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## PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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## INVESTOR ADVISORY GROUP

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## MEETING

+ + + + +

WEDNESDAY  
OCTOBER 16, 2013

+ + + + +

The Advisory Group met in the Hamilton Ballroom of the Hamilton Crowne Plaza Hotel, 1001 Fourteenth Street, Northwest, Washington, D.C. at 9:00 a.m., Steve Harris, Investor Advisory Group Chairman, presiding.

PRESENT

STEVE HARRIS, PCAOB Board Member, Chairman  
BRANDON BECKER, TIAA-CREF  
ROBERT T. BUETTNER, Newbrook Capital  
Advisors  
MERCER E. BULLARD, University of  
Mississippi, Plancorp, LLC, and Fund  
Democracy, Inc.  
CURTIS L. BUSER, The Carlyle Group  
T. GRANT CALLERY, FINRA  
JOSEPH V. CARCELLO, University of Tennessee  
NORMAN J. HARRISON, FTI Consulting, Inc.  
MICHAEL J. HEAD, TD AMERITRADE Holding  
Company  
PETER H. NACHTWEY, Legg Mason, Inc.  
BARBARA L. ROPER, Consumer Federation of  
America  
LAWRENCE M. SHOVER, Solutions Funds Group  
DAMON A. SILVERS, AFL-CIO  
ANNE SIMPSON, California Public Employees'  
Retirement System (CalPERS)

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TONY SONDHI, A.C. Sondhi & Associates, LLC  
JUDGE STANLEY SPORKIN, U.S. District Court  
(Retired)

ROBERT M. TAROLA, Right Advisory, LLC  
LYNN E. TURNER, Managing Director,  
LitiNomics and former SEC Chief  
Accountant

GARY G. WALSH, Luther King Capital  
Management

ANN L. YERGER, Council of Institutional  
Investors

ALSO PRESENT

JIM DOTY, Chairman, PCAOB

LEW FERGUSON, Board Member, PCAOB

JEANETTE FRANZEL, Board Member, PCAOB

JAY HANSON, Board Member, PCAOB

MARTY BAUMANN, Chief Auditor and Director of  
Professional Standards, PCAOB

BRIAN CROTEAU, Securities and Exchange  
Commission

GREG JONAS, Director, Office of Research and  
Analysis, PCAOB

HELEN MUNTER, Director, Division of  
Registration and Inspections, PCAOB

SANTINA ROCCA, Deputy Director, Division of  
Registration and Inspections PCAOB

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

2 (9:02 a.m.)

3 CHAIRMAN HARRIS: I want to welcome everyone to  
4 the Fourth Annual Meeting of the Investor Advisory Group  
5 of the Public Company Accounting Oversight Board.

6 I know that all of you are very busy and I  
7 appreciate the time you have taken to participate in  
8 today's meeting, especially during the course of a day  
9 which is clearly going to be an eventful day on the Hill  
10 and throughout Washington.

11 I'm going to be interested to see how many of you  
12 are checking your BlackBerrys during the day to see  
13 whether or not there's any resolution, especially those  
14 of you who invest real money on a real-time basis.

15 But to the extent that we can keep your attention  
16 throughout the day, we'd appreciate it and we will have  
17 a couple of breaks throughout the day.

18 And in particular, I want to thank the members of  
19 each of our working groups for the effort they have  
20 devoted to the topics that we will be discussing this  
21 morning and this afternoon. I think they've done a  
22 terrific job. I think today's going to be a very

1 interesting day.

2           And I also want to welcome our newest members,  
3 Bob Buettner, Mercer Bullard, Curt Buser, Tom Callery,  
4 Larry Shover, Gary Walsh.

5           And we regret that due to illness William Morris  
6 is not going to be able to attend but he sends his  
7 deepest regrets.

8           I also want to indicate that much as we wanted  
9 Chair White to attend and thought that she'd be able to  
10 break away from her extremely busy schedule and prior  
11 commitments, unfortunately and totally understandably  
12 it's shutdown time, hopefully not, but debt-ceiling time,  
13 decision times, in terms of what's going on in Washington  
14 and she deeply regrets that she's not going to be able  
15 to make it.

16           But in the meantime, I do want to welcome Brian.  
17 Brian, thank you very much for attending and from your  
18 prior attendances, so we very much appreciate the close  
19 collaborative working relationship that we have with the  
20 SEC.

21           And once again, as I say, Brian, thank you for  
22 coming, participating at these group sessions and if you



1 would reiterate some of what you've heard or all of what  
2 you've heard to the Chair and to Paul and others, we'd  
3 very much appreciate that.

4           But we totally understand the circumstances of  
5 the day. Hope it works out very well for the SEC, more  
6 importantly for the United States of America, for the  
7 government, and so we wish her and the Commission full  
8 funding, continuity, and the very best.

9           And at the outset, in a minute I want to  
10 recognize Chairman Doty and the other Board members and  
11 offer them an opportunity to make any brief opening  
12 remarks they would like to, following which I will ask  
13 each of our advisory members to briefly introduce  
14 themselves, and then we'll move forward with today's  
15 program.

16           Before we get started, though, let me remind  
17 everyone that the standard PCAOB disclaimers apply, and  
18 that is that each Board member who speaks today is  
19 representing his or her own views and not necessarily the  
20 views of the Board or its staff.

21           And, of course, the same disclaimer is true of  
22 any of the PCAOB staff participating today.

1           And with that, Chairman Doty and Lew and Jeanette  
2 and Jay, I want to offer you the opportunity to make any  
3 brief opening remarks you'd like to make.

4           DIRECTOR DOTY: Thank you, Steve. It's been an  
5 extraordinary spring and summer for the Board.

6           I think that with this group it's important to  
7 point out that the audit reporting model proposal was  
8 issued. It's out there, the comment period that runs for  
9 a long time, giving everybody time to get comments in  
10 through the end of the year and after.

11           We have published broker-dealer standards. The  
12 SEC adopted their 17a-5 standards, and it was very  
13 important that we get out broker-dealer audit standards.  
14 We did that. They're now up and running on the web where  
15 people can look at them.

16           Coming along behind this and, as I've said  
17 before, it's important to me that we move on the  
18 transparency concept of naming the engagement partner and  
19 naming the foreign firms and the other participants.

20           I know that in this group this is in some of your  
21 views an overdue proposal. I think it's certainly an  
22 idea whose time has come.

1           We intend to re-propose it. That is after some  
2 thoughtful discussion with the staff of the SEC, and I  
3 concur. I think that they're urging us wisely to re-  
4 propose, given the fact that we have three new members  
5 of the Commission.

6           So this will allow time for them to familiarize  
7 themselves with an issue with which many of you and the  
8 staff of the Chief Accountant's Office and we in the  
9 Board are familiar and have been thinking about for a  
10 long time.

11           In addition to that, I think the time has given  
12 us some advantages. We have been able to refine and  
13 sharpen our perception of what should undergird and  
14 justify a standard like this, which has generated some  
15 controversy in the profession.

16           Lewis Ferguson, Jeanette Franzel, Board members,  
17 have taken care to try to test and think carefully about  
18 what the actual justification of this proposal should be  
19 and how it should be expressed.

20           In the interim, there have been very important  
21 scholarly and empirical studies that have emerged.

22           I think since October 2012 we have had a lot in

1 the form of scholarship, some of it by members of this  
2 working group, which tends to confirm in my view,  
3 supports in my view the importance of doing something in  
4 this area.

5           It's also something which I think we can do while  
6 the audit reporting model proposal is out there and being  
7 considered.

8           Finally I know that various of us are concerned  
9 that with this approach to transparency being one that  
10 is spreading in other jurisdictions, not only Europe but  
11 around the world, that we do not want to be seen as being  
12 recalcitrant and behind the times.

13           I say all this because I think the first time  
14 this proposal went around the profession was largely  
15 opposed to it. They were opposed to it on concerns about  
16 litigation risk.

17           In my view when you expand disclosure you  
18 necessarily expand some litigation risk, but this is a  
19 disclosure standard.

20           I think you can look to see something out,  
21 certainly by the first week of December we should be in  
22 a position to re-propose this.

1           Your views as investors on the pros and the cons,  
2 either the virtues of it, the utility of it or the lack  
3 thereof, are all going to be interesting to us because  
4 those are all issues that have been raised in comments  
5 before and will be raised again.

6           So that's where we're headed and with that,  
7 Steve, back to you.

8           CHAIRMAN HARRIS: Why don't we just go and, Lew  
9 and Jeanette and Jay, you're welcome to make any opening  
10 remarks you care to see fit.

11          MEMBER FERGUSON: I'd just like to join with  
12 Steve and welcome you and to say thank you for the work  
13 that you do for us here.

14          I know it's time out of your busy schedules but  
15 it's very, very, very important to us. You make a  
16 valuable contribution. What you say to us we listen to  
17 and we deeply appreciate the work you do for this  
18 organization.

19          MEMBER HANSON: Just a brief good morning and  
20 welcome and echo the comments and pass it on to Jeanette.

21          MEMBER FRANZEL: I also want to welcome everybody  
22 and thank you for being here.

1           This is a very important meeting and I want to  
2 compliment all of you on the agenda, and these are very  
3 important topics that the Board has been spending a lot  
4 of time thinking about but it's really time to make some  
5 of these happen and operationalize them.

6           And things like audit quality indicators and  
7 improving our communications on inspections reports and  
8 general reports, our communications with audit  
9 committees, if we can figure out how to operationalize  
10 these going forward this will have a lasting impact, I  
11 think, on the system of oversight of audits and financial  
12 reporting.

13           So, thank you. You're making a big difference,  
14 and I look forward to today's agenda.

15           CHAIRMAN HARRIS: I think Chairman Doty last  
16 night articulated your importance to the Board and I  
17 think that's been reiterated again by all the Board  
18 members.

19           But let me make a few opening remarks regarding  
20 the group's previous recommendations and contributions,  
21 especially for those of you who are new members.

22           But last year was the tenth anniversary of the

1 Sarbanes-Oxley Act and, likewise, 2013 marks the tenth  
2 anniversary and the year of the operation for the PCAOB.

3           And with that milestone in mind, we have provided  
4 each of you with a copy of our 2012 Annual Report which  
5 outlines many of the Board's accomplishments since our  
6 inception.

7           While we are proud of what we have done so far,  
8 our work to protect investors by improving the accuracy  
9 and reliability of corporate disclosures and improving  
10 audit quality is an ongoing effort.

