

NOTICE: This is an unofficial transcript of the Public Company Accounting Oversight Board's March 21, 2012 Public Meeting on Auditor Independence and Audit Firm Rotation.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD
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AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION
PCAOB RULEMAKING DOCKET MATTER
NO. 37

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PUBLIC MEETING

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WEDNESDAY,
MARCH 21, 2012

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The public meeting convened in the
National Association of Home Builders
Auditorium, 1201 15th Street, N.W.,
Washington, D.C. at 8:15 a.m., James R. Doty,
PCAOB Chairman, presiding.

THE BOARD:

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

PCAOB STAFF:

MARTIN F. BAUMANN, Chief Auditor and
Director of Professional Standards
MICHAEL GURBUTT, Associate Chief Auditor
J. GORDON SEYMOUR, General Counsel
JACOB LESSER, Associate General Counsel

OBSERVERS:

BRIAN CROTEAU, U.S. Securities and Exchange
Commission
JIM KROEKER, U.S. Securities and Exchange
Commission

PANELISTS:

JAMES ALEXANDER, Head of Equity Research,
M&G Investment Management

MAX H. BAZERMAN, Jesse Isidor Straus
Professor of Business Administration,
Harvard Business School

JOHN H. BIGGS, former Chairman and Chief
Executive Officer, TIAA-CREF

JOHN C. BOGLE, founder and former Chief
Executive, The Vanguard Group

THE HONORABLE CHARLES A. BOWSHER, former
U.S. Comptroller General

THE HONORABLE RICHARD C. BREEDEN, Chairman
and Chief Executive Officer, Breeden
Capital Management, LLC; former
Chairman, U.S. Securities and Exchange
Commission

STEVEN E. BULLER, Managing Director,
BlackRock, Inc.

THEODORE BUNTING, JR., Senior Vice President,
Chief Accounting Officer, Entergy
Corporation (a member of the Edison
Electric Institute)

STEPHEN CHIPMAN, Chief Executive Officer,
Grant Thornton LLP

PETER CLAPMAN, Chairman and President,
Governance for Owners USA, Inc.

EDWARD J. DURKIN, Director, Corporate
Affairs, United Brotherhood of
Carpenters

JOE ECHEVARRIA, Chief Executive Officer,
Deloitte LLP

STEPHEN R. HOWE, Jr., Americas Managing
Partner and Managing Partner of the

U.S. firm, Ernst & Young LLP

GREG JENKINS, Professor of Accounting and
Information Systems and the William S.
Gay Faculty Fellow, Virginia Polytechnic
Institute and State University

RICHARD L. KAPLAN, Peer and Sarah Pedersen
Professor of Law, University of Illinois

at Urbana-Champaign

PANELISTS (Continued):

THE HONORABLE ARTHUR LEVITT, Senior Advisor to The Carlyle Group, Goldman Sachs Group, Inc., and Promontory Financial Group; former Chairman, U.S. Securities and Exchange Commission

DON A. MOORE, Associate Professor of Management of Organizations, Haas School of Business, University of California at Berkeley

ROBERT E. MORITZ, Chairman and Senior Partner, PricewaterhouseCoopers LLP

THE HONORABLE HARVEY L. PITT, Chief Executive Officer, Kalorama Partners LLC; former Chairman, U.S. Securities and Exchange Commission

VALARIE L. SHEPPARD, Senior Vice President and Comptroller, The Proctor & Gamble Company

DAMON A. SILVERS, Director of Policy and Special Counsel, AFL-CIO

JOHN B. VEIHMEYER, Chairman and Chief Executive Officer, KPMG LLP

THE HONORABLE PAUL A. VOLCKER, former Chairman of the Federal Reserve; former Chairman of the Economic Recovery Advisory Board

DARREN WELLS, Executive Vice President and Chief Financial Officer, The Goodyear Tire & Rubber Company

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(8:13 a.m.)

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3 CHAIRMAN DOTY: I want to welcome
4 everyone, to the Public Company Accounting
5 Oversight Board's first public meeting on the
6 Board's Concept Release on ways to enhance
7 auditor independence. The discussions we
8 undertake today will raise important questions
9 for our financial markets and the protection
10 of investors.

11 Investors need reliable financial
12 reporting in order that they or their
13 intermediaries can fairly evaluate a potential
14 investment as well as management's stewardship
15 of the companies in which they have purchased
16 interests.

17 These investor protection
18 considerations form the expressed purposes for
19 which Congress created the Public Company
20 Accounting Oversight Board. The
21 Sarbanes-Oxley Act requires that the PCAOB in
22 furtherance of investor protection establish

1 standards that foster auditor independence.

2 The linchpin of investor
3 confidence is the independent audit of a
4 public company's financial statements. The
5 statutory franchise to conduct these audits
6 has been accorded to the accounting
7 profession.

8 To perform their role properly, to
9 assure that reported financial and economic
10 successes are not illusory, auditors must
11 approach their jobs with independence,
12 objectivity, and skepticism. They cannot
13 allow themselves to be caught up in their
14 audit clients' business goals.

15 It is the rare case, the rare
16 case, in which an auditor knowingly
17 compromises his or her integrity. But
18 well-intentioned auditors, as with other
19 people, sometimes fail to recognize and guard
20 against their own unconscious biases.

21 We are nearly ten years from the
22 adoption of Sarbanes-Oxley. With that

1 experience, we have embarked on an in-depth
2 examination of an issue that continues to
3 trouble many of the most thoughtful supporters
4 of the audit profession: the subtle and not
5 so subtle influences on the auditor's mindset
6 and the implication for the integrity of the
7 audit.

8 In August 2011, the PCAOB issued a
9 Concept Release, seeking public comment on a
10 variety of questions about how to improve
11 auditor independence, objectivity, and
12 professional skepticism. Our discussion today
13 will supplement the written comments we have
14 received on the Concept Release.

15 The discussion will focus on ways
16 to insulate the audit process from the
17 pressure to maintain a long-term relationship
18 with the audit client, pressure that could
19 affect how an auditor approaches tough
20 decisions on an audit.

21 Many people are troubled by
22 reports of audits that span decades, even a

1 century. These are the engagements that no
2 partner wants to be the one to lose. At the
3 same time, we should be concerned about the
4 relatively new audit that the auditor may hope
5 to turn into a long-term engagement.

6 The panelists who are speaking to
7 us over these two days include some of the
8 most authoritative and experienced voices to
9 address the subject of audit quality, auditor
10 independence, and the challenges to both.

11 These panelists have different perspectives
12 and divergent views on rotation of audit firms
13 and a range of related subjects.

14 In issuing the Concept Release, I
15 recognize that fixed term limits would
16 significantly alter the status quo. The idea
17 is not popular among audit firms and
18 companies. The Concept Release did not raise
19 it lightly and was candid about the challenges
20 of implementing mandatory term limits.

21 I have no predetermined outcome in
22 mind other than that the debate be robust. If

1 there are better alternatives to accomplish
2 the goal of improving independence, we should
3 hear them.

4 We will hear honest debate about
5 whether term limits will enhance auditor
6 independence, objectivity, and skepticism and
7 about potential collateral drawbacks that
8 could result from rotation. To that end, the
9 meetings today and tomorrow include a wide
10 variety of perspectives. This is not a
11 contest to judge the loudest voice.

12 I want to acknowledge and thank
13 the many speakers scheduled for the next two
14 days for setting aside time and in many cases
15 traveling significant distance to be here.
16 Your participation is critical to helping us
17 fill the scope of opinion for our examination.

18 I hope to hold similar meetings in
19 other cities around the country. I look
20 forward to each of those meetings informing
21 this important debate.

22 And now I want to recognize my

1 colleagues for a brief comment as well. Mr.
2 Harris?

3 MEMBER HARRIS: Mr. Chairman, I
4 will be brief. I commend you for initiating
5 these public hearings and for making the
6 enhancement of auditor independence,
7 objectivity, and professional skepticism a top
8 priority of the Board. Having such a
9 distinguished group of experts to talk about
10 these issues is testament to the importance of
11 this topic to financial markets, capital
12 formation, and to investor protection.

13 The drafters of the Sarbanes-Oxley
14 recognized that independence is the bedrock
15 upon which audit quality is built and included
16 several reforms designed to enhance
17 independence. For example, among other
18 things, the responsibility for selecting and
19 overseeing external auditors was taken from
20 management of listed companies and given to
21 audit committees, auditors were banned from
22 providing numerous non-audit services to their

1 audit clients, and audit firms were forced to
2 rotate lead engagement partners every five
3 years.

4 However, even with these important
5 reforms, the inspection findings of the Board
6 as well as those of our international
7 counterparts indicate that more needs to be
8 done. In addition to the findings of our
9 PCAOB inspectors, regulators in, for example,
10 Australia, Canada, Germany, the Netherlands,
11 Singapore, and the United Kingdom have cited
12 deficiencies in professional skepticism as a
13 cause of persistent problems at audit firms.

14 And, just as we in the United
15 States are considering ways to improve auditor
16 independence, objectivity, and professional
17 skepticism, so are many of our international
18 counterparts. Investor groups and leaders of
19 the profession alike recognize that the status
20 quo is not an option.

21 The Board has received over six
22 hundred comment letters in response to our

1 Concept Release. In addition to mandatory
2 rotation, suggestions have included, for
3 example, mandatory re-tendering, audit-only
4 firms, enhancing auditor training, joint
5 audits, strengthening audit committees,
6 enhancing independent standards, and more
7 targeted PCAOB inspections. Some assert that
8 as long as auditors are paid by their clients,
9 independence issues will continue to surface.

10 We have a responsibility to
11 explore all options and carefully consider the
12 intended and unintended consequences of each
13 option, including the costs of each.

14 It is a particular pleasure to
15 welcome Chairman Volcker, Chuck Bowsher, and
16 Richard Breeden and later Damon Silvers,
17 Harvey Pitt, John Biggs, Rod Hills, and Arthur
18 Levitt. 2012 marks the tenth anniversary of
19 the passage of the Sarbanes-Oxley Act, and it
20 was ten years ago last month that each of you
21 testified before the Senate Banking Committee
22 and provided such valuable input to the

1 Committee.

2 I look forward to hearing your
3 comments and suggestions as well as the
4 remarks of all of those who participate in
5 these roundtables over the next two days.

6 Thank you, Mr. Chairman.

7 CHAIRMAN DOTY: Mr. Ferguson?

8 Thank you.

9 MEMBER FERGUSON: We are grateful
10 to the many distinguished individuals who have
11 been willing to share their time with us today
12 to give us their views on what is an important
13 issue to us. (Microphone On) We are grateful
14 to the many individuals who have decided to
15 come here and spend two days with us talking
16 to us about what for us is a very important
17 topic, namely auditor independence and how it
18 contributes to the kinds of public company
19 audits that I think we all share the view that
20 we need.

21 This board member at least
22 approaches the issue of auditor independence

1 and its relation to the question of auditor
2 compensation and audit firm tenure as a
3 curious skeptic. Despite the many, many rules
4 we have that try to create a structure of
5 independence, at least the PCAOB inspection
6 program over the last few years has revealed
7 a number of audit deficiencies that are
8 repeated year after year and that appear to
9 stem from an absence of auditor skepticism.
10 The question is, where does this absence of
11 skepticism come from? Is it related to the
12 structure of auditor compensation and is it
13 related to the absence of audit firm tenure
14 limitation?

15 So I hope that we can address a
16 number of questions today. First of all, does
17 such a relationship exist? Secondly, even if
18 it were the case, what would the costs of a
19 mandatory audit firm rotation regime be? What
20 would it cost for a new auditor to learn a
21 complex business? What would the costs be in
22 terms of the time of the client's management

1 that would be diverted from the core business?
2 What human capital costs would be involved,
3 particularly where large audit clients are
4 located in places where the only significant
5 audit firm office is the client's longstanding
6 auditor?

7 Would audit deficiencies, in fact,
8 increase in the early years of a new auditor's
9 tenure as it learned the client's business?
10 Would any increase in independence outweigh
11 whatever these costs are? These are the
12 questions on which we seek your views.

13 Another area of inquiry that
14 deserves focus is whether the auditor
15 independence and its correlative, auditor
16 skepticism, is even related to the structure
17 of auditor compensation or auditor tenure. In
18 other words, are we barking up the wrong tree?
19 But if so, what are your suggestions for
20 improving what the Board's inspection program
21 reveals to be serious deficiencies in auditor
22 skepticism that seem to underlie many audit

1 failures.

2 I hope that participants in this
3 meeting will also discuss whether audit
4 committees are able effectively to monitor
5 auditor independence and to counteract
6 whatever force the existing auditor
7 compensation and tenure models exert in
8 undermining independence. Do participants
9 believe that audit committees, to the extent
10 one can generalize in this way, even perceive
11 a problem? If so, do they possess the
12 technical skills or have access to the
13 technical skills to ask the right questions?

14 Any rule that would overthrow
15 longstanding and well-accepted practices that
16 are not obviously wrong bears a heavy burden
17 of proof, but the board is faced with stubborn
18 and persistent issues of audit deficiency that
19 raise serious and fundamental questions about
20 how the current independent audit model for
21 public companies works. On these issues, we
22 seek your wisdom.

1 CHAIRMAN DOTY: Mr. Hanson?

2 MEMBER HANSON: I would like to
3 join Chairman Doty and my fellow Board members
4 in thanking today's panelists and welcoming
5 them to this event and everybody listening,
6 whether in person or over the internet,
7 especially the busy lives of the panelists.
8 It's really important and remarkable that we
9 have them here today. Your experience and
10 insight are invaluable as we consider the
11 important but difficult issues of auditor
12 independence, objectivity, and skepticism.

13 I noted back in August of last
14 year, when the Board issued the Concept
15 Release on auditor independence, that my main
16 goal for the Concept Release was to provide a
17 vehicle to gather information and spark
18 discussion about whether the board should do
19 more to enhance auditor independence,
20 objectivity, and skepticism and if so, what
21 steps the board should take. Today's event
22 continues that effort.

1 Based on the number of comment
2 letters we received, over 620, this clearly is
3 a topic in which many people have an interest.
4 The comment letters demonstrate strong support
5 for the board to consider the issue of auditor
6 independence, objectivity, and skepticism,
7 although mandatory auditor rotation as an
8 approach to enhance independence had
9 significantly less support.

10 I am pleased that we received
11 substantial input from investors through
12 members of the audit committees given their
13 important role in ensuring the independence of
14 auditors. Investors lie at the core of our
15 mandate. So I am particularly sensitive to
16 their views and look forward to learning more
17 about their varying perspectives.

18 The audit committee comment
19 letters expressed virtually unanimous
20 opposition to mandatory firm rotation, and I
21 think it is important that we understand why.
22 So I anticipate that we will get into that

1 today.

2 I am also interested in
3 understanding the factors considered by those
4 audit committees who have voluntarily
5 established periodic auditor rotation. I
6 would like to hear from them and others
7 whether making auditor rotation mandatory,
8 rather than leaving it as a voluntary option
9 for audit committees, would provide any
10 additional benefits. At the same time, I am
11 concerned about comments suggesting that the
12 board's actions could undermine the role of
13 the audit committees, making them less
14 effective.

15 Feedback on rotation from
16 investors other than audit committees was more
17 mixed. I hope to hear more about how we might
18 be able to accomplish our goal of enhancing
19 auditor independence, objectivity, and
20 skepticism without causing negative unintended
21 consequences, such as unreasonable costs or a
22 decrease in audit quality.

1 Audit firms and financial
2 statement preparers also provided extensive
3 comments, in some cases highlighting what they
4 believe are significant downsides to mandatory
5 auditor rotation. Auditors and preparers have
6 extensive hands-on experience with audits, and
7 they provide a valuable perspective. Yet,
8 firms are not unanimous in their opposition to
9 mandatory rotation, so hopefully we can
10 explore the reasons for their varying views.

11 Finally, we have heard from a
12 number of academics who have attempted to look
13 at the related issues empirically, and several
14 well-regarded university professors are
15 joining us today. I look forward to hearing
16 about their research, and I am always eager to
17 hear about the steps that learning
18 institutions can take to prepare students for
19 their important roles in the capital markets.

20 I anticipate that the questions we
21 pose to the panelists today will range far and
22 wide and should foster a good debate. Themes

1 to explore from my chair include defining the
2 problems that we are trying to solve,
3 including by trying to better understand the
4 extent to which our panelists believe auditors
5 currently lack independence, objectivity, and
6 skepticism and what evidence we should
7 consider in support of such views; the role
8 and effectiveness of audit committees in
9 ensuring auditor independence; auditor
10 behavior since the enactment of the
11 Sarbanes-Oxley Act, including actions firms
12 have taken and are continuing to take to
13 enhance auditor independence, objectivity, and
14 skepticism, and the effectiveness of those
15 measures; and, most importantly, I would like
16 to hear what other alternatives people have to
17 talk to us about related to a mandatory
18 auditor rotation.

19 So let me end by thanking the
20 staff of the Office of the Chief Auditor,
21 including Marty Baumann and Michael Gurbutt
22 sitting here up front with us, as well as the

1 staff of the SEC that worked very hard with us
2 on coming up with this Concept Release. We
3 have many frequent discussions with them. And
4 I look forward to the event.

5 CHAIRMAN DOTY: Ms. Franzel?

6 MEMBER FRANZEL: Thank you,
7 Chairman Doty, for calling these public
8 meetings to discuss ways to improve auditor
9 independence, objectivity, and professional
10 skepticism.

11 I am so pleased that the board
12 will be receiving input over the next two days
13 from so many distinguished panelists
14 representing a wide range of stakeholders. I
15 want to thank all of the panelists, their
16 staff, and their constituencies for taking the
17 time and effort to assist us in exploring
18 these important issues.

19 I am personally committed to
20 exploring the broad range of issues that
21 impact auditor independence, objectivity, and
22 professional skepticism and advancing the

1 board's efforts to forge a path for improved
2 audits that help ensure investor protection
3 and audit quality.

4 Clearly an independent,
5 high-quality, and reliable audit function is
6 fundamental to investor protection and the
7 public interest. Auditor independence is the
8 cornerstone of informative, accurate, and
9 independent audit reports. This is a complex
10 and difficult topic because the concept of
11 auditor independence challenges personal
12 behavior and ethics of auditors as well as
13 ingrained business models and business
14 interests.

15 But we need to deal with these
16 difficult topics, the results from PCAOB
17 inspections are troubling. PCAOB inspections
18 continue to find serious audit deficiencies
19 where auditors do not conduct basic testing
20 procedures required by the standards in areas
21 that are material and that impact investors.

22 The potential causes for these

1 problems are complex and vary in nature across
2 cases. We need to continue to analyze the
3 causes of why auditors issue clean opinions in
4 cases when the audit work is incomplete or not
5 properly conducted.

6 When financial statement
7 information is contradicted by other available
8 evidence or when audit conclusions on material
9 issues are based on management's views without
10 independent verification, unfortunately, the
11 Board has seen too many examples where
12 auditors go ahead and issue clean opinions
13 without fully or properly completing the audit
14 work in important areas that impact investors.

15 The methods for improving auditor
16 independence and audit quality won't be easy
17 or simple. There will not be one single silver
18 bullet. Accordingly, the Board has set a
19 broad agenda looking at a variety of issues
20 that could help improve auditor independence
21 and audit quality.

22 It is my hope that the ongoing

1 discussions on these issues will lend insights
2 into the multiple, interrelated factors that
3 influence the behavior of auditors and audit
4 firms.

5 The bottom line here is that we
6 must come up with a package of solutions that
7 will be solid and effective in protecting
8 investors and the public interest. This will
9 involve looking beyond the status quo.

10 At the same time, we need to
11 analyze the potential costs and benefits of
12 various actions as well as the risks
13 associated with unintended consequences so
14 that in the end, we are effective in
15 protecting the interests of investors and
16 furthering the public interests.

17 I look forward to working with my
18 fellow board members, the staff of the PCAOB
19 and the SEC, and our stakeholders on these
20 important issues. I welcome the input of the
21 panelists over the next two days.

22 CHAIRMAN DOTY: Thank you,

1 Jeanette.

2 We are, as always, grateful for
3 the support we get from the SEC and the staff
4 we have here today Jim Kroeker and Brian
5 Croteau from the staff. They will be
6 questioners at times, and we are grateful for
7 their interest in this project. Only a panel
8 of the distinction of the one we have in front
9 of us, could have gotten this many people out
10 this early in Washington, D.C. I think.

11 But before us we have the
12 honorable Paul A. Volcker, former Chairman of
13 the Federal Reserve Bank and a former Chairman
14 of President Obama's Economic Recovery
15 Advisory Board, who is widely credited, of
16 course, with ending high levels of inflation
17 seen in the United States in the 1970s and
18 '80s, whose career stretches back decades to
19 the Treasury and the Federal Reserve Bank of
20 New York, where he was the President from '75
21 to '79.

22 The honorable Charles A. Bowsher,

1 Chuck Bowsher, is former U.S. Comptroller
2 General of the General Accounting Office.
3 Appointed by President Reagan in 1981, he had
4 a 25-year career in public accountancy. He
5 served as Assistant Secretary of the Navy. He
6 is currently a member of the Research Advisory
7 Council of Glass Lewis and serves on many,
8 many boards, including -- he is a public
9 member of the NASD Board of Directors and of
10 the FINRA Board. And he is a member of our
11 Advisory Board at the Public Company
12 Accounting Oversight Board.

13 The honorable Richard C. Breeden
14 was Chairman of the United States Securities
15 and Exchange Commission from 1989 to 1993. He
16 now heads Breeden Capital Management, LLC and
17 serves as a director and has served as a
18 director of a number of American public
19 companies and has been Chairman of the Board
20 of H&R Block from November 2007 to April 2011.

21 So these gentlemen bring a wealth
22 of experience. And we would like to begin by

1 asking Mr. Volcker to address us all. Thank
2 you.

3 MR. VOLCKER: Well, thank you, Mr.
4 Chairman and members of the Board. I
5 appreciate the invitation to appear here.

6 You are dealing with a very
7 important issue of auditing integrity. You
8 made clear that the concerns go well beyond
9 the question of auditor rotation, which is the
10 centerpiece of this particular hearing. But
11 auditor rotation is a significant element in
12 how we proceed.

13 I have a chance to read the
14 written statements of Chuck Bowsher and John
15 Biggs and John Bogle and found myself in
16 substantial agreement with those I thought
17 convincing arguments in terms of auditor
18 rotation. And I won't take the time to repeat
19 all of that argument.

20 Let me say that it is obvious we
21 are all aware of lapses in auditor performance
22 in recent years that get widely reported.

1 Those have continued beyond Sarbanes-Oxley and
2 the appointment of this Board.

3 Most impressive to me is not what
4 we read about in the papers but the careful
5 reviews that the Board has made and the staff
6 has made of auditing performance and the
7 number of occasions where you have pointed out
8 indications of divided loyalties or
9 inattention contrary to the professional
10 discipline and ingrained skepticism that we
11 should expect of auditors.

12 And I do understand, as I guess
13 Board Member Harris mentioned, that these
14 concerns extend to a number of other European
15 countries, in particular, who are in the
16 process of reviewing this issue.

17 My own experience is embedded in a
18 maybe rather unfortunate period when I was
19 deeply involved in Arthur Andersen and could
20 observe its sad demise. Here you had a firm
21 that historically was considered the
22 strongest, most disciplined of auditing firms.

1 That discipline and integrity I have to say
2 was not displayed in the days preceding my
3 involvement in Arthur Andersen. And that,
4 directly or indirectly, led to the ending of
5 that firm. It was simply a failure of
6 internal management controls, compensation
7 practices that rewarded retaining clients and
8 success in attracting new business, rather
9 than the exposure of inadequate financial
10 reporting, constant tension between auditing
11 partners and consultants in terms of the
12 existence and profitability of the firm. So
13 we had a once-leading firm that became the
14 victim of a succession of auditing failures.

15 Let me say I have also seen many
16 different perspectives that may be relevant of
17 professional auditors at their best. I at one
18 point was chairman of a committee to look into
19 allegations of Swiss banks misusing the funds
20 of Holocaust victims and also a committee
21 looking into corruption in the U.N.
22 Oil-for-Food Program. In both those cases, we

1 were heavily relying upon professional
2 auditors in pursuing the problem.

3 I must say I think both of those
4 investigations were successful, but perhaps
5 not so coincidentally, those audits, while
6 indirectly funded by the institutions
7 investigated, had the sole responsibility to
8 those in charge of the investigation, not to
9 those paying the bills. And that may have
10 released a certain amount of constructive
11 energy.

12 As a corporate director, I also
13 observed one important instance where a
14 succession of problems led to a change in
15 auditors. And ensuing auditors, certainly in
16 reviewing the earlier evidence, found a lot of
17 weaknesses in the auditing process by a firm
18 that had been long involved in that company.

19 So, although that experience does
20 suggest to me the importance of requiring
21 auditor rotation, it does seem to me that
22 regular audits should not become a sort of

1 long-term annuity for the accounting firm paid
2 for by the company being audited, rather than
3 being responsive to the true client: the
4 investment public.

5 I know there is a natural
6 reluctance to risk interrupting the
7 relationship, the long-term, perhaps rather
8 cozy relationship, of the employing committee
9 or executive offices or companies. The idea
10 of friction between the auditor and the
11 company raised deserving questions for both
12 the auditing company and the company being
13 audited. So the possibility can't be
14 dismissed that judgments may be influenced,
15 consciously or not, by the potential for
16 consulting relationships extending over a
17 period of time.

18 I do think the sense that work may
19 be subsequently reviewed by another auditing
20 firm can be a powerful incentive to maintain
21 professional discipline. I understand why it
22 makes an auditing firm perhaps uneasy to know

1 that its term as auditor may be up and another
2 firm is going to come and look over the work,
3 but I think that is a useful point of
4 uneasiness.

5 I also would suggest that perhaps
6 a senior auditing partner should sign the
7 auditor report, a little different subject, to
8 add a bit to the sense of personal as well as
9 firm responsibility in the auditing.

10 I know the red light is on. I
11 know there are some downsides in terms of
12 cost. I think we can discuss that a bit in
13 the subsequent discussion. I know Mr. Bowsher
14 and Mr. Breeden will refer to it. So let me
15 stop at the moment.

16 CHAIRMAN DOTY: You will be called
17 on again, Mr. Volcker. Thank you.

18 Mr. Bowsher?

19 MR. BOWSHER: Thank you very much.
20 It is a pleasure to be here. And I think this
21 is such an important issue, the issue of audit
22 independence and the interface of the

1 professional audit firm and their client.

2 You have to start with the idea
3 that there is an inherent conflict of interest
4 when the big corporate clients are paying the
5 audit fees. And I think that is true of
6 rating agencies, too, as well as the audit
7 profession. Therefore, you must decide on how
8 best to strengthen the audit independence.
9 And I think audit rotation is one of the main
10 issues.

11 I believe the Sarbanes-Oxley
12 legislation, Mr. Chairman, that you and Steve
13 Harris especially talked about, has been a big
14 success in strengthening and improving the
15 audit independence in the vast majority of the
16 small and medium-sized client situations.
17 However, I think many people believe that in
18 the 2008 financial crisis, there were far too
19 many incidents where the audit firms did not
20 insist on full disclosure of risks and
21 material weaknesses of their biggest clients.
22 And all too many of the financial statements

1 did not fairly present the financial position
2 of the client.

3 I list a number of companies,
4 starting with Lehman Brothers and Bear Stearns
5 at that. The biggest financial institutions
6 and some of our biggest companies, General
7 Electric, General Motors, would be in that
8 category as far as I am concerned.

9 So I believe it is very timely and
10 somewhat long overdue that the SEC and the
11 PCAOB consider additional issues that would
12 further strengthen auditor independence in
13 addition to the ones enacted in the SOX
14 legislation. And I believe the most important
15 change and improvement would result from the
16 requirement of an audit firm rotation for the
17 biggest clients of the Big Four firms.

18 I believe the comment memorandum
19 that John Biggs, retired Chairman and CEO of
20 TIAA-CREF, submitted to the PCAOB last
21 November is really an excellent paper on the
22 history of the audit firm rotation issue and

1 why the events of the last ten years, since
2 SOX was passed, clearly showed the need for
3 requiring that public companies periodically
4 rotate their audit firms.

5 Now, there are two main benefits
6 of firm rotation. And they were featured in
7 the Cohen Commission report back in 1978.
8 First, since the tenure of the independent
9 auditor would be limited, the auditor's
10 incentive for resisting pressure -- and
11 "pressure" is a very key word here -- from
12 management would be increased. Second, a new
13 independent auditor would bring a fresh
14 viewpoint.

15 At the same time, there are many
16 issues and arguments against rotations, but I
17 think there are three big ones. One is the
18 increased cost. The second one is steep
19 learning curve for the new auditing firm,
20 which might lead to an audit failure; and too
21 much disruption for the auditing firms. Let
22 me address each of those.

1 I believe that it would be wise on
2 the cost issue to limit the adoption of the
3 audit firm rotation at the beginning here to
4 somewhere between 25 and 40 very large
5 companies. This selection should include all
6 the major financial institutions and certainly
7 any firm that is designated as "Too Big To
8 Fail" by the FDIC. Also, I think the
9 selection should include some of the biggest
10 industry leaders, such as General Motors and
11 General Electric. In addition, it would be
12 prudent, of course, to include any large
13 companies that appear to have significant
14 audit and accounting problems.

15 If rotation is limited to the very
16 large companies, the cost issue really is
17 moot. The cost of an audit for the very
18 largest companies is a very, very small
19 percent of their overall cost structure.

20 The second issue is the steep
21 learning curve issue, which I have always been
22 somewhat suspicious of, but it can be

1 addressed I think very well by requiring a
2 dual audit by the two firms in the last year
3 of the audit term. If it's the 10th year,
4 that would be the year. And those large
5 companies can easily afford this. In
6 addition, by requiring each firm during that
7 tenth year to submit an independent report to
8 the Board of Directors, the investors, make it
9 public, the PCAOB, and the SEC on the overall
10 condition of the financial statements and the
11 systems and controls of their client.

12 This would result in what John
13 Biggs called in his November paper a
14 "real-time" peer review. His paper goes on to
15 state "The outgoing auditor would want the
16 work papers to be complete and of high quality
17 with all problems clearly resolved. The new
18 firm would review them, and could either
19 challenge the results or start with fresh
20 eyes."

21 Now let me just digress for a
22 minute. When I was with Arthur Andersen from

1 1956 into the '70s, it was led by Leonard
2 Spacek. And, as Paul said, it was the great
3 firm. It was the best firm. I'm prejudiced,
4 but let me tell you Leonard Spacek knew how to
5 handle tough clients. And he knew how to
6 build a great firm. And we were a small firm,
7 though. So we lost a lot of clients every
8 year to Pricewaterhouse and the big English
9 firm, as we call it. And the English firm is
10 in New York. And so he always wanted to make
11 sure there were no problems. And when he
12 heard of a merger and acquisition taking place
13 that would remove one of our clients to one of
14 the big New York firms, he always made sure
15 that he put another couple of partners on
16 there to do an independent review, you might
17 say. He didn't want any problems to come back
18 like that.

19 When I came out of the job as
20 Comptroller General, I went onto several
21 Boards, as you pointed out, Mr. Chairman. One
22 was American Express Bank. And Dan Akerson,

1 the current CEO of General Motors, a new CEO
2 of General Motors, he was the Chairman of the
3 Audit Committee for the corporation. And I
4 was Chairman of the Audit Committee for the
5 bank.

6 And, of course, when SOX came in,
7 why, we worked together quite a bit. And one
8 of the things I urged on them, that we would
9 have two big firms working for us, one that
10 did the audit and one that did everything
11 else, internal audit reviews, tax work,
12 everything else. And he bought into that.

13 Later, after I left, he actually
14 rotated off the first audit firm to the second
15 audit firm. And he told me just the other day
16 when I saw him that, you know, there were some
17 problems, there were some difficulties but
18 nothing that was hard to handle. And he said
19 now that he's at General Motors -- and I think
20 he said they have had the same auditors for 90
21 years was his term. He is a supporter he said
22 of the overall idea of rotation. And he

1 wished us well. Let me put it that way.

2 The third issue now in this whole
3 thing is, would it be too disruptive for the
4 auditing firms and all the big auditing firm
5 managers? They don't want this because it is
6 easier if you have the annuities from your
7 past. And especially if they are 20, 30, 40,
8 50-year clients with big fees, why it is much
9 easier to manage the firm.

10 But I think the independent look
11 is more important. And I have never been
12 convinced that when I was Comptroller General
13 of this it's too disruptive. When we did the
14 Yellow Book, which was the standards for the
15 states and large cities and municipalities, we
16 included a requirement for the auditors to be
17 rotated every five years. And that is what
18 has been happening for the last 20-plus years.

19 It also should be noted, as you
20 mentioned, that the European Commission is
21 considering the audit firms will be required
22 to rotate after a maximum engagement period of

1 six years with some exceptions, as they say.

2 So I say that, you know, at the
3 beginning, if you were just limiting this to
4 40 companies or some number like that and
5 stagger the rotation over 10 years, the result
6 would be the big firms would be losing maybe
7 1 or 2 firms each year and maybe picking up 1
8 or 2 firms.

9 In each year now, they all lose
10 more than that from mergers, sales, and
11 acquisitions of clients. So, of course, we go
12 back to 2002, when Arthur Andersen went down,
13 for the very reasons that Paul pointed out,
14 unfortunately. Why, hundreds had to rotate
15 off and go to other firms. And there were
16 problems, no question, but it was also
17 successfully accomplished.

18 So, just in conclusion, I would
19 just like to say as the last Chairman of the
20 POB, I strongly recommended to the Congress
21 ten years ago the creation of the PCAOB
22 because of the POB's inability at that time to

1 oversee the big firms and the AICPA.

2 I salute the current leadership of
3 the PCAOB for taking on these major issues now
4 on your agenda. And I said at the beginning
5 the rotation issue is number one. We have
6 debated it for 30 years. I think the last ten
7 years have provided more than enough evidence
8 that it should be adopted.

9 CHAIRMAN DOTY: Thank you, Mr.
10 Bowsheer.

11 Mr. Breeden?

12 MR. BREEDEN: Chairman Doty,
13 Commissioners, and staff of the PCAOB, it is
14 a great honor for me to be here and
15 participate in this discussion of auditor
16 independence, objectivity, and professional
17 skepticism. In fact, I consider myself a
18 lifelong skeptic on a variety of topics. And,
19 therefore, it is a pleasure to discuss that
20 issue, in particular.

21 Having served together with
22 Chairman Doty during my time as Chairman of

1 the SEC, it is immensely gratifying to me to
2 see the PCAOB under his most thoughtful
3 leadership. And just as important is the
4 outstanding group of commissioners and superb
5 staff that have been assembled at the PCAOB.
6 And, although I would defer to Steve Harris on
7 this point, from my perspective, I think the
8 PCAOB has already exceeded the hopes of those
9 who helped create the agency. And, yet, I am
10 sure that the best is yet to come.

11 I don't have a specific yes or no
12 answer on the issue of mandatory rotation of
13 audit firms. Rather than either supporting or
14 opposing mandatory rotation this morning, I
15 would like to offer a few observations based
16 on my practical experience. And, as the
17 Chairman noted, those include serving as
18 monitor of KPMG under its deferred prosecution
19 agreement with the Justice Department
20 following tax shelter frauds, a three-year
21 stint as a senior partner of Coopers &
22 Lybrand, overseeing the restructuring of

1 WorldCom and the restatement of its financial
2 statements, the largest restatement ever
3 undertaken, serving as the director of more
4 than a dozen companies, and investing several
5 billions of dollars in 65 different companies
6 in the U.S. and Europe.

7 And in those experiences -- and in
8 the course of that, I have been through
9 probably a dozen accounting firm transitions
10 of companies where I was a director or
11 investor or had oversight responsibilities.
12 Those experiences leave me believing, pretty
13 much as I did when the SOX was being
14 considered, that mandatory rotation would
15 benefit some companies and it would probably
16 harm others. And I am not able to tell the
17 actual proportions of those two eventualities.
18 So let me highlight a couple of concerns that
19 may be helpful in your thinking as you address
20 these issues.

21 First is the issue what I think of
22 as the elephant in the room. And that is the

1 issue of concentration in the accounting
2 profession. Over the years, when I first
3 started worrying about these topics, we had a
4 Big Eight. Then it was a Big Six. And then
5 it was a Big Five, and now it's a Big Four.
6 And if I hadn't been successful saving KPMG,
7 unlike my friend Mr. Volcker's inability to
8 save Arthur Andersen, we would have been down
9 to Big Three. And that would have been a
10 disaster.

11 But for companies and their audit
12 committees, the lack of competitive firms,
13 competitive choices significantly limits their
14 practical options. For many reasons, Ford is
15 reluctant to have the auditor of General
16 Motors as their auditor. Whether it is a
17 direct competitor, whether it is a potential
18 hostile acquirer, whether it is a firm that's
19 on the opposite side doing litigation work in
20 a massive litigation, there are many reasons
21 why members of an audit committee might see
22 some of the other of the Big Four as

1 unattractive potential and as not viable as
2 potential audit firms.

3 So this is a serious issue. And I
4 think if we were dealing in a world of eight
5 major accounting firms, mandatory rotation
6 would be a much easier topic than a world in
7 which there may only be one viable firm,
8 particularly in the large companies that Chuck
9 was talking about.

10 By the way, I agree with Chuck's
11 suggestion that if you are going to do this,
12 the large companies is the place to start.

13 Another issue is the question of
14 independence and the economically inherent
15 issue of the fees. And for a very large
16 global company, it is not at all unheard of
17 for the audit fee to be up in the tens of
18 millions of dollars.

19 I think back ten years ago.
20 Enron's audit fee was in the 20 to 25
21 million-dollar range. As a purely financial
22 matter, the \$25 million audit fee in

1 perpetuity with a discount rate of 5 percent
2 has a present value, that audit relationship,
3 of somewhere around \$500 million or a
4 half-billion dollars.

5 So the ten or so largest audit
6 relationships of any of the Big Four firms
7 could have an aggregate present value of
8 several billion dollars assuming continued
9 incumbency. That's an immense sum for any
10 professional firm, and it helps explain why
11 the issue of auditors trying to please the
12 largest clients continues to arise,
13 notwithstanding how many inspections the PCAOB
14 performs.

15 The largest audits support the
16 audit firm's core existence, and they pay the
17 pensions of the partners. That is something
18 that every audit partner understands, whether
19 you tell them that explicitly or not.

20 To some, that is a reason to force
21 rotation in hopes that that will break that
22 conflict and the immense influence of the

1 fees. For various reasons, though, I'm not
2 sure that improved objectivity would be the
3 result.

4 If the mandatory rotation period
5 is reasonably long, such as 10 or 12 years,
6 then the partners of the incumbent firm would
7 still be afraid of losing the audit in the
8 early years of that tenure. The guy who loses
9 the audit in year two or three of a ten-year
10 period is going to be just as disadvantaged
11 internally in the firm as a person who might
12 lose it in later years without rotation.

13 Even as the time for rotation got
14 close as you got into year seven, eight, or
15 nine, the incumbent firm would be highly
16 preoccupied trying to find replacement clients
17 to replace those that it was losing. And they
18 would want the management of the firm they are
19 losing to be singing their praises to other
20 firms that might be considering swapping if
21 Ford and GM are going to swap their auditors.

22 So I am not convinced that lack of

1 objectivity would suddenly result from
2 rotation. Ultimately, rotation would replace
3 one set of somewhat conflicted audit partners
4 with another set of partners with exactly the
5 same issue. One group of people would lose
6 their relationship, and another group of
7 people would step right into their shoes.
8 Theoretically the new firm would know it was
9 going to lose the client down the road, but,
10 again, it would be six or seven years before
11 that was a realistic discipline.

12 Thus, you would have some degree
13 of musical chairs among audit firms. And I
14 really doubt that objectivity levels would
15 rise that much as a result.

16 I would like to before I stop here
17 for the red light mention a word, say a word,
18 about the PCAOB inspection program and how
19 critically important that is.

20 When I was monitor of KPMG, I had
21 the occasion to look at some of those reports
22 and consider several very significant issues

1 that came to light as a result of them. And
2 I think to the extent that rotation is not
3 something that you move forward with
4 immediately, that the inspection program is
5 developing far better empirical evidence about
6 the scale and scope of problems and how to
7 address them than we ever had before and
8 better than any of the opinions many people
9 may have. So I hope that that can be enhanced
10 as you go forward.

11 My own suggestion for a possible
12 middle course, is to instead of having
13 mandatory rotation if you conclude that's not
14 viable, would be to use a U.K. or European
15 system of comply or explain and that the PCAOB
16 could set a ten year expectation and in year
17 seven or eight be sure that it does an
18 inspection of the large audit client.

19 If that inspection comes back
20 showing unacceptable levels of problems for
21 objectivity and independence, then there
22 should be no option for renewing the audit,

1 but if the firm got a clean opinion, if the
2 inspection report showed that they were doing
3 a good job, then that would in my view allow
4 you to comfortably allow the audit committee
5 to then make a judgment. So you would have,
6 in essence, a rebuttable presumption of a loss
7 of independence at the end of ten years. But
8 if they had acceptable inspections, if they
9 did a reproposal and considered the
10 alternatives, and if the audit committee then,
11 being fully aware of the situation voted to
12 continue the incumbency, I would allow that
13 option.

14 Thank you very much.

15 CHAIRMAN DOTY: Thank you, Mr.
16 Breeden.

17 We have about 25 minutes for
18 questions and dialogue with this distinguished
19 panel. And I think we should go in reverse
20 military order. So, Jeanette, the floor is
21 yours.

22 MEMBER FRANZEL: Thanks, Mr.

1 Chairman.

2 Mr. Bowsher, you talked about the
3 need to start this rotation with the largest
4 firms first because of the increased risk in
5 those firms and those audits. We've also got
6 the concentration issue. Can you speak a
7 little bit more about the risks you see with
8 the big audits and how concentration might
9 play into the more immediate proposal that you
10 are making to start with the big firms and the
11 big audits?

12 MR. BOWSHER: Yes, I would be
13 pleased to do that. There is no question you
14 have concentration, both in the audit firm --
15 and I wish we had the Big Eight, instead of
16 the Big Four, as Richard pointed out, but we
17 are saddled with that situation. And a lot of
18 the industry -- and we have big four banks now
19 that really dominate the whole issue. So this
20 is not a perfect situation by any stretch of
21 the imagination.

22 But I do believe that if you

1 rotated the auditors, I do believe the
2 decision-making in the audit firms is more
3 than one audit partner, the engagement
4 partner. I think if it's done right, like
5 Spacek used to do it, you do it with a team.

6 And you also have a compensation
7 that the partners that are losing or have to
8 give up the client, they don't suffer any
9 compensation or even that office, as we used
10 to have one worldwide partnership pool at
11 Arthur Andersen, not when they went down but
12 for the many, many years there. And so when
13 they could give up the Keating big S&L in
14 Phoenix, the Phoenix office, the Phoenix
15 partners, none of them lost anything. And a
16 big firm can share losses. These firms are
17 huge, multibillion-dollar operations today.
18 They can be more independent than they have
19 ever been before, but they don't operate that
20 way with their biggest clients.

21 So I think the problem really lies
22 in the biggest clients. And I think, although

1 Richard points out some problems because of
2 the limited number of firms, I think it's
3 doable.

4 And I have been on several Board
5 audit committees where we did rotate and we
6 actually enhanced the role of the audit
7 committee. I know some people think that it
8 does not enhance. It does because you really
9 then starting to interview the other firms.
10 You are really figuring out what are the
11 problems that we might be having to transfer
12 over, anything like that. It really gets the
13 audit committee into the whole issue.

14 So I think it's very doable. It's
15 not perfect.

16 CHAIRMAN DOTY: Mr. Hanson?

17 MEMBER HANSON: Thanks.

18 For any of the panelists, I
19 appreciate your experience over many, many
20 years. And you bring a wealth of experience.
21 And we're really benefitted from your
22 presence. But I would like to hear some of

1 your thoughts on your observations of what is
2 happening with the audit committees in their
3 oversight of the auditors post-implementation
4 of SOX and also your observations about
5 auditors and how they might have changed after
6 the Sarbanes-Oxley Act was implemented.

7 CHAIRMAN DOTY: Mr. Volcker, do
8 you want to start them off again?

9 MR. VOLCKER: Start with me
10 because I am at an age where I have a lot of
11 experience with being a member of Board of
12 directors since Sarbanes-Oxley. So I'll leave
13 it to my colleagues up here, but I must say I
14 was concerned at the reports that the Board
15 itself has put out about auditing, a lack of
16 diligence I suppose is a way to put it since
17 Sarbanes-Oxley.

18 I am surprised to see that those
19 comments could be so obvious in a way and so
20 incriminating so many years after
21 Sarbanes-Oxley has passed.

22 MR. BREEDEN: I know as a member

1 of an audit committee, I would dearly love to
2 be able to read the inspection reports that
3 are today kept confidential. And I think that
4 is robbing the directors who have
5 responsibility on audit committees of vital
6 information to help them evaluate the conduct
7 and tenure of their audit firms.

8 I must say I share Paul's dismay
9 at it's been ten years since Sarbanes-Oxley
10 and the continued occurrence of the same
11 problems over and over again that are
12 documented in your inspection reports. I can
13 see why you are considering proposals that
14 would go of the nature of mandatory rotation
15 to say, "Well, we have got to find a way to
16 break through whatever is the -- barrier that
17 is" -- it should be a simple thing for firms
18 to understand that if you are going to sign an
19 opinion, that you need to have some reasonable
20 basis in your work papers for doing so and
21 particularly where the particular issue might
22 be highly material. And I don't have an

1 explanation for that.

2 I think people have become more
3 process-driven subsequent to the enactment of
4 SOX, but I don't know that the inherent
5 judgment and wisdom of decisions has actually
6 gotten significantly better.

7 I might also as a footnote just
8 say, having been through a number of
9 switchovers -- at H&R Block, we had an
10 independence issue with KPMG. There was an
11 incumbent and replaced them with Deloitte.
12 And I've been through transitions at WorldCom
13 and other companies. And I think often,
14 putting aside the fact that if you did
15 mandatory rotation, I would invest in
16 interstate moving companies because of the
17 thousands of people that are going to be
18 moving around the country, switching
19 accounting firms can often -- you know, people
20 talk about the risk of problems. It can be a
21 hugely beneficial thing.

