it's half my time in various different capacities, and, you know, I can't recall a time when I've seen (1), as someone else pointed out, the immediate responsiveness to the Board after our previous meeting which I think helps to inform the degree of energy that people brought to this meeting.

When you know that you're talking and it doesn't just sort of echo away down the halls, that it gets serious attention, that really makes a difference and I thought this was terrific.

So thank you.

MR. CROTEAU: Brian Croteau, and I'll just follow along with Jim and Mike in really thanking you, Steve, for inviting us today and to the full Board, really commending you and the group here today. I think a lot of really excellent dialogue as we think about audit quality and improving audit quality for the benefit of investors, I think really getting at identifying what are the real problems we're trying to solve, what are the causes of those problems, and what are the right next steps, and there's really a lot to think about coming out of today's meeting and so really thank everyone for that participation.

In particular, I thought a lot of the input from the survey on the auditors reporting model will be very helpful to the PCAOB's standard-setting project in this area. So really look forward to continuing our work together with the IAG and with the PCAOB and with the IAG on projects coming out of the discussions today.

So thank you.

MR. HARRIS: Well, I think a lot of the momentum that we brought today was as a result of Dan's efforts and leadership in terms of the list of priorities that he met. Dan, I don't know whether you or other board members want to make closing comments.

MR. GOELZER: The only thing I'd say is sitting here thinking about all the things that were on our agenda already and then all the additional ones you've added today, we're going to be very busy over the next six months.

MR. FERGUSON: I'd just like to say listening to all this today, it seems to me our job is really quite simple and it's simply to be worth of you.

Closing Remarks

MR. HARRIS: And I, before letting the Chairman wrap up, I want to thank all of you again. I think you put a ton of effort into it. It's easy for us, at least speaking for myself, to spend a day listening to you. I welcome it. Sometimes I like to hide behind the umbrella of the ideas that you bring to the table and lay a foundation so that I can be supportive or, in those instances, non-supportive but I certainly like to hear it.

And I especially want to thank Joanne Hindeman who has been invaluable helping us on all aspects of today's meeting, both substantively and organizationally. So, Joanne, it could never have happened without you. Appreciate it very much.

And, Mr. Chairman, I leave the Closing Remarks to you.

MR. DOTY: I really have nothing to add, except to say thank you, as I said last night, to the Investor Advisory Group, that there may be a group that we talk to who is as important as this one but there isn't anybody that we talk to in the year that are more important than this group and you're doing a great public service.

Thank you, all.

[Whereupon, at 3:45 p.m., the meeting was adjourned.]