11           This is where you, the Investor Advisory Group,  
12 come in, and beginning with its inaugural meeting in May  
13 2010, the IAG has provided insight and advice to the  
14 Board in areas that are of significance to investors.

15           Many of the actions taken by the Board in the  
16 past few years have been informed by and, indeed, have  
17 been in response to the recommendations voiced by this  
18 group, and let me just go through a couple of those.

19           For example, during our first meeting in 2010,  
20 the group asked that the Board redouble its efforts to  
21 obtain access to foreign-registered accounting firms for  
22 the purpose of conducting inspections.

1 Under the leadership of our Chairman and with the  
2 dedicated efforts of our Office of International Affairs  
3 and Division of Registration and Inspections, that is  
4 exactly what we have done.

5 Since 2010 the PCAOB has entered into 12  
6 cooperative arrangements with audit regulators from such  
7 countries as the United Kingdom, Germany, Finland,  
8 France, Switzerland, the Netherlands, Spain, Norway and  
9 Japan.

10 While these are significant achievements, we  
11 recognize that we have more to do, especially in those  
12 smaller European countries where we still lack access to  
13 carry out inspections, as well as obviously in China.

14 Fortunately in June the EU issued a new adequacy  
15 decision for the PCAOB that runs through July 2016. The  
16 adequacy decision in effect certifies that the PCAOB has  
17 the ability and the necessary systems in place to protect  
18 non-public information.

19 This new adequacy decision should allow us to  
20 conclude cooperation agreements in coming months with a  
21 number of those, dozen or so smaller EU countries where  
22 we would like to conduct inspections.



1           It has also allowed us this summer to renew our  
2 existing cooperation agreements with the major EU audit  
3 regulators.

4           The net result is that we anticipate being able  
5 to inspect in all EU member states at least through July  
6 2016 when another new adequacy decision will be needed.

7           With respect to China, we are also continuing to  
8 negotiate with them on a statement of protocol that would  
9 allow us to carry out our inspections there.

10           The fact that we reached a Memorandum of  
11 Understanding on enforcement with China in May was a  
12 breakthrough and has given us some momentum in our  
13 negotiations around the Statement of Protocol.

14           In addition, we are working to reach cooperation  
15 agreements with regulators in a number of other  
16 jurisdictions, such as Brazil, Chile, New Zealand and  
17 Turkey.

18           While these arrangements and agreements are not  
19 necessary for us to inspect in these jurisdictions, they  
20 are useful because they strengthen our relationships with  
21 the audit regulators in those countries.

22           Finally, on the international front, in response

1 to an IAG suggestion our website now provides a list of  
2 the issuer clients of PCAOB-registered firms in  
3 jurisdictions where the PCAOB is still prevented from  
4 conducting inspections.

5           Turning back to the home front, this group also  
6 asked the Board to study and report on lessons learned  
7 from the financial crisis.

8           In response, in September 2010 we issued a report  
9 on the observations of PCAOB inspectors related to audit  
10 risk areas affected by the crisis.

11           Then in December 2010 we issued an Audit Practice  
12 Alert on the audit implications and breakdowns in the  
13 mortgage foreclosure process.

14           And in December 2011 we issued a Practice Alert  
15 on assessing and responding to risk in the current  
16 economic environment.

17           And we're always open to suggestions in terms of  
18 whatever Practice Alerts you think we ought to consider  
19 in the future, and we are considering a number.

20           Similarly the IAG also wanted the Board to issue  
21 timely guidance on topical issues for auditors and Board  
22 of Directors.

1           Five Audit Practice Alerts have been issued in  
2 the past three years, ranging from the principal auditors  
3 use of the work of foreign auditors to risks in emerging  
4 markets and most recently an alert about professional  
5 skepticism.

6           We've also issued five general inspection reports  
7 in 2012 and 2013 and Helen Munter will discuss some of  
8 our communications efforts and solicit your advice and  
9 recommendations in terms of how we can do better in that  
10 area.

11           The auditor's report has also been an important  
12 and recurring topic of discussion in nearly all of our  
13 meetings.

14           In 2010 it was suggested that the Board consider  
15 requiring disclosures, the major issues that concerned  
16 the auditor during the audit.

17           In the 2011 meeting, the working group on the  
18 auditor's report and the role of the auditor presented  
19 survey results on the usefulness of the current report.  
20 These results further indicated what investors are  
21 looking for in the report.

22           Then during the 2012 meeting, the IAG working

1 group on the role, relevancy and value of the audit  
2 provided us with the results from another survey that  
3 demonstrated what investors believe auditors should do  
4 with respect to the other information that accompanies  
5 the audit report.

6 Our staff considered the views expressed at those  
7 meetings as they developed the Board's current proposal  
8 which was issued for comment on August 13th.

9 We ask that you continue your efforts in this  
10 area by carefully considering this recent proposal and  
11 provide the Board with your comments. In the past, your  
12 input is critical to this process.

13 And then in October 2011, the Board published a  
14 rule proposal on the disclosure, the engagement partner  
15 and certain other participants in the audit. This is  
16 another topic that the IAG has addressed repeatedly.

17 As reflected in the latest standard-setting  
18 agenda which is on our website, we are planning to have  
19 a re-proposal, as the Chairman indicated, on the subject  
20 of transparency.

21 Going concern was another topic that the group  
22 discussed in depth during the 2002 meeting. As is

1 reflected in our latest standard-setting agenda, we  
2 anticipate coming out with a proposal on going concern  
3 sometime before 2014.

4           These are just a few examples where the Investor  
5 Advisory Group's input has made a difference and helped  
6 the Board to establish its priorities and advance its  
7 efforts to protect investors.

8           Just as in the past, the Board intends to  
9 carefully consider the views you express and the topics  
10 you have chosen for today's discussion.

11           We'll be taking up four specific subjects, as  
12 you're all aware, followed by a final hour for general  
13 discussion.

14           They are, first, audit quality indicators;  
15 second, PCAOB communications, general and inspection  
16 reports; third, audit firm governance and incentives; and  
17 fourth, auditor interaction with audit committees.

18           With respect to the four presentations and  
19 discussion topics, each topic will begin with a brief,  
20 no more than five-minute presentation by the working  
21 group that has been researching and considering that  
22 topic.

1           We do not have a working group for the PCAOB  
2 communication session. This discussion will instead be  
3 introduced and led by Helen Munter, Director of the  
4 Division of Registration and Inspections, and Santina  
5 Rocca, the Division's Deputy Director.

6           After each working group presentation, the  
7 presenters will lead a discussion among all members about  
8 the topic.

9           Of course, the Board members and SEC, Brian, are  
10 more than welcome to join in on the discussion at any  
11 time and we welcome that participation.

12           And at the end of the day, I hope there will be  
13 time for each member to bring to our attention any issue  
14 of particular interest to him or her.

15           As I mentioned at the outset, we had hoped that  
16 Chairman White would be here but we totally understand  
17 her attending to, at this point, far greater business.

18           I would note that today's meeting is being  
19 webcast and transcribed. Therefore, I would ask each of  
20 you to identify yourself prior to speaking.

21           This meeting is open to the public and all  
22 presentations will be posted on the PCAOB website.

1           And now let me recognize the working group  
2 leaders. Tony Sondhi will provide a brief overview of  
3 his working group on audit quality indicators. His  
4 working group members are Michael Head, Norman Harrison,  
5 Lynn Turner and Damon Silvers.

6           Grant Callery, Grant, who is new to the IAG, very  
7 graciously agreed to serve as the lead of the audit firm  
8 governance and incentives working group. We very much  
9 appreciate that, Grant. And his working group members  
10 consist of Brandon Becker, Curt Buser, Joe Carcello and  
11 Lawrence Shover.

12           And Ann Yerger is the lead on the auditor  
13 interaction with audit committees working group. And her  
14 group includes Mercer Bullard, Howard Morris, who as I  
15 say regrets that he is unable to be here due to an  
16 illness and we wish him speedy recovery, Pete Nachtwey,  
17 Bob Tarola and Barbara Roper.

18           So with that, Tony, why don't you start off and  
19 then Grant and Ann for five minutes each on the overviews  
20 and then we'll get right into the program. Thank you.

21           MEMBER SONDHI: Thank you. Okay and, Steve, you  
22 said it's a five-minute overview?

1           Okay, very good.

2           Fundamentally our group has worked on these  
3 indicators and we've decided that, in essence, what we  
4 recommend is that you prescribe a set of audit quality  
5 indicators that would measure the quality of the audit,  
6 the actual audit, the output, the results that you get,  
7 help establish the accountability for that audit quality.

8           And these indicators ought to be forward-looking  
9 and have a significant amount of information and  
10 predictive content, because that's what we need.

11          In essence, we need to find audit quality  
12 indicators that'll help us understand how well the audit  
13 was performed, assign responsibility and accountability  
14 for that audit.

15          The working group also believes, again, that the  
16 current focus seems to be on audit firm quality and the  
17 audit process, rather than audit quality itself.

18          And we believe that investors are most concerned  
19 about the reliability and the credibility of the audit  
20 and we're interested in understanding how those audits,  
21 what those audits tell us about the companies that we are  
22 currently invested in and/or companies that we're



1 interested in.

2 Many of us who've served on or advised audit  
3 committees have found that audit committee members are  
4 also most interested in the quality of the auditor's work  
5 for their company, in essence, rather than the actions  
6 that their audit firms have taken that relate to audit  
7 quality, but in general rather than specifically with  
8 respect to the output of the audit itself.

9 The final point I'd like to make in the  
10 introduction is that we think we need a focus on output-  
11 based indicators or results-based indicators of audit  
12 quality and we're going to propose a few of those in our  
13 principal discussions. Thank you.

14 CHAIRMAN HARRIS: Thank you very much, Tony, and  
15 I did look at the slides late last night and I think  
16 you've done an excellent job and we look forward to the  
17 presentation.

18 Grant, you want to give us a brief overview?

19 MEMBER CALLERY: Sure. The topic that our group  
20 was looking at was governance of incentives and what  
21 we've put together is a group of slides that raise a  
22 number of questions I think.

1           We have not really come to dispositive  
2 conclusions with respect to what needs to be done here,  
3 although as we talk through it we probably will get to  
4 some of those.

5           But I think we've looked at indicators, various  
6 things in the way that some of the PCAOB observations  
7 coming out of inspections and some of the various pieces  
8 of the way that firms incent themselves, and then have  
9 looked also at some of the potential governance issues,  
10 such as whether there is a need for having some sort of  
11 an independent, non-executive person, people, in the  
12 governing process of the firms.