22 You get a reexamination of every

1 possible accounting judgment, every possible
2 estimate that is material when a new audit
3 firm comes in. And that delivers some real
4 benefits.

5 MR. BOWSHER: Well, as I said in
6 my opening statement, I really think SOX has
7 been a big success for everybody practically
8 except the very biggest companies.

9 And when I see the audit
10 committees in the big banks and the big
11 broker-dealers not doing their job -- and I
12 have interviewed some of those people since
13 the crisis. And it's amazing to me that they
14 admit that they just didn't understand some of
15 those financial instruments that were being
16 created: the mortgage-backed securities, the
17 CDs, all the derivatives, and everything like
18 that. And, of course, I can understand that.

19 I'll always remember one time
20 Judge Sporkin said, you know, when he was the
21 general counsel of the CIA, if they wanted to
22 hide something, they complicated it. And

1 Michael Lewis in his first book that he ever
2 wrote said that's what was happening on Wall
3 Street. They were complicating all of those
4 things and hoping the regulators wouldn't
5 understand it. And, of course, sometimes it's
6 hard for the audit committees.

7 But the audit committees have a
8 right to seek counsel from specialists and
9 everything like that. So I think our problem
10 basically lies with these very big companies.

11 You know, another problem we
12 seldom ever talk about, when we were on the
13 POB at the end, we had two or three new
14 members. One was Norm Augustine. And he was
15 of course the distinguished former head of
16 Lockheed Martin. And I knew him when we were
17 both at the Pentagon. He's a really brilliant
18 and capable guy.

19 And he said to us, "Can you give
20 me a list of all of the audit busts that we've
21 had in the last ten years that came to the
22 POB? So we gave him a list of about 15.

1 And when he looked at the list, he
2 said, "Well, you know, I'm not an auditor.
3 I'm not an accountant. But I can tell you
4 what comes off this paper. And that is the
5 arrogant, strong-willed CEOs of these
6 companies." And so that is one of the big
7 issues, too, that the audit committees have to
8 deal with.

9 I think when AIG got into trouble,
10 you know, the audit committees very wisely
11 went over and saw some lawyers. And the
12 lawyers explained what their responsibilities
13 were. And they did the right thing there.

14 But in the past I think when
15 you're dealing with the Sandy Weills and a few
16 others of these guys, it's not an easy job.
17 And that's why the auditing firms have to
18 mobilize themselves so that they can make
19 tough decisions when they go to see the client
20 and say, "You've got to make these kinds of
21 adjustments. You are not fairly presenting."
22 That's what you've got to do.

1 But I think the audit committees,
2 by and large, have improved immensely. I
3 really do. But I can't defend them in those
4 big banks and big broker-dealers and some of
5 those other big companies because I don't
6 think they did do their job.

7 MEMBER HANSON: Yes.

8 CHAIRMAN DOTY: Mr. Ferguson?
9 Lewis?

10 MEMBER FERGUSON: Yes. I would
11 like to get your views on the human capital
12 costs of a mandatory rotation regime. And by
13 that I mean -- Richard, you mentioned the
14 moving companies that would probably be some
15 of the great beneficiaries of this, but the
16 examples I think of are a company like John
17 Deere in Moline, Illinois or Berkshire
18 Hathaway in Omaha. And there are many others
19 where a very large corporation is
20 headquartered in a town that probably only can
21 support the one audit firm.

22 Are we simply going to have

1 hundreds of people changing team hats if we
2 had mandatory rotation? I mean, the Ernst and
3 Young hat would be switched for a Deloitte hat
4 or a Pricewaterhouse hat? And if so, would
5 that really achieve the kinds of changes and
6 fresh view that we want? And how great would
7 these costs be?

8 MR. BREEDEN: I think they would
9 be meaningful, pretty significant. There
10 would probably be some level of, as you
11 suggest, at lower levels staff accountants,
12 even up through young managers, of the firm
13 that is rotating away. The new firm coming in
14 might hire large numbers of the former staff
15 who helped perform the audit. And that would
16 certainly undercut some of the benefits that
17 are held out from rotation, although you would
18 certainly have a change in the partners.

19 Among all the Big Four, it
20 certainly was my experience at Coopers and I
21 suspect it was Chuck's at Andersen that the
22 engagement partners are used to moving around

1 the world. They frequently have to rotate off
2 accounts. And if they move from Pfizer to
3 Citicorp, a movement that's local, but if they
4 rotate onto a different account on the other
5 side of the country, they accept the fact that
6 the profession entails frequent family moves.

7 So I don't know. You may make
8 that more frequent, but it's not something
9 brand new certainly for the more senior
10 leaders in the firm.

11 In that respect, I think auditing
12 is different than law firms and investment
13 banks, where people may be able to go through
14 their entire career working out of one city,
15 admittedly doing a lot of commuting. But I
16 think the audit profession moving around the
17 country is much more common.

18 CHAIRMAN DOTY: Mr. Bowsher?

19 MR. BOWSHER: One of the things
20 when Spacek ran Andersen was that we didn't
21 have near as many offices as other firms. And
22 you never would put an office in a small town

1 where we had a big client because you didn't
2 think the firm or the people working in it
3 could be audit independent.

4 When I became head of the GAO, I
5 closed down all the audit sites in the cabinet
6 office buildings and in the small towns, where
7 we had a big, let's say, IRS service center
8 and the guys went over there and did the same
9 work year after year after year. I think that
10 if you went to rotation, there would be some
11 firms that might have to close some of these
12 smaller offices.

13 When I was on a big steel company
14 Board, when they ran into trouble, they had a
15 small office in Fort Wayne, Indiana. And I
16 remember Wally saying to them, "You ought to
17 close that Fort Wayne, Indiana office and work
18 out of Chicago" because I think it does color
19 people's independence if they think they're
20 going to lose a client.

21 And so I think rotation would be
22 more -- they can handle rotation better

1 because they know it's coming up, but I also
2 believe that this is always a problem, but it
3 is not a big problem that should stand in the
4 way of moving to rotation myself. Yes.

5 CHAIRMAN DOTY: Mr. Harris?

6 MEMBER HARRIS: I think throughout
7 the next two days, we are going to hear the
8 issue of cost-benefit analysis come up. And
9 how would you all weigh the benefits versus
10 the cost? And how would you deal with the
11 argument that we ought to get empirical data
12 for the benefits that would come out of
13 auditor rotation?

14 MR. VOLCKER: The mantra of
15 cost-benefit is it sounds good. It's
16 applicable to many operations of government or
17 business. I don't think it's particularly
18 applicable in this particular case because the
19 costs are identifiable. They may look large
20 in terms of a change, but the cost is not
21 measurable and could be enormous.

22 What we're worried about is a

1 breakdown in the auditing process that leads
2 to damage to the firm, may lead to the end of
3 the firm, may lead to enormous reputational
4 problems, which you can't equate in any normal
5 cost-benefit analysis.

6 You have got a continuing stream
7 of relatively small cost with the risk of a
8 huge catastrophe for the company. I don't
9 think that is susceptible to normal
10 cost-benefit. I don't think you can go around
11 and say, "You know, it's worth three basis
12 points to the investment firms over time" or
13 whatever. It doesn't work.

14 MR. BREEDEN: You know, I think
15 this is an excellent question and really goes
16 to what I have struggled with, both at the
17 original time this topic was considered a
18 decade ago. And now I come at it slightly
19 differently from Paul. I wonder how do you
20 quantify whether mandatory rotation would
21 indeed be successful. It's great.

22 If we knew for a fact that

1 changing the legal rules or forcing rotation
2 would suddenly cause auditors to be more
3 professional, verify opinions more frequently,
4 be more skeptical, be more objective, great.
5 I think everybody would support it.

6 The question is can rules,
7 ultimately, that you might enact cause
8 individuals -- these are subjective qualities.
9 Is somebody too trusting? Are they
10 sufficiently wary? Are they alert to signs of
11 problems? And rules won't necessarily change
12 that. So I'm not sure.

13 There's a leap of faith involved
14 in buying into the idea that rotation will, in
15 fact, mean that a given audit partner suddenly
16 does a better job, as opposed to that given
17 audit partner, instead of failing at this
18 company, will fail at this company over there.
19 And if all it does is move around a badly
20 performing partner or team, then the benefits
21 may not occur to offset the costs.

22 So it is a very difficult issue.

1 It will be a very difficult one to litigate,
2 I suspect, if challenged under the statutes
3 requiring cost-benefit analysis.

4 I do, parenthetically, think that
5 the costs are in some respect overstated.

6 I've tried to think back in the dozen or so
7 times where I have seen audit firms -- now,
8 these were all voluntary cases where we
9 repropose on an audit committee and picked
10 somebody new. But in every single case, the
11 fee was the same or lower, not higher.

12 And I think the competition on the
13 part of if the auditor of Ford is rotating
14 off, if PwC is losing that 100-year joint
15 venture to a mandatory rotation rule, then the
16 competition among the three who might get it
17 will be immense. And there will be a lot of
18 cost-cutting.

19 So I think both on the cost side
20 and on the benefit side, it is going to be a
21 tricky issue for the economists and others to
22 really document.

1 MR. BOWSHER: It is difficult to
2 do a good cost-benefit on practically any
3 issue. And this one I think is -- just as my
4 panel members were pointing out some of the
5 problems. I do believe strongly that if you
6 do a cost-benefit, you have to really go back
7 a few years and look at the costs and look at
8 the benefits in the past because you are then
9 dealing with real costs.

10 Most cost-benefits are what I
11 always call economic projections, rather than
12 cost-benefit analysis because they're always
13 looking forward and they get the economists to
14 always build in more assumptions and data.
15 And sometimes they do it on a modeling thing
16 and everything like that. And then it comes
17 out and looks great, but the truth of the
18 matter is if you don't look back, sometimes
19 you are kidding yourself.

20 And if you look back in the last
21 ten years here and figured out what the cost
22 was of these big meltdowns of the big banks,

1 the big broker-dealers, and General Motors and
2 Chrysler and General Electric's problems and
3 things like that, AIG, why, you would soon see
4 that the cost of the audit or rotation, any
5 additional cost, would be very, very small
6 compared to those costs.

7 And then I think what would be
8 good for the PCAOB to do is what you are doing
9 right now. And that is look every ten years
10 at whatever you decide to do now. And so it's
11 SOX plus what you decide to do now ten years
12 and see what the costs would be.

13 So it's good I think to try to do
14 some, but I think lots of times cost-benefits
15 are not done well at all. And so you've got
16 to be careful.

17 I always love to tell the story --
18 I was Secretary in the Navy. The Air Force
19 started walking around the Hill in the
20 Congress with a study pointing out that
21 land-based air was cheaper than sea-based air.
22 And the Chief of Naval Operations showed it to

1 me. And he said, "What do you think of this?"

2 And I said, "Well, let's look
3 back." And when I did a special study and we
4 came up with the fact that we lost a lot of
5 the air bases that we built in Spain and
6 places like that, and it turned out the sea
7 base there with the carriers was really more
8 cost-effective.

9 Now, I always try to point out
10 that Ken Lay was a young naval officer who was
11 on my staff. And he worked on that
12 cost-benefit analysis. I've had more than one
13 Air Force general say he would like to have a
14 recount. But, anyway, I think you have to be
15 very careful.

16 I think also I really agree with
17 Richard on the costs are overstated generally
18 on this because when we were with Arthur
19 Andersen and we would get a new client, we
20 would eat the first-time costs. And we were
21 a small partnership, and we could afford that.

22 And I think when I have been on

1 these audit committees 20-30 years later, we
2 don't get big bids of cost increases. So I
3 think that you're coming in and especially if
4 you have that overlap that I am recommending.
5 It would seem to me that that would be an
6 extra cost, the overlap. But I think that is
7 really good to get that in there.

8 But I believe that the idea that
9 the future costs -- and you've got to always
10 remember, just like on 404, the better the
11 accounting systems and the closing processes
12 of your company and your client are, the
13 cheaper the audit should be. In other words -
14 - and that is what is happening now. The
15 audit fees are going down.

16 A lot of people think it is
17 because of pressure. I don't know what's
18 causing it myself, but I would guess that one
19 of the reasons is when you walked in today,
20 the accounting systems and the financial
21 reports are in much better shape than they
22 were ten years ago because of Sarbanes.

1 CHAIRMAN DOTY: We have less than
2 five minutes. Military order -- and this
3 means kind of a rough calculation of the
4 Chairman between length of service and
5 biological age, but I want to be sure that we
6 have covered everyone else.

7 I do think it would be useful,
8 Chairman Volcker, if you told us whether the
9 conflict inherent in the fee, the fee
10 structure, can and should be addressed by
11 something short of looking at other solutions.

12 In Europe now, they are talking
13 about a third party payor, having an insurance
14 firm, having someone else pay the audit,
15 select the auditor. Moving away from the
16 inherent conflict of the fee, are we on the
17 right track trying to come up with some
18 combination of arrangements and standards of
19 the kind that you are talking about that the
20 panel has talked about and that we will hear
21 from today? And do we have a chance of
22 avoiding the third party payor? Can the

1 conflict be solved within the current
2 structure?

3 MR. VOLCKER: I don't see how it
4 can be solved within the current structure.
5 You're asking, can you change that payment
6 system? I would think that would be
7 fundamentally important if you could do it, if
8 you have a better system.

9 I don't think we devised just how
10 to do this without some kind of a -- I don't
11 know how you would do it. Would some
12 government agency say, "This is who your
13 auditor is going to be, and this is how you
14 are going to get paid"? I think that's more
15 -- if you could deal with that payment
16 problem, it's more important than auditor
17 rotation, in my view. Auditor rotation is a
18 way of getting around the existing problem.

19 If you could face it more
20 directly, God bless you but I don't know how.

21 CHAIRMAN DOTY: And how do other
22 panelists feel about the alternatives?

1 Richard and Chuck?

2 MR. BREEDEN: I think trying to
3 have any system where you socialize payments
4 through government agencies or something would
5 be an unmitigated disaster. I think audit
6 committees feel a real responsibility for
7 policing the audit costs. And changing that
8 would hurt shareholders.

9 I guess if we are starting with a
10 clean slate, what I would do to address the
11 conflict issue would be to say that the
12 ultimate authority for picking -- I would copy
13 what the Nordic countries do and say that for
14 selection of the auditor as well as for
15 selection of members of the audit committee
16 and maybe the entire Board but at least the
17 audit committee, I would let a committee of
18 either the five or the ten largest
19 shareholders meet in advance of the AGM and
20 make those decisions, instead of the Board, as
21 currently constituted.

22 That way you would have the people

1 who are ultimately both paying the fee and
2 shouldering the risk of what it breaks down,
3 be it the people who say, you know, "I am not
4 comfortable with this audit committee. I want
5 to see some changes. I'm not comfortable with
6 that 50-year tenure of that auditor. I'm
7 going to force some changes," rather than the
8 current system that resists shareholder
9 involvement.

10 But they are ultimately paying the
11 bills. Why not put more responsibility on
12 them for deciding.

13 CHAIRMAN DOTY: Chuck, briefly?

14 MR. BOWSHER: I agree, Richard. I
15 wouldn't turn it over to a government agency.

16 I think, actually, I am kind of an
17 optimist in life. You have to keep improving
18 whatever process you have. The SEC made the
19 decision in the 1930s under Joe Kennedy and
20 the original team that they would rely on the
21 private sector auditing profession.

22 I think on balance, it has done a

1 good job over the years, but there are times
2 when they don't do an adequate job. And I
3 think what you are doing right now is
4 terrific. Look at it and see how you can
5 improve it. So I think that is what you want
6 to do. You want to come up with how we can
7 make it more independent.

8 I think what we did in SOX, making
9 the audit committee more independent and
10 making there be a financial expert, making the
11 CFO and the CEO certify, all of that has
12 really worked quite well. But then the big
13 firms, for some reason, especially in the
14 financial area -- even when you think about
15 like General Electric's problem, which to a
16 great extent, was in their financial arm.

17 So these things I think any
18 improvement you come up with, whatever mix you
19 finally decide on I would hope would work and
20 would improve. And ten years later or five
21 years later, we ought to take another look.

22 CHAIRMAN DOTY: Let me say this

1 again. These three gentlemen sitting before
2 us have a rather remarkable record of having
3 been right about a great many very difficult
4 questions of financial policy and regulation
5 over a very long time. I exclude you,
6 Richard, from that, but we are in awe of the
7 wisdom and the perspective you bring to this
8 exercise. We are grateful for your time.
9 Thank you again.

10 MR. VOLCKER: Could I have one --

11 CHAIRMAN DOTY: Yes, sir?

12 MR. VOLCKER: One comment, Mr.
13 Chairman.

14 CHAIRMAN DOTY: Yes, sir.

15 MR. VOLCKER: I don't want to let
16 this business about storing for the big
17 companies go by without some comment. They
18 obviously are a big problem. You've got a big
19 problem with concentration in the auditing
20 industry. You do not have a problem with
21 concentration with small firms and small
22 auditors. There is lots of competition there.

1 And it is very easy to make a change.

2 I had forgotten when I said
3 earlier, I'm no longer a director. I am a
4 director of a small company that happens to be
5 right in the midst of changing auditors. And
6 they do it because they wanted to get a
7 different perspective, not because it's a
8 problem.

9 CHAIRMAN DOTY: Thank you,
10 Chairmen. Thank you all. Thank you.

11 Next panel -- and I will introduce
12 them as they make their way forward.

13 We have people now who have
14 invested serious money and who have spent a
15 lot of time looking at these issues in
16 governance. James Alexander is the head of
17 Equity Research at M&G Investment Management,
18 a subsidiary of Prudential PLC. He's been at
19 M&G for ten years specializing in the
20 financial sector, particularly bank analysis.

21 Prior to M&G, he was ten years in
22 equity research at a number of investment

1 banks in London. He has a B.Sc. in economics
2 from the LSE, London School of Economics,
3 followed by a M.Sc. and a Ph.D. in economic
4 history at that institution, at London School
5 of Economics.

6 Peter Clapman. Peter Clapman is
7 the Chairman and the President of Governance
8 for Owners USA. He was the Senior Vice
9 President and Chief Investment Council for
10 TIAA-CREF until his retirement in 2005. He is
11 a member of Stanford Law School Institutional
12 Investors' Forum, teaches at directors' and
13 fiduciary colleges.

14 He is on the advisory Boards of
15 the Yale Milstein Center for Corporate
16 Governance, programs at Delaware. He was
17 appointed by the New York State Comptroller to
18 the Pension Fund Task Force in 2008. He is an
19 independent Chairman of the AARP Mutual Funds
20 Board of Trustees and a member of the Risk
21 Metrics ISS Governance Leadership Council.
22 Peter has a long and distinguished career in

1 governance.

2 Ed Durkin is the Director of
3 Corporate Affairs of the United Brotherhood of
4 Carpenters. He coordinates government and
5 investment activities of the carpenters' U.S.
6 and Canadian pension funds with assets of 40
7 billion, with a b.

8 He has been a leader in efforts to
9 further auditor independence, option
10 expensing, majority voting, and director
11 elections through that medium. He is a former
12 Co-chair and a Board member of the Council of
13 Institutional Investors.

14 If Damon Silvers is in the
15 building or joins us, he will be welcome at
16 the table. But first I think we should begin
17 and proceed.

18 Mr. Alexander, thank you. Please
19 proceed.

20 MR. ALEXANDER: Thank you very
21 much for inviting me.

22 I'm not so used to these

1 proceedings, coming from London. I should
2 emphasize these are my personal views and not
3 those of my company, either M&G or Prudential.
4 I have discussed them with some of my
5 colleagues. I am a very humble user of
6 company accounts, especially in the presence
7 of such a distinguished roster of panelists
8 and Board members.

9 I think myself and most of my
10 colleagues are in favor of auditor rotation.
11 We think it is a good idea in principle. I
12 think it has some problems with the size of
13 the companies, the size of the auditors. I
14 think there are conflicts of interest. I
15 think we also need to just keep in mind the
16 value of audits and how valuable they are, not
17 how lacking in value they are. And also I
18 would like to say a word about the financial
19 company audits, in particular, which is kind
20 of my area of specialty.

21 I think while we think rotation of
22 auditors is a good idea, a very good idea in

1 theory, it may not be that particularly
2 important. Trust in management is the most
3 important thing for investors. And I think we
4 shouldn't lose sight of that when we are
5 talking to company management, we're not
6 thinking about the audit. We're thinking
7 about do we think that management know what
8 they're talking about, are they competent.
9 It's not always the case. Are they good? Are
10 they entrepreneurs? Those are the sort of
11 questions that we think about as investors.
12 The audit is not at the top of our minds at
13 that time.

14 I think Boards should be
15 responsible for our auditor rotation. And I
16 hear what some of the earlier speakers said
17 about Boards not always being as engaged or
18 understanding of the audits or the audit
19 process.

20 And I think one slightly sad thing
21 is that you end up with people on audit
22 committees who are former auditors. And so

1 you can just perpetuate a culture of auditors
2 know best.

3 I think we certainly would agree
4 with the U.K. view that Boards should do more
5 to explain their choice of auditors and their
6 reasons for not rotating, so comply or explain
7 when they don't rotate.

8 But I think there are some very
9 serious practical problems with the lack of
10 choice in auditors, especially for the bigger
11 companies.

12 The concentration has been pointed
13 out. There are only four auditors around that
14 most Boards feel comfortable with. And that
15 really is a serious, serious lack of choice.

16 I think that's a consequence of gigantism, if
17 you like, where we get bigger and bigger
18 companies needing bigger and bigger auditors.

19 It's probably a consequence of
20 globalization, which is a good thing in many
21 ways. I don't want to knock it. It's a good
22 thing that promotes economic efficiency and

1 trade and everything. But it does lead to
2 some very, very large companies that are very,
3 very complex to analyze or very complex to
4 manage, very complex to analyze and very, very
5 hard to audit as well.

6 Smaller companies just have no
7 chance when you have got a global company of
8 being able to manage a global audit. And if
9 there are lots of subsidiaries around the
10 world, that becomes even more of a complex
11 situation. So there are some real challenges
12 for them to audit and analyze a big company.

13 With smaller companies, after
14 talking to them and looking at their accounts
15 and auditing them, you can get to think you
16 know them quite well, but with the bigger
17 companies, this is a real issue.

18 I think it's an agency problem.
19 It's an agency problem that is more acute in
20 giant companies as they become so much bigger
21 than individual investors, these three, four
22 hundred billion market cap companies out

1 there. They are almost too big to invest in
2 it with any real confidence. I think that is
3 an issue. They have become too powerful. And
4 the managers can become too powerful.

5 So I think where do we end up?
6 With giant companies requiring giant auditors
7 or do we just have to have giant investors?
8 Everyone has to be a Blackrock? Is that where
9 we end up? And I'm not sure that would be a
10 great place to end up, even though Blackrock
11 is obviously very good at what they do.

12 It's almost like an arms race that
13 you end up by following this path of size in
14 everything. It's a real challenge.

15 I think also just on the conflict
16 of interest issue, I did look at some audit
17 companies before I came, just the latest
18 accounts. And I was surprised, actually, by
19 this drift to earning fees from non-audit
20 sources. And that up to 70 percent, 75
21 percent of revenues are from non-audit sources
22 at the big audit companies. And I think that

1 is a bit surprising. I know that it's good.

2 In most cases, they don't earn
3 those fees from their audit clients, they earn
4 them from non-audit clients. But I still
5 think there's an issue as the non-audit fees
6 grow so quickly relative to audit fees that
7 this is going to become even more of an issue
8 for these firms. And I think it becomes more
9 challenging for them to manage those
10 conflicts.

11 In particular, where audit firms
12 don't maybe get captured by the firms that are
13 paying them but they get captured by the
14 industry, where you've only got four big
15 companies in an industry or big banks in an
16 industry, they will be earning audit fees from
17 one firm earning non-audit fees from two of
18 the other big firms and the fourth firm, they
19 can't really work for because of conflicts of
20 interest. So if you do have auditor rotation,
21 you kind of wonder who is going to turn up to
22 the pitch. So that's quite an issue.

1 I see the red light has come on.
2 I just want to say two quick things. One is
3 about the value of audits. I think they're
4 not very expensive relative to the revenues.
5 I think that has been made clear. So you've
6 got to wonder what value they really have when
7 they're so low-cost. I think that's got to be
8 an issue.

9 But also you have got to remember
10 I think that, although auditing is a very,
11 very good thing in some sense, economic sense,
12 firms are audited by their competitors. And
13 weaknesses in those big firms appear as
14 competitive opportunities for their
15 competitors. And that is what is exploited.
16 Scandals happen when those weaknesses are
17 covered up by accounting issues. And I think
18 that is the issue that blows up every now and
19 again. But, generally speaking, firms are
20 audited or reviewed by their competitors who
21 find out their weaknesses.

22 And last I would just like to say

1 something about financial company audits.
2 This is an area where I do quite a lot of work
3 trying to understand banks. They are
4 incredibly complex. I think they're a
5 decent-sized investor. I'm lucky to be a
6 specialist in the banking sector. But it's
7 still incredibly difficult to work out exactly
8 what is going on in a bank as an investor on
9 the outside.

10 And I think in some sense audits
11 don't matter for banks. What really matters
12 is the regulatory process. The regulator's
13 yea or nay is the key decision for a bank, not
14 necessarily or even the going concern of an
15 auditor.

16 I think you can end up in many
17 cases with what the Japanese or what investors
18 called zombie banks in Japan, where the banks
19 aren't really going concerns but there is a
20 sort of public nod and a wink to let these
21 banks carry on between the bank and the
22 regulator. And everyone knows they're not

1 really taking the write downs they should on
2 their assets. So they're not really going
3 concerns, but, you know, we just have to live
4 with that. And that compromise and conflict
5 I think is an issue for a lot of companies,
6 especially banks.

7 CHAIRMAN DOTY: Peter Clapman?

8 MR. CLAPMAN: To start, I must
9 commend the PCAOB for raising the issue of
10 audit firm rotation as a means to strengthen
11 and enhance auditor independence. And my
12 position is straightforward. I support
13 periodic audit firm rotation as the best
14 policy with this goal of increasing audit firm
15 independence as the best policy and periodic
16 audit firm re-bidding, bringing in other audit
17 firms to bid for the assignment at periodic
18 intervals, as the next best policy.

19 But I do think that unless the
20 PCAOB takes the regulatory action to require
21 something in this area, the status quo, which
22 encourages audit firm for life or forever,

1 whichever comes first, will continue. And
2 investor concerns about audit firm
3 independence will persist.

4 I am speaking on behalf of
5 Governance for Owners USA, the parent of which
6 is a British investment manager that promotes
7 investor engagement with our portfolio
8 companies.

9 I have looked at these issues from
10 a global perspective for many years -- and
11 auditor rotation is now a global issue -- for
12 a long time, having been a former Chairman of
13 the International Corporate Governance
14 Network. I am also speaking on the basis of
15 my past personal experience as the Chief
16 Investment Counsel for TIAA-CREF, which is the
17 largest investment pension system in the
18 world. I also managed the TIAA-CREF corporate
19 governance program.

20 Auditor independence has always
21 been an important issue to my organizations
22 and me professionally. At TIAA-CREF, I

1 participated in three auditor rotations at
2 intervals between eight and ten years. The
3 results were better audits, similar costs, and
4 none of the dire consequences being argued by
5 many of the commentators against the PCAOB
6 Concept Release.

7 Additionally, as a major investor,
8 TI-CREF asked a number of major companies to
9 voluntarily adopt a policy of auditor
10 rotation. And we had no takers. My clear
11 sense was that these companies refused to even
12 consider periodic audit firm change.

13 A clear theme emerges from this
14 experience and any fair reading of the bulk of
15 comment letters from the corporate community.
16 The vast majority of companies will not
17 seriously consider voluntary adoption of
18 rotation because they have come to think that
19 it is an act of folly to change audit firms.
20 These companies have argued the familiar dogma
21 that costs will inevitably go up substantially
22 and that initial audits will suffer in

1 quality. This familiar dogma, however, in my
2 view is based on faulty assumptions.

3 Why would audit quality decline
4 with a change of audit firms? This contention
5 supposes that good audit committees, the
6 outgoing auditor, and the incoming auditor are
7 professionally incapable of developing the
8 appropriate transition, a supposition I
9 reject.

10 To the contrary, my own experience
11 indicates that better audits will result as
12 the outgoing firm is aware that another
13 quality firm might take a fresh look at some
14 of the prior decisions and when fresh looks
15 actually do take place, better audits result.

16 Significant cost increases,
17 another claim against audit firm rotation. I
18 do not see this occurring because competitive
19 forces will encourage cost competition. Audit
20 firms will want to win new assignments, which
21 they can anticipate will last for a number of
22 years. And with competition, they can be

1 expected to bid wisely and win the assignment.

2 Investors, of course, will look at costs as
3 justified if auditor independence is enhanced.

4 Another charge against the PCAOB
5 initiative is that it would intrude upon the
6 authority of company Boards and audit
7 committees. To that, I observe that few, if
8 any, of the now generally accepted governance
9 reforms were adopted without some regulatory
10 or legislative intervention. Regrettably,
11 most governance reforms have rarely occurred
12 otherwise.

13 For example, take the current
14 important audit committee practices, now
15 widely accepted as positive. It took the SEC
16 initiative under Chairman Levitt to require
17 that audit committee members should have
18 financial literacy and that committees should
19 include a financial expert. It took
20 Sarbanes-Oxley to eliminate the conflict when
21 audit firms provided substantial consulting
22 services to companies they audited.

1 These and other reforms
2 instructing companies as to who may serve on
3 their audit committees and how companies
4 receive consulting services were far more
5 intrusive into company affairs than a
6 requirement that audit committees must choose
7 different audit firms at periodic intervals
8 while leaving the discretion as to which audit
9 firm to the committee.

10 In conclusion, my experience both
11 as a company executive and as a corporate
12 governance professional leads to a clear
13 conclusion. The time is right for the PCAOB
14 to implement the appropriate policy of audit
15 firm rotation or if that is too big a bite,
16 compulsory audit firm re-bidding, again
17 leaving the ultimate decision to the audit
18 committee but to promote change in order to
19 promote greater auditor independence, a key
20 issue for many investors.

21 And unless the PCAOB takes action
22 along these lines, the system will remain

1 largely unchanged. And that would be
2 regrettable.

3 We all need to recognize a
4 practical reality and examples abound that our
5 corporate governance system often will need an
6 external impetus to adopt governance reforms
7 later understood to be the right steps to
8 take. In retrospect, these were perhaps
9 intrusions, but they were appropriate
10 intrusions. Auditor rotation through action
11 by the PCAOB is the right step to be taken
12 now.

13 CHAIRMAN DOTY: Thank you, Peter.
14 Ed Durkin?

15 MR. DURKIN: On behalf of the
16 United Brotherhood of Carpenters and Joiners
17 of America, I would like to thank you and the
18 members of the PCAO Board for the opportunity
19 to participate in this public hearing.

20 Carpenter members in the United
21 States and Canada participate in over 100
22 pension funds with assets of \$40 billion. Our

1 members' retirement security is dependent upon
2 the integrity of the nation's securities
3 markets with accurate and reliable data,
4 financial reporting, the foundation on which
5 those markets operate. For these reasons, we
6 commend the Board for its clear focus on the
7 issue of auditor independence.

8 Our pension funds have engaged
9 hundreds of companies over the past decade
10 with auditor independence and financial
11 statement integrity issues.

12 In 2002, prior to Sarbanes-Oxley,
13 new corporate auditor fee disclosures enabled
14 us to challenge corporations on their use of
15 audit firms to provide non-audit services.

16 Strong shareholder support allowed us to
17 negotiate limits on non-audit fees and secure
18 corporate commitments to institute fee
19 pre-approval processes.

20 In subsequent proxy seasons,
21 shareholder initiatives forced hundreds of
22 companies to retreat from plans to eliminate

1 shareholder auditor ratification votes and
2 buttress FASB's successful stock option
3 expense and rulemaking.

4 This past fall, carpenter funds
5 submitted shareholder proposals to several
6 dozen large cap companies, requesting that
7 they establish an audit firm rotation policy.
8 The corporate reaction to the proposal was
9 mixed. Some disliked it while others really
10 disliked it.

11 Several companies quickly sought
12 no action relief from the Securities and
13 Exchange Commission to exclude the proposal
14 from their proxy materials. The SEC staff
15 agreed with corporate assertions that the
16 auditor rotation proposal presented an
17 ordinary business matter not appropriate for
18 a shareholder vote.

19 Our request for full Commission
20 reconsideration of the decision was rejected
21 by the SEC staff. In recent weeks, we have
22 submitted new auditor independence report

1 proposals to a number of companies with long
2 audit firm relationships.

3 The proposed independence report
4 entails proxy disclosure on aspects of the
5 audit firm engagement, including Board and
6 audit committee efforts to protect auditor
7 independence. Again, several companies have
8 chosen to seek no action relief from the SEC
9 with a decision on those requests pending.

10 Despite the challenges to the
11 rotation and the report proposals, a majority
12 of the companies have chosen to engage in
13 constructive dialogue on the auditor
14 independence issue. Corporate discussion
15 participants have included audit committee
16 members, CFOs, controllers, general counsels,
17 and corporate secretaries.

18 While these corporate
19 representatives express confidence in their
20 policies and practices to protect auditor
21 independence, many acknowledge shortcomings in
22 current disclosure practices regarding the

1 issue.

2 The ongoing give and take has been
3 productive. For example, Citigroup's recent
4 proxy statement, issued I think on March 8th,
5 contains new audit committee report
6 disclosures, including information on KPMG's
7 tenure as Citigroup's independent auditor; the
8 factors, including tenure, involved in the
9 committee's decision to recommend shareholder
10 ratification of KPMG; the details of an
11 assessment of KPMG prepared by management,
12 including a fee assessment; and a statement
13 that the audit committee has concluded that
14 the retention of KPMG to be in the best
15 interest of Citigroup and its investors. And
16 in recent days, several companies have agreed
17 to expand their proxy auditor independence
18 disclosure in response to withdrawal of the
19 report proposal.

20 The new disclosure in the auditor
21 ratification vote narrative will state that
22 the audit committee is directly responsible

1 for the appointment, compensation, retention,
2 and oversight of the independent external
3 auditor; two, the date of the beginning of the
4 audit firm's tenure as independent auditor;
5 three, that the audit committee is responsible
6 for fee negotiations with the audit firm;
7 four, that the audit committee periodically
8 considers whether there should be a regular
9 rotation of the independent audit firm; five,
10 that the audit firm and its chair are directly
11 involved in the selection of the new lead
12 engagement partner; and, six, that the Board
13 of directors and its independent audit
14 committee believe that the selection of the
15 company's independent auditor is in the best
16 interest of the company and its investors.

17 We believe these commitments to
18 new auditor independence disclosure represent
19 a solid step forward. Enhanced independent
20 proxy disclosure that informs investors and
21 promotes internal practices and processes to
22 protect auditor independence is essential.

1 Improved shareholder disclosure will transform
2 the routine auditor ratification vote into a
3 meaningful exercise of shareholder voting
4 rights.

5 Further, expanded disclosure will
6 facilitate and inform use of shareholder
7 majority voting rights in director elections.
8 This shareholder empowerment will focus Boards
9 and their audit committees on protecting
10 auditor independence. Achieving improved and
11 uniform auditor independence proxy disclosure
12 through shareholder private auditing actions
13 will be difficult and time-consuming.

14 We urge the Board as part of its
15 ongoing efforts to protect auditor
16 independence to consider new proxy statement
17 auditor independence disclosure requirements.
18 We believe such an initiative would represent
19 the next best step in auditor independence
20 reform.

21 Thank you, Mr. Chairman.

22 CHAIRMAN DOTY: We have been

1 joined by Damon Silvers, Director of Policy
2 and Special Counsel for the AFL-CIO. Damon
3 was Deputy Chair of the Congressional
4 Oversight Panel for the Troubled Asset Relief
5 Program. He served on the Treasury
6 Department's Advisory Committee on the Audit
7 Profession. He was a clerk for Justice
8 William T. Allen. And he serves on the
9 Investment Advisory Committees of the
10 Securities and Exchange Commission and the
11 PCAOB.

12 Welcome, Damon.

13 MR. SILVERS: Thank you, Mr.
14 Chairman. And thank you for the opportunity
15 to testify -- I guess it's not testify --
16 speak before the Board today.

17 As you noted, I served as Chair of
18 the Competition Subcommittee of the Treasury's
19 Task Force on the Future of the Auditing
20 Profession. And in that context, we reviewed
21 the fundamental issues involving
22 competitiveness in the auditing profession and

1 the fact that, as has been mentioned by my
2 fellow panelists, from the perspective of
3 larger public companies, there are effectively
4 four audit firms functioning in the United
5 States today, which presents fundamental
6 problems in terms of both fee competition and
7 the role of competition among audit firms to
8 foster auditor independence.

9 We found through that process on
10 behalf of the Treasury Department that there
11 are fundamental structural obstacles to
12 expanding the number of audit firms capable of
13 doing an audit of a large public company and
14 that any path to having a larger number of
15 firms is very much a long-term path. That
16 fact overshadows I think the PCAOB's
17 consideration of steps that need to be taken
18 at this stage to increase auditor
19 independence.

20 The primary initiative that is in
21 front of the Board today, the question of
22 mandatory firm rotation has been a matter of

1 widespread public debate intermittently,
2 intermittently widespread since the Enron and
3 WorldCom scandals and the bursting of the
4 dot-com bubble in 2001 and 2002.

5 Firm rotation was contemplated as
6 part of the Sarbanes-Oxley Act but was
7 ultimately not included in the act. Instead,
8 there really was an approach that promoted two
9 distinct ideas. One was this primary role, as
10 my other panelists have mentioned, of the
11 audit committee of the Board as a means of
12 quasi-independent oversight. That is my term,
13 "quasi-independent" of the auditor.

14 The notion is that the audit
15 committee is distinct from management and is
16 even in a certain respect distinct from the
17 rest of the Board in the levels of
18 independence required of the audit committee
19 and in the requirement that there be a
20 financial expert. This was enhanced by the
21 requirement of partner rotation.

22 I think that if you look at these

1 two measures over the least ten years, while
2 we have not had similar evaporations of mega
3 cap companies, such as Enron and WorldCom, in
4 the context of audit failure, in the last ten
5 years, we have had something rather more
6 insidious and longer-term occur that argues,
7 I think fairly strongly, for additional
8 protections for auditor independence and the
9 encouragement of the appropriate professional
10 skepticism that this Board, in particular you,
11 Mr. Chairman, have highlighted as the
12 appropriate stance of the independent auditor.

13 Part of the reason why I believe
14 that this sort of long-term deterioration has
15 occurred and the relevance of independent
16 auditing can be identified by little things,
17 like the fact that over this last ten-year
18 period, while they have auditor rotation,
19 while we have had audit partner rotation, we
20 have not had the audit partner sign the letter
21 from the auditor, creating a situation where
22 there is an appearance of accountability at

1 the partner level but at a level of
2 accountability that is rather hard for
3 investors and the public to enforce. As my
4 colleague Ed Durkin mentioned, absent
5 disclosure, it's rather difficult to get much
6 of anything done.

7 The upshot here is that when the
8 financial crisis of 2008 occurred, it became
9 quite clear. And my fellow panelists have
10 discussed this as well. It became quite clear
11 that there was a diminished relevance of
12 audited financial statements to the
13 functioning of the financial markets. This
14 was I think rather obvious in that we had in
15 2007 and into 2008 audited financial
16 statements from major firms that suggested
17 that those firms were healthy and those firms
18 very quickly thereafter sought public support
19 to avoid systemically catastrophic bankruptcy.

20 Following those events, at
21 numerous meetings of the standing advisory
22 group of the PCAOB, it was impossible for any

1 member of the auditing profession to answer
2 basic questions about how this could have
3 happened, but when those questions were posed
4 at that body, the result was deafening
5 silence. And I mean questions as simple as
6 "What is the nature, in relation to the going
7 concern rules, of a company which but for
8 government support, which is not guaranteed as
9 a matter of contractor law, would fail?"

10 No auditor was prepared to answer
11 that question in a public setting. This
12 suggests to me a profound problem of auditor
13 independence.

14 Now, last fall, just to show that
15 these problems were not temporary in
16 relationship to the financial crisis of 2008,
17 last fall, we saw during a period when there
18 were jitters about Europe that the credit
19 default swap spread for major banks and
20 publicly traded financial institutions in U.S.
21 markets went to levels in some cases exceeding
22 those that were in play in the markets in the

1 Fall of 2008.

2 This occurred while again our
3 audited financial statements for these very
4 same firms suggested that not only were they
5 healthy but that they were healthier than they
6 had been in years. It appeared, though, that
7 the markets for their debt just simply didn't
8 see it that way.

9 Now, I believe that the
10 diminishing relevance of audited financial
11 statements and of the audit process itself has
12 contributed to the legislative environment we
13 have today, where key protections that were
14 mentioned by my fellow panelists are now under
15 legislative assault this morning as we meet
16 down the street on Capitol Hill in the form of
17 the so-called JOBS Act.

18 Now, as my fellow panelist Ed
19 Durkin mentioned, there are some obstacles
20 today to investors taking up the next step in
21 auditor independence, which would be firm
22 rotation on a private ordering basis. In that

1 context, it is the view of the AFL-CIO that it
2 would be appropriate for this body, the Public
3 Company Accounting Oversight Board, to move in
4 the direction that, frankly, many independent
5 commentators on this matter urged on Congress
6 in 2002, which is to move from partner
7 rotation to firm rotation.

8 Thank you very much.

9 CHAIRMAN DOTY: Thank you, Damon.

10 We have about 25 minutes for
11 questions. And I'll begin with Mr. Harris.

12 MEMBER HARRIS: Mr. Alexander, I
13 wish you would explain a little bit the
14 British requirement for comply or explain for
15 not rotating. I'm not familiar with how that
16 works. I think you mentioned it.

17 And then also if you could talk a
18 little bit about the role of relevancy of the
19 audit and value of the audit? Both you
20 mentioned that, and Mr. Silvers mentioned
21 that. How do we make the audit more relevant
22 and valuable?

1 But, first of all, if you could
2 talk about the comply or explain for not
3 rotating requirement in the U.K.

4 MR. ALEXANDER: I am not an actual
5 expert on that area, but it's a principle I
6 think that is adopted quite widely in U.K.
7 corporate governance that there are codes,
8 voluntary codes, of corporate governance for
9 a whole variety of areas when it comes to U.K.
10 companies. And the rules are laid down
11 voluntarily, but the Boards have to either
12 comply with the rules that are laid down or
13 explain why they are not. That is basically -
14 - it's pretty much as it sounds: comply or
15 explain. So rotate your auditors or explain
16 why you're not. It's the same sort of
17 principle.

18 I think maybe you've gotten some
19 -- Citigroup, I think, was adopting this year
20 in that proxy. It's the same sort of
21 principle, just better disclose -- better
22 explanation of why you have adopted something

1 that maybe people think isn't in the public
2 interest but you do it anyway because there
3 are good reasons for it. So it's comply or
4 explain is the basic principle.

5 I'm not sure it brings about a lot
6 of change, but I think it at least fosters
7 debate from the Boards that perhaps people
8 didn't think was happening. And puts Board
9 members and non-executive members on, the spot
10 a bit more than they otherwise would have been
11 if they say they talked about it, then you
12 assume they have talked about it. And there
13 should be some paperwork on that and should be
14 some discussion of that. So that's where you
15 get to. So that might help move things in the
16 right direction.

17 What was the other issue? The -

18 MEMBER HARRIS: Damon raised the
19 issue, Mr. Silvers raised the issue, about --
20 I think your exact words audits don't matter
21 for banks. And then Mr. Silvers raised the
22 issue of the relevance of audits and how do we

1 enhance the relevance of the audits and why
2 the problem with respect to the possible
3 diminished relevance of audits, as you just
4 articulated.

5 MR. ALEXANDER: Yes. I think it
6 is around the "Too Big To Fail" issue, the
7 large, systemically important financial
8 institutions, not just banks. Notice that two
9 or three nonbanks were in the latest Fed's
10 stress test. Large, systemically important
11 financial institutions are too big to fail.
12 And, therefore, when they get into
13 difficulties, they have to find some other
14 solution for them other than bankruptcy
15 because that is so difficult and so complex.

16 And so I think then the markets
17 assume there are problems. And you can see
18 there are problems. And everyone, most market
19 participants know it. But nothing really can
20 be done of that because these institutions are
21 too big.

22 I think maybe we've got that in

1 some other areas, not just in financials but
2 financials tends to be the core one because
3 they're so complex and so linked to each other
4 in so many ways, these large financial
5 companies, that it becomes very, very
6 difficult.

7 It's a problem of size, I think.
8 To make the audit more relevant and more
9 important, it's very, very challenging. It
10 was interesting. When you were talking about,
11 it was raised a question of maybe having some
12 independent body to appoint the auditor and
13 not the Board and some independent person pay
14 for it, it was immediately assumed it would be
15 the government in some way or other that would
16 do it.

17 And to a certain extent, we have
18 already got that when it comes to financial
19 institutions with the intrusive and
20 all-enveloping regulation that financials have
21 from the SEC and the FDIC and the whole
22 enormous structures of the regulations, not

1 just in the U.S. but in the U.K. and in most
2 other countries. There's an awful lot of
3 audit-type work being done by regulators and
4 by official bodies already. So the audit has
5 been moved a bit to one side, I think.

6 CHAIRMAN DOTY: Peter?

7 MR. CLAPMAN: If I could just add
8 to the point about the British system of
9 comply or explain? And that's really the
10 variation that I suggested in my remarks about
11 perhaps having a system of compulsory
12 re-bidding where you could have a general
13 premise that a company will at least review
14 audited tenure at periodic intervals with a
15 more or less presumption that you would rotate
16 auditors, but if a particular company having
17 gone through that process believed that it was
18 just not feasible or impractical, they could
19 explain it in their proxy statement or in some
20 other disclosure document.

21 Disclosure, as my colleagues have
22 indicated, is currently absent as to why a

1 company has a continued auditor for 25-50
2 years without explaining anything about
3 auditor tenure. So you could have that as a
4 variant of comply or explain.