13           There have been recommendations in the past that  
14 this be done. It's being done in the U.K. to some  
15 degree, and Joe has actually had some conversations with  
16 people about the outcomes of the U.K. work in that area  
17 and we'll be talking about that.

18           And then thinking about whether there are  
19 structural things within the firms that may need to be  
20 done.

21           There is a slide in there that talks about the  
22 balance of the pieces of the business of the major firms

1 and the percentages are interesting.

2           They're only a beginning of a conversation I  
3 think because you have to look into what the non-audit  
4 business is but I think there are some things that the  
5 PCAOB can be doing to look into those and see whether  
6 there are solutions that we need to be putting in place  
7 to avoid issues like we had a decade or so ago.

8           CHAIRMAN HARRIS: Thank you very much, Grant.  
9 And then, Ann, if you want to just briefly give an  
10 overview.

11           MEMBER YERGER: Sure, thank you. Well, it goes  
12 without saying that audit committees today play a vital  
13 role for investors in the capital markets given their  
14 significant mandated responsibilities including  
15 overseeing the financial reporting process and the hiring  
16 and the performance of the independent auditors.

17           The audit committees play a front-line defense in  
18 ensuring high-quality, reliable financial reports.

19           And in turn, accurate and reliable financial  
20 reporting is critical to investor confidence and the  
21 integrity of our securities markets.

22           Our subcommittee actually took a fairly big-

1 picture view of the issue so we didn't focus just  
2 narrowly on communications.

3           We thought about audit committees in large and we  
4 wrestled with really one question, which was how could  
5 audit committees enhance their performance?

6           And in analyzing this question, we centered in  
7 three areas. First, the skills of the committee members,  
8 in particular those of the financial expert; second, the  
9 quality of the communications from the independent  
10 auditor to the audit committee; and finally, the quality  
11 of the communications from the audit committee to  
12 investors.

13           And I note that the PCAOB only has direct  
14 authority over one of these topics, which is the auditor  
15 to audit committee communications.

16           The SEC generally has authority over the other  
17 two areas. However, given the importance, we thought,  
18 of all three, we think it's important to address the  
19 issues.

20           Like Grant, we don't have really any formal  
21 recommendations for the committee. We have more  
22 information and questions, so we really look forward to

1 your input on these issues. Thank you.

2 CHAIRMAN HARRIS: Thank you, Ann. And before  
3 actually getting started, I think it might be helpful if  
4 everybody introduced themselves since I don't think --  
5 last night at dinner there were a number of people that  
6 couldn't make it to the dinner.

7 So, Jim, why don't we go right around the table  
8 and make introductions and then we'll get started.

9 DIRECTOR DOTY: Jim Doty, PCAOB.

10 MEMBER SONDHI: Tony Sondhi, A.C. Sondhi and  
11 Associates.

12 MEMBER HARRISON: Norman Harrison, FTI  
13 Consulting.

14 MEMBER HEAD: Mike Head, retired, Chief Audit  
15 Executive, TD AMERITRADE.

16 MEMBER TURNER: Lynn Turner, Trustee of COPERA.

17 MEMBER WALSH: Gary Walsh, with Luther King  
18 Capital Management.

19 MEMBER CALLERY: Grant Callery, retired, General  
20 Counsel of FINRA.

21 MEMBER SHOVER: Larry Shover, Chief Investment  
22 Officer at SFG Alternatives.

1 MEMBER BUSER: Curt Buser, The Carlyle Group.

2 MEMBER BECKER: Brandon Becker, TIAA-CREF.

3 MEMBER CARCELLO: Joe Carcello, University of  
4 Tennessee.

5 MEMBER TAROLA: Good morning. Bob Tarola,  
6 President of Right Advisory LLC and a board member on two  
7 public companies.

8 MEMBER ROPER: Barbara Roper, I'm Director of  
9 Investor Protection for the Consumer Federation of  
10 America.

11 MEMBER NACHTWEY: Pete Nachtwey, CFO, Legg Mason.

12 MEMBER BULLARD: Mercer Bullard, Fund Democracy  
13 an investor advocacy group and University of Mississippi  
14 School of Law.

15 MEMBER YERGER: Ann Yerger, Executive Director of  
16 the Council of Institutional Investors.

17 JUDGE SPORKIN: Stan Sporkin, I have my own firm  
18 and I'm also the Ombudsman for BP America.

19 MEMBER SIMPSON: Anne Simpson, from the  
20 California Public Employees' Retirement System which is,  
21 I believe, the largest pension fund in America.

22 MEMBER BUETTNER: Robert Buettner, private

1 investor.

2 MR. CROTEAU: Good morning. I'm Brian Croteau,  
3 Deputy Chief Accountant in the Office of the Chief  
4 Accountant at the SEC and I'll just take one minute to  
5 add my thing because I know any remarks you hear from me  
6 today are certainly my own and not those of the  
7 Commission, Commissioners or staff.

8 But I know I do speak on behalf of many at the  
9 Commission in adding our own thanks to all of you for the  
10 efforts that you've put in.

11 I join Jeanette really in congratulating you on  
12 a really, really great agenda.

13 We at the SEC have been very supportive of all of  
14 the topics that you've got on the agenda here today, many  
15 of which are linked to the PCAOB's near-term priority  
16 projects that were announced nearly a year ago and absent  
17 from the list perhaps and on the near-term priority  
18 projects are also some direct linkage to auditing  
19 standards and updating auditing standards, another topic  
20 that we're very, very supportive of and encouraging of  
21 relative to perhaps that being the most clear and  
22 effective and direct way of improving audit quality.

1           And so I look forward to the discussion today and  
2 very much look forward to the input from this group and  
3 thank you very much, again, for all of the efforts.

4           MR. JONAS: Greg Jonas, PCAOB.

5           MEMBER FRANZEL: Jeanette Franzel, PCAOB.

6           CHAIRMAN HARRIS: And Steve Harris, PCAOB.

7           And now starting with Audit Quality Indicators,  
8 as early as 2010 this Advisory Group suggested the Board  
9 develop audit quality indicators.

10           Later, in our 2012 meeting, the working group on  
11 audit firm practice and transparency recommended the  
12 issuance of a concept release on AQIs, initiating a  
13 project to identify audit quality measures with a longer  
14 term goal of tracking such measures over time is one of  
15 the priorities of the Board. The PCAOB Office of  
16 Research and Analysis has been leading this effort

17           And as you will hear from Greg Jonas, the  
18 Director of the ORA, during our first presentation today,  
19 the staff of ORA has been working hard to identify  
20 certain key audit quality indicators.

21           And as part of the effort, ORA has reached out to  
22 the Board's various advisory groups, including the IAG.



1 I've asked Greg to start off the discussion with  
2 a very brief overview and then we'll turn it over to  
3 Tony.

4 But, Greg, congratulations on a terrific start,  
5 a terrific effort on an extraordinarily difficult subject  
6 matter and we appreciate your opening it up.

7 MR. JONAS: Great, Steve. Thanks. Good morning,  
8 everyone.

9 Among the challenges to audit quality is the  
10 curious circumstance that the customer of the audit, the  
11 investor and the buyer of the audit, the audit committee  
12 really has limited visibility today into the underlying  
13 quality of the audit work.

14 Now, to be sure, they understand when things go  
15 wrong, restatements, missed fraud, last-minute problems,  
16 and so forth.

17 But the absence of a problem, of course, doesn't  
18 necessarily indicate a high-quality audit.

19 As we've thought about it, we view the audit very  
20 much like an iceberg where the customer and the buyer  
21 really see only the tip and there's very little  
22 visibility into the largest part of the iceberg, which

1 is the part that's underwater.

2           And so at its heart, we fashioned the AQI project  
3 as trying to give visibility to that part of the audit  
4 that is underwater.

5           And with the sunshine on that section, we think  
6 there are four broad beneficiaries of the information.

7           First, for investors we think the insight can  
8 give them knowledge, better knowledge of risk in the  
9 companies that they invest. We also think it can help  
10 inform their proxy voting.

11           For audit committees we think that insight can  
12 help them understand the right questions to ask the  
13 auditor and that will inform their hiring decision and  
14 their compensation decision of the auditors.

15           Firms we think can benefit from this by being  
16 able to compare their firm with others, to ask themselves  
17 the right questions, to know where to invest, where are  
18 the problems and what to do about them and ultimately to  
19 be rewarded for a job well done.

20           And for regulators, too, there's help. It can  
21 help us understand where there is risk. It can help us  
22 understand the system of quality control and it can help

1 focus the regulatory endeavor.

2           So we've been on this. Brian mentioned this  
3 project has been named a strategic priority, a short-term  
4 strategic priority, and we've been at it since last  
5 December.

6           And we fashioned our first milestone to be a  
7 concept release that we hope to issue at around this  
8 year-end.

9           We envision that the concept release will have  
10 three broad sections. One would be background purpose  
11 of the project. The second would be about quality  
12 indicators. We fashion a portfolio of metrics,  
13 quantitative measures, informing audit quality. And the  
14 third section would be to discuss possible uses of these  
15 indicators.

16           We do not intend this document to be declarative  
17 at this point, but rather to in a structured way tee up  
18 important issues and seek public comment on those issues.

19           Let me hum a couple bars first about the  
20 indicators. What we have in mind is a balanced  
21 portfolio, kind of a scorecard of measures that give  
22 insight into quality.

1           We do not envision that this is benchmarking. We  
2 do not believe that these indicators will answer  
3 questions, but rather they will focus people on the right  
4 questions.

5           We envision the metrics to be balanced in the  
6 sense that some will relate to people, some will relate  
7 to process and some will relate to results, the output  
8 of the audit.

9           To date, we have embarked on a fairly extensive  
10 research effort, trying to read all that has gone before  
11 us about quality indicators and there is a fair amount.

12           We have fashioned a definition of quality. We  
13 have developed a framework for thinking about quality and  
14 we've surfaced roughly about 70 different measures that  
15 we think are candidates for metrics.

16           We've discussed these candidates with many  
17 thought leaders, including our advisory groups, with the  
18 SEC and others.

19           And we have been in the process for the past few  
20 months, really since May, of trying to screen the list  
21 of 70 down to something more manageable that we think  
22 would be the most promising indicators, maybe in the

1 range of 25 to 30 that we would put forth in the concept  
2 release.