5 CHAIRMAN DOTY: Mr. Ferguson?

6 MEMBER FERGUSON: I would like to
7 have the panel give us their views on the
8 relationship between auditor concentration and
9 non-auditor services. It specifically arises
10 in this context. One of the things we hear
11 repeatedly is that one of the major problems
12 with a mandatory auditor rotation regime would
13 be that it would be very difficult for many
14 companies to find another auditor because
15 there are only four big audit firms that could
16 do the audits of the kind, large entities.

17 Oftentimes the other three firms
18 are already providing services for the client.
19 And that would make it very difficult. It's
20 almost like, you know, you're dealing with
21 someone who has created a structure that makes
22 it impossible to change the structure.

1 The question is, if we had
2 audit-only firms, if firms could only do
3 audits, would that a) help the problem of
4 independence and b) would it potentially in
5 the longer run help the problem of
6 concentration? Because I tend to believe with
7 Damon that the concentration problem is
8 something that is an extraordinarily difficult
9 problem to solve.

10 It's certainly not going to be
11 solved in the short run and not by this Board.
12 But I would welcome your views on that
13 question or that set of questions.

14 MR. DURKIN: Over the past couple
15 of months, we have talked and negotiated with
16 about 40 companies on these two resolutions.
17 So we have had these discussions.

18 And the concentration, just to
19 appreciate that, it's not the three other
20 firms. For instance, Coke won't use the same
21 firm that PepsiCo uses. So, you know, in the
22 defense industry, one defense contractor won't

1 use -- you know, so you're talking about it
2 more limited.

3 You're talking about the other
4 services. There are very few companies that
5 we found. Legg Mason is one. There are very
6 few companies who have a practice of freeing
7 one of those other firms up, like not having
8 any entanglements so that if they have to,
9 they could rotate to somebody, one of the
10 other Big Three.

11 We certainly support that
12 practice, limited as it may be. But the
13 concentration is even more limited than the
14 other three in most cases. But the question
15 is, would any one of them be more independent?

16 When we went after fees 12 years
17 ago, we were concerned. We saw ratios in the
18 fee disclosure of ten to one. It wasn't
19 surprising to see ten to one non-audit to
20 audit fee ratios. The companies 10-12 years
21 ago didn't even know how much they were
22 spending on non-audit fees until the SEC

1 regulation required them to compile it. That
2 was our concern about independence.

3 Our concern about independence now
4 is just the size and the tenure of these
5 relationships.

6 You know, it's a point of fact
7 that the companies don't even have to put it
8 in their proxy materials, companies that are
9 now agreeing to this new disclosure. Some of
10 these go back decades. They have talked about
11 it in terms of it being an annuity. So it's
12 just -- forget about the non-audit fees, just
13 the tenure and the size.

14 Some of our shareholder proposals
15 want the companies that in the last seven
16 years have made close to a half a billion
17 dollars in fees. That alone is a challenge to
18 independence.

19 MR. SILVERS: In addition to what
20 Ed just said, which I agree with, I think if
21 you look at the arc of public policy around
22 this subject, the intention, beginning with

1 Sarbanes-Oxley, was to try to move the
2 auditing profession back to an audit-only type
3 of regime.

4 I think it's quite obvious that
5 the public policy tools that were deployed to
6 achieve that sort of goal -- and I think if
7 you look back in 2001-2002, 2003, you will see
8 many sort of expert documents.

9 The one that I was involved in,
10 together with my former employer, Chancellor
11 Allen of Delaware, was the American Academy of
12 Arts and Sciences did such a document. It
13 talked about the need to restore
14 professionalism in auditing.

15 The clear direction was back in
16 the direction of audit only. But what, in
17 fact, happened instead -- and Ed just
18 described to you how it plays out practically
19 -- was that while the use of non-audit
20 services by the firm's actual auditor was
21 constrained, the firms issued prepared -- the
22 operating firms tended to seek those services

1 from other audit firms. And so the net
2 balance between audit and non-audit services
3 within each large audit firm diminished
4 somewhat but not decisively.

5 The result where essentially
6 preparers of financial statements are locked
7 in, as you described, is not really an
8 acceptable result. And it raises the question
9 of, you know if the interaction between issuer
10 and the four large audit firms is such as to
11 create that locked-in dynamic, then what they
12 have really done collectively is force
13 policy-makers to go back to the question of,
14 you know, is having private audit firms a
15 viable solution and to raise issues that are
16 now 70 years old, going back to the beginning
17 of the securities laws, as to that, we ought
18 to have another model entirely.

19 My view is that it would be
20 possible through a series of actions. And one
21 of them is mandatory firm rotation. It would
22 be possible through a series of coordinated

1 actions to create a much more friendly
2 environment for the expansion of the number of
3 firms capable of auditing a large firm from
4 the current four.

5 And this was the conclusion, by
6 the way, of the Treasury Department in a kind
7 of general sense that the Treasury
8 Department's Task Force on the Future of
9 Auditing is that that is an important public
10 policy goal, but it would require some
11 coordination between this body, the Securities
12 and Exchange Commission, and perhaps Congress
13 to really achieve it over time. But, to be
14 blunt, someone has to start.

15 CHAIRMAN DOTY: Do other panelists
16 have views on that question as well?

17 MR. CLAPMAN: Well, just very
18 briefly, it's a dilemma that your question
19 raises. Unfortunately, if you take that
20 concern to its extreme, you would basically
21 seem to acknowledge that some firms can have
22 the audit firm for life, which I think would

1 be a policy mistake.

2 And I think if the PCAOB takes
3 action, the system would adjust. And
4 obviously if you could have audit-only firms,
5 it would be a good thing. I think it would be
6 a difficult thing to achieve. You certainly
7 could have the limits on and you do have the
8 limits on consulting, which I think have
9 dramatically changed the relationship between
10 audit firms and companies they audit.

11 MR. DURKIN: One quick point. In
12 talking to some companies, they indicate that
13 the other firms, the ones that are not doing
14 the audit now, aren't interested in doing
15 their audit because the engagement on the
16 other fees is too lucrative and too
17 attractive.

18 CHAIRMAN DOTY: Mr. Hanson?

19 MEMBER HANSON: A couple-part
20 question that maybe start with an over-arching
21 question and just get down to a granular
22 question wrapped into it.

1 The over-arching question is --
2 and I would like your reactions to it -- do
3 you think SOX with a ten-year hindsight now
4 has been effective at giving investors better
5 information and more reliable information?

6 And, one level down, do you think
7 the PCAOB has been effective at improving
8 audit quality? But then I really wanted to
9 zero in on a couple of the comments that
10 several of you have made about audit
11 committees.

12 And I think Mr. Silvers mentioned
13 a comment like quasi-independent audit
14 committees. And, really, the acid test
15 question, do you think audit committees today
16 are doing the job that Congress intended with
17 the Sarbanes-Oxley Act? And if not, what
18 things could be done to improve their
19 effectiveness?

20 MR. CLAPMAN: Somebody has to take
21 a first crack at it. I will try. I am on an
22 audit committee of a public company. And I

1 think audit committees have dramatically
2 increased their effectiveness over this period
3 of time. And I think the PCAOB has been
4 effective in fostering the positive change.

5 I think we are now, though, in a
6 policy level looking at next steps because
7 some of us believe the results to date are yet
8 not fully effective in terms of auditor
9 independence or, really, taking the concerns
10 of investors into account.

11 And I think, partly what has
12 happened is that many audit committees, in
13 effect, have been sold a bill of goods for a
14 variety of reasons and probably think that
15 changing audit firms -- I use the term "an act
16 of folly." And I think that is an unfortunate
17 position.

18 I think they have been led to
19 believe that these dire consequences would
20 occur, that they want to preserve their own
21 authority. As I tried to indicate in my own
22 presentation, and I think your earlier panel

1 reflects this as well, that audits would
2 improve with a change in practice. Costs
3 would not go up.

4 And this would be a reasonable --
5 I would put again, underline the word
6 "reasonable" -- intrusion on their authority
7 to pick another audit firm. And it's their
8 choice which firm it would be.

9 And if it turned out that going
10 through a process, let's say re-bidding or
11 under a rubric of audit firm rotation, that it
12 just could not be done, I'm sure that a system
13 could be worked out with the PCAOB to try to
14 work through the practical consequences of
15 that.

16 But I think we're really at the
17 next stage of policy-making.

18 MR. DURKIN: To the question of
19 the Sarbanes-Oxley impact, I think it created
20 good structures. I think we missed the
21 opportunity to have audit firms in the
22 post-Sarbanes-Oxley SEC rulemaking on

1 non-audit fees. I think the industry won
2 there.

3 What it hasn't done is it took
4 from management these responsibilities and put
5 them in the audit committee. But the audit
6 committee -- if you look at the disclosure
7 documents, the audit committee report is pure
8 boilerplate.

9 And if you look at the auditor
10 ratification vote that's in the proxy
11 statement, you have a proposed -- you have a
12 hearing here on an issue of auditor rotation.
13 Companies aren't even required to put the
14 auditor up for ratification.

15 The auditor ratification vote
16 that's in proxy statements now is in there for
17 one reason. It's so that companies can get
18 quorums to hold their meetings. That's the
19 only reason it's there because broker
20 non-votes can actually be registered at the
21 meeting as present. And that allows the
22 company to have a quorum because auditor

1 ratification is the only routine vote left on
2 shareholder proxy statements.

3 So this issue is being used by
4 companies to make sure they get a quorum for
5 their meeting. Okay? And then the audit
6 committee has this boilerplate. They never
7 take ownership of the powers that I think
8 Sarbanes-Oxley has given them. And that is
9 what we are trying to push with this
10 disclosure.

11 Tell us how long this relationship
12 has lasted. Tell us why it makes sense to
13 continue with this firm versus rotating. The
14 lead partner -- the shareholders don't know
15 about the lead partner rotation. And we found
16 all kinds of experiences from the firm
17 dictating, the audit firm dictating the new
18 partner, to management dictating who the new
19 partner is, to the audit committee chair being
20 involved. Start explaining that process a
21 little bit.

22 That audit committee, which was

1 empowered by Sarbanes-Oxley, needs to take
2 more ownership. And they need to tell the
3 shareholders because now we do have voting
4 rights where we can vote out audit committee
5 members.

6 There are accountability
7 mechanisms. But the SEC is standing in the
8 way. The SEC staff is standing in the way on
9 the no-action process.

10 This issue at the SEC technically
11 is considered a routine, ordinary matter,
12 auditor rotation, not suitable for a
13 shareholder vote. Yet, we're having a public
14 hearing here about it and we had 600-plus
15 respondents to your rulemaking to show you how
16 important it is.

17 CHAIRMAN DOTY: It may not be
18 strategic. It may be in the ordinary course
19 of business, important but not strategic.

20 Damon?

21 MR. SILVERS: Well, yes. You have
22 asked an enormous set of questions. I'll try

1 to give you a very compact set of answers.

2 With respect to the overall
3 effectiveness of Sarbanes-Oxley and the PCAOB,
4 I think the key dynamic to be aware of is what
5 Ed mentioned in one instance, which is the
6 regulatory give and take over the last ten
7 years and the occasional interventions of the
8 Congress have I think not left Sarbanes-Oxley
9 and now I think are not leaving Dodd-Frank
10 more or less what they were intended to be
11 when passed. And so it's hard to assess.
12 It's hard to pull apart where things have been
13 weakened and left unable to do what Congress
14 initially intended and where perhaps the
15 framework wasn't properly constructed in the
16 first place.

17 That being said, I agree with my
18 fellow panelists that as a general matter, the
19 quality of audit committees has been
20 significantly improved by the independence and
21 expert requirements and by the cultural change
22 that the Sarbanes-Oxley Act signaled.

1 I think in certain respects,
2 aspects of the Sarbanes-Oxley Act, like the
3 internal controls provisions, actually ended
4 up sort of properly aligning the audit firms
5 and honestly their political power with the
6 interest of the investors and the general
7 public. That was helpful.

8 The limitations, though, which I
9 embodied in my use of the term
10 "quasi-independent" for the audit committee,
11 the limitations here are structural. Right?

12 The audit committee is made up of
13 members of the Board. Members of the Board as
14 a practical matter are the outcome of a
15 process that is almost always initiated by
16 management in terms of the selection of those
17 auditors.

18 There is a profound and justified
19 cultural tendency within the Boards of public
20 companies to want to operate as a team in most
21 circumstances. That renders an audit
22 committee made up of the most independent,

1 well-meaning people with a competent expert,
2 nonetheless fairly closely tied to management.
3 It's unavoidable. And not only is it
4 unavoidable, but the business community
5 literally demands it.

6 Whenever any change is suggested
7 in the way the Boards are selected, the
8 business community comes in and demands of
9 policy-makers that they do nothing to
10 interrupt the team functioning of the Board.
11 That team functioning of the Board is another
12 way of saying quasi-independent.

13 Now, where the success of
14 Sarbanes-Oxley stopped, I think, was revealed
15 by the financial crisis. And what it turned
16 out to be was that this structure, partner
17 rotation --

18 CHAIRMAN DOTY: Separation of
19 audit from non-audit services.

20 MR. SILVERS: Right, separation of
21 non-audit services. Actually, I was thinking
22 of public partner rotation, audit committee

1 independence, and expert, and separation of
2 non-audit services.

3 What that structure ended up not
4 being able to properly foster was an ability
5 on the part of the audit committees and the
6 outside auditor in the context of what turned
7 out to be very important major financial
8 institutions to take a skeptical eye to
9 complex financial structures within the firms
10 they were looking at. And the consequences of
11 that failure were very grave.

12 In the aftermath, it is my view --
13 and I think this has enormous consequences for
14 our financial system and for our economy; in
15 the aftermath of the events of 2008, an
16 inability of that system to simply tell the
17 truth about the nature of financial
18 institution balance sheets.

19 And that comes back I think to the
20 limitations of that model I think it has
21 turned out as an empirical model to do fairly
22 well in relationship to essentially the

1 WorldCom problem. Somebody took a pencil and
2 erased numbers and filled in zeros, right?
3 That problem we have not been faced with in
4 the last ten years.

5 Complexity. Complexity that adds
6 up to the same thing. A bankrupt firm? Not
7 so good.

8 I would also mention something
9 that has almost been forgotten in the
10 consequence of the 2008 fiascos, which was the
11 option backdating scandals. Those scandals
12 suggested, again, that this system was not
13 very good at dealing with matters that were of
14 intense interest to executives but might not
15 rise to the level of blowing up the firm, that
16 in those circumstances, this system was not
17 very good at producing really independent
18 audits.

19 CHAIRMAN DOTY: Jim Alexander, you
20 had a comment before. I want to get to
21 Jeanette.

22 MR. ALEXANDER: Yes. You guys

1 have already said everything that needed to
2 say. Just I would just say that I think the
3 scale of the recession you just had in the
4 United States, I think, and the fact that
5 there weren't many financial scandals in the
6 non-financial area, non-financial companies,
7 it does demonstrate something must have
8 improved because recessions always find out
9 the weakest companies and the problems and the
10 scandals.

11 And, actually, there weren't that
12 many scandals, despite the pretty catastrophic
13 drop in GDP. That was pretty impressive.

14 I do see on the financial sector
15 complexity. Maybe some of it has leaked out
16 somewhere else into the financial sector and
17 with the systemic risks that have increased,
18 as opposed to idiosyncratic risks. Not that
19 many individual firms go, but when one does
20 have a problem, it does seem to bring down the
21 whole industry.

22 And that is something that, the

1 coziness, I think, of having the Big Four
2 audit firms and doing a lot of non-audit fee
3 work for non-audit clients can lead to a group
4 thing that I think has been raised quite --
5 actually, a group think has been raised quite
6 a lot. And there is a danger that the
7 auditors and the non-audit colleagues get
8 captured by the industry that they are working
9 for. And they will end up thinking the same.
10 And that is when you have problems. So more
11 firms is better.

12 MEMBER FRANZEL: I am interested
13 in exploring the benefits that you all have
14 seen in live cases where the audit committee
15 is employing a practice such as disclose or
16 explain, you know, on the consideration of
17 audit rotation. Or disclosing a re-bidding
18 process. Or disclosing oversight of auditor
19 independence, so the benefits that you have
20 seen in real cases there.

21 Also I am very interested in Mr.
22 Clapman's comment or view that audit

1 committees aren't going to get there
2 voluntarily and that there is some type of
3 regulatory intervention needed. And if you
4 all could comment on that as well?

5 MR. CLAPMAN: Well, if I can take
6 a first crack at it from the point of view
7 that my prior organization, TI-CREF, went
8 through three auditor rotations. This
9 actually went back many, many years, even
10 prior to John Biggs' tenure as CEO of the
11 company.

12 We didn't disclose it. There were
13 no reasons to disclose it. But to just
14 quickly get to the benefits, what we found was
15 that, as I indicated, we didn't have an
16 increase in costs, that basically audit firms
17 that wanted our audit contract bid on the
18 basis of trying to obtain it. And cost just
19 never was a factor.

20 In terms of benefits to the audit,
21 what we found -- and this was both anecdotal
22 and I think could be substantiated, is the

1 outgoing auditor I think is a little more
2 careful. The audit firms try to clearly do
3 the best job possible, but knowing that
4 another audit firm of similar quality is going
5 to come in and take a look at some of the
6 decisions that actually took place I think
7 adds a certain impetus to their awareness of
8 the sensitivity of making the correct
9 decision.

10 And then what we found as well is
11 that the incoming audit firm did take a fresh
12 look at some of the prior decisions. I
13 witnessed these personally as chief investment
14 lawyer of the company. And some of the
15 accounting conclusions were changed. And, in
16 hindsight, I think those changed conclusions
17 were the right thing to have done, not that
18 the prior auditor didn't do a good job, but
19 that a fresh look created a different impetus
20 within the organization.

21 In terms of voluntary compliance
22 of that, as I say, when I was doing this for

1 TI-CREF, we went to a number of companies to
2 see whether they would voluntarily change
3 their -- we didn't even call it mandatory
4 auditor rotation. We called it tenure review.
5 And companies simply were unwilling to do
6 that.

7 And I think if you look at the
8 bulk of comment letters that came in to the
9 PCAOB during this process, you get this
10 repetition of increased costs. There's
11 repetition of poor audits, both of which I
12 think are belied by my own experience. And I
13 think some of the comments in the earlier
14 panel would support the notion that these
15 don't occur and then again, finally, that it's
16 sort of human nature to continue relationships
17 unless you are more or less required to go
18 through a process of reviewing them.

19 So that's where I come out that
20 unless the PCAOB does something, I think the
21 bulk of companies are just going to simply
22 stay with the status quo and simply not

1 review, even on a voluntary basis, tenure
2 review.

3 CHAIRMAN DOTY: We are going to
4 have to leave it there. This panel has
5 brought a wonderful perspective to bear,
6 breadth and of linkage of the specific issues
7 raised by the Concept Release with broader
8 issues of disclosure, of governance, of
9 restoring trust with focus on financial
10 institutions.

11 Jim Alexander's papers on this are
12 riveting. Ed Durkin's comments and Damon's
13 comments and Peter's on what they have seen
14 have been very helpful.

15 We are going to take a break. The
16 break will be a short break. But the next
17 panel is a panel of one. The next panel is
18 the honorable Harvey Pitt, Harvey L. Pitt. So
19 we will reconvene here promptly at 10:35.
20 Thank you.

21 (Whereupon, the above-entitled
22 matter went off the record at 10:27 a.m. and

1 resumed at 10:38 a.m.)

2 CHAIRMAN DOTY: Ladies and
3 gentlemen, I can assert with confidence that
4 there is no subject of important financial
5 services regulation or public policy in the
6 securities or finance area that is not
7 benefitted by spending an hour with Harvey L.
8 Pitt.

9 Harvey Pitt, of course, was the
10 26th Chairman of the United States Securities
11 and Exchange Commission. For a quarter of a
12 century, before becoming Chairman, he was a
13 senior corporate partner at the New York law
14 firm of Fried, Frank, Harris, Shriver &
15 Jacobson. He was a founding trustee of the
16 SEC Historical Society. He has been an
17 adjunct Professor of Law at Georgetown, George
18 Washington, Pennsylvania, the Yale School of
19 Law. And he served from 1968 until '78 as the
20 Commission's general counsel, and in that
21 role as a mentor and a guiding spirit for all
22 of us.

1 A member of the Global Advisory
2 Forum, of the COS Hedge Fund, member of the
3 Regulatory and Compliance Advisory Council of
4 Millennium Management. Serves on the Board of
5 Directors of Paulson and Co. And is the
6 founder and the operator of Kalorama Partners,
7 LLC of which he is the Chief Executive
8 Officer.

9 Harvey L. Pitt, thank you and
10 welcome

11 MR. PITT: Thank you, Mr.
12 Chairman, and members of the Board. I'm
13 actually honored and flattered to be asked to
14 offer my personal observations. It is ironic
15 that it was ten years to this precise day that
16 I testified on this subject before the Senate
17 Committee, at which time Mr. Harris was its
18 chief counsel, on what ultimately became
19 Sarbanes-Oxley and on a lot of these issues.

20 I would like to start by
21 commending the Board on this critical
22 initiative and the thoughtful and transparent

1 manner in which you are proceeding. My
2 written statement outlines my views in some
3 detail, so I would like to take only a few
4 minutes to summarize some of the core concepts
5 I recommend that you consider, and then
6 attempt to respond to any questions that you
7 might have.

8 Although this hearing is
9 specifically focused on the question of
10 whether to mandate audit firm rotation, that's
11 but one method for trying to achieve the
12 Board's appropriate objective, improving the
13 independence, objectivity and professional
14 skepticism of external auditors with a view
15 toward improving the quality of public company
16 financial statements.

17 That objective is unassailable and
18 unfortunately never ending. Audited financial
19 statements of public companies are improving,
20 thanks in large part to the efforts of this
21 Board and the SEC. But we continue to see
22 egregious instances of inaccurate, misleading,

1 opaque, imprecise, and doubtful financial
2 reports with disastrous consequences not just
3 for investors, but for capitalism itself and
4 the economic integrity that secures our
5 fundamental political freedoms.

6 Unfortunately, nothing this Board,
7 the SEC, or the audit profession can do will
8 eliminate all future fraudulent financial
9 statements. But that doesn't mean the Board
10 should abandon its effort. In this context,
11 the perfect is always the enemy of both the
12 good and the sensible. We can and must
13 constantly strive to improve quality controls
14 at all professional audit firms and in my view
15 that was the precise reason this Board was
16 created in 2002.

17 There are three facets to the task
18 the Board has wisely undertaken. First is the
19 methodology the Board should employ. The
20 second is differentiating between short and
21 longer term solutions. And the third is
22 developing the kind of empirical data that

1 will justify whatever conclusions the Board
2 ultimately thinks it wise to reach.

3 To me, the starting point is
4 recognizing that firms which do sloppy or
5 improper professional audits should not be
6 allowed to remain in a position of trust and
7 confidence, namely, serving as a public
8 company's outside audit firm.

9 Conversely, the imposition of what
10 I would call a dead hand switch regulation,
11 preventing the exercise of any human
12 discretion by requiring auditors to be
13 replaced no matter how ably they may be
14 serving, does not seem to me to reflect the
15 thoughtfulness we want to foster vis-a-vis
16 public company financial reporting.

17 I favor placing burdens on audit
18 committees realistically and skeptically to
19 consider the performance of their company's
20 outside auditors on a regular and periodic
21 basis and to compel them to consider factors
22 that this Board thinks may be lacking in

1 instances where it has observed audit
2 deficiencies.

3 The ultimate deliverable, in my
4 view, should be an affirmative finding by
5 audit committees that their outside auditors
6 exceed quality control levels set by this
7 Board, if the public company wants to retain
8 the audit firm beyond some specified period.

9 To do this, the Board and the SEC
10 should assist public company audit committees
11 in developing a systemic methodology for
12 assessing the performance of outside auditors
13 and define the types of circumstances under
14 which outside auditors should be discharged.

15 I also believe that careful
16 attention will have to be paid to anticipated
17 costs and benefits. Given the speculative
18 nature of those issues of costs and benefits
19 from something not now in effect, I think the
20 utilization of a pilot program, as raised in
21 the Concept Release, would permit the Board to
22 test its theories, assess its proposed

1 response and ensure that the public is well
2 served by whatever mechanisms the Board puts
3 in place. I think it would also allay
4 questions from the judiciary about cost-
5 benefit analysis by providing a predicate for
6 gathering appropriate data.

7 I'd like to conclude my oral
8 statement by commending the Board again for
9 its thoughtful, disciplined, and transparent
10 approach to an issue that is well deserving of
11 the attention you are giving it. I'm pleased
12 to have been a part of this process and I'll
13 be happy to try to respond to any questions
14 you may wish to pose.

15 CHAIRMAN DOTY: Thank you,
16 Chairman Pitt. Ms. Franzel.

17 MEMBER FRANZEL: Thank you, Mr.
18 Chairman.

19 Mr. Pitt, I'd like to hear a
20 little bit more about two of the main points
21 that you made. First, the systemic
22 methodology that you suggested for audit

1 committees to use in evaluating the
2 performance of auditors. What are some of the
3 criteria and factors that you would envision
4 being in such a methodology?

5 And then secondly, how would you
6 envision a pilot program to be conducted to
7 sort of test and develop that methodology?

8 MR. PITT: First, part of the
9 difficulty in anything like this is that an
10 audit committee of a public company, assuming
11 it wants to do the right thing, is confronted
12 only with the knowledge relating to its own
13 company, whereas the PCAOB does quality
14 control reviews and sees these firms in
15 multiple contexts. There needs to be a way,
16 in my view, and I know about the statutory
17 limitations which I think are most unfortunate
18 in a sense, but there needs to be a way for
19 the generic data to be communicated if a firm
20 constantly crops up on the PCAOB's problematic
21 list, but an audit committee doesn't know
22 about that. It makes it difficult for the

1 audit committee to do the right thing even if
2 it wants to do it.

3 So there needs to a methodology
4 created, and I think you'll need the
5 assistance of the SEC and you may need
6 legislation on that, although I believe that
7 it may be possible to provide generic data
8 instead of specific data, although there might
9 be litigation over that and I'm not sure it's
10 worth your while to spend time on that. But
11 I do think that getting that kind of data out
12 was important.

13 Second, what are the factors that
14 the Board sees that cause you concern? The
15 Concept Release differentiated in a sense
16 between what it called audit failures and then
17 what it talked about as potentially violative
18 conduct and said the fact that there's an
19 audit failure doesn't mean that the financials
20 were misleading. Which is true, although as
21 I point out in my statement, we should never
22 be satisfied with what I call inadvertent

1 compliance with the law. So the fact that
2 somebody got through this and didn't get
3 burned by their ineptitude or their
4 carelessness or what have you is irrelevant,
5 because that could happen.

6 The Board can define the types of
7 behaviors, the types of incidents. So even if
8 you don't put out a report, you can put out
9 statistical analyses. You can put out generic
10 descriptions. I think there's a lot of
11 thought, although obviously, I defer to your
12 able staff on how far you can go, but my view
13 would be to assume more.

14 Your second element, with respect
15 to a pilot program is this: I think that you
16 may not want to try a single pilot program,
17 but you may want to try several pilot
18 programs. The advantage of trying several
19 pilot programs is that I think it will make it
20 difficult for someone to say you have a
21 preordained conclusion as to where you're
22 coming out and you were really just making an

1 effort to delay the ultimate introduction.

2 So one thing that I would see as a
3 possibility, if you thought about that, is I
4 have recommended the approach that audit
5 committees be required at a set interval to
6 make an affirmative finding that the
7 accounting firm that they want to keep,
8 assuming they want to keep it, exceeds
9 whatever standards this Board articulates.
10 And if you did that, you could start a pilot
11 program. You could try to get volunteers,
12 which would be the best way, and there may be
13 companies that want to volunteer.

14 At the same time, if you wanted,
15 although this is in an area where I have more
16 concern, if you wanted to get some experience
17 with what would the audit costs rise to for
18 companies that had to replace their auditors
19 on a five-year cycle and what burdens might it
20 provide and what difficulties were encountered
21 in trying to replace the audit firm?

22 We tend to view the now Big Four

1 as monolithic. But the fact is they're all
2 very different. And some of them have
3 fabulous skill sets in certain areas and
4 certainly professional skill sets, but perhaps
5 not as fabulous in other areas, so they're not
6 directly interchangeable. This would give you
7 a chance, in essence, to sort of decide what
8 your data is, and having multiple pilots at
9 the same time, in my view, would give you a
10 direct comparison. You could carefully pick
11 the areas that you wanted.

12 MEMBER HANSON: Thank you for
13 coming today, Mr. Pitt. Your written
14 statement that you submitted has some very
15 intriguing thoughts and I really appreciate
16 those.

17 I've got a question for you about
18 how your views have evolved since the
19 enactment of Sarbanes-Oxley. I want to frame
20 it with a quote from one of the other letters
21 that we received.

22 So Charles Rossotti, currently an

1 independent Board member, former Commissioner
2 of the IRS, he said in his letter, "My views
3 on mandatory auditor rotation have changed
4 since the enactment of the Sarbanes-Oxley Act.
5 When the act was initially being considered,
6 I was surveyed and expressed the view that
7 mandatory auditor rotation was a concept that
8 should be seriously considered in lieu of
9 several other proposals. However, the Act
10 itself as now put in place a very robust set
11 of structures and policies that make it
12 unnecessary to impose the additional costs and
13 risks of mandatory auditor rotation." So that
14 is the view that he expressed.

15 So I'd just like to hear some of
16 your personal experiences from what you've
17 observed of auditors and your roles in the
18 Board rooms in the last ten years.

19 MR. PITT: I am privileged now to
20 work with public companies and sort of see how
21 Sarbanes-Oxley operates in real time and in
22 the real world. I think it has created

1 improvements, but I think that fears of
2 liability and tendencies on the part of
3 everyone to devolve into rote approaches means
4 that the Act has not achieved what it should
5 and I think that's why I was very impressed
6 with your Concept Release because it notes
7 that things have gotten better, but there are
8 still too many audit difficulties or
9 deficiencies.

10 I looked at my testimony from 2002
11 and my views have not evolved a great deal
12 from what positions I was expressing, at that
13 time for a unanimous Commission, but they have
14 changed in a couple of ways. I get very
15 concerned when people take absolute positions.
16 I think that creates a real problem for
17 regulators and your job is just to exercise
18 your judgment in the best way you know how and
19 not allow people to either parade horrors
20 about the terrible things that would happen or
21 parade sugar plums of all the benefits that
22 might arise and so on.

1 But I think that, ultimately,
2 mandatory auditor rotation, as most people
3 think of it, and I use the analogy to a dead
4 hand switch, that would never allow the audit
5 committee to exercise real judgment would be
6 an unfortunate solution. And I think
7 ultimately, the cure could turn out to be --
8 I'm not saying it would -- but could turn out
9 to be worse than the disease, depending, for
10 example, on the amount of time that people
11 were required to rotate off.

12 But I think if instead what you do
13 is put the onus in the one place where it can
14 most properly be exercised by an independent
15 audit committee, armed with whatever
16 appropriate information this Board and the SEC
17 can give it, and if you spell out, in a sense,
18 what kinds of determinations will permit an
19 accounting firm to remain beyond whatever the
20 period is, I think you can avoid the potential
21 of lip service on the part of some audit
22 committees. I think you can get the benefits

1 of auditor rotation where it's warranted. But
2 if a firm is doing the kind of top-rate job
3 it's doing, then getting rid of them or
4 forcibly rotating them is not ultimately going
5 to benefit the shareholders of the company.

6 CHAIRMAN DOTY: The five-minute
7 mark. Mr. Ferguson, please, go.

8 MEMBER FERGUSON: Just a couple of
9 questions. Your suggestion of the audit
10 committee having to sort of determine whether
11 the auditor has exceeded our standards is an
12 intriguing one and I have a couple of
13 questions about that.

14 First of all, would the standard
15 be, for example, that the auditor -- that the
16 specific audit involved exceeded our standards
17 or that the audit firm's performance as a
18 whole exceeded our standards? And the reason
19 I ask that question is when we look at these
20 reports that we get on audit firms, they vary
21 widely for all the firms. I mean, some of the
22 work is absolutely superb. Some of it is not

1 good. So it's very hard to generalize. So
2 just to focus on that question.

3 The second question is are audit
4 committees, in fact, equipped to do the kinds
5 of detailed analysis that would really be
6 required? I mean, the analysis that we do
7 when we examine audit quality and whether it
8 meets our standards is oftentimes highly
9 technical, we'll go into -- and requires
10 batteries of very skilled auditors themselves
11 who go in and look at this and examine these
12 things again. I'm not sure that audit
13 committees, at least the ones I'm familiar
14 with, really have that skill. Where would
15 they get them? Would they hire experts?
16 Would they have to hire outside experts? How
17 would you envision this would work?

18 MR. PITT: First, I think in order
19 to get the best judgment and to improve audit
20 quality overall, I think this Board's mission
21 is much broader than making sure that Pitt
22 Company has good audits. This Board's mission

1 is to make sure all public companies have the
2 best audits we can inspire those in the
3 profession to achieve.

4 So as a result, I think the audit
5 committee has to take into account information
6 that might show that in certain circumstances
7 their audit committee, although not at their
8 company, may have cut some corners or been
9 professionally less than excellent and so on
10 and take that into account. There's no way
11 that any public company can get that
12 information unless, as I said earlier, this
13 Board and the SEC find a way to create the
14 tools.

15 And I want to stress here, I'm not
16 suggesting that this Board make the decision
17 on a case-by-case basis, obviously, as to who
18 stays and who goes, although I will say even
19 there, I think if you see something egregious
20 enough, I think you have that ability and you
21 should exercise it.

22 What I'm really talking about is

1 giving the audit committee the tools. And
2 that sort of segues into your second question.
3 And I think that audit committees need a lot
4 of help. I think there is some excellent
5 audit committees, but some don't fully
6 comprehend what their job is. And so one
7 thing I suggest in my statement is that this
8 Board ought to delineate the kinds of findings
9 the audit committee will have to have made in
10 order for the company to keep its auditors
11 beyond a set period.

12 And what you could do, I mean
13 there are so many variables on this, you could
14 say every five years there has to be an
15 affirmative determination. You can have a
16 much more shorter period for this than you
17 would if you were doing a formal rotation
18 where there would be a lot of reasons to allow
19 firms to stay longer. And so I worry. I
20 think if you put people on the test to
21 demonstrate that they're performing and after
22 every five years it may be that the audit

1 committee has to do this every other year. It
2 doesn't get to wait another five years. But
3 it has to make an affirmative finding and the
4 committee has to put its imprimatur on what's
5 going on.

6 I think with help from this Board
7 and from the SEC and outside advisors, I think
8 there's a real way to get people informed,
9 advised, and functioning well.

10 MEMBER HARRIS: I realize we're
11 out of time for this. I just want to make one
12 closing statement. It was ten years to the
13 day, as you point out in your testimony, that
14 you wrapped up our ten days of hearings on
15 Sarbanes-Oxley. But the most memorable two
16 days of hearings that I participated in during
17 my 25 years on the Hill, I was first of all
18 9/11 Superior. I can't resist the temptation.
19 And the second one was September 20th when you
20 testified after the crisis and you were the
21 right person, at the right time, at the right
22 place. I just wanted to thank you for your

1 outstanding service at that time on the other
2 related issue and for your service on
3 Sarbanes-Oxley. I did have questions, but
4 I'll refrain from asking them.

5 CHAIRMAN DOTY: Thank you, Steve.
6 Thank you, Mr. Pitt. Thank you, Harvey.

7 MR. PITT: Thank you.

8 CHAIRMAN DOTY: The next panel, we
9 now move, we're going to move now to preparers
10 and registrants. And as they make their way
11 to the table I will introduce with pleasure
12 Steven Buller.

13 Steve Buller, a managing director
14 of BlackRock, Inc., as a managing director,
15 he has oversight of accounting policy
16 controls, auditor independence, and over other
17 financial aspects of BlackRock's 3500
18 investment companies. He's a member of the
19 wholly-owned bank of BlackRock's system and he
20 previously served as their Chief Financial
21 Officer. Prior to joining BlackRock, Mr.
22 Buller spent 30 years at Ernst & Young, LLP

1 where he was the global director of Asset
2 Management Services. And he is also a member
3 of the PCAOB Standing Advisory Board, for
4 which we are very grateful.

5 Theo Bunting is the senior vice
6 president and Chief Accounting Officer of
7 Entergy Corporation. He has a long and
8 distinguished career, not only with Entergy
9 where he has been at various times the Senior
10 Vice President of Nuclear Operations and of
11 System Energy. He has served in senior
12 capacities in various Entergy subsidiaries.
13 But from 1999 to 2000, he's been the head of
14 various utility operations, a partner with
15 Public Energy Services, Inc., from '97 to '99.
16 Theo Bunting knows the energy industry. He
17 knows the issue or side of that. We're
18 delighted to have him.

19 Valarie Sheppard is the Senior
20 Vice President and Comptroller of the Proctor
21 & Gamble Company, one of America's crown
22 jewels in our corporate governance system.

1 Senior Vice President and Comptroller has
2 joined the company -- she joined in 1986. For
3 the previous five years, she held the
4 positions of Manager of Finance and Accounting
5 for Global Household Care, Manager of F & A
6 for Global Fabric and Home Care, and Finance
7 Director for the Northeast Asia Market
8 Development Organization.

9 Darren Wells. Darren Wells is
10 Executive V.P. and Chief Financial Officer of
11 the Goodyear Tire & Rubber Company, another
12 one of the crown jewels of American corporate
13 life. He was named Executive VP and CFO in
14 October of 2008. He had been the Treasurer.
15 He had also served as the Treasurer of Visteon
16 which is a parts manufacturer which was spun
17 off from Ford Motor Company. He worked -- Mr.
18 Wells worked in Ford's Australian operations
19 from 1998 to 2000, Comptroller of Ford
20 Investment Enterprises and as a Finance
21 Director of Ford Credit Australia.

22 So we have a distinguished panel

1 of people who bring a new and different
2 perspective to the whole discussion that we've
3 been having and I'll take the liberty of
4 starting with you, Steve. If you'll begin.
5 Thank you.

6 MR. BULLER: Thank you. I
7 appreciate the opportunity to participate in
8 this public meeting on auditor independence
9 and audit firm rotation. I'm speaking based
10 upon the input I've received from our firm's
11 analysts, as well as our corporate and
12 investment fund financial statement preparers.

13 BlackRock manages approximately
14 \$3.5 trillion of assets and sponsors
15 approximately 3,500 investment funds,
16 substantially all of which are subject to
17 annual audits. We utilize two of the Big Four
18 audit firms for our SEC attest services and
19 all five, or the five largest accounting firms
20 for advisory services, to give you some
21 perspective.

22 The PCAOB's Concept Release on

1 auditor independence and audit firm rotation
2 offered a number of alternatives to enhance
3 auditor independence and objectivity. I will
4 address mandatory rotation momentarily.

5 We support some of those
6 alternatives, including further restrictions
7 on the scope of non-audit services that may be
8 provided by an audit firm to its SEC-
9 registered clients if those services do not
10 relate to the audit or control environment.

11 We don't object to audit firms performing
12 advisory services which may provide their
13 professionals with business acumen that will
14 enhance their audit skills. However, we have
15 observed that some firms continue to expand
16 their advisory practices into areas that are
17 less aligned with traditional audit and tax
18 practices.

19 We recommend the PCAOB and SEC
20 consider whether certain non-audit services,
21 including bookkeeping, financial information
22 system design and implementation, appraisal or

1 valuation services, or actuarial services may
2 be performed for a registrant by a company's
3 independent auditor even when those services
4 will not be subject to audit procedures during
5 the client's financial statement audit.

6 We also encourage review of other
7 non-audit services to determine whether they
8 should be identified as potential conflicts.
9 For example, personal tax services for company
10 employees, compensation consulting, staff
11 augmentation and project management all may
12 provide the appearance of lack of
13 independence.

14 So turning to a central aspect of
15 the release, we do not support mandatory
16 rotation. Our corporate audit committee, our
17 analysts, and management are concerned about
18 the restrictions in a company's ability to
19 select the most qualified firm, the loss of
20 institutional knowledge, and the reduced
21 incentive for audit firms to invest in the
22 audit relationship when the time horizon is

1 short. This is particularly when the firm has
2 a large global footprint, like we and I think
3 all firms at the table here today have.

4 An auditor's effectiveness is
5 lowest at the beginning of a new audit
6 relationship and the learning curve may last
7 for several years. Companies also may be
8 limited in the selection of a new audit firm
9 by a number of factors including industry
10 expertise and employees who are former audit
11 partners in a financial reporting oversight
12 role. So in my case, I'm one of five partners
13 from my former firm who are employed in
14 financial reporting and oversight rules at my
15 firm. And we either have the choice to hire
16 that firm as auditor for SEC work, of either
17 having the firm pay all of this out of our
18 pensions which they have said they would not
19 do, or my firm fire all five of us, which I
20 hope they will not.

21 As we sponsor investment funds
22 that are part of an investment company complex

1 for SEC auditor independence purposes, every
2 fund is subject to the SEC auditor
3 independence rules even though they may not be
4 an SEC registrant. As a result, mandatory
5 rotation would be a logistical challenge,
6 given our monthly year-end cycles and the need
7 to coordinate auditor selection with about 15
8 different corporate and fund Boards of
9 directors that all must decide upon the
10 auditor for their specific responsibilities.

11 As we indicated in our written
12 responses, other alternatives to mandatory
13 rotation include requiring registrants to
14 disclose their policy with respect to periodic
15 tendering of the audit and the date upon which
16 the most recent audit tender occurred, and as
17 previously mentioned, further restricting
18 advisory services.

19 The PCAOB should continue to
20 emphasize the importance of independence and
21 objectivity through their comprehensive
22 auditor inspection process which we believe is

1 very productive.

2 Finally, we believe the PCAOB
3 should share as much information as possible
4 for all their inspections -- or from all their
5 inspections with audit committees and provide
6 criteria that should be considered in
7 evaluating auditors, thereby putting the audit
8 committee members in a better position to
9 enhance the audit process and monitor auditor
10 independence.

11 So overall, we're satisfied that
12 the current audit and professional standards,
13 quality control measures implemented as a
14 result of Sarbanes-Oxley, the PCAOB
15 inspections, and mandatory partner and staff
16 rotation requirements have helped ensure high-
17 quality audits and we applaud the PCAOB's on-
18 going efforts to enhance those standards.
19 Thank you.

20 CHAIRMAN DOTY: Thank you. Theo,
21 yes. Mr. Bunting.

22 MR. BUNTING: Thank you. As was

1 mentioned earlier, my name is Theodore
2 Bunting. I'm Senior Vice President and Chief
3 Accounting Officer for Entergy Corporation.
4 Also today I'm speaking on behalf of the
5 utility industry in general through the Edison
6 Electric Institute which most of us are a
7 member.

8 I appreciate the opportunity to be
9 here and to provide my point of view on the
10 issue of auditor independence, objectivity,
11 professional skepticism, as well as the
12 current consideration being given to audit
13 firm term limits. At Entergy, we have given
14 a lot of thought to this issue and we
15 certainly devote a significant amount of time
16 and attention to the external audit.

17 I have the primary management
18 responsibility for working with external
19 auditors and in this role I'm responsible for
20 understanding and working to resolve or
21 correct any significant findings or issues as
22 a result of the audit. My group owns all the

1 financial processing of transactions and the
2 development of accounting conclusions on
3 issues which are the primary areas of focus
4 during the audit as well as the associated
5 external reporting.

6 I, along with the Chief Financial
7 Officer, have the primary management
8 responsibility to support and answer to the
9 audit committee or the Board which includes
10 providing management's point of view on audit
11 findings and significant accounting issues.
12 It is primarily from this experience and
13 vantage point that I have formed my opinions
14 as it relates to issues being discussed here
15 today.

16 I would like to start by
17 discussing our approach in preparing financial
18 statements. One key point that I would like
19 to emphasize is that my objective as the Chief
20 Accounting Officer is to make every effort to
21 get it right. And that means preparing and
22 issuing financial statements and maintaining

1 internal controls that comply with all
2 applicable requirements and that meet the
3 needs of our financial statement users. I
4 believe that management of the company has the
5 ultimate responsibility for financial
6 statements and is ultimately responsible to
7 its investors and the SEC.

8 In my experience, one of the
9 factors that helped to get it right is to
10 undergo a robust audit process by a qualified
11 audit engagement team, a team with the right
12 level of experience focusing on the right
13 things. And experience includes experience
14 with the company and the utility industry.

15 During my career as Chief
16 Accounting Officer, I've not observed a
17 situation where I felt the external auditor
18 backed off on a material issue because of a
19 concern about client relationships or audit
20 fees.

21 I do agree that having a good working
22 relationship with the external auditor is

1 important, but for me, that working
2 relationship is important because it fosters
3 communication that helps to avoid surprises in
4 the process and helps our company have an
5 awareness of material issues so that those
6 issues can be addressed in a timely fashion.

7 But in my opinion, having a good
8 working relationship with the audit firm and
9 having a quality audit are not mutually
10 exclusive and I do not believe that the audit
11 fee is an issue that should affect auditor
12 independence, objectivity and professional
13 skepticism.

14 This brings me to the issue of
15 proposal of audit firm term limits. Entergy
16 is a large, highly specialized and regulated
17 entity. We file multiple external reports
18 with various regulatory agencies, including
19 the SEC and the Federal Energy Regulatory
20 Commission. We have several utility operating
21 companies which are separately and distinctly
22 regulated by various state and local

1 regulatory bodies.

2 The utility industry is a complex
3 industry and we are a complex company. These
4 complexities can be difficult to comprehend
5 and require significant time to understand.
6 In our circumstances, a mandatory change in
7 audit firm would result not only in a
8 disruption to our business from a resource
9 perspective to execute that change, but more
10 importantly be disruptive from a risk
11 perspective because of significant loss of
12 auditor knowledge. This requirement seems
13 particularly counterintuitive to us in a
14 situation where we have a qualified audit firm
15 with very good technical accounting ability
16 and significant industry experience and, more
17 importantly, specific company experience.

18 My point is simple. The
19 implementation of audit firm term limits
20 could, in fact, have the opposite of its
21 intended effect because a great deal of
22 insight by the audit firm will be lost in

1 those types of required transitions. In
2 addition, when we initiate certain
3 transactions, those transactions may take
4 years to execute. A required audit firm
5 change in the midst of a large transaction
6 would not only disrupt normal business, but
7 could be an impediment to the completion of
8 the transaction, which certainly would not be
9 beneficial to our investors.