3           The third section of the document deals with  
4 uses. Again, we don't intend to be declarative but  
5 rather to tee up in a structured way the many questions  
6 we have about possible uses.

7           Let me give you some examples. Should engagement  
8 teams discuss with audit committees engagement-level  
9 metrics? Should they also discuss firm-level metrics?

10           Should firms themselves publish publicly in their  
11 reports on audit quality quantitative metrics of audit  
12 quality and what insight they get from those metrics and  
13 what they're doing about weaknesses?

14           Should regulators publish insight about the  
15 metrics, comparing one firm to another, offering  
16 observations for the good of audit quality?

17           Should these programs be voluntary or should they  
18 be mandatory? How might we phase in such a program of  
19 audit quality indicators over time?

20           Scope, should all public companies be subject to  
21 these metrics or should we exclude certain company  
22 audits? Are all firms in or should we exclude certain

1 firms?

2           And we'll ask questions, I suspect, about  
3 benefits and costs of an audit quality indicator program.

4           As others have mentioned, I too deeply appreciate  
5 on behalf of the staff the help that you have given us.  
6 Tony and his task force have been terrific and we've had  
7 the benefit of one-on-one conversations with each of the  
8 task force members.

9           But, of course, we haven't had the benefit of the  
10 full group discussion and the great dynamics that come  
11 from that.

12           So it's an excellent time for this group to weigh  
13 in to influence our thinking. You already have, and I  
14 know today's discussion will do so again and we eagerly  
15 await the conversation. Thank you, Steve.

16           CHAIRMAN HARRIS: Tony, now let me turn it over  
17 to you and I'm not sure we've got our tech system working  
18 but hopefully we can flip to the slides, you know, as you  
19 go through them.

20           MEMBER SONDHI: Yes, I think we can manage that.  
21 Thank you very much, Steve, and thank you, Greg, as well  
22 for that introduction.

1           Let me begin with just a very simple comment on  
2 the fact that I have been helped greatly by members of  
3 my group and also by Matt Waldron of the CFA Institute.

4           He's given me access to a great deal of  
5 information. I'm going to report on one of the surveys  
6 that he's provided that they conducted last year.

7           And in addition to that, I've had conversations  
8 with several other people, members of the IASB, some  
9 accounting firms, and I've tried to gather as much  
10 information as I could to bring in to inform this  
11 discussion and some of these issues that I'm going to  
12 present.

13           But I must say that despite all their help, there  
14 will be some shortcomings and those are mine, so just  
15 keep that. I promised Norman that I would mention this  
16 so that the -- no, I'm just --

17           But I do appreciate everyone's help and  
18 particularly George Wilfert and Greg, spent a great deal  
19 of time with them so the PCAOB staff has been very, very  
20 helpful.

21           So let me go back and begin with the executive  
22 summary that I had just briefly mentioned earlier.

1           In essence, as I said earlier, we believe that  
2 these audit quality indicators ought to be designed to  
3 measure the quality of the audit itself.

4           We need to be able to develop indicators that  
5 help us understand and also establish the accountability  
6 for that audit quality.

7           But probably most important, these audit quality  
8 indicators need to have these two characteristics, that  
9 is they should be forward-looking and at the same time  
10 also have information of predictive content because, as  
11 we're going to show you, investors and the audit  
12 committee, of course, need information about the audit  
13 quality more than anything else.

14          So investors are concerned about the reliability  
15 and the credibility of the audits and I think that's what  
16 the audit quality indicators ought to emphasize.

17          Another thing that I mentioned earlier is that  
18 those of us who served on or advised audit committees  
19 have found that committee members are mostly interested  
20 in the quality of the auditor's work for their company.

21          So it's a very specific interest and that's why,  
22 again, I emphasize that we're interested in output-based



1 or results-based audit quality indicators.

2           The objectives of this project we think should be  
3 the development of indicators that help you measure audit  
4 quality.

5           In effect, the objective would be to provide the  
6 investors with timely information that they can use to  
7 understand the credibility of the audits.

8           That information would also help investors in  
9 their annual voting on auditors and retention and  
10 appointment of the auditors.

11           The audit committees would benefit from the  
12 publication of timely information on audit quality  
13 because that'll help them with respect to the specific  
14 oversight responsibilities that they have, as well as the  
15 selection of audit firms.

16           So overall, what we're looking for is information  
17 about risks that are identified. It would be helpful to  
18 get that information from the results of the PCAOB  
19 inspections and what's been discussed in those PCAOB  
20 reports as well.

21           With respect to the data collection,  
22 dissemination and the publication of that information,

1 we believe that audit firms should be required to provide  
2 the regulator, the PCAOB, with that data on the audit  
3 quality indicators.

4           One of the things that I think is interesting  
5 with respect to these audit quality indicators and their  
6 collection and dissemination is that although the  
7 quantitative information is likely to be most helpful,  
8 I do believe there are places where some qualitative  
9 information would be helpful as well.

10           And the data that is collected and then  
11 disseminated by the audit firms ought to be subject to  
12 review, verification and comment by the PCAOB.

13           Greg had pointed out that there's a question as  
14 to whether that ought to be analyzed by regulators and  
15 that's something that I think we ought to explore during  
16 our discussions.

17           What we're talking about here, in essence, is  
18 that it should be collected and disseminated by the audit  
19 firms and it should be subject to review and verification  
20 by the PCAOB.

21           With respect to the audit quality indicators  
22 themselves, what we have decided here is to present three

1 categories.

2           Some indicators we believe ought to be collected,  
3 analyzed and disseminated at the engagement level.

4           There's another category that we believe makes  
5 sense at the firm level, but there also indicators that  
6 we think should be collected at both, so just to sort of  
7 give you a broad view and perspective on the types of  
8 indicators that we're going to talk about.

9           Now, finally, with respect to these indicators,  
10 we recommend one other aspect and that is the audit  
11 quality indicators should be stratified, and the question  
12 then becomes what kind of stratification makes the most  
13 sense.

14           And I think this is a function of the type of  
15 audit client, it's a function of the type of audit  
16 quality indicator.

17           Some audit quality indicators may be best  
18 stratified in terms of the size of the client. Others  
19 we may need information about the business that the  
20 client is involved in or different businesses.

21           So we've discussed stratification measures such  
22 as SIC class, the codes or something similar.

1 I want to be very clear. I don't think there's  
2 a single answer with respect to stratification. In fact,  
3 I strongly believe that it's important to have good  
4 understanding and apply them judiciously to different  
5 types of indicators.

6 But I do believe that stratification is going to  
7 be critical because otherwise it's very difficult to  
8 understand.

9 For example, you know, take a very simple case.  
10 What I want to know about an audit of a company the size  
11 of Citigroup or JPMorgan is a little different from the  
12 bank down the street that has two branches or maybe  
13 three.

14 But that's a very simple argument but that also  
15 does express the nature of the stratification that I do  
16 believe we need, okay?

17 Now what I'd like to do is to spend a little bit  
18 of time talking about some very specific indicators.

19 Sort of an overarching comment that I'd like to  
20 make is please take these suggestions and recommendations  
21 as an approach to looking at and developing indicators.

22 These are not, in any sense, final. This is, as

1 Steve and Greg have both pointed out, a fairly complex  
2 undertaking and it is our first stab at it so please keep  
3 in mind that these are suggestions. They're what we've  
4 been thinking about.

5           We think they're important, very critical, and  
6 yet we certainly agree and would accept that they do have  
7 to be evaluated carefully and may require various levels  
8 of discussion and modification over time.

9           So I'm going to begin with the specific  
10 engagement level indicators. It's important, I believe,  
11 to understand how the time is spent on an audit, so the  
12 partner and manager hours relative to the hours charged  
13 by the rest of the engagement team, the identification  
14 of key risk areas in an audit and how much time was spent  
15 on those.

16           Another set of indicators relates to the  
17 inspection, whether that particular audit has been  
18 inspected by the PCAOB in the most recent year, what  
19 types of deficiencies were identified and a description  
20 of the types of those deficiencies, the amount of time  
21 that's spent by the audit partners and the staff and  
22 firms that are not subject to inspection and this, I

1 think, is a critical element in understanding the audit  
2 and the output of the audit itself.

3           A few others, and here what I believe we're  
4 looking for is the amount of time that is spent by people  
5 outside the immediate audit team.

6           So one of the indicators looks at the amount of  
7 time, the audit hours outsourced to either another firm  
8 or to an affiliate in a foreign country, whether there  
9 was any consultation with the national technical office  
10 and, if so, on what issues.

11           So we're looking, in other words, for what kinds  
12 of other information, other help you've used.

13           And then ultimately, third one in this case is  
14 the name of the lead engagement partner which would allow  
15 us to assess whether they have participated in other  
16 audits which were inspected and where credibility was an  
17 issue.

18           So that would clarify the types of audits and  
19 provide us with some more information on those.

20           So let's move now to some audit firm-level  
21 indicators. The policy and measurement and management  
22 of audit quality indicators ought to be public. That's

1 just a general comment with respect to the audit  
2 indicators.

3           And this I believe is an expression from the firm  
4 itself that's collecting and disseminating that  
5 information and this aspect, of course, would also be  
6 different and the regulators would give us their  
7 perspective on it.

8           With respect to the audit firm-level indicators  
9 compensation policy, the executive partners for the audit  
10 partners on the engagement and the audit staff, what we  
11 believe is important to understand with respect to  
12 compensation levels is how those are linked to audit  
13 quality, including the specific triggers measured and  
14 used in linking that audit quality to compensation  
15 levels.

16           The average billing hours and responsibility of  
17 audit partners, also the average chargeable hours of  
18 partners, managers and the audit staff. So we're looking  
19 for some detailed information with respect to both the  
20 compensation and how they're spending time on the audit  
21 itself.

22           Another set of indicators at the firm level would

1 look at specific audit engagements and provide  
2 information on the number of audit engagements for which  
3 an independent review occurred. And of those where an  
4 independent review occurred, we would like to see  
5 information about the number and the aggregate estimated  
6 fees of non-audit engagements which the firm declined to  
7 accept.

8 Information about the identification of  
9 affiliates not subject to an inspection by the PCAOB and  
10 identification of affiliates who do not provide audit  
11 documentation to the U.S. affiliate in compliance with  
12 SOX. And we can look at that at different levels,  
13 different types of compliance and so on, but the idea is  
14 to get a sense of who participated in the audit and to  
15 what extent they're subject to regulation.