10 I've read some of the findings of
11 the PCAOB inspections and understand that
12 there is a concern about the level of audit
13 quality. In my opinion, a more robust
14 discussion surrounding the PCAOB's findings
15 and what may be the root cause of those
16 findings may provide additional insight.

17 I also believe a broader
18 discussion about whether audits are
19 sufficiently risk-based would be extremely
20 valuable. Given the compressed filing time
21 lines and growing compliance requirements, we
22 have concerns as to whether the pressure to

1 complete the audit is allowing sufficient time
2 to be spent on high-risk areas in the
3 financial statements. We also support
4 performing an evaluation of existing
5 compliance requirements at the audit committee
6 and management level and whether some of these
7 compliance requirements can be expanded and/or
8 focused more narrowly on riskier areas and
9 areas involving a high degree of judgment.

10 In closing, I do believe this is
11 an extremely important issue and want to
12 support the PCAOB's efforts in whatever way
13 that we can. Again, I appreciate the
14 opportunity to speak with you on this issue.

15 CHAIRMAN DOTY: Thank you.

16 Valarie Sheppard.

17 MS. SHEPPARD: Thank you very much
18 for the opportunity to provide Proctor &
19 Gamble's view on the PCAOB's Concept Release
20 on auditor independence and audit firm
21 rotation.

22 We really appreciate and support

1 the Board's effort to improve the overall
2 quality of the audits by looking for ways to
3 enhance auditor independence. However, we do
4 not believe auditor rotation will accomplish
5 those goals. To the contrary, we actually
6 believe there's risk that the overall audit
7 quality could erode and result in higher costs
8 and significant disruption for our internal
9 resources.

10 Finally, we believe the disruption
11 and added costs are more significant for
12 larger companies.

13 So let me give you a little bit of
14 background on our company. P&G is a multi-
15 national consumer goods company with over \$80
16 billion in annual sales in approximately 180
17 countries. The company's brands include
18 household names such as Pampers, Tide,
19 Pantene, Gillette, Crest, Olay and many more.
20 We have on-the-ground operations in
21 approximately 80 countries operating through
22 500 legal entities and employing around

1 130,000 employees. The sales, supply chain,
2 personnel, and financing needs of a company of
3 our size and footprint requires a complex
4 legal entity structure, business model,
5 accounting and systems infrastructure which
6 involve both internally and externally-sourced
7 systems and personnel.

8 We directly employ 7,000 staff in
9 our finance and accounting function. The
10 structure of the independent audit team must
11 mirror our company structure in terms of
12 global footprint and relative size and
13 complexity. The independent audit team for
14 P&G is composed of over 900 audit and tax
15 professionals in 75 countries including 170
16 partners and 200 managers.

17 The audit team includes
18 professionals with a number of specialties
19 including tax, treasury, actuaries, valuation
20 experts, technology experts and, of course,
21 general audit and controls professionals.

22 Because of the overall size and

1 complexity of our business, the overall design
2 and execution of the audit is very complex.
3 Therefore, the auditors must have an extensive
4 understanding of our business model, legal
5 entity structure, internal control systems and
6 accounting processes. This institutional
7 knowledge enables the audit firm to more
8 thoroughly assess risk, review trends, and
9 design and execute the most efficient and
10 effective audit procedures.

11 The requisite level of knowledge
12 cannot be effectively gained over a period of
13 a few years. It is built over a much longer
14 period of time. We believe mandatory rotation
15 of the audit firm would result in a loss of
16 institutional knowledge of our company's
17 operations. This would lead to less effective
18 planning and execution of the audit.

19 It's important to note that audit
20 complexity considerations are even more
21 pronounced in large multi-national companies
22 like P&G than they might be in smaller

1 domestic or regional companies due to the
2 existence of much more complex environments in
3 terms of legal, regulatory, tax, and other
4 considerations.

5 Accordingly, we believe mandatory
6 rotation of the larger or only the largest
7 companies would be relatively more disruptive
8 and carry higher risks to audit quality than
9 for smaller companies.

10 Another concern with the mandatory
11 audit rotation is that there are real costs
12 and disruption impacts. In the Concept
13 Release, the GAO report estimated initial
14 audit fees would go up by more than 20
15 percent, about 20 percent. We believe this
16 estimate is a little bit low. In a mandatory
17 rotation environment, we'd be forced to
18 discontinue our relationship with one of the
19 firms in order to guarantee we had AN
20 independent firm to which to rotate to.

21 We employ all the Big Four
22 accounting firms. One is an independent

1 auditor and the other three through various
2 consulting capacities. Requiring us to rotate
3 auditors on a regular basis would have a
4 detrimental impact on our ability to source
5 our non-audit consulting needs. At a minimum,
6 we would need to effectively decide on our
7 auditors one or two rotations out to ensure
8 the new auditors are independent at the time
9 of rotation. This would effectively lock us
10 into our next auditor and eliminate any notion
11 of a competitive bidding process, likely
12 resulting in higher fees.

13 There's also the costs of the firm
14 to get our personnel in the -- the firm's
15 personnel in the appropriate global locations.
16 For larger companies with significant
17 operations in remote locations, a significant
18 portion of the audit staff is dedicated
19 virtually year-round to our audit. The
20 mandatory rotation would have dramatic
21 consequences to those offices and carry
22 significant risk to the incoming audit firm in

1 staffing up to service our account.

2 Internal resources to P&G would
3 also be required to train new auditors and
4 that would be significant. Importantly, this
5 investment by company personnel reduces the
6 amount of time we would have available for on-
7 going control stewardship and other business-
8 building priorities.

9 In summary, while we agree with
10 the Board regarding the importance of auditor
11 independence, we're not supportive of the
12 PCAOB moving forward with development of the
13 rotational proposal, including consideration
14 of the length of rotation period, the size of
15 the company, or the industry. We feel
16 mandatory rotation would not result in an
17 improvement in auditor independence,
18 objectivity or professional skepticism. In
19 fact, in our situation, we believe it would
20 decrease the audit quality and it would also
21 significantly increase both audit fees and
22 internal costs.

1 We really appreciate the
2 opportunity to share our views on this very
3 important matter. Thank you.

4 CHAIRMAN DOTY: Thank you. And
5 Darren Wells.

6 MR. WELLS: Good morning. I think
7 in my remarks you'll hear some things that are
8 similar to what Valarie and Theo have laid
9 out. I do think that we'd like to add to
10 those some thoughts that we had in terms of
11 actions that could be taken to further address
12 the issue that's given rise to the hearings.

13 As Chairman Doty said, I am Darren
14 Wells. I'm Executive Vice President and Chief
15 Financial Officer of the Goodyear Tire and
16 Rubber Company. Goodyear is a multi-national
17 company with \$23 billion in net sales,
18 operating 53 manufacturing facilities in 22
19 countries. Goodyear develops, manufactures,
20 markets, and distributes tires in almost every
21 country around the world. We appreciate the
22 opportunity to comment on the topic of auditor

1 independence and audit firm rotation.

2 To open, let me share with you a
3 summary of Goodyear's views on PCAOB's 2011
4 proposal. While we agree that auditor
5 independence, objectivity and professional
6 skepticism are critical to the success of an
7 audit, and periodically reviewing the audit
8 approach from a fresh perspective provides
9 value. We are not convinced of the
10 correlation between the length of an audit
11 firm's tenure with a company and a failure of
12 the auditor to approach an audit with the
13 required independence, objectivity and
14 professional skepticism.

15 We do not support the proposal for
16 mandatory audit firm rotation, nor are we
17 convinced that these will achieve the PCAOB's
18 desired improvement in these areas. We
19 believe that the current processes for audit
20 firm selection, partner rotation, and quality
21 control within the audit firms, while not
22 perfect, support auditor independence and

1 objectivity, while also providing a fresh
2 perspective to audit engagement and promoting
3 professional skepticism.

4 These processes include the role
5 of the independent audit committee in its
6 oversight of a company's independent audit
7 firm, annual shareholder ratification of the
8 appointment of the independent audit firm,
9 mandatory rotation of audit engagement
10 partners and engagement quality review
11 partners every five years, the role of the
12 national office review system by audit firms
13 in reviewing and challenging a company's
14 accounting for significant transactions, and
15 lastly, the PCAOB's inspections of the
16 operations and audit procedures conducted by
17 the public accounting firms.

18 We also point out that there are
19 significant drawbacks and limitations to the
20 proposal for mandatory audit firm rotation.
21 First, as my colleagues on the panel have
22 said, there are a limited number of firms who

1 have the global footprint sufficient to meet
2 the needs for audit and non-audit services of
3 large multi-national companies. For example,
4 under a mandatory audit firm rotation
5 requirement there would currently be only one
6 of the Big Four audit firms remaining that
7 would be able and be permitted to provide us
8 with audit services, thereby effectively
9 eliminating a competitive bidding process.

10 Higher costs, not just in
11 additional audit fees, but also increased
12 internal staff work, which would relate not
13 only to the company's consolidated financial
14 statements, but also to nearly 100 statutory
15 audits required annually for our subsidiaries,
16 for the time needed to gain the understanding
17 of the tire industry, our business, and the
18 multiple IT platforms that are used worldwide,
19 and to perform the testing needed to rely on
20 system-based and process-level internal
21 controls to execute an effective integrated
22 audit.

1 These additional fees and internal
2 costs would be recurring at each rotation
3 period with no guarantee that significant
4 incremental costs and time incurred by
5 companies as a result of mandatory audit firm
6 rotation would result in the PCAOB's desired
7 result which is the benefit of increased
8 objectivity, independence and professional
9 skepticism.

10 Conversely, we are concerned that
11 mandatory audit firm rotation would actually
12 decrease audit quality as the new audit firm
13 would not initially have the appropriate
14 understanding of company-specific risks,
15 processes, and IT systems to plan and perform
16 a high-quality, risk-based audit.

17 While we do not support the
18 proposal for mandatory audit firm rotation as
19 a means to increase or to achieve increased
20 auditor independence, we're supportive of the
21 PCAOB's desire to identify alternatives to
22 achieve the same goal. Some alternatives that

1 we think could be beneficial and should be
2 explored further include more timely
3 inspection of audits, forced audit firm
4 rotation in the event of an audit failure, and
5 mandatory audit firm communication to the
6 audit committee regarding alternative
7 accounting considerations for significant
8 transactions.

9 In order for audits to be
10 effective and conducted with independence,
11 objectivity and professional skepticism that
12 is required to benefit the company's financial
13 statement users, both the company's management
14 and auditors must willingly hold themselves to
15 the highest professional standards. No amount
16 of regulation, including mandatory audit firm
17 rotation, can legislate or persuade those who
18 do not currently adhere to these high
19 professional standards to adopt such an
20 approach.

21 To impose the significant costs
22 and inefficiencies that are part of mandatory

1 audit firm rotation on all public companies in
2 an attempt to force the minority which do not
3 adhere to a high level of professional
4 standards to do so is punitive and unlikely to
5 achieve the PCAOB's desired result. Thank
6 you.

7 CHAIRMAN DOTY: Thank you, all.
8 You're the first panel representing the group
9 of people who engage the auditors. And you
10 heard Chairman Pitt say that our job is to try
11 to be sure that all of the American companies
12 get the best audits.

13 I'm going to start with a question
14 for all of you and to hear your response. And
15 I would simply say this is extremely valuable,
16 so if these questions are somewhat more
17 probing of the way in which audit firm
18 management works, I hope you will take them as
19 being sincere attempts to get information and
20 not to pushback or to reject your rejection of
21 audit firm rotation.

22 But it sounds, from where I sit,

1 it sounds as if perhaps if one took an
2 approach that eschewed what Harvey Pitt called
3 a deck hand switch, if in fact, there was not
4 a one size fits all approach to audit
5 rotation. If in fact the consideration of
6 whether independence of an auditor had been
7 impaired by tenure or by the inattention of an
8 audit committee were based upon some record
9 which we had compiled, and if it turned out
10 that, in fact, the non-audit services of an
11 issuer may not require a Big Four firm to
12 perform those audit services. If in fact, we
13 could give more information to the audit
14 committee publicly than we can now give under
15 the statutory restraints on the use of our
16 information so that you knew more about what
17 our inspection results meant. If in fact, we
18 adopt our repropoed standard on audit
19 committee communications which, in fact, is
20 going to enhance the communications that
21 auditors are supposed to give the audit
22 committee. If we adopt the standard on

1 related parties which require auditors to be
2 more explicit with audit committees about
3 where dangerous transactions may exist in the
4 related-party area. If we take a somewhat
5 holistic approach, instead of a one size fits
6 all mandatory term rotation, how does that
7 affect your attitude and your issuers and your
8 funding sources toward the concept and the
9 Concept Release?

10 Steve, do you want to begin and
11 take a crack? Let others formulate?

12 MR. BULLER: Sure. Well, first of
13 all, it's a more positive step and it probably
14 is responsive to individual situations that,
15 for example, if there were a series of audit
16 failures, or if there were known instances of
17 the failure to adhere to auditor independence
18 requirements, and if in reviewing certain
19 firms you found that with respect to those
20 engagements they had failed to properly
21 identify a specialized industry expert as an
22 independent reviewer as well as the

1 coordinating partner on key engagements, those
2 are probably all indications of where it may
3 be appropriate to require an auditor rotation.

4 I think there are things that can
5 be done in addition to those though that you
6 may have mentioned. One is the part of the
7 PCAOB's inspection process. The one thing
8 which they had been striving to do, I know, is
9 to enhance the level and quality of
10 documentation that shows the critical
11 objectivity in evaluating audit situations.
12 And I think that is very important because it
13 also allows the independent reviewer and the
14 firm to better assess the level of objectivity
15 that is exercised at the local level, the
16 individual audit level. I think those would
17 probably be my general comments to start.

18 MR. BUNTING: I guess we
19 will just proceed down the row. I echo
20 Steve's comment, initial comment in terms of
21 it being a positive step in the right
22 direction. I also believe that any

1 information, additional information that can
2 be brought to the audit committee in its
3 assessment of the performance of the audit
4 firm can only help. I also believe bringing
5 that information on a timely basis, obviously,
6 would help.

7 I do believe though the decision
8 to make the change has to be one that rests
9 with the audit committee of the company and it
10 has to make that decision, I think, in a
11 diligent manner considering all the various
12 aspects of the information as well as
13 tangential issues. The one thing -- a couple
14 things that still would concern me in that
15 construct that you laid out, Mr. Chairman, is
16 the fact that in the utility business today
17 there's probably two firms probably do the
18 abundance of the audits in the industry and
19 there's a reason for that. And it's because
20 of their level of expertise, the knowledge,
21 and the ability of the firms' staffs. And we,
22 as a company, generally use the non-audit firm

1 to do a lot of the non-audit services because
2 of that same reason.

3 And so again, I believe it would
4 be a step in a positive direction. I think it
5 puts the focus back where I think the focus
6 should be which is with the audit committee
7 and their role in terms of making that choice,
8 in terms of having a determinative position as
9 to whether or not the auditors are exhibiting
10 a level of independence, thus appropriate at
11 a level of skepticism. But I would still have
12 some concern as to how it might impact some of
13 your non-audit services relative to -- if you
14 had to make a change, how would you transition
15 that change given the fact that you're
16 engaging probably the other firm that would
17 most likely be capable to do the work in non-
18 audit services.

19 MS. SHEPPARD: I also agree with
20 the comments from the previous panelists as
21 well. And I think the emphasis on making the
22 audit committee more responsible for managing

1 the relationship with the auditors is right on
2 point. And I think anything that improves the
3 communication with the audit committee and the
4 independent auditors is also on point.

5 So the items you talked about
6 around increasing communication to the audit
7 committee is important as well as making sure
8 key findings that occur with the PCAOB are
9 shared with the audit committee. I think
10 that's important as well. There are a few
11 other things that we also think might help one
12 of which is having the audit committee on some
13 periodic basis review and assess the quality
14 of the audit firm, so we are supportive of
15 that. Over time, we think that's a healthy
16 change. And as well as some things like
17 limiting an audit firm's ability to pay for
18 entertainment costs of a client would be
19 another example of things that could be done.
20 That's policy within our company today, so it
21 wouldn't be a change for us, but it could be
22 something that would both help the appearance

1 of independence, as well as in fact
2 independence. So we do think that there are
3 some measures that can be taken in the spirit
4 of continuous improvement versus kind of what
5 we would see as mandatory rotation having some
6 negative connotations to it and unintended
7 consequences.

8 MR. WELLS: I won't reiterate what
9 some of the other panelists have said, but I
10 think first of all, the holistic approach
11 makes an enormous amount of sense. There are
12 a number of different factors that have to be
13 taken into account in any situation like this.
14 And I will echo the comments that have been
15 made about the empowerment of audit committees
16 and maybe expand on that a bit because I think
17 the critical thing for audit committees is
18 they do have full information and not only
19 about the relationship the company maintains
20 with the audit firm which we provide today and
21 is an area that our audit committee is very
22 focused on, but also the specifics of the

1 reviews that the PCAOB has done of the firm
2 that audits us. And ideally, it would be
3 information about reviews that the PCAOB has
4 conducted of our audit.

5 Now the thing that would make it
6 most helpful in many ways for the audit
7 committee would be if that audit could take
8 place at more or less real time with the
9 preparation of the financial statements
10 because that timeliness is of a lot of value.
11 The audit committee is in a better position to
12 take action, to ask questions, to become
13 involved if, in fact, the information that
14 they're reviewing is timely. It's something
15 that's going on now or has gone on in the
16 recent past.

17 We have an example of a similar
18 situation in that the IRS now conducts a real
19 time audit of Goodyear's tax returns and it's
20 something that has improved the efficiency
21 enormously and has led to better quality
22 returns so by the time our returns are filed

1 the audit has already been conducted. I think
2 something like that for the PCAOB could be
3 very helpful because not only would the audit
4 committee be hearing the result of the audit
5 of the financial statements, but they'd also
6 be getting information about what level of
7 quality the firm was applying as it conducted
8 the audit.

9 CHAIRMAN DOTY: Steve Harris.

10 MEMBER HARRIS: Mr. Buller, why do
11 you think that the periodic tendering of the
12 audit is important and what would be your time
13 frame that you would envision?

14 MR. BULLER: I am not sure I said
15 I would support periodic tendering or time
16 frame. What I think would be useful is having
17 the audit committee provide internal criteria
18 as to the time lines that they may use in
19 assessing the auditor and perhaps if they so
20 desire having a policy that they will
21 periodically go out for tender. I don't think
22 we would suggest necessarily there should be

1 a specific time line for a tendering.

2 MEMBER FERGUSON: Yes, I'd like to
3 probe a little bit some of the underlying
4 assumptions of a couple of things you said.
5 First of all, let me raise the question of
6 long-term institutional knowledge. And I
7 fully understand how for companies as complex
8 and the companies all of you operate
9 institutional knowledge is very important and
10 leads to efficiency.

11 On the other hand, it seems to me
12 that long-term tenure also potentially causes
13 the auditor to develop an identification with
14 and a deference to the client. Isn't it
15 almost always the case that too much
16 familiarity prevents fresh thinking? That's
17 why lots of institutions in the society we
18 require changes of leadership, changes in
19 leadership at the top to get fresh thinking.
20 You don't have that when your auditor has been
21 your auditor for 100 years, it seems to me.
22 That's the first question.

1 The second question is and this is
2 a question that you raised, Mr. Wells, that
3 part of the limitation or the problem with
4 auditor tendering would be that you could only
5 find one other audit firm presumably because
6 of independence problems, you were raising,
7 from non-audit services. Is that a problem
8 with rotation or is it a problem with non-
9 audit services? What if we only had audit-
10 only firms? Wouldn't that solve that problem?

11 MR. WELLS: Maybe I'll address the
12 second question first and then come back to
13 the question of the impact of long-term tenure
14 of an audit firm on the level of review.

15 Yes, I think the practicality is
16 what we're -- what we would be focused on in
17 the case of mandatory rotation, so if there
18 was a separate system, if there were more
19 firms available who had the global resource
20 and reach to provide the services that a
21 company like Goodyear requires, then in that
22 hypothetical certainly it would be easier.

1 Finding firms that are willing and
2 able to make an investment at the level that
3 would be required either for non-audit
4 services or for audit services seems to be the
5 challenge because the number of countries we
6 operate in, the number of locations that have
7 to be reviewed is very significant and the
8 level of integration and consistency across
9 all of those reviews is critical. So in other
10 words, it doesn't work to have multiple firms
11 trying to communicate with each other using
12 different processes. It's very important that
13 we have something that's integrated in order
14 to meet reporting timing requirements. So I
15 think that's how I would respond to the second
16 question.

17 Although I would respond to the
18 first question as well. And I understand that
19 there are firms, including the one that I work
20 for, that have long-standing relationships
21 with their auditors. However, in the ten
22 years that I've been an officer of the

1 Goodyear Tire and Rubber Company, I've had
2 three different partners that have reviewed
3 our financial statements and three different
4 review partners that have reviewed their work.
5 And during that time I've had the opportunity
6 to have numerous accounting treatments and
7 transactions reviewed by a variety of experts
8 at the national office of our auditor. My
9 impression and clearly the evidence is that
10 those discussions were -- had a high level of
11 independent thought, a high level of
12 objectivity, and a significant amount of
13 debate.

14 I look at the evidence of our
15 discussions and would say that there is no
16 evidence that I've seen of any deference to
17 management. And in fact, there is a high
18 level of evidence that the different
19 individuals that are involved and responsible
20 for the audit all bring with them their very
21 own perspective. So the firm is not a uniform
22 perspective. The individuals themselves take

1 their professional credibility very seriously
2 and I'm sure they take the protection of their
3 firms very seriously, but each of them has
4 behaved as if their professional credibility
5 was on the line and that that was first and
6 foremost in their mind as we had discussions
7 on the preparation of our financial
8 statements.

9 CHAIRMAN DOTY: Jay Hanson.

10 MS. SHEPPARD: Is it okay if I
11 answer as well?

12 CHAIRMAN DOTY: Valerie, I'm sorry
13 -- Yes.

14 MS. SHEPPARD: Just to the first
15 question around long audit tenure, of course,
16 at Proctor & Gamble we have that situation and
17 we don't really see a correlation between
18 audit tenure and independence. And it's for
19 many of the same reasons that have already
20 been mentioned. Since Sarbanes-Oxley was
21 enacted, we've had three lead audit partners.
22 We've also had three audit committee chairs

1 and two CFOs, two comptrollers. So the
2 individuals do rotate and I think the roles
3 that were put in place to have that rotation
4 within the firm are very helpful. Also, of
5 the key managers at the firm, they rotate as
6 well every seven years.

7 So we are all, of course, focused
8 on getting it right, the consequences of not
9 getting it right are severe, and so we find
10 that our auditor is challenging us as we work
11 through issues with staff. We find that there
12 is good communication between the auditor and
13 the audit committee as well.

14 Not too much more to add to the
15 second question. I think it was covered very
16 well. It's not just the audit service issue.
17 It's just the practical nature of trying to
18 find the ability to every ten years get that
19 firm up and ready to be able to manage an
20 audit for large companies.

21 MR. BUNTING: Do you mind if I
22 also respond and I'll only take a quick

1 second, but I'd like to maybe pose a corollary
2 to you as it relates to our industry. We are
3 very highly regulated industry with tremendous
4 oversight. And I think oversight is the key
5 word. And that oversight tends to keep
6 complacency out of the process. And my view
7 is with appropriate oversight and some of the
8 things we've talked about previously in terms
9 of the audit committee, audit committee
10 engagement, communication, my view is that
11 oversight process will help remove the
12 complacency along with some of the specific
13 points others on the panel have made.

14 CHAIRMAN DOTY: Very good. Thank
15 you. Jay?

16 MEMBER HANSON: Two questions and
17 I ask one of them of Valarie specifically
18 since I think Proctor & Gamble is the largest
19 company represented at the table. And then a
20 second question, I'll let the rest of you
21 answer.

22 The question for Valarie, I'll

1 just pose first and that's some have suggested
2 and Chuck Bowsher this morning suggested that
3 this transition effort and the additional
4 costs and the disruption that it's really
5 overblown, that it's not that big of a deal.
6 When Andersen failed, many companies got a new
7 auditor and the world didn't end. So I want
8 you to react to that question of a little more
9 color around the things that you put in your
10 letter which were very helpful with the actual
11 data about the number of people on the ground.

12 For the rest of you, I want to
13 quote something that Richard Kaplan who is on
14 this afternoon said in his letter and these
15 aren't the exact words, but effectively that
16 long-term client relationships are too
17 important to be jeopardized by one difficult
18 partner. And so the question for you is if
19 you could just share some of your experiences
20 with the partner rotation process and whether
21 the new partner on one end is kind of rubber
22 stamped with what's gone on by everybody in

1 the firm before versus on the other hand, the
2 fresh set of eyes, that the rotation really
3 envisions. So just a little comment on your
4 experience with the partner rotation process.

5 Valarie, being the devil's
6 advocate is what you're saying is way
7 overblown? How do you react to that?

8 MS. SHEPPARD: Well, I think the
9 numbers do speak for themselves in that, as I
10 mentioned, we have over 900 audit
11 professionals that are touching the audit of
12 the Proctor & Gamble company. So if you just
13 think about the need to even if you were just
14 to spend a day onboarding them and it would take
15 more time than that, it would be significant,
16 just for them to learn the acronyms we use in
17 our company could take some time.

18 So that is real and so to that
19 question I would say look at the facts. And
20 I think the facts support it. But I would say
21 the more important thing relative to this
22 question about rotation is not just the cost

1 and disruption. That's important. But what
2 concerns us even more is that the audit
3 quality could be diminished. And so our
4 concern is if we don't do a good enough job
5 and spend all that time and effort bringing
6 them up to speed and trying to remember that
7 that would be every single person touching the
8 audit would have to be brought up to speed
9 versus today when we have rotation that occurs
10 at different times, it's much more manageable,
11 then the real concern is if whether the audit
12 quality will be there or not, whether they'll
13 be able to spot trends. And so that is a
14 bigger concern. The cost and disruption, I
15 can assure you, is quite real for us.

16 MR. WELLS: I guess addressing the
17 question of partner rotation, I think the
18 thing that's most prominent in my mind,
19 partner rotation is that while clearly their
20 efforts to ensure that the incoming partner is
21 well educated and understands the acronyms and
22 the industry dynamics and the specifics around

1 the company's audit and there's some
2 information sharing from the prior partner to
3 the new partner, what struck me is that in the
4 case of our most recent rotation, the new
5 partner focused his attention on a variety of
6 new issues and, in fact, did bring a very
7 fresh perspective. And the fact that he had
8 worked in other industries that were different
9 than his predecessor and with companies that
10 were different than his predecessor caused his
11 questioning and his interrogation to take a
12 different form.

13 So while there were some of the
14 same issues challenged, he also found a number
15 of additional issues to challenge. So that
16 experience leaves me with the feeling and in
17 a lot of ways in my position a very comforting
18 feeling that he's come in with a fresh set of
19 eyes and is looking for new issues and other
20 things that we need to be considering.

21 MR. BUNTING: I would like to
22 follow up. I think Darren's point is very

1 good. I had a similar thought as well. What
2 I would add to that is generally partners have
3 different strengths and so generally people
4 focus, as most do, in areas where their
5 strengths are. And so I think when you get
6 that rotation you will see somewhat of a
7 different focus in areas that maybe were not
8 focused on as much. I'm not saying that we're
9 not audited well, but maybe not focused on as
10 much just because of the change in the
11 individual and the change in the skill set.

12 I also think what happens when you
13 see that change occur is the new partner
14 obviously wants to ensure that there's a level
15 of comfort that he has relative to what has
16 been done as it might affect what is going to
17 take place going forward. I mean many
18 transactions and many issues play out over a
19 period of time. And so it's really important
20 that you have a really good understanding and
21 strong insight on what has been done and you
22 can get comfortable with that as you think

1 about issues that you have to address as you
2 go forward.

3 MR. BULLER: Maybe just one last
4 quick comment. I don't mean to infer that
5 large companies have better audits than small
6 companies, but in large companies you do have
7 multiple partners and senior level people who
8 are involved in the engagement. And they tend
9 to, I shouldn't say travel in packs, but they
10 certainly tend to have a large group that are
11 part of the decision-making process. So even
12 while you also have a rotation within that
13 group of partners, you also have a body of
14 partners who are involved with different, as
15 Theodore said, different levels of expertise
16 that provide the decision making that I think
17 that's fairly important, including people who
18 over time from the national office of those
19 firms and the national accounting areas in
20 particular, understand your issues and have
21 the ability to benchmark that against what
22 other firms are doing and providing you more

1 meaningful and timely advice during the audit.

2 CHAIRMAN DOTY: All big firms
3 bring that advantage to a big client.

4 MEMBER FRANZEL: We've had a lot
5 of discussions about some of the factors and
6 methods that you all have seen put in place
7 that you believe impact auditor independence,
8 so I'm just asking for a very quick wrap up,
9 summary, laundry list here.

10 In your experience, what are the
11 most important factors or processes that
12 you've experienced with the audit committee
13 and the auditor that really make you believe
14 that it's an independent audit?

15 MR. WELLS: So I will start. I
16 think first is the direct relationship between
17 the auditor and the audit committee and the
18 relationship there takes place not only during
19 scheduled meetings, but also and particularly
20 with the audit committee chairman outside and
21 in between meetings. And there's an enormous
22 amount of information sharing and

1 communication that takes place without any of
2 us present. Clearly, there's a high level of
3 ownership there by the audit committee of the
4 relationship.

5 The second thing is the
6 opportunities that exist when we are reviewing
7 financial statements or significant
8 transactions, opportunities for the
9 representatives of our audit firm to meet
10 privately with the audit committee. I think
11 those two processes are critical.

12 MS. SHEPPARD: I agree with those
13 two processes for sure. I think the other key
14 one is the mandatory rotation of lead partners
15 every five years and other significant
16 partners every seven years is also very
17 critical.

18 MR. BUNTING: I would agree with
19 both of those as well and to emphasize the
20 transparency of the relationship between the
21 auditors and the audit committee. Our
22 auditors have opportunities to meet with audit

1 committee when they desire a meeting. And
2 those meetings do not include management and
3 so there is a very strong relationship between
4 the audit committee and our auditors and I
5 think that's important.

6 The rotations I also think are
7 helpful, but I think one of the things that I
8 view as being very supportive to the process
9 that I take comfort in in terms of having an
10 audit firm that fundamentally is doing the
11 right thing is the level of engagement that I
12 have with that audit firm. We don't always
13 agree. And to be able to debate an issue and
14 we have had situations where their position
15 was the position that the company went with
16 even though I think at times we felt like we
17 had a strong position relative to what we
18 thought was the appropriate interpretation.
19 But from the audit committee's perspective,
20 they had a level of comfort with the auditor's
21 position and that was the direction we headed.
22 So it's the process of the strong engagement

1 and then the oversight that weighs that
2 engagement and determines what is and takes
3 some role in making that determination.

4 I would also say the fact that
5 again, we approach our audit not from the
6 standpoint of making our decisions relative so
7 much to how it will play out with the
8 auditors, but what we view as our ultimate
9 regulator, which is the SEC.

10 CHAIRMAN DOTY: Steve?

11 MR. BULLER: The only point I'd
12 add is I think what gives me a great deal of
13 comfort is critical challenge. And that's the
14 critical challenge that the audit committee
15 gives the auditors and also the auditors in
16 turn give management. There are difficult
17 decisions.

18 CHAIRMAN DOTY: I think our chief
19 auditor, Martin Baumann, may have a question.

20 MR. BAUMANN: Thank you, Mr.
21 Chairman. This is a question, I guess, for
22 Valarie, but anybody could follow on. Putting

1 aside the fact that other firms may have
2 performed non-audit services for you, so just
3 taking that out of the equation for the time
4 being, if you were to put your audit out for
5 competitive bid, it would be likely that the
6 other three firms would all propose for your
7 audit. And if the other firms said they had
8 a managed transition, they understand the
9 risks of a large organization, the engagement
10 partner they're putting on this job has
11 audited jobs with a thousand-person staff in
12 80 countries and is an industry expert in your
13 particular industry, and the nature of the
14 rest of the team they'll put together in each
15 of the countries understands the type of
16 business you're in and has audited a multi-
17 national of this type, and they say we believe
18 we can do this audit with very high quality
19 and we believe we'll do it without any
20 transition problems. What would you think?
21 Would the firm not be really understanding the
22 situation? Would they be naive to say that or

1 what would your perspective be of the firms
2 who said that, that they didn't get it?

3 MS. SHEPPARD: I understand the
4 question and I do think that if we were to bid
5 out, if you will, that you're right, that the
6 other firms would all say that they could
7 handle the audit. And they would say they
8 could manage the transition. And so I
9 understand the question. What I would say
10 though is that we feel that there are a number
11 of other safeguards in place to create a very
12 independent relationship with our auditor and
13 so as we would look at that, we would have to
14 weigh, our audit committee would have to
15 weigh the loss of the institutional knowledge
16 and therefore the issue with audit quality for
17 the first few years as the audit firm tried to
18 ramp up. Because while those other firms do
19 have and service other multi-national
20 companies, I think that you would find that
21 every single large company has -- if you just
22 took and looked at technology. We use SAP.

1 Many other companies use SAP. Ours is
2 customized. And it's a very P&G-specific
3 solution that's come up and grown over time.

4 We've had acquisitions that have
5 come in with the Gillette acquisition and
6 those systems and processes have been
7 different and as we've melded those together
8 our firm, as well as many other large
9 companies, don't tend to have standard kinds
10 of systems and processes.

11 And so while again the concern
12 then is the loss of the ability to know and be
13 able to do quality audits in that first two or
14 three years of getting up to speed, maybe
15 longer, frankly, and getting up to speed on
16 our particular unique situation. And that's
17 why we feel that it shouldn't be mandatory and
18 it shouldn't be on a clock, so to speak. It
19 should be the responsibility of the audit
20 committee to look at and review the quality of
21 other firms and to assure that we have the
22 best audit firm we have.

1 So I'm not saying that might not
2 ever happen, I'm just saying that saying it on
3 a clock every ten years mandatory rotation
4 would not be a way to achieve what I think the
5 right goal of the Board is which is to improve
6 audit quality and improve independence. And
7 we just see this as something that would work
8 counter to that.

9 CHAIRMAN DOTY: We are at the noon
10 hour. We're on schedule. This panel has
11 been remarkably beneficial and fruitful for
12 all of us. It's been a real pleasure to have
13 you here. I hope it's been a pleasure for
14 you. You got a trick question from Lewis, but
15 you got a soft ball from Jay, so I think you
16 all ought to be happy about that.

17 (Laughter.)

18 We may have the opportunity to
19 discuss these very same subjects again in
20 another forum with this same group because you
21 all do bring to the table an extraordinary
22 combination of what represents American

1 business and American corporate life. It's
2 been a pleasure to have you.

3 After lunch, we will have another
4 very distinguished panel. We will hear from
5 John Biggs, Jack Bogle, and the Honorable
6 Arthur Levitt, former Chairman of the SEC.
7 That should get you all back here on time
8 because we will begin promptly at one. Thank
9 you. We'll break.

10 (Whereupon, the above-entitled
11 matter went off the record at 12:02 p.m. and
12 resumed at 12:58 p.m.)

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

2 (12:58 p.m.)

3 CHAIRMAN DOTY: This is an
4 important panel. If it's not the most
5 important panel of the day, it may be the most
6 important panel of the two days. And we need
7 to start on time. Chairman Levitt has got a
8 2:00 hard deadline.

9 We have here three of the pundits
10 and senior statesmen of the financial
11 regulatory area who have been, along with Paul
12 Volcker and Chuck Bowsher, been right about
13 different subjects more times than any of us
14 can think. And they are here doing us a great
15 honor and giving us a great privilege of
16 hearing from them on this subject.

17 John Biggs is the former Chairman
18 and Chief Executive officer of course of TIAA-
19 CREF. He began his professional career with
20 General American Life in 1958. He was Vice
21 Chancellor for Administration and Finance at
22 the Washington University in St. Louis, the

1 CEO of Centerre Trust Company in St. Louis, a
2 trustee of the Danforth Foundation of
3 Washington University, and has had an amazing
4 impact, a huge impact on corporate finance and
5 corporate governance and regulation.

6 John Bogle, John C. "Jack" Bogle
7 is the founder and former CEO of The Vanguard
8 Group, created Vanguard in '74. He was CEO
9 until '96. He was appointed by then Chairman
10 Arthur Levitt to the Independent Standards
11 Board. He has served as the director of many
12 companies. He is a best-selling author. He
13 is finishing his book by Friday, he says.
14 We've got to get him out of here, because he
15 has until Friday to finish his last book, The
16 Clash of the Cultures: Investment Versus
17 Speculation.

18 The Honorable Arthur Levitt,
19 Senior Advisor of The Carlyle Group and of
20 Goldman Sachs and Promontory Financial of
21 course was the former Chairman of the United
22 States Securities and Exchange Commission. He

1 was its 25th chairman.

2 Before joining the Commission, he
3 owned and operated Roll Call. He served as
4 Chairman of the American Stock Exchange. He
5 was 16 years on Wall Street. He serves on the
6 Boards of Bloomberg, CCBN, he is on the Board
7 of Overseers of Teachers Annuity, and the
8 College Retirement and Equity Funds.

9 So we are, gentlemen, in your debt
10 for being here, and welcome. Mr. Biggs, do
11 you want to begin?

12 MR. BIGGS: This is a topic I have
13 been interested in for many years, first
14 testifying on it in the 1990s, and thinking
15 about it and working on it since then. And I
16 think this may be the time for a decision to
17 be made.

18 I think it is a pernicious idea,
19 that it is okay to enter into perpetual
20 relationships between the auditor and the
21 audited firms, creating an intolerable
22 incentive to the audit firm not to take any

1 action that might diminish the value to the
2 firm for that perpetuity.

3 Accounting firms understand the
4 present value of a growing stream of fees
5 extended out indefinitely. If the growth rate
6 exceeds the discount rate, the value is
7 infinite. That has been a trap for many stock
8 analysts over the years, where they thought
9 that the growth would be perpetual. But I'd
10 like to talk about two personal experiences I
11 have had that involve this issue.

12 First is when I became a director,
13 a member of the Audit Committee of JPMorgan
14 Chase, it was about a year before we had to
15 pay out over \$4.4 billion in settlement costs,
16 which were due in part, not entirely, to audit
17 failures of the two companies. In my
18 considered opinion, those audit failures would
19 likely not -- would not have occurred had
20 auditor rotation been required for the firms.

21 When I joined the JPMorgan Chase
22 Board in 2003, Bill Harris, its CEO then,

1 asked me to take a personal look at the
2 adequacy of their underwriting of Enron and
3 WorldCom bonds in the years before they
4 failed. I did so. I didn't know much about
5 bond underwriting before that time, but I
6 learned a lot in the process, studying the --
7 working with the lawyers and the bankers on
8 what they had done and what they relied upon.

9 What I found was that the
10 underwriting process met and exceeded the
11 standard for a bond underwriting -- for bond
12 underwriters at that time, which I would have
13 expected from JPMorgan.

14 I read other countries' judicial
15 opinions, and they confirmed that view. The
16 issue that led to the underwriting failure, in
17 virtually everyone's opinion, was their
18 reliance on one of the Big Five accounting
19 firms' audit opinions. In both cases, the
20 firms -- the auditing firms had been auditing
21 the companies for many years.

22 These were not examples of a

1 failed audit by an auditor recently appointed
2 to the job. In each case, the audit firm fees
3 were enormous, and the companies were growing
4 rapidly. In the case of Enron, the total fees
5 were \$51 million a year, with double-digit
6 growth projected out. To the auditing firm,
7 the present value of those fees appeared to be
8 worth probably a billion dollars. How could
9 a firm be called "independent" when such
10 values were at stake? How could the local
11 senior partner step up to oppose a determined
12 management when his firm had so much at stake?

13 The simple institution of required
14 rotation would have slashed the value of that
15 perpetuity to human terms, still valuable for
16 several years but not obscenely valuable as a
17 perpetuity.

18 The firm would know that if it did
19 the right thing it would only lose those fees
20 for a few years, and there has been plenty of
21 evidence in the autopsies that have been
22 written about that -- the Enron collapse that

1 members of that firm did know what they should
2 have done.

3 It seems preposterous to me that
4 there are opponents of rotation who think the
5 benefits of rotation do not offset the small
6 cost. Four billion is a lot of benefit. Not
7 all of that could be accounted -- it's not
8 necessarily true that we would have gotten all
9 of that with auditor rotation, but in my
10 opinion it was very likely.

11 But that was just JPMorgan's loss.
12 Citicorp had similar losses, and then there
13 were further shareholders and employers who
14 lost many billions of dollars in that process.
15 Given the company's business failure, probably
16 those losses would have eventually been
17 incurred, but with a decent audit the
18 bondholders might have been protected.

19 My second personal experience,
20 which I believe is relevant to your
21 consideration, is the excellent experience we
22 had at TIAA-CREF where we had a rotation

1 policy in effect for almost 50 years. During
2 my 13 years as President, and later as
3 Chairman and CEO, we made two rotations of our
4 audit firms. They were on a seven-year cycle,
5 which I replaced for an earlier five-year
6 cycle that had been adopted in the 1950s.

7 We moved from Ernst & Young to
8 Deloitte, and then seven years later back to
9 Ernst & Young. After that they moved to
10 PricewaterhouseCoopers, and I think they --
11 and that was the change after they left from
12 Ernst & Young.

13 The rotation process was done on a
14 tightly planned basis, with primary emphasis
15 on the quality of the auditors and their
16 backup experts within their firms. We did not
17 negotiate a fee until after the appointment
18 decision was final.

19 I can assure you that there was
20 nothing like a 20 percent increase in fees in
21 the first year, and that the trivial cost of
22 our own process was well worth the money for

1 the rejuvenation that it provided for our
2 audit relationship with new people, fresh
3 outlook. And Peter Clapman testified this
4 morning there were changes, which we thought
5 were in the right direction that the new
6 auditors found.

7 I have always taken the auditor
8 relationship very seriously. I expect the
9 senior audit professional to meet with me
10 quarterly, and our conversations were open and
11 challenging. For most of such relationships,
12 I received significant information about what
13 was going on in my company, but the auditor
14 knew I took the independence relation very
15 seriously.

16 I cite one experience which the
17 representative of Procter & Gamble mentioned
18 this morning that should be part of the
19 independence culture and companies. I learned
20 that our CFO at TI-CREF, who was an avid
21 golfer, had enjoyed an occasional golf outing
22 at the club of, and at the expense of, the

1 audit firm. We then adopted a policy that
2 excluded any acceptance of entertainment by
3 the audit firm by any of the staff of the
4 company.

5 I learned later -- and I have
6 commented on this -- that Jamie Dimon had
7 adopted that policy at Bank One about the time
8 I had done so at TIAA-CREF. And he brought
9 that then to JPMorgan, one of the other
10 wonderful things about that acquisition.

11 The auditors picked by the
12 company, paid for by the company, and perhaps
13 unreasonably is expected to be independent and
14 effectively working only for investors. Our
15 investors were mostly college professors and
16 higher education employees, since TIAA-CREF is
17 nonprofit.

18 I testified in the 1990s several
19 times about our experience. And later, as a
20 member of the Public Oversight Board, I urged
21 rotation in my testimony before the Sarbanes
22 Senate Committee.

1 I was disappointed by the failure
2 to include rotation in SOX, but understood
3 that many other limitations included in the
4 law advanced significantly the cause of
5 independence. I thought we had made enormous
6 progress in showing the way to a culture of
7 independence, for example, by the assignment
8 of hiring of the auditor to the Audit
9 Committee, the hard-wired prohibition of using
10 the audit relationship for the purpose of
11 getting other business from the client, the
12 creation of a federal regulator after all --
13 the PCAOB -- for the auditing profession, and
14 then the five-year statutory requirement for
15 the rotation of the senior audit partner.

16 Subsequently, I sensed in my own
17 Board experience real progress and acknowledge
18 the independence issue, and in many cases the
19 need for rotation. Although I disagreed with
20 the conclusion -- the broad conclusion and the
21 process of the GAO study that was required by
22 SOX, I did agree heartily with the final

1 conclusion that it was too early, after just
2 two years, to impose firm rotation.

3 I thought the 20 percent cost
4 number was very high from my own experience,
5 where we had seen actual cost reductions after
6 the rotation. But that has now been quoted so
7 often, so everyone believes it, although I
8 think it was hedged properly in the document.
9 We certainly saw no such increases.

10 I also thought the final
11 conclusion that the subject should be reviewed
12 after a few years of PCAOB inspections was a
13 good one. Now that that has happened, and the
14 finding seems clear that the professional
15 skepticism that arises from true independence
16 is missing in too many cases.

17 Rotation, I believe, will help
18 significantly in making it clear to auditors
19 and to companies that independence is
20 essential.

21 I also mentioned in my written
22 documents at some length what -- I see this as

1 a real-time peer reviews. I thought the peer
2 reviews which were done under the POB
3 supervision were useful, although not as
4 strong as they might have been. I think
5 having them in real time, as between the two
6 audit firms, going over the papers would be
7 very powerful and very effective just on an
8 ongoing basis.

9 I don't believe there is a greater
10 danger of a failed audit after rotation, and
11 I can talk more about that if there is further
12 questions. There are other ideas that you
13 could include without going to full rotation.
14 I think disclosure of the audit tenure in the
15 proxy statement would make a lot of Audit
16 Committee chairmen very uneasy, and that would
17 be, in my opinion, a good thing.

18 I think that Chuck Bowsher this
19 morning proposed auditing the large firms. I
20 would wonder if possibly whenever the total
21 fees of the firm exceed \$5 million a year, or
22 some number, that might be a time that you

1 could require rotation, because the present
2 value of that on a perpetual basis would be
3 such an extraordinary number.

4 I think we all want to improve the
5 quality of audits, and I think this particular
6 action is one of -- it's not a silver bullet,
7 but it would be at the top of my list of ways
8 to improve quality.

9 Thank you.

10 CHAIRMAN DOTY: Thank you, John.

11 Jack Bogle.

12 MR. BOGLE: Good morning. Good
13 afternoon, I should say, gentlemen. And first
14 of all, I hope it is not gratuitous to say
15 that I, for one, as an outsider applaud the
16 increasing activism of the PCAOB, and hope you
17 will get even tougher and tougher, because we
18 have a lot of problems in this area. They are
19 not coming -- going to come to solution
20 easily.