16 This set of indicators -- let me begin actually  
17 with the last three and then I'll come back to the first  
18 two. The billable fees or hours by major industry  
19 groups, and this is something that'll allow us to  
20 understand what type of expertise the audit firm has.  
21 Portion of the audits that are assessed as being high-  
22 risk audits and how they're spending the revenues on the



1 audit staff.

2           We've also proposed two indicators that are  
3 effectively output-based, and those are the number of  
4 restatements and the number of material weaknesses  
5 reported by a major industry group.

6           As you can see, we brought in at different places  
7 certain kinds of stratifications, so we do make certain  
8 recommendations, but please keep my earlier point in mind  
9 that it is important to understand and to be clear about  
10 what kinds of stratification is needed and where.

11           We're also interested in understanding the  
12 resources that the audit firms are spending on audit  
13 tools and audit technology. We need to understand the  
14 number of pending SEC and PCAOB enforcement actions with  
15 respect to the firms, the average salary for new hires  
16 on the audit staff, the number of first-year audit  
17 engagements where the prior auditor resigned or there was  
18 disagreement that was reported with respect to the prior  
19 auditors.

20           Certain additional indicators, remember I pointed  
21 out that we have three categories and this is our third  
22 category where we'd like information on both the

1 engagement level and the firm level. The average number  
2 of hours of professional education for partners, managers  
3 and staff assigned to the audit. Please keep in mind  
4 that this is information that we think will help us  
5 better understand the type of the quality that the audit  
6 firm brings to the audit, the kind of expertise that they  
7 bring to the audit.

8           We are, however, we do understand, we're clear  
9 about the fact that, you know, just the hours or the  
10 dollars spent aren't going to give us very good  
11 information. So this is something that we need to think  
12 carefully about as to how to develop and design these  
13 indicators so they can actually tell us what type of  
14 expertise is being developed and what expertise they  
15 have.

16           Information about turnover in staffing at  
17 partner, manager and staff levels. That turnover is very  
18 critical because it helps us understand, again, the type  
19 of expertise that comes in and what's happening to the  
20 staff levels there. The average years of experience of  
21 the audit partner and personnel staff assigned to the  
22 audits, experience on the specific engagement, experience

1 in the industry and overall audit experience. We think  
2 one of the most critical things in audits is to  
3 understand what type of industry and business expertise  
4 the auditors bring to their audits. Any violations of  
5 the PCAOB auditor independence rules. Okay.

6           Now, I'd like to step away from the audit quality  
7 indicators and tell you a little bit about one of the  
8 surveys that the CFA Institute conducted last year in  
9 September 2012. The CFA Institute, as you know, is the  
10 one that administers the Chartered Financial Analyst  
11 designation, and I can provide you with a lot of  
12 information about where they are. They're represented  
13 all over the world.

14           They surveyed 498 members of their financial  
15 reporting survey pool, so these are people who are really  
16 well-informed that expressed an interest in these issues.  
17 The response rate was 21 percent and the margin of error  
18 is 8.5 percent at the 95 percent confidence level. The  
19 objective the CFA Institute had in mind in conducting  
20 this survey was to provide feedback to the International  
21 Forum of Independent Audit Regulators for use in the  
22 deliberations and proposed changes to the audit process.

1 I'm going to use these in this discussion to  
2 illustrate investor preferences with respect to expanded  
3 transparency in audit regulation as well as the  
4 independent audit report. For those of you who are  
5 interested, the entire survey and the questions, et  
6 cetera, are available at the CFA Institute website.

7 Let's focus on four of the questions that were  
8 asked in this survey. The first question concerned the  
9 quality of the audit, and the question was to what extent  
10 do you agree or disagree that regulatory oversight and  
11 enforcement of the independent audit improves the quality  
12 of the audit?

13 Now here, 72 percent of the respondents agreed  
14 that regulatory oversight and enforcement improves audit  
15 quality. What's interesting is the divergence of views  
16 around the world. The Asia-Pacific members, 47 percent  
17 of them strongly agreed with this contention, 40 percent  
18 in Europe and Middle East and Africa and then 34 percent  
19 in America. But you can see that you got a fairly  
20 significant number of respondents who feel that oversight  
21 and enforcement are critical to improving audit quality.

22 The next question that the CFA Institute asked

1 was with respect to current regulatory oversight and  
2 enforcement. The question was to what extent do you  
3 agree or disagree that current regulatory oversight and  
4 enforcement of the independent audit is effective? Now,  
5 I at least found the results here somewhat mixed. Take  
6 a look at it and you'll see what I mean. Thirty-seven  
7 percent neither agreed nor disagreed. Thirty percent  
8 agreed that current regulation and oversight are  
9 effective.

10 Now, I don't know. It, you know, depends on what  
11 you do with the neither agree nor disagree contingent  
12 here, but interestingly what I found was that the EMEA,  
13 47 percent of those respondents and one third of the  
14 respondents in the Americas do not believe that the  
15 current regime is effective.

16 (Off microphone discussion)

17 MEMBER SONDHI: I'm not sure. I don't think  
18 they're inconsistent. I think the first one is telling  
19 us that people believe that regulatory oversight and  
20 enforcement would help. What the second one is talking  
21 about is the current regimes that we have around the  
22 world, what they believe in about those.

1           But as I said, and I think that's partly, you  
2 know, the reason why I assume you're asking is,  
3 interestingly enough, that only 18 percent of the APAC  
4 members disagree with that. Lynn, did you --

5           MEMBER TURNER: No. In response to Jim's  
6 question --

7           MEMBER SONDHI: Yes, please.

8           MEMBER TURNER: I think the first set of  
9 questions say do you think regulatory oversight's  
10 important? Yes. And the second set of questions is do  
11 you think it's getting the job done? And there was  
12 interesting views on both, yes.

13          MEMBER SONDHI: And it's interesting to see the  
14 differences across the three groups that are represented  
15 as well. The third question --

16          MEMBER SIMPSON: Can I make a comment on that,  
17 Tony?

18          MEMBER SONDHI: Please.

19          MEMBER SIMPSON: I'm sorry, because I think this  
20 is a really interesting point and it rather backs up what  
21 Greg said at the very beginning. And I speak in all  
22 humility as one of those wretched investors who have a

1 strong opinion that regulation is a terrific idea and  
2 then become rather hazy when asked, well, what's really  
3 going on and do you understand what's going on? So I  
4 think this really sets the stage for a message for the  
5 investor community, that we need to be better informed  
6 and we really need to back up our regulators.

7           So, you know, more on that later when we get to  
8 the general discussion about what we could be and should  
9 be doing. It's a little bit, you know, like sitting  
10 around wanting the world to work more effectively but not  
11 stepping up to do the work that's needed. So I think,  
12 you know, the investor community, we need to look to our  
13 own record here. It's not inconsistent. I think it  
14 probably says more about the investor community than the  
15 regulatory community.

16           MEMBER SONDHI: And I think you're right because  
17 over the years that we've conducted surveys and talked  
18 to analysts, we don't get very detailed and informed  
19 responses with respect to the audit report. But if you  
20 tell them what happens if we take it away --

21           MEMBER SIMPSON: Oh, yes.

22           MEMBER SONDHI: Yes and, you know, then there is

1 an uproar. So you're right, there's no question that  
2 analysts need to be more informed.

3           But remember, you're also looking at, you know,  
4 some levels of technical expertise that's required in  
5 order to understand these. And we do have various types  
6 of analysts out there. There are some people who use  
7 accounting information and there are many, or some who  
8 don't, so that makes a difference as well and has an  
9 impact on some of these results in the surveys that we  
10 conduct.

11           MEMBER TURNER: Tony.

12           MEMBER SONDHI: Yes.

13           MEMBER TURNER: I wouldn't put the focus on  
14 investors and say that takes away from it at all. I  
15 think it reflects how these people who are using the  
16 financial statements actually perceive the process.

17           And that's what's important because what you're  
18 trying to build is trust and confidence here. And if  
19 they don't have trust in the regulator actually getting  
20 the job done, then that's, in essence, what they're  
21 telling you and then the regulator needs to take steps  
22 to address that shortcoming, either in reality or in



1 perception. But clearly there's a perception there that  
2 is a serious issue.

3 MEMBER SONDHI: Right, thank you, yes. Please.

4 CHAIRMAN HARRIS: After the judge asks the  
5 question, maybe you can finish off the full presentation  
6 because there are a ton of issues here on this subject  
7 matter. So, Judge, go ahead and then everybody else --

8 JUDGE SPORKIN: Well, maybe this is the wrong  
9 time --

10 CHAIRMAN HARRIS: -- hold your peace until after,  
11 you know, after we're finished, but by all means.

12 JUDGE SPORKIN: Yes, I don't know whether it's  
13 the right time but I didn't see a whole lot in the  
14 planning of the audit as to a quality indicator. Is that  
15 in here?

16 Because I've found that with good plans, when you  
17 sit down and look at the company and determine what areas  
18 they're in and whatnot and how you're going to go about  
19 to do that audit, that I've found that's extremely  
20 important. Has that been looked at, the audit planning  
21 stage?

22 MEMBER SONDHI: Yes. We've actually, we've

1 talked about that a great deal and we will come back to  
2 that as well. I certainly agree with you, no question,  
3 and the group itself in the discussions has made that  
4 very clear, that that's a -- the distinction that I'm  
5 trying to draw here is to bring our focus on to the  
6 outputs.

7           But I agree with you. That's part of the  
8 process. There's no question. And you're not going to  
9 have a good audit without that. But if you would bear  
10 with us, let me provide a little bit more information  
11 about the general report and then, as Steve suggested,  
12 we do have about 45 minutes for the discussion so we'll  
13 come back to that.

14           The third question that the survey asked had to  
15 do with the transparency of inspection reports, and we  
16 asked whether those need to be more transparent. The  
17 results here are clearer, 80 percent of the respondents  
18 called for increased transparency and the highest  
19 proportion of that is 88 percent of America's  
20 respondents, 73 percent in the APAC and 69 in Europe.  
21 And that, as I said, you know, that seems straightforward  
22 and clearly that's what, and you'd expect that.

1           And finally, the independent auditor's report,  
2 should risk factors associated with measurement  
3 uncertainties in the entity's financial statements be  
4 included in the independent auditor's report?

5           And here, respondents called for the disclosure  
6 by a three-to-one margin, all right, so they're looking  
7 for disclosure. What was also interesting in here is  
8 that 57 percent of the respondents wanted to limit the  
9 disclosure to significant risk factors, whereas 18  
10 percent, which is a reasonable number, would prefer to  
11 have all risk factors disclosed. And, you know, you can  
12 think of that as information and how they're going to use  
13 it, but that's the idea here.

14           So to summarize the survey, certainly I think  
15 that the respondents agree that regulatory oversight and  
16 enforcement have a positive impact, but one in three  
17 don't believe that currently we're getting what we would  
18 like to get with respect to that.

19           And then finally, 75 percent of the respondents  
20 would like to see more disclosure of risk factors and 80  
21 percent are calling for greater transparency. So that  
22 should, you know, give you a good sense of what people

1 are looking for.

2           What I'd like to do now in the last few minutes  
3 that I have, is to focus on another set of indicators.  
4 I've talked a great deal about and I mentioned output-  
5 based indicators, but here's what I'd like to say about  
6 that. We strongly recommend that the PCAOB develop  
7 output-based indicators, the quality and the credibility  
8 of the audits.

9           Now, what we believe this calls for is the  
10 development of indicators that are credible early warning  
11 signals or forecasts of risks. The output-based  
12 indicators of predictive content, in essence they involve  
13 an assessment of the decisions that relate to recognition  
14 or timing and the measurement or the amount of a  
15 particular issue and those choices. And very often those  
16 choices are based on variable or uncertain data or soft  
17 data, as we often call it, and that type of soft data  
18 requires significant judgment and estimates that have to  
19 be combined with a really good comprehensive  
20 understanding of your own business.

21           One example is the use of discretionary accruals  
22 and I believe that Greg and his team have been thinking

1 about this and I believe you've included this or an  
2 indicator based on discretionary accruals. Now the  
3 fundamental challenge, of course, with developing these  
4 types of indicators, informative, forward-looking  
5 indicators, is that many if not most of them are observed  
6 ex post. It's after the audit and the financial  
7 statements have been made public.

8           So for example, the number and frequency of  
9 restatements, errors in going concern assessments, the  
10 impairments, issues with valuation, the adequacy of  
11 allowances or reserves for contingencies and the  
12 valuation allowance for deferred tax assets, for example,  
13 these are all observed, generally speaking, after the  
14 fact.

15           Now, we believe that an important characteristic  
16 of these types of forward-looking and informative  
17 indicators is their ability to forecast risks and  
18 problems. So I'll give you just a brief idea of what I  
19 am thinking about here. See, research shows that  
20 financial statement recognition, in other words the  
21 timing of impairments and also the amount of the  
22 impairment recognized with respect to long-lived tangible

1 assets, like machinery equipment, for example, these are  
2 often preceded by LIFO inventory liquidations. In fact,  
3 research shows that sometimes LIFO inventory liquidation  
4 can be as much as a year or two years prior to the  
5 company acknowledging that that particular business isn't  
6 working.

7           If you look at bricks and mortar retailers, and  
8 I draw that distinction because Internet retailers are  
9 quite different in respect to this and you have to think  
10 about them differently, but for a long time analyses of  
11 financial distress on a very timely basis can be achieved  
12 by looking at trends in the operating cycle. How long  
13 does it take to sell your inventory? How many days does  
14 it take to collect your receivables? That's what we, the  
15 analytical world, we call that the operating cycle. If  
16 you subtract from that the amount of time the suppliers  
17 allow you to pay off for your purchases, that gives you  
18 a cash cycle.

19           And trends in these operating and cash cycles  
20 have been indicative of financial distress for as much  
21 as three years. And three years, as most of the investors  
22 would agree, is almost, you know, an eternity in the

1 financial markets. So from that perspective, these are  
2 the kinds of measures that I think are very helpful or  
3 can be very helpful.

4 Similar analyses of deferred tax footnotes,  
5 valuation allowance for deferred tax assets, the way  
6 statements of cash flows present and provide information,  
7 these I think would yield significantly useful  
8 indicators.

9 The fundamental challenge, however, is in  
10 identifying appropriate risk measures in order to develop  
11 these types of output-based indicators.

12 All right, so that's my presentation, Steve.

13 CHAIRMAN HARRIS: Well, Tony, thank you very  
14 much. I think that's an excellent presentation. I think  
15 what I'd like to do is let you lead the discussion, or  
16 the general discussion, with respect to the questions  
17 and, Greg, you should feel free to join the fray as you  
18 see fit.

19 But I think there are a number of questions and,  
20 first of all, I'd like to open it up to the members to  
21 ask whatever questions, recognizing Security and Exchange  
22 Commission first, so Brian.

1           MR. CROTEAU: Well, thanks very much. I just  
2 wanted to go back to the point that you raised, I don't  
3 know if the slide has a number, but on transparency of  
4 inspection results.

5           And it's not surprising 80 percent of respondents  
6 called for increased transparency but, of course, that  
7 can mean a lot of different things. And the PCAOB  
8 certainly is looking at this relative to improving the  
9 content of inspection reports and this is on the agenda  
10 for today.

11           But is there any more detail relative to what  
12 that meant to the respondents in terms of the types of  
13 transparency that respondents were looking for?

14           MEMBER SONDHI: Before I answer that, though, let  
15 me just mention that, you know, all of my group, you're  
16 all welcome to respond to these. I've been doing all the  
17 --I've done the presentation, but please feel free  
18 because you've obviously contributed to this and you have  
19 your own views as well on this.

20           Brian, with respect to that specific question,  
21 you know, one of the problems or one of the sort of  
22 shortcomings of questionnaires is that you provide a



1 certain amount of information. One of the things that  
2 we've done, that the CFA Institute has been doing lately,  
3 is for particularly difficult issues they provide a great  
4 deal of information beforehand.

5 For example, they recently conducted a survey on  
6 leases and they presented both the FASB and the IASB  
7 perspectives and provided information in those webcasts  
8 and slides and explained aspects and then asked  
9 questions, right?

10 But in this particular instance, I don't think we  
11 had that much detail and what you see, in a sense, is  
12 what you get. But I certainly agree that, you know, that  
13 could be one of those questions that we need about five  
14 or six different aspects of it probed and then we could  
15 get better information from our respondents on that.

16 CHAIRMAN HARRIS: Identify yourself for the  
17 person that's taking the transcript, if you would.

18 MEMBER HEAD: Mike Head, and I only have a  
19 population of one because I interacted with my company's  
20 audit committee on a regular basis and on multiple years  
21 of inspection reports.

22 And when they talked about in our dialogues in

1 the meeting on transparency relative to the inspection  
2 reports, it really tied very closely to but what's it  
3 mean for our engagement? What's it mean about our team?  
4 What's it mean about -- and so we would go through  
5 exercises and we got to a point where we anticipated it.

6           After the first one, it was a fire drill but then  
7 it was more routine, is taking the other firms'  
8 inspection reports, comparing it to ours and then going  
9 through every question and saying if that was applicable  
10 to our industry and our company and, if so, having our  
11 auditors respond to how they were addressing it for our  
12 audit.

13           So, I think the audit quality indicators  
14 initiatives and what our audit committee saw as missing  
15 information to connect the dots was what about our  
16 engagement, our team and the quality of that relative to,  
17 because our audit didn't happen to be in the sample that  
18 was inspected, and that was the disconnect for them.

19           CHAIRMAN HARRIS: Tony, I'm going to let you lead  
20 the discussion but as the tent cards go up I think that  
21 Barbara's went up and then Peter's went up. But why  
22 don't you lead it and --

1 MEMBER SONDHI: Yes. Barbara.

2 MEMBER ROPER: Barbara Roper, Consumer Federation  
3 of America. Thanks for the presentation. I found it  
4 very useful.

5 You know, I come at this from sort of a certain  
6 approach, which is that I think we have a business model  
7 for auditors that's fundamentally inconsistent with their  
8 gatekeeper role. So we then spend a lot of time -- so  
9 when the client is paying the person who is supposed to  
10 be holding the management accountable, that creates a  
11 fundamental problem in the auditor's willingness to serve  
12 in that role effectively.

13 So we spent a lot of time on policies that are  
14 designed to create counter-incentives, and this strikes  
15 me as an important part of that effort. One of the  
16 problems we're dealing with here is that there is an  
17 incentive and even with the audit committee oversight of  
18 the audit, there is an incentive to under-invest in a  
19 quality audit, to have pressures on the fees and to have  
20 that be a factor that drives the conduct of the audit.

21 And to the degree that we can look at audit  
22 quality indicators that are designed to create a counter-

1 incentive to invest in a high-quality audit, I think that  
2 has the potential to be beneficial in the long run. And  
3 I think a lot of what you've gotten at here in these  
4 specific suggestions go toward that in terms of both  
5 looking at how the audit is staffed and the expertise and  
6 the area.

7           And I think it has a secondary benefit in the  
8 sense of holding audit committees accountable for who  
9 they hire and how they oversee that audit. So, I think  
10 you've done a good job in focusing on some key issues  
11 that are really important to that and I'm very  
12 supportive.

13           MEMBER SONDHI: Thank you, Barbara. Norman, did  
14 you want to respond?

15           MEMBER HARRISON: Yes. Barbara, thank you. I  
16 agree. I think you raise a very important concept and  
17 point and we certainly were mindful of that in our  
18 deliberations and in preparing our presentation remarks  
19 for today. And you've provided me an opening or a window  
20 to raise a similar issue that I think should inform the  
21 staff's and the Board's thinking as you get to the task  
22 of identifying specific indicators or categories of

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1 indicators and their relative value or worth.

2 I guess what I would suggest is, and perhaps  
3 appropriately given that we are the Investor Advisory  
4 Group, that as you consider specific candidates for input  
5 and process and output-based indicators, that you overlay  
6 an investment framework as well, because at the end of  
7 the day I think what we're doing here in the process of  
8 developing or proposing indicators is in one form or  
9 another measuring behavior, measuring behavior of  
10 individuals, measuring behavior of an enterprise.

11 And individuals is relatively straightforward.  
12 It's the technical competence and the quality and the  
13 integrity of the people conducting the audits and the  
14 results of their performance in prior years. But when  
15 it comes to measuring or assessing the behavior of an  
16 enterprise, I think one of the ways we have to do it is  
17 by looking at where and how they've chosen to spend or  
18 invest their resources. And I think that the audit  
19 quality indicator discussion and framework gives us an  
20 opportunity to look at that.

21 And as I look back at the discussion paper that  
22 was prepared for the SAG meeting in the spring and the

1 exhibits which outline the framework and the  
2 considerations that underlie each of the potential  
3 indicators, it occurred to me that some of those fall  
4 more into the category of an expenditure as such, whereas  
5 others have more the quality of an actual investment  
6 associated with them.