21 I have been a business man sort of
22 all my career, but I have had in fact a lot of

1 personal involvement in the accounting area.
2 Most recently, I served as a member -- one of
3 four independent members -- of the Independent
4 Standards Board, appointed by SEC Chairman
5 Arthur Levitt, and we work for the four CEOs
6 of the major accounting firms to try and
7 develop the whole idea of independence.

8 I have one little anecdote that I
9 think I'd like to tell you about that, and
10 that is I got a little bit tired of hearing
11 these accountants, these CEOs of the
12 accounting firms, say they would never do
13 anything wrong because they had reputation
14 risk. And I finally looked at them and I
15 said, "Well, you know, it's interesting to
16 think about reputation risk. How many clients
17 would you have if you got a reputation for
18 being the toughest, most unyielding, sternest
19 accounting firm in the country that refused
20 one iota of compromise between Generally
21 Accepted Accounting Principles in their spirit
22 and the letter, how long would you get along

1 in your business?"

2 They didn't seem to have a very
3 good answer for that. Obviously, they are
4 very much tied into all of these accounting
5 firms, tied into the firms that they
6 supervise, and that is just the risk of the
7 present system.

8 I should say that after hearing
9 the testimony from the previous four witnesses
10 before you this morning, if "witness" is the
11 right word, I kind of came to an odd
12 conclusion. They make an unbelievably
13 powerful case that auditors should never be
14 rotated. Never. I mean, I would have said 20
15 years would be -- I don't think it is going to
16 change the world, by the way, but I think
17 every 10 or 20 years. Seems like "never" is
18 a word that one should, well, never use.

19 And so I am willing almost to
20 concede, then, that because the interlinkage
21 of these two giant mega-lists, the giant
22 corporation, the giant auditing firm, that in

1 fact that would be a very, very difficult
2 thing to do. And if we decide not to do it,
3 I wonder if they have thought about the
4 consequences of that, because the system is
5 not working. And if rotation is not the
6 answer, what is?

7 Well, one thing that occurred to
8 me as I worked in the group headed by Paul
9 Volcker and Chuck Bowsher, in fact, back at
10 the time of the demise of Arthur Andersen, and
11 we had put together a little bit of a -- kind
12 of a group of people, like myself and them,
13 who prepared to act as independent directors
14 of Arthur Andersen, to have an independent
15 Board.

16 And the Justice Department
17 rejected that, but I couldn't help thinking
18 about the idea that if the CPA firms, the CPA
19 industry business profession has a public
20 purpose -- and it clearly does have a public
21 purpose -- why does it have private
22 governance? You know, we do exactly that in

1 our government-sponsored enterprises -- Fannie
2 Mae and Freddie Mac -- and that doesn't seem
3 to be working out so well. So we maybe ought
4 to be thinking about the very governance of
5 these firms.

6 And then I want to mention that I
7 think it was Board Member Hanson mentioned --
8 advanced this a little bit this morning --
9 that -- here we are -- are audit committees --
10 was that your question, sir? Were audit
11 committees equipped to do the job? I think
12 they are not.

13 I have served on audit committees,
14 actually served as Chairman of the Audit
15 Committee of Instanet, a small technology
16 market trading firm. And I was Chairman of
17 the Audit Committee during Sarbanes-Oxley Rule
18 404. I worked with the accountants. I had
19 the total confidence of the board, and we got
20 it all done, and I thought it was a good rule,
21 if somewhat expensive.

22 But if the audit committees aren't

1 working -- and I have seen on both sides of
2 the table, both as a CEO and as an audit
3 member -- what is to be done?

4 Well, there are not a lot of easy
5 things to do. The Chairman is going to be
6 appointed by the management. They have
7 responsibility, but not enough knowledge.
8 Perhaps the Audit Committee should retain its
9 own independent staff members or consultant to
10 assure that the significant issues surrounding
11 the corporation's financial statements will
12 receive a full hearing.

13 I have an uneasy feeling that
14 corporate managements may not warm to that
15 issue. But there we are; they may have to
16 warm to it. That's one of the things that we
17 might be able to work on a little bit.

18 The other thing that occurs to me
19 is there is a lot of -- with all due respect
20 to everybody in the room, a lot of minutia in
21 accounting. You know, let's make sure that
22 the liabilities in Turkey are exactly right

1 and the books balance over there, and there
2 are hundreds and hundreds of these decisions.

3 And everything has got to be
4 cleared and approved and go through this
5 process. But somewhere along the line
6 judgment has gotten lost in this morassing
7 process. And I see to this day it is better
8 but it is nowhere near solved. I see short-
9 term decisions being made by managements who
10 are inevitably only there for a short term, or
11 almost inevitably, but don't change the
12 corporation's financial statements over the
13 long run. That's a very difficult thing to
14 do.

15 But if you start writing off
16 things more rapidly, or put a high return in
17 your pension plan -- I will come back to that
18 in a second -- you know, you're gonna improve
19 the short-term picture of the company in favor
20 of the existing management, and you will meet
21 your earnings guidance. You will please Wall
22 Street.

1 Pleasing Wall Street should not be
2 part of the accounting profession's mandate --
3 my opinion, deeply held. These issues are
4 everywhere, and I outline them on the last --
5 these kinds of issues -- or Chairman Levitt
6 did -- about seven or eight or maybe 10 years
7 ago, a wonderful job up in New York of laying
8 out all of these things, like cookie jar
9 reserves, that whole litany, you had, sir.

10 And there is a lot of fussing
11 around that goes on above this detailed level
12 where everything has to tie in, work out,
13 about managing earnings. We call it financial
14 engineering, and we are going to get to those
15 earnings by hook or by crook.

16 And I have always found it quite
17 amazing that companies, corporations that are
18 in the volatile businesses all over the world,
19 are able to tell you early in the year what
20 they expect their earnings to be. Remarkable,
21 truly remarkable. But there is a lot of
22 accounting -- for want of a better word -- I'm

1 sorry to be so blunt, but I guess I'm known
2 for that, and I can't help it, but there is a
3 lot of finagling going on to get there.

4 And I will give you, before I
5 close, my favorite, and that is pension fund
6 assumed returns. I don't think auditors audit
7 them. I don't know how you would audit them.
8 But American corporations are today assuming
9 an eight percent return on their pension plans
10 in the years ahead.

11 I state to you unequivocally they
12 are not going to get an eight percent return.
13 With a two percent Treasury bond? You've got
14 to be kidding me. How are they going to do
15 that? It's impossible. The math doesn't work
16 out.

17 In my new book -- thanks for the
18 mention, Mr. Chairman -- I have a little
19 analysis of what you have to do to get the
20 eight percent, and you wouldn't believe what
21 it will take. But in any event, they are not
22 going to get there, but from an accounting

1 standpoint shouldn't the accountants -- you
2 know, this is an accounting number that we are
3 given here.

4 And shouldn't the accountants, at
5 least if the corporation is projecting eight
6 percent, shouldn't they at least say, "If the
7 return turns out to be -- let's be fair, if it
8 turns out to be 10 percent, here is how much
9 money we will have extra.

10 "And if it turns out to be six
11 percent, here is how much we will have to put
12 into the" -- you know, it seems like the
13 tiniest thing in the world, but a lot of
14 numbers that should be touched are not, and a
15 lot of numbers it doesn't really matter
16 whether they are touched, are touched, and I
17 don't think that is in the interest of full
18 disclosure.

19 So I don't think there is enough
20 independence. I think it is difficult to
21 change auditors. But we've got to change
22 something, and the sooner the better.

1 CHAIRMAN DOTY: Thank you.

2 Chairman Levitt.

3 MR. LEVITT: I am honored to be
4 before this group -- a group that was spawned
5 at a time of great national crisis, and one of
6 the few agencies in America today that is
7 really the investors' protectors.

8 What Steve Harris did in terms of
9 the Sarbanes-Oxley bill, what you, Mr.
10 Chairman, did during your years of service at
11 the Commission, what all of you have done in
12 public life, is really a model for really
13 superb public service.

14 When we talk about auditor
15 rotation, I think we have to recognize the
16 fact that auditing is not a mathematic formula
17 where the answers will always come out
18 precisely the same. Professional judgment
19 figures into the results, and, therefore,
20 investors deserve the perspectives of
21 different professionals every so often,
22 particularly when an auditor's independence

1 can be reasonably called into question.

2 Listening today and hearing the
3 major criticism about auditor rotation is the
4 damage to institutional memory among the audit
5 teams. I think it fair to say that most of
6 the billable work of the audit is done by
7 front line professional staff who themselves
8 rotate from audit firm to audit firm. And the
9 real continuity is among the partners and
10 managers who oversee the work.

11 So the concern about lost
12 institutional memory strikes me as being, at
13 best, misplaced. And as much as auditor
14 rotation would help the cause of investor
15 confidence and transparency, there is now, in
16 my judgment, a much greater threat on the
17 horizon. It's the so-called JOBS Act.

18 I focus my concern in particular
19 on proposed rule changes that would lower
20 reporting standards for post-IPO companies.
21 My experience, both as a regulator and as
22 chairman of a public exchange, and as a member

1 of 20 different public Boards, was that any
2 time basic reporting standards are weakened,
3 investor protections and market transparency
4 are weakened as well.

5 As Chairman of the American Stock
6 Exchange, floor brokers endeavored to persuade
7 me to lower the listing standard, so that they
8 could trade many more companies. For them, it
9 was about increasing the overall volume of
10 potential business. The problem was the kind
11 of listings we would attract. I had to
12 consider the overall reputation of the
13 institution.

14 The AMEX had previously dealt with
15 significant challenges, reputational
16 challenges. We had by then recovered from
17 that damage, but I don't want to repeat the
18 mistakes that got us there. We held the line;
19 I'm glad that we did.

20 My fear is that in the current
21 debate we are experiencing IPO envy. One
22 doesn't measure the strength of a national

1 economy by the number of public company
2 listings, nor do investors care very much
3 whether they lose money on a large public
4 company or a small public company, and
5 watering down the rigorous requirements for
6 public listings is merely good for the
7 economy, the investment bankers, the early
8 stage investors, and some high-level employees
9 at the IPO firms.

10 There would be very little public
11 policy benefit measurable either in GDP or
12 jobs created or public prosperity. I would
13 urge the PCAOB to resist the legislation. A
14 decline in regulatory standards always is
15 followed by damage to public investors.

16 I know this is somewhat off topic,
17 but I believe this bill goes to the heart of
18 what created this remarkably important
19 organization. The issues that you are dealing
20 with are enormously important, and anything
21 that stands in the way of your efforts and
22 investor protection, which is really what you

1 were created for, I think is to be fought with
2 every possible vigor we can muster.

3 So I commend you for your boldness
4 in taking on an issue where you are likely to
5 be opposed so vigorously by most segments of
6 the business community.

7 There is not much glory in what
8 you are doing, nor do I consider the job of
9 listening to a lot of us pontificate hour
10 after hour wasn't what you really signed on
11 for. But you are doing really God's work, to
12 use a terribly overused expression.

13 (Laughter.)

14 I would be glad to answer your
15 questions. Thank you very much.

16 CHAIRMAN DOTY: Well, thank you
17 all. And given the importance of this panel,
18 the first question goes to our newest Board
19 member, Jeanette Franzel.

20 MEMBER FRANZEL: Thank you, Mr.
21 Chairman. I want to take advantage of the
22 tremendous amount of distinguished experience

1 that this panel has. And it is clear that you
2 are all strongly in favor of change and some
3 pretty significant change.

4 And so I want to ask all of you,
5 from a public policy standpoint, the systemic
6 risks that you think might be introduced right
7 now by the current business model and way of
8 doing business, this morning we heard that
9 very large companies need very large auditors,
10 and that because of the concentration it is
11 very difficult to rotate, and if not
12 impossible.

13 But in the pre-Sarbanes-Oxley
14 days, and the days after, we were referring to
15 those times as a crisis of confidence, where
16 there was just tremendously devastating
17 results from the systemic risk that had been
18 embedded in the business models and how
19 auditors were doing business.

20 I would like your perspectives on
21 where we are today in the systemic risk area.

22 MR. BIGGS: I would like to

1 comment on that. Systemic risk in the last
2 collapse, the panic of 2008, was I think much
3 greater than earlier when the Enron and
4 WorldCom collapses occurred.

5 What has interested me in this is
6 how silent the auditors were throughout this
7 period. Where were the auditors for Lehman
8 Brothers, AIG? They are all in this room, I'm
9 afraid, and I know that there were very
10 difficult issues for them. But they were part
11 -- they played a role in a systemic failure of
12 our financial institutions.

13 They were there. Could they have
14 done something better? I would think so.
15 They probably look back on it and they know
16 better than I will ever know what their roles
17 were and what they would have done
18 differently.

19 But I think the importance of the
20 audit relationships is incredibly important in
21 heading off systemic problems. And if the
22 auditors feel that that is a role for them, to

1 warn companies when they are getting into a
2 dangerous area, I think they play a very
3 positive role in reducing systemic risk.

4 What I'm afraid is they didn't
5 play that role. They don't appear to me to
6 have played that role in the major financial
7 institutions that broke down during 2008 and
8 '09.

9 MR. LEVITT: Well, the problems of
10 2008 and '09 have lots of parentage to it. It
11 wasn't a failure of the auditors. It was a
12 failure of managers and a failure of rating
13 agencies, a failure of investors. There were
14 a whole -- certainly a failure of oversight,
15 failure of regulatory bodies.

16 I wouldn't cite the accountants as
17 being generators of systemic failure. I think
18 that the accountants today, their leadership
19 today, in my judgment, is far better than it
20 has ever been in my memory. And I believe
21 that is a function of having fought these
22 battles and dealing with the issues of

1 conflicts of interest.

2 And, realistically, you are not
3 going to eliminate conflicts of interest,
4 either in this arena or in any commercial
5 arena. There are buyers and sellers, and
6 there are inevitable tensions that arise in
7 transactions between those buyers and sellers.
8 And I think we have to approach how we deal
9 with conflict, and how we deal with
10 transparency, and what kind of public
11 confidence this spawns.

12 And, again, an environment where
13 auditors change from time to time has a better
14 feel to it, has a better smell to it, than an
15 environment where the auditor has worked with
16 the same client year after year after year.
17 There is nothing inherently dishonorable about
18 that act, but it doesn't feel quite as good.

19 And I think that perception is so
20 important in these relationships to more
21 specifically address the question of systemic
22 risk. The audit firms are critical in this

1 regard. Do I think that by changing auditors
2 you will necessarily have greater attention
3 paid to those things which bring about
4 systemic problems? I wouldn't say that.
5 That's not one of the arguments that I would
6 make.

7 MR. BOGLE: Let me add, if I may,
8 to me the biggest systemic risk is the
9 constant focus on short-term earnings, and
10 very strong, still to this day, which has
11 companies take their eye off the long-term
12 ball. This can be documented time and time
13 again and written up in academic journals.

14 It is really quite clear there,
15 and, you know, the way CEOs can get their big
16 bonuses, for example, is to slash the way they
17 operate the company -- fire people, maybe very
18 good, loyal people, and do all kinds of
19 economies, cut out R&D, do things that cut to
20 the heart of corporate value, which is, to be
21 very clear, where all of the value in the
22 stock market is created. The stock market is

1 nothing but a conduit.

2 And so the risk comes less in the
3 stock market, I think. It is going to go up
4 and down in its own funny way, and it will be
5 doing that forever. But it comes to how we
6 actually operate our corporations themselves.

7 We had two of the gatekeepers, as
8 I call them in my new book -- one more little
9 plug, Mr. Chairman, I hope that's all right --
10 that we haven't talked about here, and one has
11 to wonder where they are or were. One is the
12 Wall Street security analysts. We still have
13 I think 85 percent or 90 percent of the
14 recommendations are to buy and not to sell.
15 I mean, really? What sense can one make out
16 of that?

17 There is a very lack of in-depth
18 analysis. There is now. There used to be
19 some good analysts at Wall Street firms,
20 excellent, who looked into the accounting side
21 of firms. I know of none anymore, and they
22 have sort of vanished because it doesn't seem

1 to work.

2 We had a survey of these firms --
3 Chairman Allen and I of the Independent
4 Standards Board -- interviewed some of the
5 best firms on Wall Street and asked them, "How
6 are you satisfied about the state of
7 accounting in America today?" And they said,
8 "It's wonderful." This was a year before
9 Enron, a year before WorldCom, a year before
10 Adelphia, a year before whatever the next one
11 is. I can't remember them all.

12 But they just did nothing, but
13 that is not the worst. The worst is the sad
14 state of ownership. The owners aren't looking
15 after their own interests.

16 As everybody must know now, if
17 only because I say it every time I get a
18 chance, 72 percent of all the stock of all of
19 the American corporations are held by money
20 managers, institutional money managers. And
21 50 percent, or I guess it's 46 percent -- I
22 think I may have an error in here, I think I

1 said 52 percent -- it's 46 percent I believe
2 -- are owned by just the 25 largest managers
3 alone, an incredible concentration of power.

4 What did they do? What do they
5 do? They've got their own security analysts,
6 not biased like the Wall Street analysts. I
7 see nothing. I see almost no voting. The
8 patterns vary, but no one steps up to the
9 plate. As far as I know, there has never been
10 a proxy proposal made by any large
11 institutional money manager in a corporate
12 proxy. It seems incredible.

13 Someone asked me in the break --
14 that's because of index funds. They're the
15 problem. Well, look, index funds may be the
16 problem -- I'll grant that -- but they are the
17 ultimate salvation, because think about it
18 this way. The old Wall Street rule so-called
19 was, "If you don't like the management, sell
20 the stock."

21 Well, the index fund has a
22 different rule, has to have a different rule.

1 "If you don't like the management, fix the
2 management." They just don't do that. They
3 don't follow up on that obvious premise.

4 So we have to awaken them.
5 Perhaps some kind of government action should
6 take place -- I hope we will get a federal
7 standard of fiduciary duty -- to bring them
8 back into the game. And because if the owners
9 aren't going to look after their own
10 interests, I don't know who is.

11 I will say very quickly -- I don't
12 want to take too much time here, which I have
13 taken already -- but the idea of the
14 accountants reporting to the shareholders may
15 sound like a funny thing to you. But I have
16 heard time and again, when the Scotts sent all
17 that money over in the late 1800s to build our
18 railroad system, they sent their own
19 accountants over. Of course they did. They
20 had their own money at stake. But that
21 linkage is lost in our present system, and we
22 need to bring it back.

1 CHAIRMAN DOTY: That was true in
2 the 17th century, in New Amsterdam.

3 Jay? Mr. Jay Hanson?

4 MEMBER HANSON: Two questions.
5 And one I will ask of Mr. Biggs just
6 specifically, but then a broader question for
7 all of you. The broader question is, this
8 Concept Release that we put out -- and this
9 hearing today is about auditor independence,
10 objectivity, and professional skepticism. And
11 we have talked a lot about mandatory rotation.
12 I understand your views on that.

13 But my question is, what other
14 things should we be considering in addition to
15 that? Because I think a lot of people
16 acknowledge that even if we do mandatory
17 rotation, it is not a silver bullet. There
18 are still lots of other environmental factors.
19 So I would really like to hear your thoughts
20 on what other things we should be considering
21 as well.

22 But, Mr. Biggs, just a very

1 specific question. You shared with us your
2 experience with auditor rotation at TIAA-CREF,
3 and I understand you are also either
4 currently, or have been in the last 10 years,
5 on several audit committees of very large
6 organizations.

7 And do those large companies that
8 you have been on the audit committee for, do
9 they have a mandatory audit rotation program
10 in place that the audit committee has
11 requested? And if not, maybe -- just share
12 some color on what your thoughts have been
13 about rotating the auditors on those
14 companies.

15 MR. BIGGS: They do not have a
16 policy. We have had discussions of it. In
17 the case of JPMorgan Chase, it happened
18 because when we did the merger with Bank One
19 we had two audit firms, and we had to pick
20 one. So it was one of the two existing firms.
21 So in a sense, it was not a rotation, but in
22 another sense it was, because they own half

1 the company. At Boeing, we have not done it;
2 we have talked about it.

3 What it comes up time -- when the
4 time comes up to consider the new senior
5 partner, unless you really have a good fit --
6 and it happened that we did have an excellent
7 fit there -- we stayed with the firm. But if
8 that had not existed, I think that would have
9 been a natural time to rotate. And I think
10 the audit committee probably would have wanted
11 to look at least and see what was available.

12 In that case, the natural rotation
13 time is when the senior partner rotates. So
14 I recommended a ten-year system, so the second
15 senior partner rotation you would do that.
16 And I think that is the time when you ought to
17 think about it.

18 But we had special problems. The
19 company was the only company in the United
20 States that uses program accounting, which
21 involves very complex accounting underlying
22 principles. And having somebody who was

1 trained and knew that, had learned it at
2 Boeing, made it an ideal change. And the firm
3 did a very good job of bringing that person
4 along, the audit firm did.

5 MR. BOGLE: Yes. I would add --
6 Chairman Breeden mentioned this this morning,
7 and it is along the lines of what I had
8 mentioned a little bit earlier. You mentioned
9 the Norway system. I'm not expert on the
10 Norway system, but apparently they pretty much
11 require 10 large investors to be participating
12 in the analysis of financial statements and
13 the analysis of whether the auditors are doing
14 a proper job and doing the right thing. I
15 think that is a good start.

16 Right here we have this big
17 problem of -- and these conflicts are
18 everywhere; this one happens to be quite a
19 parallel. But one of the problems we face in
20 the field of institutional investment
21 management is that we're managing money for
22 all of those clients out there, and we own

1 those stocks in our portfolios.

2 And as I have said many, many
3 times -- too many perhaps -- there are only
4 two kinds of clients we don't want to offend
5 in the money management business -- actual and
6 potential. And that, believe me, is a lot of
7 clients. And in a way, the accountants are
8 facing that same problem themselves. You
9 know, they don't want to offend their actual
10 clients, but they also don't want to offend
11 anybody who might think of hiring them in the
12 aftermath of a firing.

13 So we have an interlock system,
14 almost a gridlock system. But I think to the
15 extent we can work toward an idea of having
16 the audit committee strengthened, perhaps with
17 its own -- as I mentioned, but with its own
18 staff or consultants -- management will not
19 like that -- and having the shareholders stand
20 up for their own rights.

21 And, actually, even as important
22 as having the shareholders stand up for their

1 own rights is to exercise the responsibilities
2 of corporate governance. It is going to take
3 a long time coming, but it is going to come.

4 MR. LEVITT: I would encourage you
5 to have meetings similar to this in different
6 parts of the country, and giving greater
7 visibility to your efforts to oversee the
8 profession, to nurture competition, encourage
9 smaller firms to be part of this process, and
10 to continue your visibility as monitors of the
11 profession. That doesn't mean punishers of
12 the profession, because I think the profession
13 has many really sound people.

14 But you've got to be certain that
15 sound procedures are followed, that your
16 inspection program is given every possible
17 encouragement possible, and that you be
18 vigorous in terms of your overall inspection
19 activities.

20 MEMBER FERGUSON: The question
21 that I would like to ask and get all of your
22 views on, if I could, is whether -- and we

1 hear this from particularly preparers.

2 Preparers say, "Look, the Sarbanes-Oxley Act
3 in 2002 gave the oversight of audit firms to
4 the audit committee," and that system is
5 working very, very well now.

6 And what we don't want to do is
7 put a bunch of rules in place that in fact end
8 up limiting the power of the audit committee.
9 And I would like to get your views on, in
10 fact, are audit committees doing what they
11 need to do?

12 Are they capable of providing the
13 kind of detailed and in-depth oversight of the
14 audit firms that I think we would all like to
15 see? And are they capable of exercising the
16 kinds of judgments that really protect
17 investors? And if not, what would your
18 suggestions be to fix that?

19 MR. LEVITT: I think that today's
20 audit committees are vastly superior to any
21 that preceded them. But there is no such
22 thing as the perfect audit committee, and some

1 are better than others.

2 I think this goes beyond that,
3 though. This is -- I don't believe that an
4 energetic, experienced audit committee would
5 take exception to the notion of auditor
6 rotation. I was an advisor to a very large
7 publicly owned company that had endured its
8 own public embarrassments that considered the
9 possibility of rotating auditors.

10 And this committee -- committee of
11 a number of people had pretty much decided to
12 make that rotation, but didn't do so because
13 the staff felt uncomfortable about it. And
14 this special committee decided that the
15 staff's views were more important, and I can
16 understand that.

17 I think that we can't afford to
18 dilute the impact of the audit committee, but
19 I honestly do not believe that auditor
20 rotation -- we are talking about a 10-, 15-,
21 20-year period -- would have any impact
22 whatsoever on audit committee morale.

1 MR. BOGLE: I would just like to
2 say, I mean, I know you are dealing with a
3 small part of a big issue, and this is beyond
4 the providence of your Board to deal with.
5 But it seems to me it begins with something
6 like corporate governance itself. I happen to
7 be a believer that the Chairman of the Board
8 should be different than the Chief Executive.

9 My friend John Biggs disagrees
10 with me, and I quickly say he is almost always
11 right, and I am almost always wrong. But I
12 think it is something that ought to be
13 pursued. And when you think about it in the
14 context of what we are talking about today,
15 then it would be that chairmen who appointed
16 the audit committee, not the president of the
17 company. It would give you more independence.

18 It is hard when -- for any
19 committee of outside directors, which comes in
20 probably six times a year and meets for six or
21 eight hours -- and, yes, they say they do a
22 lot of homework in between, and I am sure they

1 do -- but how can they contend with management
2 with all of the facts? We have to balance
3 somehow the responsibilities of our
4 corporations to the public rather than to the
5 management, to the stockholders rather than
6 the management, I put it even more acutely.

7 MR. BIGGS: Yes, I would comment
8 briefly. I think most of the large company
9 audit committees are taking this
10 responsibility very seriously. And I agree
11 with Arthur's comment that there is a huge
12 difference between audit committees today --
13 of the companies I have been involved with --
14 and 10, 15, 20 years ago.

15 However, there are some 17,000
16 companies out there. And when you get down
17 into the ranks, I think then you may not find
18 people getting the message. The audit
19 committee should take that role. And CEOs
20 really don't much like the idea that the audit
21 committee is going to make this decision, and
22 perhaps independently of the CEO.

1 I think the NACD, the National
2 Association of Corporate Directors, is really
3 doing God's work on getting out to all of the
4 directors in all of the major cities around
5 the country, and to the extent that PCAOB
6 could support them. But this is a theme that
7 I hear all the time at their meetings is now
8 the audit committee has got a new
9 responsibility, and how are they doing it?

10 And people get up and testify what
11 they have done, what others have done. And I
12 think that is -- I always think that is
13 incredibly powerful and helpful. And to the
14 extent you can participate or encourage that
15 in corporate governance, I think that could be
16 helpful.

17 MEMBER HARRIS: I have now learned
18 to couple questions into one from Lew and Jay,
19 who asked multiple questions in one round. So
20 let me put a couple together and ask a couple
21 into one, and answer them as you see fit.

22 But number one is, earlier

1 panelists have suggested that mandatory
2 rotation is too costly, too disruptive, anti-
3 competitive, and not feasible with respect to
4 the largest companies. You touched upon that,
5 John, but if you could expand upon that.
6 That's one part of a tripartite question.

7 Separately and unrelated, I would
8 like to get the idea -- the answer from all
9 you, who do you believe is the primary client
10 of the auditor? Is it the investor, or is it
11 management?

12 And the third is, with respect to
13 auditing and accounting, why do some of you
14 believe that the system is not working?

15 MR. BIGGS: Well, let me comment
16 on the cost issue. Clearly, there is some
17 additional cost when a new firm comes in. But
18 it seems to me the firms deal with that. They
19 are not going to come in and immediately
20 increase the fees by the amount of that extra
21 cost, but they get it worked out over time,
22 and that they see an audit relationship as

1 being -- they see it as a ten-year
2 relationship.

3 Even if the 20 percent number were
4 right, that would only be a two percent
5 increase in fees smoothed out over time, and
6 that is in the noise of audit fees. I mean,
7 I think having pushed on audit fees, trying to
8 get them lower always, and the Board's
9 situations, a two percent change is hardly
10 noticeable.

11 So I don't -- and I think 20
12 percent is way too high, because I think the
13 firm -- the major firms can come in, you know,
14 the senior people can find their way pretty
15 quickly. I mean, proper rotation is they have
16 full access to everything that the previous
17 audit firm did, and all of the issues are
18 surfaced immediately. They don't have to
19 spend a lot of money to find those. They are
20 there, and then they can take those up with
21 the company.

22 So I think the cost issue needs to

1 be considered in a cost-benefit. But the
2 benefits of avoiding one bad error that causes
3 huge losses is so enormous that I don't find
4 that the cost-benefit analysis -- but I'm
5 sorry that some academic didn't take the
6 wonderful opportunity to do a test when they
7 took all of those Arthur Andersen forced
8 rotations that occurred.

9 Did anybody go out and really look
10 at, well, what did that cost the firms? What
11 happened to fees, the Arthur Andersen fees,
12 and the new fees? I suspect -- a priori on
13 that is they would have found very little in
14 the way of increased costs and increased fees
15 to the companies.

16 Unfortunately -- or fortunately,
17 rather, for the audit firms, Sarbanes-Oxley
18 came across -- came along about that time, and
19 fees in the firms skyrocketed to help
20 companies comply with Sarbanes-Oxley.

21 So I think the cost-benefit
22 analysis could be done differently. It seems

1 to me rather than ask the audit firms what do
2 they think it is, when they know that it is
3 going to be used possibly in a contested
4 environment, about whether this is a useful
5 change, it doesn't get there.

6 What you need is some kind of
7 actual study of rotation -- firms that have
8 rotated their auditors, and go in and get
9 information from the audit firm and the
10 company when that occurs. And I think firms
11 would be willing to provide that data, so it
12 is another study for the GAO or for -- I'm not
13 sure if PCAOB could engage in that.

14 MR. BOGLE: Let me just add to
15 that that, you know, all of -- I think cost
16 kind of is the last refuge of the scoundrel,
17 and we fall back on that to justify everything
18 else. And here is a company paying its CEO
19 \$25 million a year. Somebody remarked on what
20 the total capital cost of that was in a
21 decade, but it is a lot of money.

22 And they talk about maybe a

1 million dollar cost in this rotation thing, if
2 any, because an audit firm eager enough for
3 the business is probably going to find a way
4 to eat that cost, and it would be zero. So
5 cost is going to be overexaggerated.

6 The same thing is true in our
7 business. We complain about accounting fees,
8 regulatory costs -- this is the mutual fund
9 business -- but we never complain about our
10 management fees. They are always wonderful,
11 and they are 100 times what these numbers all
12 put together were. So, you know, cost is kind
13 of in the eye of the calculator.

14 And let me say this about cost-
15 benefit. I think maybe the worst thing that
16 Congress has done -- I know that is a tough
17 standard, but the worst thing they have done
18 is require a cost-benefit analysis, because we
19 all know intuitively -- our common sense
20 doesn't mislead us -- cost is so easy to
21 measure, and benefit so difficult to measure.

22 Benefits, in a lot of ways, can't

1 be quantified. What would the benefit be if
2 we had a purely independent accounting system,
3 if the auditors were truly independent?
4 Nobody can tell you that, but your common
5 sense isn't going to let you down. It is
6 priceless. So how do you measure the easily
7 priced versus the priceless? And you can give
8 me that answer in your next meeting.

9 MR. LEVITT: I think what Steve
10 was asking, essentially, was: who do the
11 auditors -- who are their customers? Who do
12 they report to? And I think it is obviously
13 the client. But in terms of their
14 reputations, in terms of their claims for
15 independence and professionalism, investors
16 are their major concern.

17 Now, the balance between those two
18 sometimes becomes skewed, and in my judgment
19 it is your job, along with the SEC, to see to
20 it that that balance is maintained in a way
21 that favors investors rather than corporate
22 interests, which would be viewed as conflict

1 situations.

2 CHAIRMAN DOTY: Gentlemen, we are
3 going to get Arthur Levitt on the way at 2:00.
4 This would be something that we would love to
5 extend, and we may have to call you back
6 again. This may not be the last time we call
7 on you to do something like this. But it has
8 been a wonderful panel. You have -- as
9 always, you have delivered great wisdom and
10 great stimulus to your auditors, and we thank
11 you all.

12 Good afternoon. Safe travels to
13 all of you.

14 MR. BOGLE: Good luck, ladies and
15 gentlemen.

16 CHAIRMAN DOTY: One of the
17 simulating things about this job and this
18 place is that you learn that there are entire
19 areas of academic discipline that you didn't
20 know existed. And you begin to realize that
21 they have a lot to offer aging students and
22 scholars, such as the ones you see here in

1 front of you.

2 We have with us Max Bazerman. Max
3 is the Jesse Isidor Straus Professor of
4 Business Administration at the Harvard Law
5 School. His research and his area of
6 specialization focuses on decisionmaking,
7 negotiation, ethics. He is the author, co-
8 author, or co-editor of 19 books and over 200
9 research articles and chapters.

10 In addition to being the Straus
11 Professor at the Harvard Business School, he
12 is formally affiliated with the Kennedy School
13 of Government, the Psychology Department, and
14 the Program on Negotiation at Harvard.

15 He has been consistently named one
16 of the top 40 authors, speakers, and teachers
17 of management by Executive Excellence. I have
18 found his works riveting.

19 His co-author for some of these
20 works, Don Moore, is the Associate Professor
21 of Management of Organizations, Haas School of
22 Business, University of Berkeley. He studies

1 human overconfidence, including when people
2 think they are better than they actually are,
3 when people think they are better than others,
4 and when people are too sure they know the
5 truth.

6 He received a Ph.D. from
7 Northwestern University and his B.A. from
8 Carlton College.

9 Welcome to both of you, and please
10 proceed.

11 MR. BAZERMAN: Thank you very
12 much. It is an honor to be here. A couple of
13 comments before I begin. First, I am not a
14 professor at the Harvard Law School. After
15 what I say, they may want to deny any
16 association.

17 CHAIRMAN DOTY: You don't have to
18 deny that. You don't have to deny that.

19 MR. BAZERMAN: Okay. So I
20 probably should clear that up in case the Dean
21 of the Law School was concerned.

22 And, second, I want to make a

1 statement about conflict of interest, because
2 we are -- this whole process is about
3 professionals potentially having a conflict of
4 interest. And in the process of people
5 providing comments, in the process of people
6 providing testimony, one of the challenges for
7 the committee is to deal with the fact that
8 people may also have financial conflicts of
9 interest as they provide their opinions to
10 you.

11 And I take that concern very
12 seriously. I want to clarify that I did
13 substantial work for the major auditing
14 accounting tax firms up through the mid-1990s.
15 I haven't had any connection to them since
16 1997, for reasons that will become apparent in
17 a little bit.

18 I believe I have no direct
19 conflict of interest with anything I am going
20 to say before your committee today. And if by
21 chance what I say leads to any consulting work
22 that I receive any financial compensation for,

1 I don't plan on keeping it. I will donate
2 that, because I don't want my comments to be
3 potentially affected by any financial conflict
4 of interest.

5 Fifteen years ago, in 1997, when I
6 first published a paper on auditor
7 independence, the AICPA's code of conduct
8 required that auditors, quote, "shall be free
9 of conflict of interest," unquote. In 1984,
10 Chief Justice Warren Burger argued that
11 auditors were required to, quote, "maintain
12 total independence from the client at all
13 times," unquote.

14 Yet in our 1997 paper, Kimberly
15 Morgan, George Loewenstein, and I argued that
16 the massive conflicts of interest that existed
17 in the structure of the auditing industry
18 created a situation where we were undoubtedly
19 failing the directive of Chief Justice Burger.
20 Quite simply, auditors were not independent in
21 1997, and I am going to argue auditors are not
22 independent today.

1 Even a decade after we made this
2 argument to the SEC in front of Chairman
3 Levitt in 2000, after the collapse of Enron
4 and Arthur Andersen, after the ineffective
5 compromises created by Sarbanes-Oxley, after
6 the financial crises where we don't know what
7 would have happened if we actually had auditor
8 independence in this country, our conclusion
9 remains the same. We don't have auditor
10 independence in this country.

11 The problem is more than the issue
12 of integrity. Mr. Bogle spoke about
13 reputation risks and the limit. But we argue
14 that the problem is far broader. The problem
15 that we believe that confronts this industry
16 is that human beings, when they have a desire
17 to see data in a particular way, they are no
18 longer capable of objectivity.

19 If you ask people how good they
20 are at -- to assess their own driving skills,
21 to assess the intelligence of their children,
22 or to assess their ability to pick the right

1 stocks, we know that people are incapable of
2 objectively assessing when they have a self-
3 interest in seeing the data a particular way.
4 And we argue that this is a fundamental
5 concern that fundamentally affects virtually
6 all auditors as a result of the structures
7 that exist today.

8 So while corruption may be the
9 problem of the few, we are arguing that the
10 lack of perfect rationality is a problem of
11 the many and should be a fundamental challenge
12 that we are concerned with in this hearing.

13 Experiments going back as long as
14 more than 50 years ago have shown the power of
15 self-serving biases, to see data as we would
16 like them to be. In one famous study by Linda
17 Babcock, George Loewenstein, Samuel
18 Issacharoff and Colin Camerer, they had
19 participants in the study play the role of
20 lawyers for a plaintiff and a defendant where
21 both sides had access to the exact same facts.

22 The participants in the study were

1 soon interrupted after a fairly small number
2 of minutes of interaction. After they were
3 interrupted, they were simply asked the
4 question: what is your estimate of what an
5 unbiased panel of experts would judge this
6 case to be worth?

7 And the interesting result is that
8 even when you motivate people to provide you
9 the right answers, plaintiffs believe that the
10 case is worth more than twice what defendants
11 believe it is worth on average. After a small
12 number of minutes playing in a role, people
13 are no longer capable of objectivity to
14 actually assess what the facts of the case
15 look like.

16 My own work with Don Moore to my
17 right, and Lloyd Tanlu, shows that actual
18 auditors will be more likely to conclude that
19 the accounting behind a firm's financial
20 reports complies with Generally Accepted
21 Accounting Principles if they are working as
22 the firm's auditor than if they are not.

1 What I find particularly
2 intriguing about the arguments that I am
3 presenting is that when we first started
4 presenting these arguments in the early part
5 of the millennium to different academic
6 audiences, we got shockingly strong
7 differences in responses.

8 When we presented this work to
9 academic psychologists, academic research
10 psychologists, the typical response is: do
11 you have anything new to tell us? They
12 basically said, "Long ago we learned that
13 people with self-interest are no longer
14 capable of objectivity, and that their bias
15 occurs in a systematic direction."

16 And the answer is: we didn't have
17 anything new to tell them. We were
18 replicating a result that had existed in
19 psychology for more than 50 years and had been
20 applied in numerous applied contexts. And we
21 were simply bringing it to one more arena.

22 At the same time, when we

1 presented this information to the accounting
2 world, the response was disdain. Quite
3 simply, the lead audit firms did not want to
4 hear the message. The accounting academic
5 profession viewed it as a threat. And more
6 broadly, anybody connected to accounting
7 wanted little to hear about this argument,
8 because it upset the way business was
9 currently being done.

10 We would argue that our current
11 institutions prevent auditor independence from
12 occurring for very predictable reasons. And
13 I believe I am answering prior questions by
14 Mr. Hanson and Mr. Ferguson. We believe that
15 we can identify the structural characteristics
16 that keep us from having independent auditing
17 in this country.

18 Audit firms have incentives to
19 avoid being fired and incentives to be
20 rehired. Audit firms profit greatly from
21 selling non-audit services to their audit
22 clients, and individual auditors often end up

1 taking jobs with client firms. These
2 structural characteristics, we believe, define
3 a condition where independence does not exist
4 in our auditing institutions today.

5 So what needs to be done?

6 Auditors should be hired under fixed contracts
7 that stipulate the true rotation of both
8 individual auditors and the firm will occur.
9 During that time period -- specified time
10 period, the client should not be able to fire
11 the audit firm. In addition, the client
12 should not be allowed to rehire the auditor at
13 the end of that contract.

14 When a client changes auditors,
15 audit firms, the personnel working on that
16 audit for Audit Firm A should not be able to
17 move with the job to Audit Firm B, which often
18 does occur in actual audit rotation situations
19 where the client decides to rotate the audit
20 firm. Sometimes the actual people doing the
21 work remain the same.

22 Auditors should not be allowed to

1 provide non-audit services, and the auditing
2 personnel for a particular client should be
3 barred from working for that client for a
4 specified number of time periods.

5 The basic concept here is very
6 simple. The auditor should not have an
7 incentive to please the client. And without
8 solving that problem, we simply don't have
9 auditor independence in this country.

10 Opponents of auditor reform have
11 provided a number of arguments having to do
12 with cost-benefit analyses, in terms of the
13 costs of the transition, the argument that we
14 need more research.

15 To be quite honest, that hasn't
16 changed one drop in the last 12 years since I
17 have appeared before the SEC. We will always
18 be able to benefit from more research. I am
19 an academic. I think funding research is a
20 lovely thing.

21 But that said, I think we actually
22 have enough data, we have enough reason that

1 we should be taking action based on what we
2 currently know, rather than using a variety of
3 delay tactics that we saw the tobacco industry
4 use to delay reform for decades, and we see
5 climate deniers using in the same way. Audit
6 firms should not be in that category.

7 I would like to ask you to think
8 about two options, about how one might go
9 about creating auditor independence. Option
10 one would be to start from scratch and have a
11 system where auditors are prohibited from
12 establishing durable, long-term cooperative
13 relationships with their clients, from
14 providing non-audit services to their clients,
15 and from taking jobs with their clients. That
16 is option one.

17 Option two is: start by creating a
18 variety of incentives that lead auditors to
19 want to please their clients at all costs, and
20 then try to create a complex set of
21 legislative and professional incentives to
22 counteract the corrupting influences that we

1 have by allowing all of the incentives to
2 exist to begin with.

3 Now, when I ask any manager this
4 question, option one is obvious over option
5 two. And what is striking is that we
6 continually decide to go with option two, to
7 treat the status quo as a place that we are
8 going to start from and create what ends up
9 being fairly small reforms one step at a time
10 as many years go by.

11 I believe, if we want to take
12 auditor independence seriously, we need to
13 think about what would that actually look
14 like.

15 The auditing industry has avoided
16 responding to the obvious arguments that my
17 colleagues and I have been making as far back
18 as our 1997 article and the 2000 hearings by
19 the SEC. The auditing industry has spent tens
20 of millions of dollars to block the creation
21 of auditor independence in the United States.

22 Only recently, the academic

1 accounting audience has begun to take the
2 issue more seriously. And after being
3 boycotted by my academic colleagues for over
4 a decade, I was recently invited to be the
5 keynote speaker at the Management Accounting
6 Section of the American Accounting
7 Association.

8 I think it is time for
9 policymakers to move in the same direction.
10 And I want to end my comments by encouraging
11 you to take the bold steps necessary not just
12 to think through, is auditor rotation a good
13 idea or not, but to ask: what would we need to
14 do if we actually wanted to have independence
15 in our auditing system in this country?

16 Thank you very much.

17 CHAIRMAN DOTY: Thank you.

18 Mr. Moore, Don Moore.

19 MR. MOORE: Thanks for the
20 opportunity to be a part of this process. It
21 is an honor to be able to present to you
22 today. Allow me to express my own personal

1 appreciation for the patience and endurance on
2 display by the five of you over these two days
3 of panel discussions.

4 I also wish to declare that I have
5 no direct financial stake in the issues before
6 the Board.

7 I speak to you as a research
8 psychologist who works in a business school.
9 And from the perspective of auditor
10 psychology, the question before you is easy
11 and obvious. Of course, the current system
12 undermines auditor independence. Indeed, the
13 very notion that the current system
14 facilitates truly independent audits is
15 laughably implausible.

16 These claims are not controversial
17 among psychologists. Indeed, there is such an
18 obvious application of the basic psychological
19 principles that we have known for quite some
20 time that psychologists find this whole debate
21 entirely uninteresting.

22 Understanding the fact that long,

1 enduring relationships between firms and their
2 auditors represents a conflict of interest
3 that compromises auditor independence is easy,
4 the real question is whether the PCAOB will
5 have the courage to act to reduce this
6 conflict of interest and increase auditor
7 independence.

8 There are some critics of reform
9 who have argued that we must pay attention to
10 the whole patient and the cost-benefit ratio
11 of the proposed treatment. While this logic
12 sounds reasonable, I believe it is problematic
13 in this instance. The auditing profession
14 exists because it promises independence.

15 Without independence, outside
16 auditors become redundant, with inside
17 auditors raising questions about whether
18 outside auditors perform a useful service at
19 all and whether it makes sense to require
20 firms to pay for audits that are in effect
21 redundant with their own internal accounting
22 reports.

1 If the PCAOB is the doctor
2 treating the ills that have befallen auditor
3 independence, there are some who would invoke
4 the Hippocratic Oath, first "Do no harm." The
5 underlying assumption there is that the
6 perfect regulatory scheme is one whose
7 implementation creates no costs, only
8 benefits.

9 In a system with as many
10 constituents and as many parts as the current
11 auditing system in the United States, it is
12 unlikely that there is any change that would
13 not harm somebody in some small way. But
14 there is no single patient to be treated by
15 the PCAOB.

16 There are many constituencies that
17 would be affected by this rule change, and
18 there are some individuals and organizations
19 whose lives would be disrupted by this change.
20 But refusing chemotherapy to a cancer patient
21 because their hair follicles will suffer is a
22 mistake.

1 We have heard howls of protest
2 from frightened hair follicles in the comments
3 already submitted, and you are getting more at
4 these panel discussions. Those organizations
5 and individuals who are most likely to have
6 their work disrupted by the reforms are
7 considering -- have mobilized to present to
8 you the costs that a change would impose on
9 them. They will lobby and cajole. They will
10 fulminate and portend disaster if you act to
11 reform the system.

12 And those who would benefit from
13 the change are, by and large, absent. I would
14 like to remind us of those people, those
15 organizations, and those institutions. The
16 hair follicles might not prefer chemotherapy,
17 even if it is in the interest of the rest of
18 the person.

19 To say that we should not increase
20 auditor independence because it is costly to
21 do so is, in my opinion, like saying that the
22 cancer patient should not undergo chemotherapy

1 because it might be bad for their hair. I
2 have little sympathy for those complaints
3 about hair.

4 To settle for partial auditor
5 independence only when it requires minimal
6 change from the highly problematic status quo
7 is akin to taking out just the easy part of a
8 malignant tumor. Partial solutions violate
9 the promise of independence on which the
10 auditing profession is based.

11 The benefits of a system that
12 delivered true auditor independence would be
13 enormous. Equity markets depend on the
14 truthful and reliable public disclosure of
15 information about public companies, indeed
16 that is the fundamental premise on which our
17 equity markets are based.

18 As the Nobel Prize winning work of
19 George Akerlof has shown, markets break down
20 when the key information is held only by
21 insiders. This is because others become
22 reluctant to trade, rightfully fearing that

1 they could be cheated by those insiders.
2 There are of course high-profile examples of
3 big public companies in which this precisely
4 has occurred.

5 Insiders have been able to cheat
6 outside investors, leaving companies that
7 collapsed when the truth finally emerged. And
8 the complicity of the firm's auditors makes it
9 so much easier for public companies to get
10 away with hiding the true state of their
11 finances.

12 If reforming our system would
13 reduce the probability of another Enron or
14 another WorldCom, even by a little bit, we
15 should be willing to endure costly and
16 disruptive change to do it.

17 The problem we have here today is
18 that the enumerable market participants who
19 would benefit from this reform are not here to
20 speak for themselves. They do not yet know
21 about the potential cases of audit fraud at
22 the companies whose stocks they own, and so

1 they have not yet calculated how much they
2 would benefit from avoiding the resulting
3 bankruptcies, because the benefits of greater
4 auditor independence would be so widespread,
5 those with an interest in seeing it occur find
6 their members and their voices too diffuse to
7 organize action.

8 They do not have enough
9 spokespeople or lobbying organizations.

10 Investors represent just a tiny minority of
11 the comments submitted to the PCAOB, and they
12 are far more favorable regarding the benefits
13 of auditor rotation than are audit firms and
14 their clients.

15 The public really only starts to
16 pay attention when high-profile accounting
17 scandals raise their outrage enough to lead
18 them to take action. It is only then, with
19 public esteem for our business leaders falling
20 to a new low, that the public expresses its
21 will loudly enough for lawmakers to be able to
22 hear it above the coordinated concert of

1 voices coming from those concentrated
2 industries, like the accounting firms that are
3 resisting change.

4 It was this sort of public outrage
5 that enabled passage of Sarbanes-Oxley, which
6 is an important piece of legislation, even if
7 it left the task of auditor reform unfinished.

8 One reason why it is unfinished is
9 that in the long intervals during which the
10 investing public is not really paying close
11 attention concentrated industries work with
12 regulators to soften the edges around legal
13 constraints, to find new ways to make money,
14 and to work around regulations.

15 Indeed, it happens too often that
16 these concentrated industries are savvy enough
17 to cap to the regulators whose job it is to
18 supervise them.

19 What you all are considering is
20 something remarkable. You are considering a
21 meaningful and useful reform without the angry
22 demands of an outraged public fresh from some

1 new scandal. You are wise enough to
2 anticipate the potential scandals and take
3 action now to reduce their future probability.

4 Allow me to commend you for it and
5 to wish you courage. It will take courage for
6 you to act to treat the cancer of conflict of
7 interest in auditing.

8 I would be happy to try to answer
9 any questions you might have.

10 CHAIRMAN DOTY: Thank you. Before
11 I let some of my colleagues have at you, I
12 thought I would ask you a couple of contextual
13 questions. First, do I understand correctly
14 that you would agree or argue that even if we
15 take the approach that Max Bazerman says, or
16 something else that -- some of the other
17 approaches that have been tendered today,
18 whatever we do in the area of addressing the
19 fundamental conflict of interest of the fee
20 structure, that we will not exclude the issue
21 of bias.

22 We will only counterweight it.

1 That we cannot exclude it completely, that we
2 will counterweight it at best. Is that your
3 conclusion as behavioral scientists?

4 MR. BAZERMAN: Yes, is the simple
5 answer. But I would say that we could make
6 tremendous progress, and the way to make
7 tremendous progress is to ask, what would a
8 system look like that would take away the
9 incentives of the auditor to please the
10 client?

11 Now, we can take this to an
12 extreme and ask, "Well, what happens if they
13 have lunch together? Is that relationship
14 going to bias the audit?" Probably not, but
15 when I worked for the Department of Justice or
16 the FTC, and it is time to go out for lunch,
17 I notice that they don't pay for me.

18 I think that that is just great.
19 It may be overkill, but better to have
20 overkill than to allow conflict of interest
21 based on relationship and favors to seep into
22 the process.

1 CHAIRMAN DOTY: Well, John Biggs,
2 for example, and Bowsher pointed to some of
3 the phenomena that tend to coalescence in this
4 area, such as, for example, if you couple long
5 tenure with population of the issuer client's
6 financial reporting staff with alumni of the
7 accounting firm, if you then have with that a
8 large volume of non-audit work, admittedly
9 under the permissible areas of non-audit work,
10 the sort of thing that was -- we talked about
11 earlier, that also increased the percentage of
12 non-audit service to audit service and the
13 revenue, when you see an emerging pattern like
14 that, as behavioral scientists you would say
15 that could be an area around which behavioral
16 analysis could operate without the requirement
17 of econometrics, or without other data to
18 support it.

19 MR. BAZERMAN: That is correct. I
20 believe you have plenty of data to act
21 currently without additional research.

22 CHAIRMAN DOTY: And you have

1 removed -- I think -- if I understand your
2 analysis correctly, what you have done by
3 talking about the escalation of commitment and
4 some of the other aspects of behavioral bias
5 here, you have removed issues of intention or
6 competence.

7 In other words, you don't think
8 that all auditors are bad people. You don't
9 consider that in fact -- that they are lacking
10 some judgmental or ethical quality or even
11 competence quality that other professionals
12 have. You are just saying we all have this
13 bias.

14 MR. BAZERMAN: We are accusing
15 auditors of being human.

16 CHAIRMAN DOTY: Human, that's it.
17 That's what I -- and I'm now going to let
18 Ferguson have at, and we'll move down the
19 line. Lewis?

20 MEMBER FERGUSON: First, I just
21 noticed, Professor Moore, when you told us or
22 congratulated us on being brave for taking on

1 a big issue in the absence of public outrage,
2 I mean, I think a lot of people might say it's
3 foolhardy to do that without the wind in our
4 sails from public outrage. But there you are.

5 I guess I'd like to ask a question
6 of both of you having to do with -- if we
7 start with the notion that people are
8 inevitably biased by the sort of structure in
9 which they operate, and in this particular
10 example the way I put it in another paper was
11 people are very reluctant to bite the hand
12 that feeds them.

13 Even if we put all of the
14 safeguards that you had mentioned, Professor
15 Bazerman, in your paper, including fixed
16 terms, you can't fire, you can't do things
17 like that, as long as the firm is being paid
18 by the client, isn't that bias still going to
19 be there? Isn't the very fact that the
20 payment is being done by the person being
21 audited going to influence the mindset of the
22 auditor? Or do you think that these other

1 structures will overcome that biasing factor?

2 MR. BAZERMAN: I don't think that
3 where the check is coming from is important.
4 I think the question is whether the check
5 depends -- whether the future checks depend on
6 what the auditor says or decides. That is a
7 critical issue, and that is why I did sneak in
8 -- it is not just auditor rotation that I am
9 for, but I am also for a provision after the
10 PCAOB decides whether it is five or seven or
11 10 or 12 years. And I am really -- I don't
12 think that I am the right person to tell you
13 how long the period should be.

14 But I think that it is critical to
15 solve the problem that you are addressing that
16 there is a no fire provision. So when you
17 hire that person for X years, they are your
18 auditor for X years. And, by the way, after
19 that X years, they won't be your auditor for
20 the following X years.

21 And since they are not providing
22 you non-audit services, they are going to look

1 a little bit more like the tax collector
2 rather than your business partner. And when
3 I hear the term "partner" used to refer to
4 your audit firm, I find that really scary. So
5 I want to eliminate any notion of partnership.
6 I want to eliminate any notion that the
7 auditor has a financial incentive to please.

8 I don't think that you -- this
9 goes back to Chairman Doty's question. I
10 don't think you can make it perfect. These
11 are human beings. They are going to interact.
12 It might be that Mr. Harris seems like a nice
13 guy, and I have been working with him over the
14 last two years, so I simply trust him more.
15 That would be a human interaction. And if it
16 turned out he wasn't as trustworthy as my
17 intuition suggested, I might be more accepting
18 of the data that he gives me.

19 So I am not arguing we can make it
20 perfect, but I think we can solve 98 percent
21 of the problem with a very, very small number
22 of rules.

1 MEMBER FERGUSON: But doesn't the
2 no fire rule have its own set of problems?

3 MR. BAZERMAN: Absolutely. For me
4 the question isn't, should we be at the system
5 we have now or in this alternative system?
6 The question is, do we want to have an
7 independent auditor function in this country
8 or not?

9 If the answer is no, there is
10 other strategies instead. If the answer is
11 yes, we have to identify, what are the basic
12 ingredients that you would need for an auditor
13 to be independent? And part of the answer is
14 having no financial incentive to please the
15 client.

16 MR. MOORE: And at the risk of
17 repeating myself, to go with the answer, no,
18 we're okay with the corrupted status quo,
19 raises questions about what purpose
20 independent auditors serve.

21 MEMBER HANSON: A couple of
22 questions. The system that we are in, there

1 is obviously a world of compromises to get
2 where we are at today, as you point out. And
3 one of the things that the Sarbanes-Oxley Act
4 acknowledged was that audit committees could
5 do more in legislating their expertise and the
6 relationship.

7 And hearing Mr. Biggs a few
8 minutes ago talk about his experience on the
9 Audit Committee of Boeing, obviously, a large
10 company, very few auditors with a skill set
11 around -- as he described, around the ability
12 to audit the program accounting, and his
13 thoughtful considerations that he described of
14 why he, as an Audit Committee member, decided
15 to continue with a long-term auditor.

16 I am just curious as to your
17 reactions as to whether you think audit
18 committees should even have a role in this.
19 If John Biggs' expertise in deciding to keep
20 the auditor at Boeing should be disregarded,
21 and any auditor, regardless of their
22 expertise, should be able to pick it up in

1 some period of time and do the job.

2 MR. MOORE: So I think Philip
3 Tetlock's work on accountability has a lot to
4 say on that question, that knowing the
5 interest and preferences of your audience play
6 a powerful role in determining the way you
7 think about the answer that you give them, and
8 your own motivations in formulating that
9 answer.

10 The Audit Committee of the Board
11 of Directors represents the owners of the
12 company and not its managers. Being directly
13 accountable to that Board of Directors and its
14 Audit Committee represents a substantial
15 improvement in terms of the accountability
16 that the auditors feel.

17 MR. BAZERMAN: I agree that there
18 are positive things about Sarbanes-Oxley, and
19 I think the Audit Committee is one those -- an
20 improvement over an inappropriate starting
21 point for discussion from my perspective.
22 Okay?

1 And when I think back to the
2 creation of Sarbanes-Oxley, by reading
3 Chairman Levitt's book and by reading The New
4 York Times, The Washington Post, pretty
5 carefully during that time period, I mean, it
6 is important that we realize why we are here
7 today on the auditor rotation question.

8 There was an enormous amount of
9 lobbying by four firms in order to change what
10 auditor rotation said in the final bill.

11 Okay? Up until days before, best estimates
12 from the media at least was that auditor
13 rotation meant firm rotation. And there were
14 four firms that did a great job in changing
15 that to their own benefit.

16 Of course, there had to be some
17 compromises. There was a public outrage that
18 Don spoke about during that time period. And
19 so for me the Audit Committee is a good thing
20 in comparison to a status quo that shouldn't
21 be the basis of comparison. And it is very
22 weak in comparison to what the ingredients

1 would look like in a true independent audit
2 system.

3 MEMBER FRANZEL: So let me try to
4 interpret what you are saying. If we were to
5 find the tools to remove some of these
6 structural impediments to independence, and
7 knowing it is not going to be perfect because
8 we are dealing with humans -- in addition,
9 there are an awful lot of other pressures
10 during the course of an audit that we are not
11 even talking about.

12 But assuming that we are able to
13 fix some of those impediments, all of these
14 problems still exist, because of the human
15 beings doing the audit. Am I interpreting you
16 correctly?

17 MR. BAZERMAN: No, I don't think
18 so.

19 MEMBER FRANZEL: That some of
20 these would counteract it appropriately?

21 MR. BAZERMAN: I think that 98
22 percent of the bias that we are talking about

1 -- we are talking about the human side rather
2 than the corrupt side -- I think 98 percent of
3 it is created by the incentives that auditors
4 across levels have in pleasing the client.

5 If we eliminate those incentives,
6 I think we are going to have a small amount of
7 remaining bias. But we are talking about a
8 trivial amount in comparison to the current
9 state.

10 MEMBER FRANZEL: Let me just add
11 some of the other pressures, then, that happen
12 during the course of an audit. You know,
13 there are complex technical issues with a
14 range of possible answers, potential
15 disagreement among the team or even with the
16 client, deadlines, heavy workloads, and then
17 deadlines as they approach and get closer. So
18 that is how an audit works.

19 Under a scenario where some of the
20 structural impediments are fixed or removed or
21 counteracted, how do these types of pressures
22 impact auditor independence?

1 MR. MOORE: So the complexity of
2 the technical issues to which you make
3 reference opens room for ambiguity where human
4 judgment can allow smart people to come to
5 different interpretations of the same
6 evidence.

7 And that is where our self-
8 interest and our human preference can affect
9 the way we interpret evidence, and the
10 evidence is quite -- the psychological
11 research evidence is quite clear that we are
12 very good at interpreting ambiguous evidence
13 in ways that it is consistent with our own
14 self-interest.

15 One of the ways in which people
16 justify decisions to protect themselves
17 produces escalation of commitment to a
18 previously selected course of action. And
19 that is high on the list of the problems into
20 which auditors are likely to get themselves
21 when they make a judgment call in one year
22 that then gets a little worse the next year,

1 but they feel like to reverse themselves on
2 the call they made the year before would be to
3 be inconsistent.

4 And so they wind up escalating
5 their commitment to allowing the client to
6 push the envelope a little further. The
7 rotation of the audit firm helps that problem
8 substantially.

9 MEMBER HARRIS: What facts or
10 examples would you point to that the system is
11 not working? And, granted, your behavioral
12 analysis with respect to the need for
13 independence in the conflicts, but what are
14 the underlying, as I say, facts or examples
15 that point to you that the system is not
16 working the way it should?

17 And then, once again, dealing with
18 the issue of the cost-benefit analysis, how
19 would you measure the benefits of changing the
20 current system versus the cost.

21 MR. MOORE: So it is a little bit
22 hard to know where to begin on problems.

1 There is evidence consistent with the notion
2 that long-term relationships between auditors
3 and their clients color the way that they see
4 their role and the way they interpret
5 information, everything from auditors
6 referring to themselves as partners to
7 differences of opinion in the interpretation
8 of accounting from internal auditors to the
9 inspectors of the PCAOB and other
10 organizations.

11 The Concept Release, which I found
12 very impressive, insightful, honest, and
13 thorough, goes into some detail on the
14 discrepancies that your organization has found
15 with the way that audits have been conducted
16 in the past.

17 On the other hand, we don't have
18 the other condition -- the condition in which
19 we could compare those same audit reports with
20 the alternative world that we are imagining.
21 And so we will forever be hamstrung in our
22 ability to answer that question.

1 MR. BAZERMAN: But I will try
2 anyhow.

3 (Laughter.)

4 So we have an enormous number of
5 important cases of companies engaging in
6 egregious behavior, where the audit firm was
7 held to be partially culpable. Those audit
8 firms can either decide to come forward and
9 say, "Yes, we were corrupt, we did that
10 intentionally" -- and I think that that is not
11 the best guess of what happened.

12 My best guess of what happened --
13 and it is the only other viable explanation
14 for how they could get it wrong so often -- is
15 that because of the incentives that we have
16 been talking about, honest people with
17 reasonable talent simply didn't notice.

18 If we think about Bernie Madoff's
19 funds, I think that the evidence is pretty
20 clear he was a bad guy. He was in the
21 intentional corruption category. But I think
22 the more interesting category is, who are all

1 of those other people who were supposed to
2 have noticed that those returns weren't
3 possible?

4 I don't think we want to go after
5 the auditor. It turns out it is a fairly
6 small auditor in that case, but there were
7 lots of other feeder funds who were also
8 audited. And the auditors didn't notice that
9 anything was wrong. Again, it's possible that
10 they were just truly corrupt, but I think a
11 far more likely explanation is that they had
12 an incentive to not notice, and that they
13 didn't notice.

14 I find the book about the
15 financial collapse by Gretchen Morgenson to be
16 a phenomenal read. And she talks not just
17 about auditors but all of the gatekeepers who
18 just didn't notice.

19 And what is unique about auditors,
20 what makes them different from all of the
21 other gatekeepers, is that is their whole
22 business. Auditors are in the business of

1 noticing when something is wrong. If they are
2 not going to notice when something is wrong,
3 it is unclear why we pay for this function to
4 exist in society.

5 And we clearly know that the
6 auditors didn't see massive problems at a
7 variety of the major organizations that were
8 central to the financial collapse. Once
9 again, the auditors can come forward and say,
10 "That was intentional, and we were corrupt,"
11 okay, but I don't think that that is the most
12 likely case.

13 I think the much more likely case
14 is that they have an incentive to not notice.
15 And as a result, they didn't notice lots and
16 lots of things that they should have noticed,
17 and they may well have noticed if we could
18 rerun those conditions under a true
19 independent auditor system in this country.

20 Thank you for the question.

21 CHAIRMAN DOTY: I want to -- I am
22 not -- I don't often have the chance to throw

1 a thought problem to a Harvard and a Berkeley
2 professor. And you may have thought this
3 through, but you may not. I just want to
4 leave it with you.

5 First, as to your analogy of the
6 tax collector, there are in this room those
7 who would say to you, as a behavioral matter,
8 the auditor really is -- of course is not
9 supposed to be an advocate, but he is not a
10 prosecutor. The tax collector has the job of
11 collecting money for the fisc.

12 So that really what you are doing
13 is trying to hit a much finer slice of
14 behavior here, that in fact the objectivity
15 that you are striving for is one which is much
16 more difficult than the IRS agent has. And it
17 is much more difficult than the policeman, the
18 cop on the beat has. And so you need to think
19 about how refined your concepts need to be to
20 get there.

21 And the second thing is, the no
22 fire rule -- and this really gets down into

1 the weeds -- but people who are talking about
2 this tend to view the no fire rule as
3 incompatible with non-audit services.

4 In other words, I think you are
5 saying they should do no audit services,
6 because the possibility for bartering -- the
7 conflict for bartering for the audit services
8 is there. But also, as a behavioral matter,
9 there is concern that the no fire rule is
10 going to lead to back scratching, especially
11 if you think about an industry where, as we
12 heard today, there may be two audit firms that
13 can audit the particular industry. So that I
14 will scratch your back if you will scratch
15 mine.

16 I am going to be out in 10 years,
17 or I am going to be out in three years, and,
18 therefore, you know, make sure that -- I will
19 be back. In other words, if I am the
20 departing auditor, I will be back in five
21 years. So isn't there a behavioral concern
22 with back scratching and tradeoffs in the non-

1 audit service area?

2 MR. MOORE: That sounds like a
3 completely valid concern, that if anything it
4 is worse under the current system.

5 CHAIRMAN DOTY: Well, that is a
6 good academic answer.

7 (Laughter.)

8 I think, if it is all right, I'm
9 going to save a little bit time here. Lewis,
10 do you have --

11 MEMBER FERGUSON: One more.

12 CHAIRMAN DOTY: One more. Yes,
13 shoot.

14 MEMBER FERGUSON: If we were to
15 adopt -- you know, start from the beginning
16 again, theoretically, or if one were to do
17 that and put in a no fire rule, with or
18 without any limitations on other audit
19 services, this is a radical change if that
20 were to be the case.

21 What would your idea of an
22 appropriate tenure be? Because clearly what

1 you don't want to do is put people in the
2 situation where they can't be fired for years
3 and years and years and years.

4 And that would lead to runaway
5 auditors, and the auditor in fact making the
6 financial decisions for the company, which I
7 think is a great concern here, too, to keep
8 the auditor in his proper place as providing
9 attest services and not taking over the
10 financial management.

11 So what, in your model, is a
12 reasonable time period?

13 MR. BAZERMAN: So I am going to --
14 I am going to give a non-answer, but I will
15 try to be informative in my non-answer.

16 The first thing, you can imagine
17 on the no fire that people are concerned,
18 well, what if my auditor is truly incompetent?
19 Well, that could be something that you have to
20 bring to the PCAOB. So no fire without
21 bringing it to the PCAOB for review. Okay?
22 And if the PCAOB says you can fire mid-term,

1 so be it. I don't think that that destroys
2 anything that we said earlier.

3 In terms of the number of years,
4 my reaction is if you have the other pieces in
5 place, so that we are creating a true,
6 independent audit system in this country, I am
7 -- Don may have an opinion -- I am relatively
8 agnostic.

9 And this is where I would actually
10 defer to what ideally the investment
11 community, with people who have served on
12 Boards, who have some experience in the
13 auditing industry, could help inform what the
14 optimal number of years would be to basically
15 solve the fact that we don't want too many
16 transitions. On the other hand, we do want to
17 see some rotation.

18 So I am shockingly -- for an
19 opinionated guy, I am shockingly open on what
20 that number of years should be. But I would
21 argue that the process should be created by
22 the PCAOB to figure out that answer from

1 people who don't have a vested interest in
2 manipulating what that answer is.

3 MR. MOORE: As a tenured faculty
4 member, I am well aware of the problems and
5 incentives -- problematic incentives created
6 by no fire rules. But I think --

7 MR. BAZERMAN: There are benefits
8 if you are on the other side.

9 MR. MOORE: Indeed. The situation
10 that university faculty face is also
11 dramatically different from one that we are
12 imagining in which there would be a fixed
13 term, as in your university can't fire you for
14 a specific period of time, and then you have
15 to go look for another job that retains many
16 of the incentives to stay productive and to
17 keep doing your job well.

18 CHAIRMAN DOTY: I think we can
19 save a bit of time here, provide for a break,
20 get ready for the next panel.

21 This has been, to say the least,
22 stimulating. I have an idea it is not the

1 last occasion we will have to talk about all
2 of this. We thank you for coming this
3 distance and for sparring with us and for
4 indulging us in this kind of analysis. I
5 think it is very helpful.

6 MR. BAZERMAN: Thank you for
7 listening to us and talking with us.

8 CHAIRMAN DOTY: Thank you. We
9 have two panels coming up. And I think that
10 since Richard Kaplan is sitting here, and I
11 think -- is Jenkins here? Is he back here
12 anywhere? We could begin the panel -- let's
13 begin the next panel promptly at 10 minutes of
14 3:00.

15 We'll take a break. That gives us
16 a 10-minute break. The panel begins at 10 of
17 3:00, and that means we will have the leaders
18 of the five firms on at least by 4:00, which
19 is what we want to do.

20 Thank you both.

21 (Whereupon, the above-entitled
22 matter went off the record at 2:40 p.m. and

1 resumed at 2:54 p.m.)

2 CHAIRMAN DOTY: Ladies and
3 gentlemen, we have two distinguished
4 academicians with us. Greg Jenkins is the
5 professor of accounting and information
6 systems and the William S. Gay faculty fellow
7 at Virginia Polytechnic Institute and State
8 University. He is also the co-author of
9 Comprehensive Assurance and Systems Tool, it's
10 an integrated practice set, and he's the
11 author of a book, The Enron Collapse.

12 He's widely published, and he
13 routinely receives outstanding teacher awards,
14 and he has published some articles on this
15 very issue of auditor independence which are,
16 to say the least, stimulating and interesting
17 articles. And I think we'll get into that
18 this afternoon.

19 Richard L. Kaplan, Dick Kaplan, is
20 the Peer and Sarah Pedersen Professor of Law
21 at the University of Illinois at Urbana
22 Champaign. He graduated with honors from

1 Indiana, highest honors from Indiana, earned
2 his law degree from Yale. He practiced law in
3 Houston for a brief period of time with the
4 current chairman of the Public Company
5 Accounting Oversight Board, did not find his
6 career blighted by that. Got out early, went
7 on to better things, to the University of
8 Illinois.

9 He's an internationally recognized
10 expert on U.S. taxation and tax policy, and
11 has lectured on these areas in three
12 continents, testified before Congress, and has
13 written course books on income taxation and
14 international taxation. Notwithstanding that,
15 he has, as his presentation will explain,
16 considerable experience on the inside in the
17 audit profession, and for that reason brings
18 a unique perspective to bear.

19 Gentlemen. Greg, the floor is
20 yours.

21 MR. JENKINS: Thank you very much.
22 Chairman Doty, members of the Board and

1 others, it is my privilege to speak with you
2 today. I would like to begin by noting that
3 I currently serve on a team of academics
4 selected by the auditing section of the
5 American Accounting Association to synthesize
6 academic literature and other data relevant to
7 the Board's consideration of mandatory firm
8 rotation. My team provided your Board a draft
9 of this report in December of this past year.

10 My remarks this afternoon are my
11 own, and are not intended to represent the
12 views of my synthesis team members, the
13 American Accounting Association, certainly, or
14 the auditing section.

15 Auditor independence has been the
16 subject of research, a significant body of
17 research, over the years. I would like to
18 just briefly describe to you what this body of
19 research reveals about several relevant
20 issues: the influence of client economic
21 importance, the provision of non-audit
22 services to audit clients, rotation, and

1 certainly tenure; all of those and their
2 effect on auditor independence. I will then
3 conclude my remarks by sharing some data
4 related to audit firm tenure for the year
5 2010.

6 Turning now to economic
7 importance, concerns related to economic
8 importance are based, certainly, on the notion
9 that auditors become so economically dependent
10 on clients that they may, in fact, be willing
11 to compromise audit quality to maintain those
12 relationships. U.S.-based research -- and
13 that's important for me to note -- U.S.-based
14 research does not reveal an empirical basis
15 for these concerns.

16 There is, however, some non-U.S.-
17 based research which does find a positive
18 association between client importance and
19 impaired independence. The differences in the
20 findings of the U.S.- and non-U.S.-based
21 studies appear to stem from two things. One,
22 regulatory environments in the other

1 countries, and corporate governance practices.

2 For example, one non-U.S.-based
3 study examined data from New Zealand,
4 admittedly quite a different environment, but
5 nonetheless a country with a self-regulated
6 accounting profession that operates in a
7 weaker corporate governance environment.
8 Companies there are not required to establish
9 particular oversight mechanisms, such as audit
10 committees, and there is no ban at all on the
11 provision of non-audit services to audit
12 clients.

13 A second example relates to China,
14 where findings of impaired independence are
15 limited to a period of time there where there
16 was a very weak legal environment and very
17 little regulatory oversight. Following a
18 period of substantial legal and regulatory
19 reform in the early 2000s in China, the
20 evidence of impaired independence goes away.

21 Given the current legal and
22 regulatory environment in our own country, it

1 seems unlikely that these findings translate
2 to the United States.

3 Turning now to the influence of
4 non-audit services, as with the matter of
5 economic importance, numerous studies have
6 examined the influence of an audit firm
7 providing non-audit services to their audit
8 clients. These studies have investigated the
9 impact of non-audit services on earnings
10 management, perceptions of auditor
11 independence, financial statement re-
12 statements, and the issuance of modified audit
13 opinions, such as going concern opinions.

14 The overwhelming majority of these
15 studies, again, find no evidence to indicate
16 that the provision of non-audit services to
17 their clients, to their audit clients, leads
18 to impaired independence. An exception to
19 this overall observation is the finding by
20 some studies that the provision of non-audit
21 services does, in fact, lead to a perceived
22 loss of independence. However, a more recent

1 study that examines both pre- and post-SOX
2 data suggests that even that perceived loss of
3 independence may now have simply gone away.

4 Some have expressed concerns that
5 audit firms are earning significant amounts by
6 providing greater levels of non-audit services
7 to their audit clients. An analysis of the
8 audit and non-audit services fees paid by the
9 Fortune 500 from 2002 through 2010 is not
10 consistent with this assertion, however. The
11 level and mix of fees, following the initial
12 years of implementing Section 404
13 requirements, have been quite stable.

14 In fact, audit fees have averaged
15 8.9 million dollars, and non-audit service
16 fees have averaged 2.4 million dollars since
17 2007, so they have been quite flat for the
18 last four or five years. The non-audit
19 service fees, 2.4 million dollars, result
20 almost entirely from audit-related and tax
21 services activities.

22 Now turning to certainly a very

1 relevant issue, rotation and tenure. The
2 academic findings on rotation are mixed, with
3 no clear picture as to whether or not rotation
4 is beneficial. Adding to this lack of clarity
5 is the increasing realization that the
6 association between tenure and audit quality
7 is rather complex. The relationship appears
8 to depend on various factors, such as the
9 length of term limits, which there was quite
10 a bit of discussion on earlier, audit
11 complexity, industry specialization, and
12 lastly the legal liability environment.

13 I would like to now turn to some
14 preliminary data related to auditor tenure in
15 the United States for public companies for
16 2010, the most recent whole year for which
17 vendor-provided data are, in fact, available
18 to academics.

19 The average tenure of an auditor
20 of a public company in the United States at
21 the end of 2010 was 9.8 years. Tenure is
22 relatively similar for Deloitte, Ernst &

1 Young, and KPMG, with an average overall
2 tenure of 10.4 years. PwC has the longest
3 average tenure, of 12.1 years. The 16 next
4 largest firms have a combined average tenure
5 of 4.7 years, so there's a marked difference
6 there.

7 Tenures also differ substantially
8 across industries. For example, companies in
9 the financial, pharmaceutical, and computer
10 industries are audited by firms with the
11 shortest average tenure, of 8.1, 8.3, and 8.9
12 years, respectively. Companies, on the other
13 hand, in the durable manufacturing, chemicals,
14 and food industries are audited by firms with
15 the longest average tenures, of 12.2, 14.3,
16 and 14.9 years. I bring these data to your
17 attention because they indicate the
18 possibility of differential effects of firm
19 rotation requirements across industries.

20 There may also be differential
21 effects on the very largest audit firms as
22 well. An analysis of the client portfolios of

1 these firms reveals varying degrees of
2 industry concentration at the end of 2010.
3 For example, KPMG audits the greatest number
4 of companies in the financial industry, while
5 PwC audits the largest proportion of the
6 industry based on market capitalization.

7 Take another example. Ernst &
8 Young audits 40 percent of the companies in
9 the pharmaceutical industry, yet again PwC
10 audits almost 50 percent of the industry based
11 on market capitalization. Other industries,
12 such as retail and utilities, are mostly
13 dominated by Ernst & Young and Deloitte, both
14 in terms of the number of clients as well as
15 the market capitalization.

16 Industry concentrations such as
17 this reflects the market's endorsement of the
18 industry specialization of these firms.
19 Indeed, this endorsement is supported by
20 fairly strong academic evidence. Research
21 indicates that industry specialization is
22 closely associated with improved financial

1 reporting quality, improved disclosure
2 quality, fewer financial statement frauds, and
3 fewer re-statements.

4 In sum, mandatory firm rotation
5 may have significant unintended negative
6 consequences for companies that require
7 specialist auditors, if they are required to
8 retain an audit firm that possesses less
9 industry specialization than their former
10 audit firm.

11 I thank you for the opportunity to
12 speak with you today, and I hope my remarks
13 have been helpful. I look forward to
14 answering your questions.

15 CHAIRMAN DOTY: Thank you.

16 Richard?

17 MR. KAPLAN: Chairman Doty, Board
18 Members Harris, Ferguson, Hanson, and Franzel,
19 thank you very much for inviting me to present
20 this discussion this afternoon. I have taught
21 accounting for lawyers for many years, but the
22 main reason I'm here today is because in 2004

1 I published an article about the Sarbanes-
2 Oxley provisions dealing with auditor
3 independence.

4 That article was entitled "The
5 Mother of All Conflicts: Auditors and Their
6 Clients." It began with the essential
7 dichotomy set out by the Supreme Court in the
8 Arthur Young decision that described the role
9 of auditing firms as "a public watchdog."
10 That position, however, conflicts with the
11 very obvious reality that this public watchdog
12 is hired, paid for, and possibly fired by the
13 very companies that it's supposed to be
14 watching.

15 That essential problem of auditor
16 independence, however, is compounded when the
17 auditor-client relationship goes on for many
18 years, or even decades. Over that period of
19 time, the auditors begin to identify with the
20 client. They brag about the client to their
21 own recruits. They substitute trust for
22 skepticism. In short, they find that long-

1 term relationships are the antithesis of
2 auditor independence.

3 To this reality, the Sarbanes-
4 Oxley response was to rotate the engagement
5 and reviewing partners. That approach is
6 simply inadequate. A moment's reflection as
7 to the realities of what the context is will
8 make this clear.

9 Although the big accounting firms
10 have thousands of partners and multitudes of
11 clients, an individual partner, such as David
12 Duncan at Arthur Andersen, will typically have
13 relatively few clients, and as a result is
14 under tremendous pressure to, at least,
15 maintain those clients. Anyone who loses a
16 major client is going to have serious
17 consequences. Anyone who loses two is
18 basically committing professional suicide.

19 As a consequence, the partner that
20 is rotated out is typically someone who has
21 been the subject of respect in the office,
22 perhaps even veneration, who has no doubt been

1 the mentor to many of the younger partners,
2 quite possibly including one of the partners
3 who's being rotated in as a new engagement
4 partner.

5 In that context, how likely is it
6 that this new partner is going to challenge
7 the decisions and judgments made by her
8 predecessor, who has probably in fact promoted
9 her very career? It is far better, in this
10 context, to change accounting firms. Then you
11 would be aligning the interests of accounting
12 firms with that of the investing public. Then
13 you have accounting firms with a professional
14 incentive to question the judgments of the
15 past, to ferret out the disputes, to have no
16 intellectual investment to what was done
17 before.

18 They have never met SALY -- that's
19 SALY, same as last year. They weren't here
20 last year, therefore they're going to take a
21 look at everything afresh. In fact, the most
22 comprehensive audits are the first-year

1 audits, when new auditors come in. Because
2 they don't know where the issues are, they
3 look at everything. The more frequently we
4 can have first-year audits, the better in
5 terms of having independent assessment of what
6 is going on.

7 There is no doubt that having
8 auditor rotation would accelerate and have
9 more frequent first-year comprehensive audits.
10 There's been a lot of discussion about higher
11 fees. The prior panel, I thought, dealt very
12 effectively with that. If we're going to have
13 audits at all, the question is what are we
14 getting? That is, frequent turnover would
15 enhance the value of those audits, giving
16 credibility to them. And a cost/benefit
17 analysis must also examine the benefit of
18 those frequent audits, not just their cost.

19 More importantly, once accounting
20 firms realize that they also have a chance to
21 audit some of these companies that have had
22 the same auditor for decades, that these

1 relationships are not fixed in stone and are
2 not locked up, there will be an incentive to
3 develop the kind of industry-specific
4 expertise that has heretofore been cabined in
5 only a few firms. As a result, we will have
6 more accounting firms being able to compete,
7 more accounting firms to provide that
8 expertise. And as a consequence, it is quite
9 likely that fees would actually go down.

10 I would be pleased to answer
11 whatever questions you have, and thank you
12 very much.

13 CHAIRMAN DOTY: Thank you both.
14 Jeanette?

15 MEMBER FRANZEL: Mr. Jenkins, I'd
16 be interested in hearing more detail behind
17 the statement that you made that the academic
18 results of research is mixed when looking at
19 audit firm tenure and the evidence of
20 impairment. And Mr. Kaplan, I'd be interested
21 in hearing your views on that.

22 MR. JENKINS: The challenge with

1 this particular literature is that we do not
2 have history with mandatory firm rotation.
3 Spain did require mandatory firm rotation at
4 one point in time, and just prior to the
5 mandatory rotation taking effect the Spanish
6 government eliminated that rotation.

7 Now, interestingly enough, the
8 study that was done around that timeframe of
9 approximately seven years in Spain actually
10 found no difference in terms of the nature of
11 the audit report that was issued for firms
12 where there was firm rotation and those where
13 there was no firm rotation. So I can give you
14 that one example, but again we don't have a
15 lot of history with firm rotation.

16 Now, in terms of partner rotation
17 and the idea that a fresh set of eyes is a
18 good thing, that's intuitively appealing to
19 me. And I think it's intuitively appealing to
20 many people. However, what the research tends
21 to show is that it's in the first two to three
22 years -- the first three years, I'll say it

1 this way -- the first three years where is the
2 greatest risk of a mis-statement not getting
3 captured.

4 Now, interestingly, the research
5 that addresses that particular point says
6 there is one very important attribute of the
7 new auditor in that first three years that
8 seems to mitigate the mis-statement not
9 getting captured, and that is is the auditor,
10 the new auditor, an industry specialist? And
11 the way specialist has been defined in the
12 accounting academic literature really is based
13 on industry concentration. Admittedly,
14 perhaps, not the best measure, but that is the
15 way it's been measured. And again, it's that
16 industry specialization that seems to catch
17 those mis-statements. But that's really kind
18 of the broad strokes of what we know about
19 that.

20 MR. KAPLAN: Thank you, Board
21 Member Franzel, for that question. There's no
22 doubt that auditor rotation is not a silver

1 bullet. What we're trying to do, however, is
2 to make it as effective as possible. That is,
3 there's no getting away from the fact that
4 it's still the client firm that is hiring
5 these people, that is negotiating the pay,
6 that is going to be firing them, that may
7 contract for other services.

8 But when you have the big
9 collapses -- not the minor re-statements, but
10 the big collapses of Enron, WorldCom, World
11 Strategy, and all the rest, Adelphi -- these
12 were long-term auditors. These were not
13 instances where they did not have the
14 expertise.

15 Accounting is really not as
16 difficult as it's frequently portrayed. As a
17 friend of mine describes, we're not talking
18 here about rocket surgery. There are four
19 sources of accounting failures: assets are
20 overstated, liabilities are hidden, revenues
21 are accelerated prematurely, expenses are
22 deferred. That's it.

1 All of the audit failures are a
2 variation on those themes, and most of the
3 times the accountants have seen what's going
4 on and have chosen not to report it. So their
5 incompetence is really not an issue. It's
6 their willingness to go along. It's their
7 willingness to say "Well, the problem wasn't
8 that bad last year. It was not material."
9 And so as a consequence, the real issue that
10 would be informative on your question is "How
11 many audit problems have we missed?"

12 That is, as long as the company is
13 doing well, we really don't know whether the
14 audit is all that good, because the only times
15 we find out is when the company collapses.
16 That's when we go around and see, why was this
17 not disclosed? And so the issue will be, is
18 it more likely that this issue will be
19 confronted and a different assessment made by
20 a new auditor? And that's where auditor
21 rotation tends to have its biggest benefit.

22 MEMBER HANSON: The paper, Greg,

1 that you mentioned, that was submitted to the
2 Board in December is helpful as a good survey.
3 And I'm just curious: you'd mentioned that
4 there's not a lot of data out there on
5 mandatory firm rotation schemes, but are you
6 aware of any studies that support the
7 conclusion that mandatory firm rotation
8 actually increases audit quality? I guess
9 either one of you.

10 MR. KAPLAN: Well, I'll go first.
11 Audit quality is very difficult to measure,
12 just to kind of reprise my prior point. That
13 is, there are a number of audit failures that
14 people don't notice because the company is
15 doing very well.

16 So it's only when the end of the
17 road is reached that then we ask. And so you
18 could say that you don't need audits at all if
19 a company is going to be making tons of profit
20 and is going to be doing well. The purpose of
21 the audit is to provide assurance that the
22 financial statements are at least some degree

1 of accurate.

2 And so what we regard as an audit
3 failure is when we have incontrovertible
4 evidence that it has failed. What we don't
5 know is when things are going along smoothly
6 for the company, the audits have not
7 necessarily been effective, but it doesn't
8 matter because the company is doing well and
9 no one's complaining.

10 So it's an issue about how we
11 define audit failures. The ones we see are
12 the ones where the company itself has failed.

13 MR. JENKINS: I would say that I'm
14 not aware of any studies that link rotation in
15 that fashion. There has been -- because we
16 don't have the situation where we can actually
17 assess firm rotation, there have been attempts
18 to address that issue through tenure, trying
19 to determine whether or not there's a
20 relationship between audit tenure and audit
21 quality.

22 And unfortunately, as I said, the

1 research is mixed. It indeed is. There are
2 some studies that suggest that tenure is
3 positively associated with quality, so the
4 longer the auditor's around, the higher the
5 quality, the higher the financial reporting
6 quality, less earnings management, and the
7 like. Other studies suggest it's the
8 opposite. Some studies find no relationship
9 at all.

10 Kind of an intriguing point is
11 that there are some studies that are
12 relatively recent that seem to suggest that
13 there's a particular sweet spot of tenure in
14 terms of when the audit quality is at its
15 peak. And there are just a couple of studies,
16 so I don't want to overstate this point, but
17 to address or answer your specific question,
18 the sweet spot seems to be somewhere between
19 14 and 16 years, based on the studies that
20 have been published. Well, one published and
21 one working paper.

22 However, there's an important

1 point that one of those studies makes, and
2 that is, there must be a very strict legal
3 liability environment in place. Meaning
4 litigation cost, litigation risk, is very
5 high, in order for that sweet spot to be
6 really that 14 to 16 years.

7 MR. KAPLAN: If I can come back to
8 that, remember that the singular form of the
9 word data is anecdote. And so if we take
10 another look back at the Arthur Andersen
11 instance with Enron, there you had an instance
12 where the partner in charge had a question
13 about the fair accounting treatment, and so he
14 referred it to the partners in the Chicago
15 office and asked what their assessment was.
16 And they came back, as a fresh set of eyes,
17 still within the same accounting firm, but
18 they had not been on this audit in years past,
19 and said that specific treatment would not
20 fly.

21 The partner in charge, however,
22 overruled that assessment of their own in-firm

1 experts -- so much for this role of industry-
2 specific expertise -- and then went ahead.
3 And an outside accounting firm, a different
4 firm, would not have had the kind of client
5 pressures that the Arthur Andersen partner
6 felt to maintain that client, and no doubt
7 would have made a different call.

8 So that's the kind of thing, that
9 what we are talking about is that auditor
10 rotation can bring a new set of eyes with no
11 reason to ratify prior judgments when the
12 client could say "Well, why are you objecting
13 to it now? Last year we did this, although it
14 was smaller." A new firm would come in and
15 say "This does not fly."

16 MEMBER FERGUSON: I am curious
17 about the statistic you cited, Professor
18 Jenkins, having to do with the average tenure
19 of the big four firms being 10.5 years, and
20 the average tenure of the next 16 firms being
21 4.1 years.

22 What explains that? Is that a

1 question of concentration? Is that a result
2 of concentration, where there are many more
3 firms as you get down to smaller firms who are
4 of roughly equivalent size? What explains
5 this vast difference in tenure depending on
6 the size of the audit firm?

7 MR. JENKINS: I'm not sure that
8 there is a satisfactory explanation that's
9 been put forth in the literature for why we
10 might see such a difference in tenure. I
11 might surmise that companies that are audited
12 by the larger firms may grow up, in some
13 fashion, with those firms.

14 As those companies grow, as they
15 experience growth and change, they have the
16 ability to reach out to their firm and receive
17 differing levels of expertise, insights, and
18 so forth, whereas in many cases smaller audit
19 firms, after a certain point in time, a
20 company may outgrow the expertise and also the
21 reach, the physical reach and resources -- the
22 capacity, even -- of some of the smaller

1 firms.

2 I would mention an interesting
3 study that is very, very recent, and that is
4 this idea of concentration, industry
5 concentration. And the study actually finds
6 that concentration itself is not a problem
7 when there is adequate competition. And
8 adequate competition in the case of this
9 particular paper is defined as simply other
10 firms being actively pursuing clients. It's
11 when the clients really have nowhere else to
12 turn that, these particular authors suggest,
13 you get into a problematic situation where the
14 auditor is not able, at that point, to be as
15 independent, if you will.

16 MEMBER FERGUSON: But we heard
17 this morning, repeatedly, that one of the
18 problems with mandatory rotation is because of
19 particularly the provision of non-audit
20 services, that there are independent problems,
21 and in fact for many very large companies
22 there isn't an option, or at most one other

1 option. How does that square with what you
2 just said?

3 MR. JENKINS: Well, the idea that
4 you have a situation where a company is
5 reaching out to a, quote, "specialist
6 auditor," and they have received or are
7 receiving non-audit services from a number of
8 other firms, perhaps including one or two or
9 several, all of the other big firms, it really
10 eliminates choice. I mean, that is a very
11 real situation.

12 The study that I'm referring to
13 not only looks at the United States, but over
14 40 other countries. And so the reality is, in
15 some cases, there is not a lot of choice,
16 because of industry specialization, because at
17 a particular point in time a company is
18 receiving various non-audit services from
19 other firms, such that those firms are not
20 currently independent.

21 MEMBER FERGUSON: But if there's
22 no choice, there can be no competition. Isn't

1 that correct?

2 MR. JENKINS: That is true.

3 MR. KAPLAN: Mr. Ferguson, if I
4 could weigh in on that, just briefly? I saw
5 the same reference in the Wall Street Journal
6 article on Tuesday, and my reaction to that
7 was "Then you should not be using those
8 accounting firms for non-audit services."
9 That is, you could hire actuaries. You could
10 hire other consultants.

11 There are other firms in the
12 marketplace that provide these other services,
13 with one exception, and that's auditing. The
14 only service that can be done by accounting
15 firms exclusively is auditing. That should be
16 their primary focus, and these other services
17 are ancillary, even when they're done by non-
18 auditing firms.

19 The point is that if there is a
20 problem with competition, then maybe you
21 should not be using accounting firms for these
22 other services. You should hire actuaries,

1 consultants, law firms, Baker Botts, somebody
2 else to do that. There is only one thing,
3 only one source for auditing, and that's
4 auditing firms.