7           And what I mean by that is, for example, if we  
8 measure the amount of money that a firm spends on  
9 training or on its promotional materials or publications,  
10 other current expenditures that are designed to talk  
11 about or characterize or reinforce its commitment to  
12 audit quality, I'm not sure what we get out of those,  
13 other than how much money they've spent. It's like  
14 looking at their grocery list for the ingredients they  
15 bought for the cake, but until we see the cake or the  
16 soufflé come out of the oven, I'm not sure what that's  
17 really told us.

18           Similarly, to jump to a balance-sheet analogy,  
19 there are intangibles that are, I think, incorporated  
20 into some of the indicators, for example tone at the top  
21 or some attempt to measure partner fortitude in standing  
22 up to a client where there may be a contentious issue.

1 Again, I'm not sure there is as much value in those as  
2 there is in what I think of as the third category, and  
3 that is places where the firm has in one or another made  
4 an actual investment. And, investment in the form of an  
5 opportunity cost, investment in the form of allocation  
6 of resources to non-fee-producing activities.

7 I think two good examples, and I'll be quick  
8 because I know that others want to speak, two good  
9 examples of that reflected in our presentation is that  
10 in some way I think the indicators that the Board  
11 proposes should try to capture and provide some insight  
12 into the independence process at the firms, the  
13 independence review process. To what extent, to what  
14 degree have they demonstrated a willingness to forsake  
15 revenue or to put revenue at risk in order to protect the  
16 integrity of their audit practice? And we had a good  
17 discussion around this at last year's meeting, discussion  
18 of the growth of the advisory businesses in the firms and  
19 some of the cultural issues that creates. I think that's  
20 relevant here as well.

21 And as a second example, again it's reflected in  
22 your discussion paper as well as in our presentation, the

1 issue of the findings of audit quality review processes  
2 internally. I think the issue there is not only, you  
3 know, what are the findings and what can we learn from  
4 them, but if there is some way to capture the level of  
5 investment that the firms are making in their QPR  
6 processes.

7 Are they taking partners, high fee-producing  
8 partners out of rotation for a period to serve in that  
9 capacity? What is the nature of the follow-on work  
10 that's being done, the remediation work that's being  
11 done, the investment that's being made in running these  
12 issues to ground and being sure they're fixed? And  
13 that's not a current period issue. That's an issue that  
14 unfolds over time so that would be my thought and,  
15 Barbara, I appreciate the point. It's a very good one.

16 MEMBER SONDHI: Thank you, Norman. Lynn, did you  
17 want to respond to this or add?

18 MEMBER TURNER: I wanted to come back to Brian's  
19 question about the transparency and more specifically  
20 what are people saying about transparency?

21 In talking to people who are analysts inside  
22 these large funds, one of the things, and this goes back



1 to one of the comments from Chairman Doty at the  
2 beginning, they're interested in transparency as far as  
3 the inspections and the PCAOB oversight process with  
4 respect to the foreign piece of the audits and that's  
5 been increased by problems in China and India and  
6 Singapore. So quite often I get questions from them  
7 about well, what part of the inspection dealt with that  
8 and what was the results of that?

9           In transparency, for example, they'll look at GM  
10 and see x percent of the assets over there. What does  
11 the PCAOB inspection process have to do with that and the  
12 foreign piece of it? So greater transparency around the  
13 foreign aspects of it is one question I often get.

14           Another, obviously it's been in the press a lot,  
15 the name of the companies. People go to vote and proxy  
16 issues come up in proxies, questions get raised about the  
17 audit and invariably there's the question about, well,  
18 is this an audit that the PCAOB inspected and was there  
19 a problem? Often it's been reported in the press where  
20 there was a problem because they're able to dig into it.  
21 And it's like, why isn't the PCAOB being more  
22 transparent, telling us that there was a lousy audit here

1 so we can then factor that into our voting decision so  
2 it's informed rather than trying to hide it from us?

3           And quite frankly, the recent SEC enforcement  
4 action against the three auditors has the same problem  
5 because the Commission has gone dark in some recent  
6 enforcement actions including that with respect to  
7 telling us about what company was it where there was a  
8 lousy audit and you took action against an auditor? So  
9 that was a transparency problem with respect to the  
10 Commission, not only the PCAOB but also the Commission  
11 in some cases.

12           And more about the error rates, if you will. So  
13 if you inspected, questions that people often arise, if  
14 you inspected audits, how many audits did you inspect?  
15 How many had a significant problem, significant enough  
16 that you note it in the report and how many were passed  
17 with no problems?

18           When you're in manufacturing, we would put out an  
19 ISO 9000 type report that would say, okay, you got a 99.9  
20 percent okay output on the chips you were doing and only  
21 0.01 error rate. That tells people something as opposed  
22 to if you say there's a 95 percent okay and 5 percent

1 error rate, so some statistics about that that tells us  
2 what the error rate is and what the okay rate is too.

3           So those were the things that I've heard fairly  
4 common in conversations with people about the inspection  
5 process and the issues that they've raised. And  
6 certainly the foreign thing that Jim raised is something  
7 that comes up quite often in light of the problems that  
8 they've had in audits. And I think it's also reflective  
9 of the survey results up there where the questions about  
10 the effectiveness of the regulation is much higher when  
11 it comes to Asia or overseas versus here in the U.S., so  
12 I think that's important.

13           And then I'd just go back to what Barb said about  
14 the audit quality and the issues with the audit. Having  
15 watched this profession over four decades now, I do  
16 believe and have come to the conclusion that until  
17 someone actually deals with the fundamental issue of who  
18 pays the auditor, that the rest of what we do, be it  
19 audit quality indicators, issues on independence,  
20 mandatory rotation or whatever, they can all be helpful  
21 but they will never solve what the problem is.

22           And we've spent 100 years now trying to find a

1 way to deal with the problem without dealing with it and  
2 I think until we deal with that problem we're just going  
3 to continue to add a lot of cost to the system but we  
4 will never, ever solve the fundamental problem. So while  
5 I support and think mandatory rotation's good, the audit  
6 quality indicators are all good, I think that's useful,  
7 it's good to know that the firms are actually managing  
8 and measuring quality, until you deal with the who pays  
9 the auditor issue, you will never solve the problem.

10 MR. CROTEAU: Can I just -- sorry, just  
11 responding to one piece.

12 MEMBER TURNER: Yes, please.

13 MR. CROTEAU: Just on the SEC enforcement actions  
14 relative to auditors. Of course, when a firm is barred  
15 by the SEC, ultimately, you're probably aware that re-  
16 audits end up being required for all of the audits that  
17 are performed by that firm ultimately because they can  
18 no longer consent.

19 And so it becomes very public who all of the  
20 audit clients are that are involved in that kind of a  
21 situation, like at least one of the ones you're  
22 mentioning.

1 (Off microphone discussion)

2 MEMBER SONDHI: Peter.

3 MEMBER NACHTWEY: Thanks, Tony. And I like what  
4 Barbara said. I think you guys did great work. I was  
5 really curious what was going to come out of this  
6 subgroup and I think, again, a lot of great work.

7 A question and then couple of observations. On  
8 the survey, the one thing I was surprised at was the area  
9 of the world that I stay awake most at night about, which  
10 would be APAC, is the one that had the strongest views  
11 around the enforcement regulatory oversight versus the  
12 U.S. where I think we have much, certainly not perfect,  
13 never will be, but I think much better than APAC.

14 Any sense of what that is? Because there was  
15 quite a big survey population, so it should have been  
16 statistically accurate I guess.

17 CHAIRMAN HARRIS: Can everybody speak into the  
18 microphone. There's some problems in terms of hearing,  
19 so.

20 MEMBER SONDHI: Yes. Peter, I certainly agree  
21 and that's, you know, explains why I put the word  
22 interesting in front of that result and that's exactly

1 what I meant. I was surprised by it and I think the only  
2 way that one could answer that would have been to go back  
3 in and ask a lot more people.

4 I do have in the survey results, if you'd like to  
5 see them, there are actually individual comments from  
6 people as well that we've captured but it does not answer  
7 the question of why there is that disparity.

8 MEMBER NACHTWEY: And then maybe that's for a  
9 future version but, you know, that one looked a little  
10 strange to me. So again, having said that, I think it  
11 was great work. You know, important to keep cost-benefit  
12 in mind and I'm reminded of something one of my early  
13 accounting professors used in one of our classes. I'm  
14 sure it was not his quote, but the old adage of not  
15 everything that's important is measurable and not  
16 everything that's measurable is important. So I think  
17 we got to, you know, keep that in mind. I think the  
18 committee did a good job, subgroup or working group, in  
19 terms of trying to filter for that.

20 But I think we should keep coming back. You  
21 know, this issue of putting cost into the system, it'll  
22 be at many levels. So important that whatever we do

1 decide to measure, that those are worth measuring and  
2 worth the cost. And whatever we decide not to measure  
3 but it's important is making sure that gets its due.

4           And I think this goes back to the focus Tony said  
5 early on as to what's the appropriate role of the PCAOB  
6 versus audit committees and other governance structures?  
7 And I think PCAOB trying to do some sort of assessment,  
8 qualitative, you know, quantified assessment audit by  
9 audit would be very difficult, and doing something by the  
10 firm level makes a lot of sense to me at the PCAOB level.

11           But then it comes down to what are audit  
12 committees doing in terms of looking at the real  
13 qualitative issues, because it is audit by audit. It's  
14 partner by partner, person by person on these  
15 engagements. And, you know, I think that Judge Sporkin's  
16 comment, I had the same reaction in terms of forward-  
17 looking, you know, types of quantitative things. I think  
18 you're going to have a hard time coming up with  
19 quantitative things that are forward-looking by  
20 definition because audits are audits of historical  
21 financial statements.

22           That doesn't mean that there aren't things,

1 though, that particularly audit committees can get their  
2 arms around. So what's the quality of the partner or  
3 partners and other senior people on the engagement?  
4 What's the level of knowledge about the industry and the  
5 company? Because the larger and more sophisticated the  
6 company, the more important it is that you not only know  
7 the industry but what's going on inside the company.

8           So just, again, I know you're being thoughtful on  
9 that but I encourage the PCAOB to be thoughtful as we  
10 come out with regulation.