5 If they are not interested in
6 providing that service -- and this has been an
7 interesting point that was raised in the
8 earlier panel, that is, this identification
9 with the client, this partnering. When did
10 this happen? Well, it's hard to pin this
11 exact point down, but at one point, in fact,
12 accounting firms took great pride in their
13 independence, in their willingness to tell
14 some client to take to the road.

15 Then there was this opening up of
16 advertising, advertising professional
17 services, raising two issues: what are you
18 going to brag about? Namely, that we are the
19 sternest ones around. And who is your
20 audience? It's not the investors. It's
21 managers. And so the focus in all those
22 instances is, once you start advertising, you

1 need to advertise what you're going to be
2 doing.

3 And at that point, the accounting
4 firm faced a real issue: where do we treat
5 auditing services? Is it our main reason, or
6 is it just a loss leader? Is it just a reason
7 to get the foot in the door so that we can
8 sell high-margin other services that do not
9 have the kind of commodification that auditing
10 services have become?

11 If we're interested in having
12 independent auditors, that should be their
13 primary focus, and perhaps some of these non-
14 audit services that they're providing, which
15 disqualify them from being auditor
16 possibilities, should be discontinued by them
17 in favor of other companies that do not have
18 auditing as part of their portfolio.

19 MEMBER HARRIS: So we've heard
20 different views with respect to how audit
21 rotation will impact competition. Some
22 believe fervently that it will diminish

1 competition. Others believe that it will
2 increase competition. I'd like to get the
3 views of each of you on that issue.

4 And then I'm led to believe that
5 certain sectors are quite heavily
6 concentrated. Commercial banking, I gather
7 only two firms audit 70 percent. Energy, only
8 two firms audit 72 percent.

9 Telecommunications, two firms audit 89
10 percent. Utilities, two firms audit 91
11 percent. How do we promote competition in
12 these sectors? And what would the impact be
13 with respect to audit rotation, pro or con?

14 MR. KAPLAN: As I suggested, one
15 of the reasons that that concentration that
16 you pointed out has existed is because the
17 auditors knew that they had a potential
18 annuity here. That is, that there was never
19 an endpoint in sight, that therefore they
20 could develop that kind of expertise because
21 they would have a long-term payoff, and it
22 also meant that they could ignore other kinds

1 of accounting, other sectors of the business
2 world, and just focus on utilities, on
3 telecommunications, on financial services, and
4 be known as that one.

5 If the client firms have to
6 rotate, then the other firms will say "Maybe
7 we should learn something about normalization
8 of utility costs, because now we actually have
9 a chance of auditing Georgia Power." It will
10 not be locked up with whoever's been doing
11 that for the last seven decades, and as a
12 consequence there will be this effort to
13 develop expertise and provide a bid, because
14 now they know that, whatever else has
15 happened, that company has to switch auditors
16 after five years, or whatever, and therefore
17 we have as good a chance as everyone else.
18 We're not going to be competing against a firm
19 that has been there for five decades and has
20 developed all these social and financial
21 relationships.

22 Once that expertise is developed,

1 there may be other firms that will grow, and
2 the firms beyond the big four will develop
3 that expertise, and you will see more
4 competition for all of these audits because
5 they'll all be in play. And the flip-side of
6 those statistics that you quite correctly
7 pointed out is that all of those companies are
8 basically hands-off. There's no point
9 learning anything about them, because they are
10 going to stay with the present auditors and
11 there's no reason to develop any
12 countervailing expertise.

13 Once that link is broken, once
14 that lock-in is stopped, then companies will
15 respond, and we will see more auditing firms
16 become eligible to be part of this auditing
17 pool. And with competition comes lower fees,
18 I'm told.

19 MR. JENKINS: To the extent that
20 an audit firm is interested in pursuing
21 providing audit services to a company, if they
22 do not have the expertise in-house, it would

1 seem a fairly logical step for them to go hire
2 people that do have the expertise. Either
3 develop that expertise in-house in some
4 fashion, or simply over time hire individuals
5 that do have the expertise.

6 And so to me, that's a logical
7 response to this idea of "Well, I want to
8 audit a particular company. Perhaps they've
9 been locked in for some extended period of
10 time, but I think I can provide some services
11 to that company, and so I'm going to prepare
12 to do that."

13 Well, one of the curious issues to
14 me is this: if we have rotation, what does
15 that mean for the individuals who have been
16 working for the accounting firm, the auditing
17 firm, that have been doing the audit? If, for
18 example, just taking the large firms in
19 alphabetical order, if the company is required
20 to rotate from Deloitte to Ernst & Young,
21 what's to stop some of the employees who have
22 been employed with Deloitte for some period of

1 time by migrating to Ernst & Young?

2 Would a rotation requirement
3 essentially eliminate the possibility that
4 audit professionals could change jobs? Or
5 would there be some level that would not be
6 allowed to change? So perhaps partners would
7 not be allowed to go from one firm to another
8 firm, or maybe senior managers?

9 And so without there being some
10 mechanism in place to ensure that you don't
11 have a movement of talent, a movement of the
12 expertise in some sense, you could potentially
13 have a situation where rotation occurs but
14 it's not clear that the people doing the audit
15 necessarily are really new people.

16 In fact, speaking of anecdotes, I
17 have a colleague who spent a significant
18 amount of time in a southern state -- not
19 necessary to name it -- but he talked about a
20 particular large city in this state that had
21 a requirement that the audit firm rotate every
22 three years. And there was kind of this

1 almost running joke in this city that the job
2 rotated back and forth between two firms, and
3 one of the firms would simply hire the people
4 from the other firm to do the work.

5 So there was rotation -- there was
6 a different signing firm -- but the personnel
7 doing the work were effectively the same
8 people. So to me rotation also has to
9 consider, are you going to allow people to
10 move or not move? And what level will you
11 limit that at?

12 CHAIRMAN DOTY: Well, we do see
13 and take consideration of a number of the
14 implementation issues involved with rotation.
15 You're going to have to do that. On the other
16 hand, firms do have -- major firms have
17 different approaches to the audit. They have
18 different procedures, they have different
19 manuals, they have different processes,
20 different training. They have different
21 reviewing partners. The kind of partners
22 you're talking about would be subject to a

1 different engagement quality review.

2 So I'm not sure the Board would
3 ever prohibit people moving. I think in
4 invoking and defining independence standards,
5 we would want to have a look at all of the
6 practical implementation aspects of it. But
7 you do -- I think in your work, you do
8 acknowledge that there is a correlation
9 between the perception of independence, of
10 enhanced independence, and rotation. I think.

11 And the question would be, isn't
12 that a starting point whereby we ought
13 seriously to consider what could be done by
14 way of enhancing independence, consistent with
15 addressing this kind of practical
16 consideration, implementation consideration,
17 but that we have to consider the effects on
18 perception. Isn't that just as important to
19 the credibility of the audit and the survival
20 of the profession as independence in fact?

21 MR. JENKINS: I would agree with
22 your assertion that there is an association

1 with the perception of independence when there
2 is a rotation. However, I'm not sure which is
3 more important, independence in fact or
4 independence in appearance. I don't know the
5 answer to that question. I think if you ask
6 people, you'll get different answers, just
7 like you're getting kind of different
8 perspectives on rotation.

9 Clearly, you have to be
10 independent in fact for there to be quality
11 there. You need to be independent in
12 appearance for people to believe there is a
13 high level of audit quality. So I would say
14 that. But let me also say this: there's
15 really no one definition of independence
16 that's been accepted.

17 And people tend to have this
18 intuition about what independence is. There
19 seems to be this notion that independence is
20 a dichotomous state: you're independent,
21 you're not independent. And I'm not convinced
22 that that's the right notion, that perhaps

1 independence is on a continuum. You can be
2 more or less independent. And so it seems as
3 though we approach it from the perspective of
4 you are or you aren't.

5 CHAIRMAN DOTY: That is an
6 interesting comment, Greg Jenkins. Because of
7 course the legal consequence is, you're either
8 independent or you're not. You are pointing
9 to an area where I wanted to ask you about
10 anyway, and that's the extent to which either
11 of you or both of you think that independence
12 in fact comes to rest in the mind of the
13 auditor.

14 I mean, at the end of the day,
15 aren't we left with the duty, as a regulatory
16 body, of trying to make reasonable conjectures
17 about how we think standards and rules and
18 existing arrangements in the industry might
19 affect the mind of the auditor? Do we have
20 anything better to work with than our
21 pragmatic experience of what we see regarding
22 the mind of the auditor?

1 MR. JENKINS: Let me -- that's a
2 good question.

3 CHAIRMAN DOTY: Well, it may be a
4 bad question.

5 MR. JENKINS: I think there is
6 some sense that independence is, indeed, in
7 the mind of the auditor: "Am I independent or
8 am I not?" But as your previous panelists
9 suggested, it's not clear that you would
10 necessarily even know whether or not you were
11 really independent. You would know whether or
12 not you were independent, perhaps, in terms of
13 referencing some set of rules. But are you
14 independent in fact? Well, you know, maybe
15 there's some debate about that. Or perhaps
16 there's not debate. It's hard for you to
17 know, exactly, whether you are independent.

18 You know, I'm reminded, as we
19 think about this, of the way the accounting
20 profession viewed independence many, many
21 years ago, in the early part of the 1900s,
22 which was -- independence wasn't even defined.

1 And the notion at that point was this: if I
2 have to define independence for you, you don't
3 know what it is. And in fact, the way the
4 profession viewed independence was "It's each
5 of our individual responsibility, as a CPA, to
6 find individuals who are not -- just in their
7 being -- independent, and get them out of the
8 profession." And the feeling was, you simply
9 cannot define it.

10 And clearly, we've gone a long way
11 from that in terms of trying to structure,
12 create rules and structure rules to try to
13 define situations where there are conflicts of
14 interest, and so consequently maybe a loss of
15 independence.

16 CHAIRMAN DOTY: Well, we tend to
17 deal with the miscreants, the people who
18 shouldn't be in auditing, on an individual,
19 specific basis, as a Board. That seems to be
20 consistent with accountability. It seems to
21 be what social norms want now.

22 But what I was really trying to

1 tease out of you, or get you to think about is
2 if, as Arthur Levitt says, there's just
3 something that feels better about a company
4 that has changed its auditors every 10 or 15
5 years, or at least has disclosed why it
6 didn't, isn't that the perception issue?

7 And doesn't that suggest that in
8 the current milieu, in which there is a lot
9 being written and said about the crisis in
10 auditing and the confidence in auditing, and
11 the confidence in the audit opinion, shouldn't
12 we be preeminently concerned with perception,
13 even if it means not necessarily having the
14 ability to define independence in any given
15 case, or to demonstrate a lack of
16 independence, to tie it to any data base?

17 MEMBER FERGUSON: Isn't it also
18 possible that the reason that there's a
19 difference in the perception and the reality
20 of independence with respect to audit tenure
21 is, in fact, the perception is a recognition
22 by a lot of people of the kinds of

1 psychological realities that the previous
2 panel talked about? That, in our human
3 experience, long relationships tend to lead to
4 identification, that you become identified --
5 the two parties that have been related a long
6 time become psychologically identified. And
7 that's what people looking at this, from a
8 perceptual standpoint, intuitively understand,
9 and that's why you get it.

10 Is that possible?

11 MR. KAPLAN: It's certainly
12 possible. Of course, part of the perception
13 gets you into the expectations gap. That is,
14 ordinary investors typically see the audit
15 certificate as akin to the Good Housekeeping
16 Seal of Approval. They think this means that,
17 at a minimum, all of the money is there, the
18 company will not go bankrupt if you invest in
19 it based on what's going on. And they're not
20 interested in the fine points of Generally
21 Accepted Accounting Principles, or that. They
22 think that this shows that it's an independent

1 check of management, sort of "What is
2 independence? Well, it means that you're not
3 a full-time employee of the company.
4 Otherwise, we'd just use the internal audit
5 staff."

6 The Supreme Court's description of
7 the role of the independent auditor as being
8 "to elevate the interests of the public" sets
9 up a certain anomaly. The public does not
10 hire, fire, or pay for these auditors. If
11 that were the case, we'd have the Securities
12 and Exchange Commission send out a team of
13 auditors, like the Internal Revenue Service
14 does. It says "These are independent
15 auditors. They work for the public. They are
16 not going to be having any connection with the
17 company."

18 We're already indulging in a bit
19 of, shall we say, make-believe, thinking that
20 companies who are going to be hiring, firing,
21 and paying for auditors are going to be doing
22 so looking for the sternest, the most

1 objective ones. No, they're going to be
2 looking for people with whom they can get
3 along, who have good chemistry and so forth.

4 And what that means is that
5 independence is, as Greg indicated, a bit of
6 a continuum. But what we're trying to do is
7 maximize not just the perception of
8 independence, but the reality. The fact of
9 the matter is, the current system has neither
10 one, when we have major companies imploding
11 and people having their 401(k) become a
12 201(k).

13 You can ask any of them what they
14 think independence means, and they'd basically
15 say "I didn't think we were investing in
16 companies that had no there there." As a
17 consequence, it's helpful to get someone who
18 will look back and say "Why have you always
19 done it this way before?" And so if the
20 accounting firm says "Well, this special-
21 purpose entity" -- and this is, again, not a
22 hypo, going back to Arthur Andersen -- "need

1 not be consolidated. Those liabilities can be
2 kept off the balance sheet as long as you
3 don't own more than 97 percent."

4 That doesn't pass the giggle test,
5 and yet it went through the accounting firm
6 year after year. Maybe some other accounting
7 firm would have come in and said "Are you
8 kidding me? Of course you've got to show
9 these liabilities." And so I would suggest
10 that independence in fact, of course, is more
11 important. But unless we are going to
12 radically change the system even more than the
13 paradigmatic shift of this proposal, it's
14 probably off the table.

15 CHAIRMAN DOTY: Are there any
16 other questions from Board members?

17 MEMBER HANSON: I just want to
18 conclude with one last question. The other --
19 and I've asked this of the other panelists,
20 too. Our Concept Release was about auditor
21 independence, objectivity, and professional
22 skepticism, and mandatory rotation is but one

1 item that we can consider. And I'm curious to
2 hear about other things that you think we
3 should be thinking about. Because it's been
4 acknowledged by many of the panelists that
5 this is not a silver bullet. This isn't going
6 to fix everything. What other things should
7 we be thinking about with respect to
8 improvements to independence, objectivity, and
9 skepticism?

10 MR. JENKINS: One of the things
11 that occurs to me is this notion that it would
12 be quite helpful for there to be a bit more
13 sunshine around audit failures. More
14 specifics: what went wrong, how did it go
15 wrong, what could have been done to prevent
16 it? Were people simply incompetent? Were
17 people thinking "Well, I'm going to lose a lot
18 of money here," or "This may be my second
19 client loss," and that's, as Mr. Kaplan said,
20 professional suicide. But really do -- taking
21 this idea almost of what physicians do when
22 there's been a medical error.

1 When there's an audit error -- an
2 audit failure, as the term is being used here
3 -- what is the lesson? What's the takeaway?
4 Now, I recognize that the Board puts out 4010
5 reports, kind of these observations, trends
6 and so forth that you see. But really being
7 able to have, in much greater, much finer
8 detail, "This is the failure. This is how it
9 happened. These are the circumstances.
10 Here's how to fix it," I think that that would
11 be something that would be quite helpful.

12 CHAIRMAN DOTY: If the identity of
13 the issuers in Part 1 and the backup
14 conclusions that we might make in Part 2 of
15 our report on quality control things that we
16 thought should be fixed in the firm, if those
17 were made available on real-time basis, you
18 think that would do a lot for the problems
19 that we face?

20 MR. KAPLAN: It certainly would,
21 but we shouldn't think that that will be the
22 complete answer. Because the history of the

1 development of auditing standards, for
2 example, is basically closing the barn door
3 after the proverbial horse has left.

4 That is, at one time auditors did
5 not do counts of physical inventory. That
6 changed. Why? Did the accounting profession
7 sit around and think "Well, we ought to
8 physically observe the inventory?" No. There
9 was an audit failure, a company went belly-up.
10 This is McKesson & Robbins. And so they said
11 "From now on, every single inventory will be
12 physically observed."

13 Then there were issues about
14 accounts receivable, and they were not
15 completely there. So another company
16 collapsed, and they said we should circularize
17 and make sure that the big ones are there.
18 And so there has always been this chasing the
19 last problem, and the real issue is what's
20 going to be on the horizon for the next
21 special purpose entity, the next derivative,
22 the next item?

1 It's certainly a good idea to say
2 that they didn't follow the procedures, if
3 that was the case. But usually it's not a
4 matter of incompetence, it's a matter of a
5 novelty, a novel situation or financial
6 instrument being created, one that might have
7 favorable tax consequences, that is treated
8 not as debt for tax purposes, or is treated as
9 debt for tax purposes but doesn't have to be
10 shown on the balance sheet for financial
11 accounting purposes. This is a major part of
12 the intellectual activity.

13 And so then there is this game of
14 leapfrog with the regulator. "Well, I don't
15 see anything here that forbids it." I think
16 there's a reason why the Concept Release
17 specifically included at the end "professional
18 skepticism." It should not be reliant simply
19 on "Where is it written that you may not do
20 this?" It's a matter of instilling
21 professional judgment, instilling professional
22 pride.

1 In fact, I would prefer if the
2 audit fees did go up, rather than using the
3 audit as a loss leader, so that people took
4 pride in the idea of catching these disasters
5 before they circulate throughout the financial
6 system and cause people to withdraw from
7 equity markets entirely.

8 CHAIRMAN DOTY: I think the chief
9 auditor may have a question.

10 MR. BAUMANN: I do. Thank you,
11 Mr. Chairman.

12 Professor Jenkins, just a couple
13 of questions. One, when you talked about the
14 average tenure of clients at the various
15 different firms, I wondered if you had done
16 any work on stratifying tenure by size, and
17 how that might be differentiated. And then I
18 have one more question.

19 MR. JENKINS: I cannot tell you --
20 I can't take the deciles, all the public
21 companies, break them into tenths, and tell
22 you what the average tenures are as I sit here

1 now. I can tell you, if you want to meet
2 afterwards, I'd be happy to provide that to
3 the Board.

4 But I can tell you, when you look
5 at the public companies for the United States
6 by market cap, taking each percentile of the
7 market, you could basically just draw a
8 straight upwards-sloping line and what you
9 would see, on average, is that tenure
10 increases with time. So the bigger the
11 companies, the longer the tenure.

12 MR. BAUMANN: Good. Thanks. And
13 then, with respect to the comment you made
14 earlier -- and I think we appreciate very much
15 the work you did on the synthesis, and it's
16 very valuable work for us. So thank you for
17 doing that. But there is a fundamental
18 problem with respect to that, and I think
19 you've pointed it out, in terms of that
20 research, in that even the comment that
21 there's potentially greater risk in years one,
22 two, and three of an audit, that's in a

1 voluntary rotation environment. So therefore
2 the real problem with research in this area
3 is, we don't have experience and research in
4 a mandatory environment. Correct?

5 MR. JENKINS: That is correct,
6 absolutely.

7 MR. BAUMANN: And that's a
8 limitation, too, to the studies.

9 MR. JENKINS: Absolutely, it is.
10 It is.

11 MR. BAUMANN: Thanks.

12 CHAIRMAN DOTY: And I think,
13 Steven, you had one?

14 MEMBER HARRIS: Yes. Professor
15 Jenkins, I think you recommended that maybe we
16 do a little bit more with respect to getting
17 the specifics around audit failures and some
18 of the lessons learned, and I think the CAQ
19 has done some work in terms of the fraud
20 center looking at issues related to that.
21 What is your vision behind that, and what
22 exactly do you think the PCAOB ought to do in

1 the area of either doing a forensic study, or
2 setting up some kind of a division within the
3 PCAOB? What do you have in mind?

4 MR. JENKINS: I don't necessarily
5 assume that the PCAOB should do this, but
6 rather I think that there should be some
7 mechanism -- and perhaps it could be done
8 through the CAQ. It could be done through the
9 PCAOB, or perhaps some other mechanism,
10 whereby the firms share the best approaches to
11 addressing audit failures.

12 They all have the same standards
13 to follow, right? They all use the same
14 auditing standards. And while their
15 methodologies may be different, and their
16 procedures might be different, fundamentally,
17 at the end of the day, an audit's an audit.
18 You confirm accounts receivable, you send out
19 letters of inquiry, you have conversations
20 with the client. You do a lot of very similar
21 things.

22 And so my feeling is, would it be

1 useful if there would be some standing body
2 that would allow firms to come together and,
3 in a very -- in a legally safe environment,
4 have a very frank conversation about an audit
5 failure, and then talk about what could have
6 been done differently, so that those lessons
7 are then shared with other firms, other
8 auditors, so that we don't have those
9 problems?

10 I guess my feeling is, kind of
11 going back to "we respond after the barn
12 door's open," I agree with that. But at the
13 same time, to draw an analogy here, when
14 there's a plane crash, there is an
15 investigation, and there are steps taken to
16 try to prevent a crash like that from ever
17 happening again.

18 There will be other crashes.
19 There will be other audit failures. But my
20 question -- or my suggestion -- is, let's take
21 additional steps to try to learn from those
22 failures, other than just saying, "Well, it

1 looks like the auditors weren't independent.
2 They were making too much money, and they
3 really didn't want to question the client."

4 Maybe it is that simple in some
5 cases, but I'm not sure, given all the people
6 I know who are audit partners, I'm not sure
7 that it is that simple. I think these are men
8 and women who really do want to do the very
9 best job they can. So I would like to see
10 more open communication about problems when
11 they do occur.

12 MEMBER HARRIS: I think that may
13 very well be a good idea. I think there may
14 be an issue with respect to the firms sharing
15 proprietary information amongst themselves, so
16 whether that's something that we would want to
17 consider, I think, is an open question. Thank
18 you.

19 CHAIRMAN DOTY: We have run out of
20 time. We thank you both. It's been a
21 wonderful discussion. We have benefitted from
22 it. We will next have the heads of the

1 largest accounting firms. We will allow
2 ourselves five minutes, and we will start
3 promptly at 4:00.

4 (Whereupon, the above-entitled
5 meeting went off the record at 3:52 p.m., and
6 resumed at 4:00 p.m.)

7 CHAIRMAN DOTY: By prior agreement
8 with this distinguished panel, I have agreed
9 not to go through the credentials that each of
10 them has -- each of them has extensive
11 credentials -- but to identify them for who
12 they are and whom they represent.

13 John Veihmeyer is the CEO of KPMG
14 U.S. Robert Moritz, PricewaterhouseCoopers.
15 Stephen Howe, Ernst & Young. Joe Echevarria,
16 Deloitte & Touche. And Stephen Chipman, Grant
17 Thornton, LLP.

18 So we have the five heads of the
19 five largest audit firms here, and would like
20 to turn it over to you to begin your
21 statements. We know from your submitted
22 comment letters generally where you are on

1 this issue, but I think it would be very
2 useful for the audience to hear it. Stephen,
3 do you want to begin this?

4 MR. CHIPMAN: Thank you, Mr.
5 Chairman. Good afternoon. As you kindly
6 introduced me, I'm fortunate to be the CEO of
7 Grant Thornton in the United States. We are
8 part of a global organization that has 30,000
9 people operating in over 100 countries, and we
10 share the same global values, audit
11 methodologies, and commitment to audit quality
12 across all of those countries. In fact, I am
13 proud to have had the opportunity to have
14 lived and worked in Europe, China, and the
15 United States as part of my career with Grant
16 Thornton.

17 So I am pleased to be able to
18 address you today on this very important topic
19 of auditor independence and audit firm
20 rotation from the perspective of a firm that
21 focuses on serving dynamic organizations.
22 These organizations include a specific focus

1 on growth-oriented public companies, a core
2 segment of the U.S. economy.

3 Auditor independence, objectivity,
4 and skepticism are the foundation for trust in
5 business and are critical to the investor's
6 ability to rely on the auditing profession and
7 their role in the U.S. capital markets. As
8 such, the continuous enhancement of these
9 elements is an important effort and we
10 absolutely support it.

11 We believe that the vast majority
12 of auditors want to do what is right. They
13 undertake their professional responsibilities
14 with great seriousness. However, we also
15 believe that audit firm tenure over a period
16 of many decades can create, at a minimum, the
17 perception of a decreased level of auditor
18 objectivity. As ours is a profession that is
19 based on trust, it is important to remain
20 vigilant in our demonstration of that core
21 value.

22 In circumstances of extreme

1 tenure, mandatory firm rotation could be a
2 component of a potential solution to this
3 perceived loss of auditor objectivity,
4 although there is no empirical evidence in our
5 view to suggest that rotation would improve
6 audit quality, and its potential negative
7 consequences may well be very significant.
8 Specifically, adopting mandatory firm rotation
9 will have an effect on the overall cost,
10 conduct, and timing of an audit.

11 We believe that the costs will be
12 disproportionately higher for smaller public
13 companies, such as those in the Russell 2000,
14 for example, and in addition we believe that
15 in the initial years of implementation, that
16 this would be the most significant challenge,
17 while any improvements in audit quality,
18 should they occur, would not be seen in the
19 short term, and unfortunately may not be
20 measurable or identifiable at all.

21 We are also concerned that, if not
22 appropriately implemented, mandatory rotation

1 would accelerate a trend of large audits
2 gravitating to a small group of firms, and
3 therefore a change in audit appointment
4 patterns will further negatively affect audit
5 firm concentration.

6 So, respectfully, we caution the
7 Board not to assume that mandatory firm
8 rotation can address all of the audit quality
9 concerns identified by your Concept Release.

10 As the release indicates, there are many
11 factors that can unfavorably impact audit
12 quality. We have seen instances where two
13 seasoned and well-informed professionals may
14 well reach different judgments about the
15 sufficiency and appropriateness of audit
16 evidence, or even the range of acceptability
17 of a particular accounting estimate.

18 We suggest that the ongoing
19 efforts to improve audit quality -- evaluating
20 existing standards, drilling down on audit
21 deficiencies, and firm quality control
22 enhancements -- should continue to play a

1 significant part in informing the Board in its
2 decision on whether and how to implement a
3 rotation system. Clearly, professional
4 skepticism and related judgments are qualities
5 that can be influenced by factors unrelated to
6 audit tenure. They could include competency
7 of individuals, training, performance of the
8 audit professionals, as well as the audit
9 firms' quality control systems and tone at the
10 top.

11 We also echo concerns expressed by
12 certain audit committee members that a
13 mandatory firm requirement will impact their
14 governance responsibilities and activities.
15 Given the audit committee's current role to
16 appoint and approve all services, compensate
17 and oversee the audit firm, it's important to
18 consider the likely diminishment of the
19 relevance of the audit committee's role in the
20 financial reporting process. We are concerned
21 that a direct offshoot of mandatory firm
22 rotation could lead to less audit committee

1 interaction at precisely the time when we
2 believe more would be warranted.

3 As we wrestle with these important
4 issues, and particularly the issues of auditor
5 independence, objectivity, and skepticism, I
6 believe it is important for us to acknowledge
7 that the issue of pay model, where
8 organizations hire and compensate the
9 professionals who audit their financial
10 statements lies at the very heart of this
11 debate and discussion.

12 Many bright minds have debated and
13 researched this issue for decades. We've
14 certainly done so at Grant Thornton, and we've
15 invested a significant amount of time looking
16 at different solutions that could help with
17 some of these inherent conflicts. We've
18 considered options that would ensure the right
19 highly qualified professionals are engaged,
20 incented, and held accountable for providing
21 reasonable assurance about the completeness
22 and accuracy of financial information.

1 We've concluded, like many before
2 us, that any option that takes the retention
3 and compensation of the auditor out of the
4 hands of those responsible professionals --
5 professionals who are in the best position to
6 know the organization, the needs of the
7 entity, and the auditors' skills and
8 competencies -- would likely diminish audit
9 quality, perhaps significantly, and in doing
10 so harm investors.

11 So I call attention to these
12 challenges to stress the importance of
13 effective regulation and oversight, as well as
14 the commitment from regulators and the
15 profession to continue to work together and
16 collaborate on improving independence,
17 objectivity, and skepticism.

18 CHAIRMAN DOTY: Thank you, Mr.
19 Chipman. Mr. Echevarria of Deloitte.

20 MR. ECHEVARRIA: I want to first
21 thank Jim and the Board for putting this new
22 emphasis on independence, objectivity, and

1 professional skepticism. The Concept Release
2 was clearly a catalyst to encourage new ideas
3 and new thinking in ways to improve the vital
4 role that auditors serve for the public
5 interest.

6 It's clear that independence,
7 objectivity, and professional skepticism are
8 indispensable attributes that are fundamental
9 to the public trust. They're also
10 foundational to a culture of professionalism.
11 But auditing and audit quality goes beyond
12 those, as identified in the Concept Release.
13 It requires expertise. It requires
14 experience. It requires deep knowledge and
15 understanding of the companies being audited.
16 And I believe those attributes could be
17 adversely affected through any arbitrary term
18 limits that might be put in place.

19 As you know, the papers that we
20 submitted, both in December and in March, we
21 went through great detail to make sure we
22 looked at every piece of evidence we could

1 find, every piece of public research. Which,
2 by the way, did include your previous
3 panelists. They were all included. And we
4 wanted to do that because we wanted to make
5 sure we made an informed decision about our
6 views on this subject.

7 So what did we conclude? We
8 concluded foundationally that the system is
9 sound. It's not perfect. It can be improved.
10 But it's still sound, and I believe it's still
11 the best system in the world. We didn't find
12 any real correlation between tenure and
13 issues. We did note that re-statements and
14 litigation related to accounting matters have
15 both declined in excess of 50 percent, so as
16 a consequence we concluded that the great work
17 that was done in putting the Sarbanes-Oxley
18 framework in place did, in fact, enhance
19 financial reporting, and did improve audit
20 quality.

21 So we believe what's required now,
22 and what the next step should be, is to build

1 on that Sarbanes framework. And we would
2 start by looking at the interactions between
3 audit committees and auditors. We would look
4 at the communications between auditors and
5 audit committees. We would look at
6 introducing a concept of the PCAOB actually
7 engaging audit committees directly.

8 And why do we say that? Primarily
9 because under the rules today, it's the audit
10 committee who represent investors. It's the
11 audit committee who is tasked with engaging,
12 compensating, and overseeing the audit firms.
13 That's essentially what their charge is today,
14 and that's why our focus is there.

15 As to mandatory audit firm
16 rotation in general, the evidence on
17 experience would suggest it's generally not
18 favorable. As to what we should do next, we
19 think the Board should consider the over 600
20 comment letters that have been submitted, what
21 you've heard today, what you undoubtedly will
22 hear tomorrow, and take a balanced view of all

1 that. And we would start with, again, the
2 interactions between audit committees and
3 auditors; yourselves and audit committees, and
4 their transparency with investors.

5 We would also suggest that the
6 good work that's already being done in terms
7 of the role of the auditor and the audit
8 report, which the PCAOB currently has
9 underway, should continue. We believe that
10 you should consider a study more broadly
11 involving all the stakeholders to deal with
12 the overall impacts of audit quality, not just
13 independence, objectivity and professional
14 skepticism.

15 We also believe that it would be
16 wise to look at those countries who have
17 attempted rotation, or are attempting it now.
18 Look at what the consequences were, both
19 intended and unintended.

20 And lastly, as Board Member Harris
21 has heard me say on numerous occasions, we
22 believe that status quo is not an option.

1 Deloitte is committed to working with the
2 Board and this very important initiative, and
3 equally important, to helping the profession
4 transform, ultimately with the goal of
5 improving audit quality and enhancing investor
6 protection.

7 I am often asked -- and I have
8 been with the firm for 34 years as an auditor
9 -- I am often asked "What is it that you stand
10 for?" I've thought about that question quite
11 deeply, and I think the answer's quite simple.
12 We stand for nothing any different than what
13 America stands for. America builds great
14 ideas, and then works tirelessly to make them
15 better. That's what we stand for.

16 So thank you for the time this
17 afternoon, and I'll turn it over to the next
18 panelist.

19 CHAIRMAN DOTY: Thank you. Mr.
20 Howe, Ernst & Young.

21 MR. HOWE: Thank you, Mr.
22 Chairman, and good afternoon to you, other

1 members of the Board, staff, and SEC
2 observers. I too am pleased to be here for
3 today's discussion, which is important.

4 The PCAOB's Concept Release raised
5 a number of questions, and today's discussion
6 certainly adds to the record established
7 through the extensive comment period. We at
8 Ernst & Young are sincerely interested in
9 exploring any and all constructive ways to
10 further strengthen audit quality. We believe
11 any ideas pursued to further auditor
12 independence, objectivity and skepticism must
13 lead to an increase, not a decrease, in audit
14 quality. And as you know, we do not see
15 mandatory firm rotation meeting this important
16 objective.

17 We also believe evidence in
18 support of such a policy is lacking. We
19 examined results of our PCAOB inspection
20 reports and our own internal inspection
21 activity and did not find correlation between
22 the findings and auditor tenure. And we

1 understand that's consistent with the PCAOB's
2 own preliminary analysis of inspection
3 results.

4 My written statement and our
5 comment letter, along with close to 600
6 others, cite things like disruption, costs,
7 and harm to corporate governance and audit
8 quality, and these should provide the Board
9 with substantial input on the possible
10 negative effects of mandatory firm rotation.
11 I'm not going to belabor any of those points
12 in these opening remarks.

13 Ernst & Young audits more than
14 1,000 public companies. Excellent audit work
15 is being performed by many thousands of our
16 auditors. Our world is increasingly complex
17 and global, and we know we must continuously
18 improve. We do truly embrace the opportunity
19 to continue to engage with the Board, with the
20 SEC, investors, and audit committees to
21 further improve audit quality. I believe our
22 interests in this regard are totally aligned,

1 and I look forward to openly sharing and
2 absorbing suggestions to continue to improve
3 our focus on independence, objectivity and
4 skepticism.

5 At this meeting, some have or will
6 express support for mandatory firm rotation.
7 In some cases, this support is consistent with
8 views predating the Sarbanes-Oxley act of
9 2002. I think it's very important to
10 recognize that much was changed by that act,
11 and much has in fact improved since that time
12 10 years ago. Audit firms, audit committees,
13 and the PCAOB itself, born of that act, have
14 indeed all contributed to these improvements.

15 Obviously, though, we cannot be
16 content to stop there. We have put forward
17 ideas that go further and build on the
18 progress made by the Sarbanes-Oxley changes.
19 These ideas seek to foster even stronger
20 alignment among auditors, audit committees,
21 independent oversight authorities and
22 shareholders.

1 I think that alignment is
2 critically important to our ability, as a
3 profession, to make continued improvements to
4 audit quality. Of the opportunities we
5 outline, some the PCAOB can perform on its
6 own. Some would benefit from the SEC's
7 involvement. Most, if not all, require action
8 by the firms. We are committed to further
9 actions.

10 It is my hope that the Board will
11 focus on our collective ongoing actions, and
12 such suggestions to further improvements. I
13 believe an extended debate over mandatory firm
14 rotation could be counterproductive, not just
15 here in the U.S. but around the world. We
16 endorse a continued commitment to ongoing
17 actions, and we offer additional measures.

18 First and foremost, I believe
19 Ernst & Young, and the profession, must
20 continue its commitment to invest in the
21 necessary tools and resources to execute
22 audits in a high quality manner, and we accept

1 accountability for that. Further measures we
2 support include the following:

3 Increasing communication and
4 transparency among auditors, audit committees
5 and shareholders, as well as between audit
6 committees and the PCAOB itself.

7 Developing and sharing among audit
8 committees the leading practices that promote
9 auditor skepticism. In so doing, we should
10 build on, not undermine, the foundational
11 reforms which SOX put in place.

12 Analyzing the true root causes of
13 audit deficiencies. This important work by
14 the Board and audit firms can help us
15 collectively address what really needs to be
16 done based on grounded analysis, not theory.

17 Carefully reviewing the Board's
18 important recent and planned auditing
19 standards to assess their impact on audit
20 quality and the effectiveness of firms'
21 implementation.

22 Engagement by the PCAOB and the

1 SEC, and capital markets' regulators outside
2 the U.S., to enhance corporate governance
3 globally, particularly with respect to the
4 composition, expertise, and responsibilities
5 of independent audit committees.

6 And empowering the PCAOB to
7 recommend firm rotation to an audit committee
8 in situations where it has been demonstrated,
9 through the enforcement process, that
10 professional skepticism or objectivity was
11 significantly lacking in the audit of that
12 issuer.

13 At present, we believe the
14 foundation for audit quality is very strong.
15 Progress has been made. More is ongoing and
16 needed. Collectively continuing these efforts
17 and embracing further approaches offers a
18 positive way forward.

19 I thank you for the opportunity to
20 participate with my colleagues today.

21 CHAIRMAN DOTY: Thank you. Mr.
22 Moritz, PwC.

1 MR. MORITZ: I know we've been
2 here, and it's been a long day. I thank you
3 for inviting me to this important discussion,
4 and I also want to thank the Board and the
5 many other panelists that spoke earlier, as
6 well as those that will be with us tomorrow,
7 for their interest, perspectives, and
8 investment of time.

9 While I have the microphone, I
10 also want to thank one other group, and that
11 is my fellow partners at PwC and the audit
12 teams. I know firsthand the tremendous work
13 our teams do, and the dedication they bring to
14 serving the capital markets and the investor
15 groups that rely on their work. I see it each
16 and every day.

17 One of the ironies of this
18 profession is that the public rarely sees or
19 hears anything when an audit is done well.
20 But even though the benefits and the workings
21 of a well-done audit are often quiet to the
22 public, the reality is a lot of great work

1 goes on behind the scenes. Our audit teams
2 make the tough calls that need to be made. In
3 fact, in a recent quality and value survey of
4 randomly selected PwC partners and staff, 92
5 percent of them -- 92 percent -- reported that
6 in the last two years, they had to have a
7 difficult conversation about an accounting
8 judgment, suggested different or improved
9 financial disclosures, or identified a
10 potential weakness in the financial reporting
11 controls that needed attention.

12 I recognize entirely, beauty is in
13 the eye of the beholder. I recognize we need
14 to do more, and we're not always perfect in
15 what we do. But we strive to be. Making the
16 tough calls, improving quality continuously,
17 and striving for that excellence, is at the
18 core of the culture at PwC.

19 The path by which we improve
20 auditors' independence, objectivity, and
21 skepticism is the subject of today's meeting,
22 and in dealing with such important topics I

1 hope that we can all agree on the need to be
2 open to different points of view, analyze and
3 explore the pros and cons, costs and benefits,
4 as well as these potential unintended
5 consequences that were talked about earlier.
6 But before moving forward, we have to actually
7 take stock of where we are today, because what
8 was hopefully noted was there has been
9 tremendous progress over the last 10 years
10 through the enactment of Sarbanes-Oxley, and
11 some of the examples we have talked about
12 today precede that enactment.

13 Many have said there have been
14 great enhancements in financial reporting and
15 audit quality, both of which go hand in hand
16 in serving the needs of the investing public.
17 Over the last 10 years, we have been on a
18 journey that has led to significant
19 enhancements in reporting requirements, better
20 execution of auditing standards by the
21 profession, clearer accountability of audit
22 committees in overseeing the financial

1 reporting process, and greater effectiveness
2 of the inspection and standards process.

3 Changes over that time --
4 including substantially limiting non-audit
5 services, moving the oversight of the audit
6 firms to the audit committees, and mandating
7 external oversight by the PCAOB -- are, in
8 fact, working. Yes, more needs to be done,
9 but they are, in fact, working.

10 And I humbly admit we, PwC and the
11 profession entirely, have more work to do. So
12 let's continue on that journey of improvement.
13 But continuing on this journey requires us to
14 focus on four topics: importance of
15 independence, objectivity and skepticism, and
16 the performance of the profession overall.
17 Audit quality is top of mind. Independence,
18 objectivity and skepticism is, of course, the
19 foundation of how auditors must approach their
20 work, but there are many other aspects of
21 audit quality. Having the right expertise, in
22 the right industries or for the right complex,

1 technical areas are a key must and an
2 absolute, and audit firms must have a
3 tremendous network, here in the U.S. and
4 around the world, to bring, in fact, the right
5 expertise, day in and day out.

6 A second factor is the
7 profession's ability to keep pace with the
8 evolving needs of the capital markets, and the
9 needs of investors. It's important that all
10 of us continually assess the auditors' work
11 product to ensure we're meeting the needs of
12 the stakeholders we serve. I applaud and
13 support the potential changes to the auditor's
14 report that have been proposed by the Board,
15 more specifically use of matters of emphasis
16 paragraphs as we think about that audit
17 product. But to me, again, it's another step
18 forward with hopefully many more steps to come
19 on that journey.

20 Third, transparency is a third
21 critical factor. If we are to sustain the
22 confidence of our stakeholders in what we do

1 each and every day, including the perception
2 of independence, we must, as a profession, be
3 much more transparent in how we think about
4 things like audit quality, the areas in which
5 we can improve, the investments needed to be
6 made, and measuring and reporting the progress
7 made to date.

8 And finally, the factor of
9 governance. Our firm, the profession, and the
10 many other stakeholders in the supply chain of
11 corporate reporting must make sure the right
12 governance mechanisms are in place to ensure
13 we're delivering quality audits to the
14 investing public. While our discussions today
15 focus specifically on independence,
16 objectivity and skepticism, I hope that we can
17 actually step back and spend equal time around
18 these broader topics.

19 Mandatory firm rotation, re-
20 tendering or other considerations, which for
21 some sound like a compelling way to quickly
22 improve the perception of independence and

1 objectivity, in my mind will result in perhaps
2 stepping off of that journey of continuous
3 improvement. Mandating when companies make
4 key governance decisions, whether through
5 mandatory firm re-tendering or rotation, in my
6 mind, is a blunt instrument. Harvey Pitt
7 talked earlier about that dead man's hand,
8 which I think will, in fact, undermine good
9 corporate governance.

10 I thought I'd wrap up with five
11 summary comments. We truly believe the
12 profession has improved over the last several
13 years in the area of audit quality. And yes,
14 more continuous improvement is needed,
15 something we are invested in and committed to
16 accomplish. But these improvements cannot
17 just be limited to the issues of independence,
18 objectivity and skepticism, but rather should
19 include the other areas of focus I mentioned
20 earlier.

21 Second, expanding auditor
22 reporting that will benefit investors is what

1 we support in addition to the other topics on
2 the table today. We support what the Board
3 has proposed and the efforts they have
4 underway. We would encourage you to enact
5 them as quickly as possible, because, again,
6 we want to work together to move that ball
7 forward and take additional steps.

8 Three, there needs to be better
9 engagement and more robust communication among
10 auditors, audit committees and investors. In
11 this regard, we believe audit committees serve
12 as the best governing mechanisms, but audit
13 committees can continually improve their game
14 as well, by actually focusing on the selection
15 of the firm, the audit partner, his or her
16 ability to actually be skeptical. And they
17 need to communicate that work clearly, each
18 and every day, to the investing public.

19 Four, audit firms need to be more
20 transparent in what they do. We cannot
21 increase that trust in us, and overcome the
22 perception issues that we have, without in

1 fact being more transparent. For example,
2 suggesting and performing a transparency
3 report, or suggesting key performance
4 indicators, or what drives quality, is
5 something we believe in.

6 And finally, we want to make sure
7 we do not rush to judgment in trying to solve
8 the problems that may not exist to the
9 magnitude some assume, or react to a personal
10 view on what is perceived to be "why not?"
11 fixes. We support today changes that enhance
12 quality, and not ones that risk even the
13 potential of a reduction of audit quality.

14 As I leave the microphone, I ask
15 one thing of this group today. We want, hope,
16 and honestly expect to be part of future
17 discussions in working with you towards
18 enhancements of the auditor's role in serving
19 what I think is our aligned goal of serving
20 the investing community. We have points of
21 view to bring to the debate. We do believe
22 status quo is not the option. And we sit in

1 front of various stakeholders.

2 The question was raised earlier
3 today, what do we brag about? We brag about
4 the tough calls we've made and the role that
5 we play each and every day to serve the
6 investing public. Thank you very much for
7 your time.

8 CHAIRMAN DOTY: Thank you. Mr.
9 Veihmeyer, KPMG.

10 MR. VEIHMEYER: Thank you, Mr.
11 Chairman, and good afternoon. You know, in
12 the Board's August 2011 Concept Release, the
13 Board asked for comments on ways auditor
14 independence, objectivity, and professional
15 skepticism could be enhanced. I'm here today
16 with the other members of the profession to
17 discuss that important and shared goal.

18 But first, I want to put that goal
19 into context, because it is just one part of
20 the Board's and the accounting profession's
21 shared mission to continuously improve audit
22 quality. As an auditor, I realize that the

1 audit itself can't remain relevant to the
2 capital markets unless it provides value. And
3 as a professions regulator, the Board very
4 much understands that as well, and it's
5 released several proposals in the last year
6 that go directly to enhancing the relevancy of
7 the audit, such as the Concept Release on
8 expanding the auditors' reporting model and
9 proposals relating to enhancing the
10 transparency of the audit, concepts and
11 proposals that KPMG in large part supports.

12 But most important to maintaining
13 or enhancing the relevance of the audit is to
14 ensure that it is done well, that it is
15 thorough, sound, and objective. And like you,
16 we understand that enhancing the auditor's
17 objectivity and skepticism improves audit
18 quality.

19 I believe that audit quality at
20 KPMG has improved since the passage of
21 Sarbanes-Oxley and the creation of the Board.
22 But we have to continue to monitor our work

1 for areas of improvement, attempt to identify
2 the root causes of deficiencies noted, and
3 remediate issues as quickly as possible when
4 they are identified.

5 But looking back across the
6 results of our quality reviews, as well as the
7 Board's inspections, we believe that when
8 audit quality deficiencies do occur they are
9 historically attributable to one or a
10 combination of several things, including
11 primarily methodology, training, time
12 pressures, and professional performance. And
13 we have found that voluntary attrition often
14 creates challenges to the professional
15 performance of the remaining team members.

16 Now, at KPMG, we've done a lot to
17 try and address those root causes, including
18 professional performance. However, as the
19 Board makes clear in its Concept Release,
20 professional performance is more than the
21 proficient application of technical audit
22 principles. A quality audit also requires

1 approaching ones job with the requisite
2 independence, objectivity and skepticism, and
3 applying professional skepticism is about
4 making tough choices.

5 At that critical point when the
6 auditor is faced with a decision about whether
7 to keep pushing, either pushing back on
8 management's representation or pushing forward
9 for more audit evidence, what forces are
10 motivating the auditor to keep at it? And
11 what forces are there that may be pushing in
12 the opposite direction? And the question
13 we're faced with today is how do we increase
14 those forces that contribute to that skeptical
15 mindset?

16 Now, the Board's Concept Release
17 spent some time analyzing the appropriateness
18 of reducing one possible negative force by
19 suggesting that there are pressures that come
20 from a desire to maintain a long relationship
21 with the client that might best be removed.
22 But at KPMG, we don't find a nexus between

1 audit tenure and insufficient skepticism, and
2 we see significant disadvantages to term
3 limits.

4 One of those disadvantages is a
5 kind of culture that a constant stream of re-
6 tendering would likely create. Many on the
7 Board have publicly commented on what is seen
8 as a potentially adverse increasing sales
9 culture at the accounting firms, but in my
10 view such a culture is far more likely to
11 exist in a system of mandatory firm rotation,
12 where every year a significant percentage of
13 a firm's audit engagements will be lost and
14 will have to be replaced. In this respect,
15 mandatory firm rotation would certainly
16 increase those forces that the Board is
17 concerned could detract from a skeptical
18 mindset.

19 Another disadvantage to mandatory
20 firm rotation is the long-term effect it could
21 have on attracting and retaining quality
22 talent in the profession. I spend a lot of my

1 time focusing on retaining and attracting
2 quality people at KPMG, and I have a sincere
3 concern that mandatory firm rotation will make
4 that considerably more difficult.

5 And with the disadvantages of
6 mandatory rotation in mind, we look for other
7 ways to address this issue of skepticism,
8 independence and objectivity, principally by
9 looking for ways that we can increase those
10 forces that encourage the auditor to keep
11 pushing forward at those critical decision-
12 making moments. Many such powerful forces
13 already exist, such as the auditor's interest
14 in his or her own professional reputation,
15 career progression, and compensation, our
16 internal quality review programs, independent
17 regulatory oversight, and the oversight of the
18 independent audit committee. These forces can
19 be strengthened and complemented, and we have
20 set forth a number of proposals to that effect
21 in our comment letter.

22 These suggestions, a number of

1 which have been implemented by some audit
2 committees, largely reflect our overarching
3 guiding principle, that SOX got it right when
4 it recognized that the audit committee is in
5 the best position to evaluate the auditor and
6 to represent the shareholders' interests as it
7 relates to audit quality.

8 The discussion of how to enhance
9 auditor skepticism is an important one, and
10 I'm proud to be part of this conversation
11 today. But whatever is done to address this
12 issue as we go forward, it's our
13 responsibility collectively to ensure that we
14 don't harm audit quality. And from my
15 perspective, one of the most important
16 ingredients to performing high-quality audits
17 is the caliber of the talent performing the
18 audit. So as we consider ways to continuously
19 improve audit quality, I would urge us to
20 evaluate any proposals from the standpoint of
21 whether they will contribute to or detract
22 from our ability as a profession to attract

1 and retain the highest quality people.

2 Thank you for inviting me to
3 participate today, and I look forward to our
4 dialogue.

5 CHAIRMAN DOTY: Thank you, John.
6 Jeanette Franzel.

7 MEMBER FRANZEL: Thank you, Mr.
8 Chairman. I appreciate the comments made by
9 the firms that we need to continually improve,
10 and that remediation is also needed. I want
11 to ask a question -- I want to have you each
12 focus on two things in your responses.

13 First, you have a lot of
14 interaction with audit committees. Where do
15 you see opportunities for strengthened
16 governance and really oversight of the audit
17 on the part of the audit committees, and what
18 have you seen that is working well?

19 And secondly, to what extent are
20 audit committees actually evaluating auditor
21 performance on a regular basis, and what does
22 that look like?

1 CHAIRMAN DOTY: Stephen, do you
2 want to start and carry it down the table?

3 MR. CHIPMAN: Thank you. We have
4 certainly seen a significant increase in the
5 capability and performance of audit committees
6 in the post-Sarbanes-Oxley era. In terms of
7 areas for improvement, we still see audit
8 committees that perhaps have less knowledge of
9 the audit process than we would like.

10 One suggestion that we have in our
11 comment letter is perhaps that audit
12 committees could have an audit expert that had
13 a broader and deeper knowledge of the external
14 audit process. We also would suggest that
15 perhaps some form of training or continuing
16 education for audit committees in the
17 oversight, appointment and evaluation of
18 auditors would be valuable.

19 And another area where we
20 certainly see room for improvement for audit
21 committees is in the appointment patterns.
22 And I referenced this in my remarks. We often

1 see audit committees certainly going through
2 a more robust selection process than perhaps
3 in the pre-Sarbanes era, but we often find
4 them weighted in their judgment towards,
5 perhaps, the size of a potential audit firm,
6 or the strength of that brand in the market,
7 and not always perhaps doing sufficient due
8 diligence around the nature of the industry
9 expertise, the alignment of the skills and
10 capabilities of the engagement teams, and the
11 other factors that would ensure a high quality
12 external audit.

13 MR. ECHEVARRIA: And I will build
14 on Stephen's comments without repeating them.
15 So I, too, have seen improvement post-Sarbanes
16 in what audit committees actually do and how
17 they conduct themselves. Having said that,
18 you have to recognize that the diversity of
19 audit committees is as great as the diversity
20 of companies. That is, you have audit
21 committees at very large companies, and you
22 have audit committees at very small public

1 companies, and so how they behave around this
2 whole process will likely be different. So
3 step one for me, Jeanette, would be just that
4 concept itself. Create some consistency and
5 best practice. It's not always the same.

6 The second is that audit
7 committees, just like us, are pivoting from
8 the notion of accounting to the notion of
9 auditing, keeping in mind that most of the
10 dialogue was about accounting, not how we, in
11 fact, go about auditing matters. And I think
12 that's the next pivot point where audit
13 committees are getting quite good, and better.
14 And Steve's suggestion -- and ours -- about
15 getting some audit expertise into that,
16 besides financial literacy, would be positive.

17 And I think lastly, the whole
18 notion about the extent to which they evaluate
19 the performance of the auditor -- it's quite
20 extensive in some companies. Not a lot of
21 that is communicated, and perhaps
22 communicating a lot of what audit committees

1 already do through some shareholder/investor
2 material would be helpful.

3 I do think it's a journey, and I
4 think if you looked at audit committees today
5 versus audit committees pre-Sarbanes,
6 significantly different to the positive.

7 MR. HOWE: I would agree with
8 several comments made already that audit
9 committees have strengthened, I think
10 significantly, since Sarbanes-Oxley was
11 enacted in 2002. Even heard Arthur Levitt
12 earlier, I think, use the word "dramatically"
13 so in terms of their improvement.

14 I still believe that they're
15 inconsistent. I think we all see that, and I
16 think we, the firms and the profession, and
17 you, the PCAOB -- together I think we can help
18 audit committees continue on that journey. I
19 think they have strengthened their expertise.
20 I think they are taking on greater
21 responsibility to represent the shareholders
22 and to take responsibility for overseeing the

1 audit, the auditors, and their hiring or
2 firing.

3 Some of the things I would
4 recommend in terms of sharing best practices,
5 I think evaluating performance every year is
6 what the best audit committees do. And
7 frankly, I don't think we assume our retention
8 on more than a one-year basis with those audit
9 committees.

10 Secondly, I think audit committee
11 chairs not only running the meetings, as they
12 do well, but interacting with the engagement
13 partner one-to-one between meetings, I think,
14 has been a best practice we've seen as well.
15 And I would also add that the partner rotation
16 process is one that helps the audit committees
17 strengthen their overall understanding of the
18 entire team. When key partners, engagement
19 partners, engagement quality reviewers are
20 rotating, we get out ahead of that with the
21 audit committees and they try and understand
22 what the capabilities they need, how the fit

1 is with the rest of the team. And I see some
2 audit committees doing that exceptionally
3 well.

4 MR. MORITZ: I think over the last
5 ten years we've seen a continuation of
6 improvements in the audit committees
7 themselves, the meetings that we have on a
8 formal basis as well as the informal
9 interaction. Those conversations, debates and
10 challenges are rich, robust. And when I look
11 to your question, I think there are many
12 improvements that have been made that we do
13 not give investing public insight to. As a
14 result, I do think we can be more transparent,
15 both about what auditors do, what audit
16 committees do, in those meetings.

17 So you asked a specific question
18 around evaluating of the auditors, and I can
19 think of the last three or four times that we
20 went through partner rotation, at which the
21 questions that were asked of me were A) do
22 they have the right skill sets, industry

1 knowledge and the like? But equally
2 important, do they have a proven track record
3 of challenging, challenging what's been done
4 by management, challenging our practices,
5 challenging each and every day what we do?
6 And do they have that proven track record, and
7 can I understand examples of where it has come
8 to life?

9 Those, to me, are some of the best
10 practices that need to now be done more
11 consistently. So I go to the conversations
12 that were had earlier today, and I think there
13 were a number of suggestions that came
14 through: the concept of more disclosure around
15 the tenure relationship, the conversation
16 around comply or explain in terms of what
17 audit committees really do. And I would not
18 say "do that every X number of years," but
19 rather leave in the audit committee's hands
20 the responsibility of annually asking that
21 question and annually telling the investing
22 community what it's done.

1 We're dealing with two challenges
2 right now. One is the actual issue of
3 independence and the behavioral issues
4 associated with that, which I am somewhat
5 skeptical of. And second is the perception
6 issue. And the perception issue, in my mind,
7 only gets overcome not by mandatory rotation,
8 because I think it will still continue, but in
9 fact more information so people can trust what
10 is being done to some level of extent.

11 So I actually believe that we've
12 got to do much more ourselves, provide better
13 information alike from you and us, as well as
14 make sure the audit committees do their part
15 in this mix, also.

16 MR. VEIHMEYER: I would agree with
17 the comments of my colleagues. The only
18 additional thoughts I think I would add are,
19 I think if the investing public, and many
20 people who have concerns which are giving rise
21 to some of the perception questions that are
22 being asked as part of this proposal process,

1 could actually participate in, witness,
2 observe the rigor that takes place not only in
3 the audit committees -- and this is, I think,
4 Jeanette to your question -- one of the
5 significant improvements that I've seen since
6 Sarbanes-Oxley is the amount of rigor that
7 takes place outside of audit committees,
8 between audit committee meetings, particularly
9 between the audit committee chair and the
10 firm.

11 The amount of rigor, time, effort
12 and focus that goes into those processes, I
13 think, would allay many of the perceptual
14 concerns that exist out there. There are, as
15 some of the other firms have summarized, as we
16 have certainly included in our comment letter,
17 some recommendations around "How do we
18 continue to enhance this?"

19 I think we put it on the auditor
20 to look for ways to continue to provide
21 greater communication with the audit
22 committee, specifically with respect to this

1 issue of skepticism and helping the audit
2 committee understand what is the nature of
3 that dynamic that I talked about earlier, that
4 critical juncture in the audit when the
5 partner and the staff have to decide "Am I
6 going further, or do I have enough?"

7 I think one of the recommendations
8 we included in our letter was greater
9 communication and conversation required
10 between the committee and the auditor around
11 those highest-risk audit processes and
12 conclusions that you reached, and what was the
13 quality, extent, and nature of the evidence
14 that you saw that led you to that conclusion?

15 So more rigor around the specifics
16 that led you to the conclusion, I think, would
17 shine a brighter spotlight in the nature of
18 that relationship between the committee and
19 the auditor, on those key moments in the audit
20 when, upon inspection, we may have situations
21 where, to the Board and from an internal
22 inspection standpoint, we would wish the

1 auditor pushed a little bit further, asked one
2 more question, or went and found one more
3 source of objective evidence. And I think
4 that could be helpful as well.

5 CHAIRMAN DOTY: Jay Hanson?

6 MEMBER HANSON: A couple of you
7 mentioned the challenges of the most difficult
8 calls that sometimes need to be made. And
9 we've all been in those spots where you have
10 a pit in your stomach about the call. And I'm
11 thinking also about the partner rotation
12 requirements of Sarbanes-Oxley and bringing in
13 a fresh set of eyes as a way to avoid the same
14 partner looking at the same facts and not
15 challenging.

16 On the panel right before this,
17 Professor Richard Kaplan in his written
18 submission had a comment, effectively, that
19 said "Long-term client relationships are far
20 too important to be jeopardized by a single
21 difficult partner."

22 And so this is a question around

1 what tone do you set individually, as the CEOs
2 of your organizations, and then how does it
3 get supported throughout the organization, to
4 back up those partners -- and any employee --
5 that says "You know, I don't agree with what
6 this really important client that we've had
7 for many years is doing, and I think we have
8 to confront it." And that partner's being a
9 difficult partner to the client, so what are
10 you doing to set the tone about that and
11 support that through the organization?

12 And then I also want to pair that
13 with the flip side of the question, which
14 Professor Kaplan also referenced the Enron
15 situation, where the national office had
16 reviewed a complex situation, given their
17 conclusion about the proper accounting, and
18 the engagement partner was allowed to overrule
19 the national office. So effectively this
20 question goes two ways: what are you doing in
21 your firms to make sure that the national
22 office experts that rule on the accounting or

1 the auditing actually get implemented?

2 How about we start with John this
3 time?

4 MR. VEIHMEYER: Thank you, Jay. I
5 appreciate that. I thought I was going to get
6 to go last on every topic here. Is this
7 because I'm the shortest, or my name begins
8 with V? I wasn't sure what order we were
9 going in.

10 MEMBER HANSON: I was just being
11 kind.

12 MR. VEIHMEYER: You know, I think
13 your question is probably one of the most
14 fundamental and important, Jay, around the
15 tone that we set. I think you do that in a
16 lot of little ways every day in your
17 interactions with your partners, and you do it
18 in some big ways in terms of decisions you
19 make around compensation strategies and other
20 very broad issues that have far-reaching, I
21 think, cultural implications through your
22 firm.

1 And is your compensation system,
2 for example, more aligned to rewarding long-
3 term contributions of a partner to the firm,
4 as opposed to short-term hits or wins, or
5 whatever you might want to reward on the flip
6 side? Is it largely -- for an audit partner,
7 is there a large incentive or variable
8 component, or again do you have a compensation
9 program which takes into account over a period
10 of years the aggregate performance of a
11 partner, and not what may be happening in his
12 or her portfolio in a given year?

13 So I think there are some very
14 broad structural issues that are important,
15 but the ones that really get, I think,
16 repeated throughout the firm are the
17 interactions you have and the situations that
18 arise that typically spread like wildfire
19 through the firm when we have a tough
20 situation.

21 And certainly in my role I'm
22 probably benefitted from the fact that I spent

1 the bulk of my career as a professional
2 practice partner in our audit practice, as an
3 SEC reviewing partner. So that's what I've
4 spent my career doing. But I certainly
5 believe a big part of my role now is, when we
6 have difficult situations with our clients,
7 that I am there side by side with our partner,
8 supporting that partner in those discussions.
9 Not just behind the scenes, saying "Head into
10 the line and do it full force," but making
11 sure that that partner feels like he or she
12 has the entire weight of the firm behind them
13 as they go into very difficult discussions
14 with the clients.

15 So the decisions you make in
16 individual cases like that, I think, send a
17 very strong message. And it's one of the most
18 important roles we fulfill as CEOs of our
19 firms, I think, to set that proper tone.

20 MR. MORITZ: Jay, it's a great
21 question, of which I would focus on five or
22 six different areas. Number one, the tone at

1 the top has to be set in terms of what is a
2 priority for the individual firm, our partners
3 and the like, and exemplify that through
4 communications, which I send out every two
5 weeks -- examples including where we've
6 actually walked away from a client or made a
7 tough call -- and the storytelling that has to
8 happen in every office you go to, not just
9 with the partners, but with the entire staff,
10 so they understand the importance of this.

11 Second, you have to put the
12 policies and procedures in place to reinforce
13 that and ensure that the compensation
14 mechanisms to try to incent the right
15 behaviors and overcome the perceptions and the
16 biases that might be there, based upon the
17 earlier panel conversations, have been, to the
18 best of our abilities, overcome. And if not,
19 put the appropriate checks and balances in
20 place to yet again try to overcome whatever,
21 in fact, may be there.

22 Third, you need to put the right

1 support in place. This is a very difficult
2 job of which, yes, there is tremendous amount
3 of second guessing. So you need support to
4 deal with the complexity of what's the right
5 accounting and what's the right auditing that
6 needs to be done, and that's where, in fact,
7 investments are being made. You go back to
8 our quality report that we issued in August in
9 terms of additional investments to provide
10 that support.

11 And you actually then go to the
12 issue of exemplifying in terms of what's
13 important, through the areas of what was
14 important in terms of what people got
15 compensated for. And again, bringing that to
16 life with real, live examples, and let that
17 word spread virally across the whole firm in
18 terms of management and the tone at the top,
19 in fact, supports this.

20 I want to come back to, though,
21 two things that were said earlier today.
22 Number one, there was a presumption that,

1 quote unquote, "An audit partner will actually
2 never risk losing a client, and they don't
3 want to be that person." And I will tell you
4 that the world has changed dramatically over
5 the last ten years for the reasons I talked
6 about in my opening comments.

7 And in fact, the name of that
8 partner will be long forgotten and replaced,
9 in fact, instead by the name of the partner
10 that got it wrong, and the fact that they
11 implicated the brand of the firm and -- which
12 is very important in terms of what happened
13 over the last ten years -- and that there were
14 regulatory issues now that we are a regulated
15 profession. And there is a specific
16 accountability that is much more evident than
17 ever before, that is yet another incentive to
18 get it right.

19 So there are many checks and
20 balances. And I think John Bogle earlier this
21 morning talked about that reputation risk not
22 being enough, and I would say it's not enough.

1 In fact, it has changed. It is well beyond
2 that today.

3 The last point I would make is
4 that, as you go back, one of the things that
5 we have tried to do -- and I exemplified it
6 with the survey that we just talked about --
7 is make sure that we're doing all we can to
8 test that those messages are getting through,
9 and to make sure that what we are saying at
10 the top is 1) actually understood by those
11 underneath, and it's actually coming to life
12 in behaviors.

13 And that's why we ended up
14 piloting this survey that I just talked about,
15 in terms of asking people to prioritize,
16 what's most important in this firm? Asking
17 them how is it they can do their jobs better,
18 and what other support we can give? Because
19 the world we live in is a tremendously complex
20 world, and changing each and every day, and
21 our challenge is actually to stay relevant to
22 the teams, to make sure they do the quality

1 jobs in being independent and skeptical, and
2 have all the tools and techniques necessary to
3 do the job at hand in serving the investing
4 public. So there's a multiple amount of
5 angles to play this, of which we have to do
6 more each and every day.

7 MEMBER HANSON: Before we go on to
8 Steve -- and John, I let you off the hook on
9 this question -- the question of the line
10 partner overruling the national office, like
11 we saw in the Enron situation.

12 MR. VEIHMEYER: I think we have
13 very specific protocols in our firm, and the
14 engagement partner has primary responsibility
15 for audit decision and accounting conclusions
16 reached on an audit engagement. Having said
17 that, we have certain matters which, if they
18 arise on an audit, require mandatory
19 consultation with our national office. And we
20 encourage a culture and an atmosphere of
21 consultation in the firm, that these are firm
22 decisions and there is a significant network,

1 and our national office is certainly a
2 critical component of that, supporting an
3 individual audit partner as he or she is
4 making difficult decisions on their clients.

5 We have very specific protocols in
6 place in terms of consultation. Once you
7 consult with our national office, the process
8 that occurs and evolves once you initiate that
9 initial consultation -- it is, in 99 percent
10 of the cases, a very collaborative working
11 through a set of facts to get to an answer, so
12 I don't want to imply at all that those
13 consultations often or typically arise in
14 differing points of view and someone has to
15 decide who has the ultimate call.

16 But when that occurs, if in fact
17 at the end of a consultation process the
18 individual engagement partner has a different
19 point of view than our national office, then
20 there is an escalation procedure within our
21 firm to resolve that and we come to a firm
22 conclusion. It is not acceptable, and our

1 partners understand that they do not have the
2 ability to arbitrarily override or ignore the
3 input and conclusion of our national office.

4 MR. MORITZ: With all due respect
5 to Mr. Kaplan, the world has dramatically
6 changed since Andersen and Enron. Someone
7 earlier today said, actually, the original
8 auspices of the Sarbanes-Oxley Act was
9 actually to increase, quote unquote, "the
10 independence, objectivity, and the skepticism
11 of the firm, and the only thing that was done
12 was identifying a five-year rotation period
13 for that audit partner." And I would
14 respectfully disagree with that.

15 We changed the audit reporting
16 requirements. We changed the rotation of
17 auditors. We actually changed scope of
18 services. And yes, we put a regulatory
19 oversight Board and you all on top of us,
20 which as a result required us to change our
21 policies and procedures that John just talked
22 about. So again, when you look at that issue

1 of the national office, I would say all of us
2 -- and I can't speak for the other four
3 panelists today or those that will be speaking
4 tomorrow -- have significantly changed our
5 processes, procedures, and the expectations of
6 our partners, and the teams, and the national
7 office, for getting it right.

8 And then you should hold us
9 accountable, in fact, if that's not the case
10 and if it's not happening, which you obviously
11 do in your inspection process and thinking
12 about what's there in the tone of the firm,
13 tone at the top of the firm, changes to
14 policies and procedures, and suggestions that
15 you all make to us as an independent third
16 party looking at our policies and procedures.

17 MR. HOWE: I will try to be
18 additive and not repetitive. They've made
19 some good points, and it's a good question.
20 I'd also commend the PCAOB, because you do
21 believe in tone at the top and tone throughout
22 the organization. And the investor public

1 ought to understand that you hold us
2 accountable for that, and that's the right
3 thing.

4 I believe it does start at the
5 top. I believe it's my responsibility to make
6 sure our Board discussions are appropriately
7 focused on tone and cascading that through the
8 organization. But a lot of that happens
9 through our partners on their teams, and I
10 wish many of them were here today to speak to
11 you. They do believe in it.

12 At Ernst & Young, we operate in
13 accordance with a common set of values around
14 the world as well. I heard Stephen mention
15 that for Grant Thornton, words like courage,
16 integrity, and doing the right thing are part
17 of our values, and any one of our 150 thousand
18 people-plus could recite them, and that's
19 important too.

20 We also believe in sharing. At
21 our most recent assurance partners meeting,
22 where Chairman Doty came and addressed the

1 group of 1,000, that same day partners were
2 sharing stories. Just like this. Difficult
3 decisions, how the firm supported them through
4 those issues, how we constantly are focused on
5 getting to the right answers. That's very
6 important, that sharing.

7 And with respect to the technical
8 questions, I think as we sit here today I
9 would tell you that, over the last couple of
10 months, this has been happening over and over.
11 I'm sure all of us have been involved in these
12 discussions, but where it is really happening
13 is through our top technical teams, with those
14 teams serving companies we audit. And they
15 are working through these issues.

16 At Ernst & Young, we too have
17 structure to enable that appropriately, and we
18 very much endorse a culture of consultation,
19 for two reasons, really. One is, no one of us
20 is as smart as all of us. But secondly, with
21 more than one involved, we're always focused
22 on getting to the right answer and doing the

1 right thing. Again, so I think you'd feel good
2 about what's been happening in the busiest of
3 our seasons these last couple of months.

4 MR. ECHEVARRIA: Again, I'll be
5 additive to what was said. To the second
6 question you asked, Jay, that one I think is
7 a bit simpler. We all have, I believe,
8 similar processes. There really is no way,
9 theoretically, for someone in the line to just
10 disregard the conclusion of the national
11 office. But what are the safeguards? Well,
12 the safeguards are, once you initiate that
13 consultation, you must see it all the way
14 through, conclusion to issuance. So we would
15 have good instincts and knowledge about
16 whether or not those decisions actually
17 manifested themselves in the opinions and the
18 reports of those financial statements
19 appropriately. So that has been said, but I
20 know that it's fundamental to what we all do.

21 As to your first question, there
22 no longer is, in my view, a partner, one

1 person, that's making that decision. It
2 becomes more of a team making the decision.
3 I think Valarie from Proctor & Gamble talked
4 about the number of partners that serve an
5 account. So in the large, complex ones, it's
6 never one person anymore. It's a broad team.
7 We put advisory partners there, who are very
8 senior partners, to help the LCSPs engage. I
9 serve in that capacity, basically so that we
10 stand up to the right issue, and I think Steve
11 talked about it, the values, and I think we
12 all have the same values.

13 I can give you a personal
14 experience, though. Nothing's better than
15 what really happens to one of you. You know,
16 I was one of those partners in my professional
17 life that lost a client that the firm had for
18 45 years. And I sit here today. So it's not
19 the end.

20 (Laughter.)

21 MR. ECHEVARRIA: For the record, I
22 didn't say that.

1 (Laughter.)

2 MR. ECHEVARRIA: So it's not the
3 end in the firm. It's a longer run. It's
4 more than that. And we really do believe in
5 sustained relationships in terms of who we
6 serve and the committees that we represent.

7 MR. CHIPMAN: Thank you. Setting
8 the appropriate tone for the organization is
9 my single most important responsibility, I
10 believe. And as part of that, it's important
11 that you create what I would describe as a
12 safe environment, a safe environment where
13 audit partners and teams can do the right
14 thing, make the tough calls, and know that
15 they are safe and embraced.

16 We put a lot of emphasis on tone.
17 If you go into our training room in Chicago
18 you will see the portrait of my predecessor
19 with his quote about "Without quality, we have
20 nothing," and I refer to that regularly. But
21 what's really important is, how do you
22 translate tone into behavior?

1 And this actually leads into your
2 second question, Jay, about the interaction
3 and oversight of the national office. Because
4 we have two mantras, if you like, that we use
5 to try and move tone to behavior. One is
6 "Consult early and often," and two is "Don't
7 go it alone." And we pound those mantras, not
8 to become just sayings, but to drive the
9 behavior, which I think we've successfully
10 done, of a very collaborative and consultative
11 level of engagement between our audit teams
12 and our national office. And I think that has
13 led to a much more effective oversight and
14 involvement in a very positive and
15 constructive way for our national office, and
16 we do share all the same protocols that have
17 been already talked about.

18 The last comment I would make on
19 this point is that we do celebrate and
20 highlight when people do the right thing. And
21 I think that's very important. We also will
22 highlight and make very visible when tough

1 decisions were made at the top of the
2 organization. Early on in my tenure as CEO,
3 I had to make a very tough call over the
4 retention of a significant audit client, and
5 we chose to exit that relationship. We made
6 sure that everybody knew that I had made that
7 decision, and the reasons why, without,
8 obviously, breaching any confidentiality.

9 CHAIRMAN DOTY: Lewis Ferguson.

10 MEMBER FERGUSON: I think the one
11 comment that probably every single commenter
12 today would have agreed with is that
13 communications between auditors and audit
14 committees are absolutely vital, and
15 strengthening those has been one of the things
16 that Sarbanes-Oxley did, but that we really
17 need to keep doing.

18 And with regard to that, I want to
19 ask you a question, or maybe a sort of complex
20 of questions, about how you help audit
21 committees understand whether they should,
22 when they're making their retention decisions,

1 whether they should retain you. How do you
2 help them evaluate what you've done?
3 Presumably the audit committee is familiar
4 with the work of the particular audit they're
5 doing, but there's a lot of other work
6 involved in your firm, showing its
7 capabilities, its strengths, and its
8 weaknesses.

9 And specifically, I want to ask
10 you about the PCAOB inspection reports, which
11 are documents that are the views of the
12 regulator on your firm. I think we would all
13 agree that Part 1 of those inspections isn't
14 particularly useful. We're constrained in
15 terms of what we can say. Part 2 of the
16 report provides a lot of information. We are
17 constrained from giving that out. The SEC is
18 constrained from giving that out. And with
19 full deference to understanding the
20 remediation time you have and the possibility
21 of waivers of privilege that are concerns with
22 respect to that, do you share that document,

1 which you could share? Do you think it would
2 be useful to share it? Do you think it would
3 provide useful information to audit
4 committees? And if you don't share it, why
5 don't you?

6 MR. MORITZ: I am happy to start.
7 I would say that the PwC organizations here in
8 the States, and hopefully around the world, do
9 it in two ways. Number one, by hosting a
10 series of audit committee forums and
11 interacting with those Board of directors and
12 audit committee personnel and explaining A)
13 the world that we live in, 2) the challenges
14 in front of us, and 3) how, collectively, we
15 can work together to make sure we overcome
16 those challenges.

17 So there's a broader educational
18 aspect to what we do, and there's a broader
19 responsibility to make sure that, again, those
20 that sit in front of us are well-informed in
21 terms of the challenges ahead. I'll go
22 specifically to what we did this past year.

1 Again, I'll go back to the quality report that
2 we issued. Within that, we identified what we
3 thought were six or seven areas where we, PwC,
4 believed we needed to make improvements. We
5 came up with those based upon the combination
6 of our own inspections process findings, your
7 inspection process findings, and then our root
8 cause analysis of, in fact, what needed to be
9 done.

10 And then what we tried to do was
11 talk to individual audit committees, and
12 asking our partners to do that, and then
13 broader, at audit committee large forums, in
14 public areas, around what it is we're doing,
15 why it is we're doing it, and in fact, here is
16 the information you need to think about, quote
17 unquote, "the performance of PwC."

18 I think in that regard, it is now
19 starting to get more information in the hands
20 of those, Lew, that have to make the decisions
21 around, quote unquote, "the appointment or
22 retention of an auditor," and that's why I go

1 to the fact that we can do more in terms of
2 more disclosures, specifically around Part 2
3 disclosures, around that. But again, I think
4 in some reform we've started to do that.

5 Second is, again, the translation,
6 is hopefully the fact that we engage audit
7 committees to talk about the robust
8 conversation we had, so the investors are
9 seeing it, hearing it, feeling it in a
10 different way, and thereby enhancing, quote
11 unquote, the level of trust in the auditors,
12 hereby enhancing the level of trust in the
13 role of the audit committee representing those
14 investors, and actually up in the game so we
15 can actually deal with both fact around
16 independence, objectivity and skepticism, as
17 well as quality, but also the perceptions that
18 are there.

19 So those would be the two examples
20 I would point to.

21 MR. ECHEVARRIA: I'd be happy to
22 go next, Lew. At Deloitte, I would say it's

1 been an evolution. If you went back to the
2 first time those reports were received, back
3 in the early 2000s, and you go to the most
4 recent ones, I think we've moved from a place
5 of having very macro, summary conversations
6 about what might be in Part 2. We did a
7 transparency report, and we spent a few pages
8 about what might be in Part 2. And in the
9 last audit cycle -- it might be two -- we
10 actually sat and took them through the real
11 details of what's in Part 2 over a time
12 horizon. Here are the issues that continue.
13 Here are the ones that we believe have been
14 successfully remediated. Here are the
15 challenges that we're having.

16 We map that up against our root
17 cause and what we see, to decide which ones we
18 think are longer-term in nature and which ones
19 are more finite and acute. And we get pretty
20 detailed. We start now with the -- we have
21 the benefit of having the Part 1s published.
22 I personally, this last busy season, went

1 around to about 25 different audit committees
2 and had individual conversations about the
3 contents of Part 2s for all of the years that
4 were in existence.

5 I think the challenge is putting
6 it in context for audit committees. Again,
7 this is an auditing concept, and they're still
8 focused on accounting and the outcomes of
9 accounting. And so pivoting around that
10 becomes difficult at times, but I think it's
11 getting better. I do think the advent of what
12 you've done has created more interest. I do
13 think they have more interest in how we are
14 viewed by you, and I think that's pushed us in
15 a position of to be more responsive in terms
16 of communicating. So we actually do now --
17 we're working on the next busy season, on how
18 to make this more systemic.

19 You know, when you have an army of
20 1,000 partners communicating, and you're not
21 in the room with all the 1,000 partners during
22 the communication, you've got to put something

1 in a framework that they can effectively do on
2 a consistent basis, and I would say that's our
3 next challenge, at least at the firm.

4 MR. HOWE: I can see we're better
5 when we go in a straight line, but I'll jump
6 in here.

7 (Laughter.)

8 MR. HOWE: I would say this. I
9 think audit committees, first of all, are more
10 interested in asking those questions about our
11 relationship with you, our regulator, and I
12 think that's appropriate and that's good for
13 the profession. We do not share Part 2 report
14 in its entirety, but we very much do talk
15 about the issues.

16 We also talk about the process.
17 You have implemented new processes in the last
18 year, and we're talking about that with
19 companies we audit and audit committees,
20 talking about how you've introduced this
21 letter asking for us for a 60 day plan to
22 address those issues. We talk about the Board

1 meetings that we have with you, which are very
2 granular. We let our clients know that, and
3 we talk to them about the dialogue we have,
4 and some of the issues that we're dealing
5 with.

6 So I think this is moving in a
7 direction of much more open dialogue, and they
8 need to understand the level of seriousness
9 with which we're taking your comments, and the
10 level of seriousness with which we're
11 implementing actions to make sure that we're
12 on side with our regulator. That's what they
13 need to hear, and that's the conversations
14 we're having.

15 MR. VEIHMEYER: Lew, we do not
16 share the full report with our clients.
17 Having said that, I think -- and I probably
18 echo Joe's comments earlier in terms of the
19 evolution that has occurred, and I would say
20 those conversations are much more rigorous in
21 the last year and a half, two years, than they
22 had been in earlier years, without question,

1 including Part 2 in terms of the nature of the
2 items there, what issues we are remediating
3 from a firm-wide standpoint, and what that
4 means to the company we may be having this
5 discussion with.

6 So I think the discussion is
7 taking place. I will say, though, there are
8 varying degrees of interest among audit
9 committees in terms of how detailed they would
10 like to get. One of the recommendations we
11 included in our comment letter response was to
12 try and drive more consistency and best
13 practice around the type of communications
14 that should take place between the auditor and
15 the audit committee in all cases, as opposed
16 to leaving that to kind of particular
17 practices in any particular audit committee or
18 company setting.

19 And again, I think most audit
20 committees are most concerned with anything in
21 the inspection report that would be relevant
22 to their audit. And so, for example, if we

1 are -- if I'm having this discussion, which I
2 do regularly, with an audit committee that is
3 not in the financial services industry, they
4 are much less interested in any of the things,
5 either in Part 1 or Part 2, that may relate
6 specifically to the audit issues uniquely
7 found in our financial services practice, and
8 vice versa.

9 So I think it's a targeted
10 discussion of the things that we believe, and
11 the committee has demonstrated and expressed
12 an interest in being briefed and informed on,
13 that are relevant to the audit for that
14 particular company.

15 MR. CHIPMAN: I won't repeat the
16 comments that have already been made, except
17 to say that we do not share the entire letter,
18 but in order to provide, as Joe mentioned, a
19 more systemic approach to communication around
20 this particular set of matters, we have a
21 standard slide deck that we provide our audit
22 teams to use for audit committee

1 communications. We obviously expect those to
2 get tailored.

3 We now include in that standard
4 slide deck several slides, one that would
5 allow them to -- and actually, they would have
6 to communicate, based on our own internal
7 process, any inspection findings in Part 1
8 that were specific to that particular audit
9 client. And then secondly, there are slides
10 that deal with the results of our inspection
11 process as a whole, whether it be Part 1 or
12 Part 2, the feedback that we've got through
13 that process, what we're working on, how we're
14 working on those matters to remediate and
15 improve our systems of quality control, and
16 engage them in a conversation.

17 And I would agree with the comment
18 that has been made, there are differing
19 degrees of interest from audit committees, and
20 we have to guard against differing degrees of
21 presentation from our partners. So we try to
22 alleviate that issue by having senior

1 partners, members of senior leadership and
2 others, attending those audit committee
3 meetings to help guide those conversations to
4 ensure that they're robust and appropriate,
5 and that the audit committees are getting the
6 full extent of the feedback that they need to
7 evaluate our performance on the audit, and
8 also our performance as a firm.

9 CHAIRMAN DOTY: Steve Harris.

10 MEMBER HARRIS: First of all, I
11 want to commend you for your working with us
12 to expand the audit report, and also with
13 respect to enhancing the transparency of the
14 audit, both of which are important to, I know,
15 a number of investors.

16 A great deal of attention has been
17 paid to communications between the auditors
18 and the audit committee, but I think that
19 investors want more, and I think they want
20 more through the audit report. And I know
21 that you're picking up that message and
22 working with us on that with respect to giving

1 them more of an idea in terms of what the
2 significant risks are that you're detecting.
3 I think that they're concerned, also, with
4 respect to issues, as you're aware, of going
5 concern during the financial crisis, how we
6 work on the going concerns. So I very much
7 appreciate your acknowledgment of those issues
8 as legitimate issues that we can all work on
9 together.

10 I think I know pretty much your
11 reaction to virtually all the recommendations
12 that we heard in the panel earlier, so I'm not
13 wanting to go through them all. But let me
14 just ask you about one, and that is that
15 Chairman Pitt recommended that independent
16 audit committees be required to consider, and
17 document their consideration, whether the
18 performance of auditors over a prescribed
19 period of time -- say five years --
20 affirmatively warrants the reappointment of or
21 dictates the movement away from the accounting
22 firm that currently audits the particular

1 company's financial statements.

2 And I was going to ask him to what
3 extent that's totally within the jurisdiction
4 and realm of the Securities and Exchange
5 Commission, what's in the realm of the PCAOB?
6 I think those issues are of interest to us at
7 the PCAOB, and he's a very imaginative and
8 creative person and so I was sorry that the
9 Chairman ran out of time and I wasn't able to
10 ask him that directly. But with respect to
11 that recommendation, what would be your
12 response to that?

13 MR. VEIHMEYER: We are obviously
14 anxious to all answer this question, Stephen.
15 You know, with respect to enhanced
16 communication between the audit committee and
17 stakeholders around conclusions they've
18 reached with respect to reassessing the
19 auditor, I think personally we are very
20 supportive of looking for ways to enhance that
21 communication. Because, as we said earlier,
22 my view is, it's a fairly rigorous process

1 that is undertaken, and it would provide some
2 greater confidence in the marketplace if there
3 was greater visibility into that.

4 My view is that should not be an
5 episodic requirement, as opposed to an ongoing
6 requirement. I think, consistent with some of
7 the comments that were made by my colleagues
8 earlier, irrespective of how many years we
9 have been serving as the auditor for a
10 particular company, I think we very much --
11 and the vast majority of the audit committees
12 that represent those companies believe that
13 this is a continual process.

14 There is a formal process every
15 five years tied to, as Bob described earlier,
16 rotating an engagement partner that leads to
17 some unique conversations about the
18 relationship, but I think our best audit
19 committees recognize that on an annual basis
20 they should be applying all of that rigor to
21 understanding how that audit firm is
22 performing, and whether or not that audit firm

1 is still meeting the best interests of the
2 company.

3 So my concern with tying that
4 recommendation to some episodic timetable is,
5 it seems to me to run counter to, I think, the
6 culture that we would try and create in the
7 committee-auditor relationship of that it's a
8 continual and ongoing process.

9 MR. HOWE: I would agree. As John
10 said, looking at the area for more
11 communication is a good, I think, conversation
12 for all of us to be having. I also would be
13 concerned about a specific period, such as
14 that suggested by Chairman Pitt. And the
15 reason really is, I think it can become close
16 to mandatory re-tendering. If a company was
17 required to disclose every five, seven, ten
18 years lots of specifics about a process, I
19 think the question would be asked "Why didn't
20 they go through an actual process?"

21 And so I see it as a slippery
22 slope towards mandatory re-tendering, and I

1 think it's important that we also have the
2 debate about that. We believe mandatory re-
3 tendering has many of the same shortcomings
4 and risks to audit quality, as does mandatory
5 firm rotation. And in particular, I would
6 point out the risk of our people being
7 involved in perpetual marketing, is a term
8 I've used.

9 I've watched this happen in some
10 markets, most recently in Brazil. And
11 frankly, with all the important audit work we
12 have to do, we just don't want tens and
13 hundreds and thousands of auditors engaged in
14 pursuit activity for tender processes, as
15 opposed to audit activity. And so that I see
16 as the biggest risk, and I think companies
17 should focus on what they're doing annually to
18 assess that audit relationship.

19 MR. ECHEVARRIA: Without, again,
20 adding to the comments that were made, I do
21 agree with Steve -- Steve, to your point, and
22 Steve, to your conclusion on that point --

1 that if we're talking about documenting that
2 which the audit committee does annually now,
3 I think that's a good thing. Because audit
4 committees, right now, annually reach that
5 conclusion. And they go through quite a
6 rigorous process to get there.

7 So I'd be in favor of that. I
8 believe we'd be in favor of that approach,
9 because it already takes place. And if
10 putting it in the sunshine makes it better --
11 one of your Board members always reminds me
12 that sunshine is the best antiseptic -- and if
13 you put it in the sunshine and make it better,
14 we would be an advocate for that.

15 If it just got picked at some
16 arbitrary format that made it feel like it was
17 something different, I don't know if it would
18 accomplish the same objective. Because right
19 now, audit committees do that on an annual
20 basis, and putting that in documentation, I
21 don't see why that should be a problem. I see
22 that as a benefit, Steve.

1 MR. CHIPMAN: Steve, I, as I said
2 earlier, would be very supportive -- and our
3 firm is very supportive of a more robust
4 selection process and increasing and improving
5 the transparency and communication around
6 that. We would encourage that that includes
7 in that transparency and communication a
8 recognition by the audit committee that they
9 have reviewed all appropriate choices, and
10 it's our indication that at times they are
11 overlooking other or additional choices which
12 could be relevant and appropriate for
13 conducting their audit in a high-quality
14 manner.

15 That choice, that competition, we
16 believe, will lead to higher quality. And a
17 more robust, transparent improved
18 communication process around audit committee
19 selections, we believe, would lead to that
20 enhancement in choice, and therefore quality.

21 MR. MORITZ: Steve, one other
22 point I'd like to make. First, yes, I'd be

1 supportive of what Harvey provided. Second,
2 to the point that was made, I think it's an
3 annual as opposed to a time-determined
4 assessment. Three, I think by doing so takes
5 best practice to consistent practice, and I
6 think Joe said earlier there is an
7 inconsistency amongst audit committees, their
8 performance, and the reporting on that
9 performance.

10 And I will say that, over the last
11 two and a half years of being in my role, I
12 walked in with the hope that different
13 stakeholders in the corporate reporting supply
14 chain would volunteer to do things
15 differently. And through the conversations
16 that we've had around the role of the auditor,
17 as we've looked beyond what you all have
18 proposed in terms of what should change -- not
19 only for what the auditor does, but what
20 corporate governance mechanism change, or what
21 the preparer community needs to change -- it
22 is clear that it is very hard to get people to

1 do so on a voluntary basis with the litigation
2 environment that we have in the States, which
3 is much different than the rest of the world.

4 So to the most important part to
5 your question, would you actually require this
6 by law or some other practice? I would say
7 yes. I think we actually now have to start to
8 do that. I know that is not ideal, in a
9 scenario where you hope for the best, but I
10 think actually going to rulemaking in this
11 regard, in terms of taking that journey from
12 where we were in Sarbanes in terms of the
13 specific accountability, and then refining it
14 for another step on the journey, is the right
15 thing to do.

16 CHAIRMAN DOTY: We are winding
17 down. And I would say that I think one would
18 have to agree that Sarbanes-Oxley has changed
19 something fundamentally. As one who was
20 around when Arthur Levitt was proposing the
21 original separation of non-audit services from
22 audit services, I reflect on how different the

1 quality of this discussion is, and how
2 different the interaction of the major firms
3 with the regulator is. And I think that's
4 something that, I would hope, we can all be
5 proud of.

6 One hears, I think, what one wants
7 to hear, but what I think I heard in the
8 course of this discussion were some
9 extraordinary steps or breakthroughs that you
10 all are coming forward with, they largely
11 relate to the building on what we have, which
12 is advocated in your various comment letters,
13 but they go beyond it.

14 I think, first of all, in the
15 building area I thought I heard substantial
16 support for our re-proposed communication with
17 audit committees release, for doing something
18 with the audit reporting model that would make
19 the audit reporting model more relevant, that
20 would get to some of the disclosure issues
21 that relate to estimates and significant
22 accounting policies.

1 I thought I heard out of that
2 come, clearly, some indication that
3 strengthening audit committees by making them
4 better and wiser and smarter about what could
5 go wrong in related party transactions would
6 also be something you all would look favorably
7 on.

8 But then I was really struck by
9 the notion that there should be greater
10 transparency in the key performance
11 indicators. That in other words, you all
12 would, as a series of businesses with a
13 business to run and commercial decisions to
14 make, you would start building morale and
15 building your attraction to recruits, and your
16 retention policies, by showing the public more
17 of what you did by way of key performance
18 indicators, to assure that they're going to
19 get a better audit, and to assure that the
20 incentives are aligned within the firm.

21 I think this is an extraordinary -
22 - that's the kind of thing Jack Welch used to

1 talk about. And then the notion that the
2 PCAOB should engage the audit committee
3 directly, that more should be laid down
4 institutionally by ourselves and the SEC to
5 facilitate that in a structured and
6 disciplined way, I thought that was an
7 extraordinary thing that came out of the last
8 hour.

9 A recommendation by the PCAOB to
10 the audit committees should be made when we
11 found things that indicated a lapse of quality
12 tied to tenure. If that happened, we should
13 be communicating that directly. And that
14 presumably carries with it some governance and
15 some disclosure issues. Whether it's
16 something we do, or would do, or could do,
17 it's a grave responsibility that we have in
18 all cases.

19 But that is groundbreaking. I
20 guess, time having expired, me having run out
21 of time, I want to thank on behalf of the
22 Board, thank all of you for a stimulating

1 session. We will go forward tomorrow. We
2 will hear more of all of these issues. But I
3 think that this certainly ranks as one of the
4 most extraordinary exchanges in a public
5 meeting that could have been put forward at
6 this time, and we thank you. You've made it
7 happen.

8 (Applause.)

9 CHAIRMAN DOTY: Applause? Nobody
10 gets applause. Regulators and accounting
11 firms don't get applause.

12 (Whereupon, the above-entitled
13 proceeding went off the record at 5:27 p.m.)
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C E R T I F I C A T E

This is to certify that the foregoing transcript

In the matter of: Auditor Independence

Before: Public Company Accounting Oversight Board

Date: 03-21-12

Place: Washington, DC

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