11           The other thing I didn't see up there, well, it  
12 may have been tangentially talked about, but there is a  
13 reliance on a lot of other experts, including internal  
14 audit. And having some sort of, you know, quality  
15 indicators about are you relying on quality experts when  
16 you're doing an audit would also be important. But,  
17 again, probably comes down to company by company type of  
18 information.

19           And then the audit firm-level quality indicators  
20 I thought were, again, interesting but important to --  
21 they're nuanced, right? So the number of hours a brand  
22 new partner can supervise versus somebody who's been



1 around 20 years is going to be very different. So I  
2 think the firm-level stats, the firms are big enough that  
3 they're probably relevant, but when it comes down to each  
4 individual audit, making sure there's some room for  
5 judgment there.

6           And ditto on the number of clients. So, I spent  
7 27 years in the profession before spending now ten years  
8 in industry. And early on in my career I was serving  
9 dozens of clients but they were all small, not very  
10 sophisticated. At the end of my career I was doing one  
11 client, but I had 400 partners working on it around the  
12 world. So again, the level of complexity I think is  
13 important and you can only get at that where the rubber  
14 meets the road, which is kind of audit committee  
15 oversight of the specific auditor and audit that's being  
16 done at their company.

17           MEMBER SONDHI: Thank you, Pete. I certainly  
18 agree with a lot of what you've said. I do believe that  
19 this is a process that's going to take us some time.  
20 These are our first steps.

21           Every single nuance that you have mentioned is  
22 certainly worth, you know, thinking about, worth dwelling

1 on, and I think what we're going to have to do is look  
2 at the initial results that we get and think about what  
3 we want to continue.

4           As you said with that quote from your accounting  
5 professor, what helps us is that we can always change  
6 what we're measuring after we learn more about what we  
7 have measured. And that's the process, as an analyst,  
8 that's what I do all the time. Again, as you said, I  
9 take historical information, I combine what I think is  
10 going on and try to develop measures based on that, risk  
11 assessments based on that. But I certainly agree. This  
12 is a learning process. You know, it's not clear to me  
13 how much of it we're going to get right the first time.

14           Joe, you had some questions or comments?

15           MEMBER CARCELLO: Yes, three, and two of them are  
16 relatively short.

17           On the first one, I saw that you had up there  
18 abnormal accruals, Tony, and it's certainly used all the  
19 time in the academic literature and I've used it a bunch,  
20 so this is really as much for Greg as anybody.

21           Greg, you might want to look at in addition to  
22 abnormal accruals, if you're looking at that, GMI has an

1 index. It's called the Accounting and Governance Risk  
2 Index. And there's a paper in the Journal of Financial  
3 Economics that takes all of these ex ante indices and  
4 then correlates them with ex post outcomes, like  
5 restatements and fraud and so forth. And there's some  
6 evidence that the AGR index may be better than abnormal  
7 accrual so, at a minimum, you probably should look at  
8 that.

9           Second comment is, Tony, you talked a lot about  
10 risk measures that at least to me toward the end of your  
11 presentation seem more related to what I would call  
12 financial reporting quality than just purely audit  
13 quality. And as I think we know, financial reporting  
14 quality is really a joint product of the effort of  
15 management, the audit committee and the auditor, and so  
16 you just have to recognize that. It makes it a little  
17 bit more complicated.

18           And another issue you have to think through, and  
19 certainly the Board will need to think this through, is  
20 not all accounting firms have equally risky client  
21 portfolios. So you do have to think -- you know, you see  
22 this now in medicine, right, where we're going to rate

1 doctors and we're going to rate hospitals, and some  
2 doctors and hospitals treat sicker people and they're  
3 going to die more often.

4           And so you've got to be careful that if you  
5 create incentives for accounting firms to say, if we have  
6 a risky portfolio we're going to get dinged, I'll just  
7 resign from my risky clients. I'm not sure that's in the  
8 best interest of the capital markets.

9           The third point is that, as I listened to this  
10 presentation, I don't disagree with many of the things  
11 you had up here, is that the challenge in my mind is that  
12 unlike the United Kingdom where much of the accounting,  
13 auditing and corporate governance regulation is housed  
14 at the FRC, we have chosen in this country to split those  
15 three roles between the FASB, the PCAOB and the SEC. And  
16 in my view, some of the most challenging issues facing  
17 the profession is going to require closer coordination  
18 and cooperation between those three groups than may have  
19 been the case historically in the past.

20           MEMBER SONDHI: Thank you, Joe. I certainly  
21 agree with respect to, again, with your comments. I also  
22 agree, certainly very strongly, that we are talking about

1 financial reporting quality, because fundamentally, as  
2 an investor, that is what I am concerned about more than  
3 anything else because that's the raw data that I use to  
4 make my assessments.

5           But I believe that combining audit quality  
6 indicators or developing them on the basis of financial  
7 reporting quality is a fundamentally critical component  
8 of what we have to do. I have no illusions about this  
9 being easy or anything at all. In fact, I remember when  
10 Steve first called me and asked me to take a look at this  
11 and do this. You know, I was wondering what the  
12 objective was and how we were going to get there. So  
13 there's no question that this is very difficult. I  
14 appreciate the comments, though.

15           And Curt, you have been very patient. Thank you.

16           MEMBER BUSER: Thank you. So first thing, I just  
17 want to applaud all the work that's been done on this and  
18 this is obviously key to everything. You can't set  
19 standards, you can't inspect if you can't define quality.

20           That said, Tony, one of your comments here really  
21 on the output-based audit quality indicators I found  
22 fascinating. And just as a crazy thought, you know, it'd

1 be interesting to explore, you know, there's a number of  
2 tools, some of the tools that Joe spoke to, that kind of  
3 would indicate fraud or other abnormalities.

4           Maybe a company is required to run that report,  
5 maybe a company is required in its public filings to  
6 respond to those indicators and maybe its auditor is  
7 required to provide assurance on both, you know, that the  
8 report was run right and that the answers provided by  
9 management were clear.

10           And you could go one step further, and what did  
11 the auditor do to test? That would provide both, you  
12 know, to your point, an output-based kind of product, a  
13 way for investors to kind of see the process and to make  
14 very good indications and evaluations based on that  
15 result and it would be company-specific. Would it be  
16 perfect? Absolutely not. And it would also have the  
17 advantage potentially of keeping things focused.

18           When you get into risk indicators, I feel like  
19 I've already got 50 pages of risk indicators and so, you  
20 know, being focused on the right things, I think some of  
21 these tools could be very helpful.

22           MEMBER SONDHI: Thank you, Curt. I certainly

1 agree that it is going to be difficult and may remain  
2 difficult to design perfect indicators. I'm reminded of,  
3 I believe it was Somerset Maugham who said that  
4 perfection is mastery of the, you know, state of nature  
5 and nature keeps changing.

6 So this is a process that's going to take us a  
7 while to get there. Certainly commendable I think.  
8 Hopefully we will keep working on it.

9 But all we can do, and if I combine what Joe said  
10 and what you said, you know, it is a difficult task. The  
11 objective, however, ought to remain clear that the idea  
12 is to see if we can improve all of this, the audit  
13 quality, the financial reporting quality, the information  
14 that's available to investors, so that they can make  
15 better and more informed decisions. But that's what this  
16 entire process is all about. Thank you.

17 And, yes, Mercer you've --

18 MEMBER BULLARD: Thank you, Tony. Mercer  
19 Bullard. It's a pleasure to be here. As a new member,  
20 I wanted to say it's already been a great experience, as  
21 I expected and look forward to working with all in the  
22 future. I had just a thought and a question. The

1 thought is on the study. You know, it's interesting.  
2 From a regulatory lawyer's point of view, when I see  
3 questions about oversight and enforcement, from my  
4 experience those are not only independent things, they  
5 operate on independent tracks and they often go in  
6 opposite directions. And if you ask a regulatory lawyer,  
7 you know, where's the SEC going? The answer will be,  
8 well, they're rulemaking or they're rulemaking by  
9 enforcement.

10           So I thought it odd. I don't know how CFA see  
11 that split, but I think that's the way a lot of lawyers  
12 would view most agencies. The other question goes to  
13 Barb's point about, well, you've got this conflict of  
14 interest that all of the public accountants have. How  
15 do you manage that?

16 And typically, in a regulatory process, you manage that  
17 by putting in place counteracting forces. And, you know,  
18 this is a presentation that was rich with details about  
19 how you would present information and use what I think  
20 is often the most effective tool and that is public  
21 disclosure of facts, empirical analysis, to try to move  
22 the ball in the direction you want it to move.



1           And in particular you have, and this relates  
2 somewhat to Joe's comment, a really rich empirical data  
3 set. For example, the chart that began with the accruals  
4 had two pages of what, at least I would see, are very  
5 concrete, to a great extent measurable objective criteria  
6 as to what's gone wrong.

7 And you could fairly easily do an empirical analysis of  
8 the correlation between that and who's not finding it and  
9 the particular auditor involved.

10           Then you have a second category, and this is how  
11 I've seen a lot of what I've learned so far in this  
12 process, is you've got the things that matter, the  
13 problems and the fixes. And then you've got what might  
14 be described as the conditions for success, tenure,  
15 salary, expertise, things that in and of themselves don't  
16 have intrinsic relevance to the product that you're  
17 trying to create.

18 But there is presumably some correlation and a lot of  
19 times I see what's up there as being intuitively  
20 correlated but I haven't really seen any empirical  
21 evidence. And I'm always extremely skeptical of those  
22 intuitions because often they turned out to be completely

1 wrong.

2 I don't know if paying more or less to somebody  
3 or more salary somewhere and less somewhere, or even  
4 tenure, is absolutely necessarily related to quality, but  
5 I certainly think that it could be correlated fairly  
6 tightly on an empirical basis. But I didn't see much of  
7 that in the program so I'm wondering, have you all looked  
8 at that? What is out there in the literature? Maybe Joe  
9 has an answer to that question. And is this something  
10 that the Board and/or the committee is looking to either  
11 do or stimulate going forward?

12 MEMBER SONDHI: Thank you, Mercer. I certainly  
13 think that there, I agree. There is a lot of academic  
14 literature, and there's a lot of other quantitative  
15 analyses out there. Analysts are always doing this.  
16 They're trying to find ways around it. This is what we  
17 do for a living in a sense. It is accessible. The one  
18 thing I would warn about academic literature and certain  
19 other kinds of analyses is that you do have to be careful  
20 about the construct.

21 And there was a great example when Brian was  
22 asking about transparency. What matters is, you know,

1 the way that question is posed. How much background  
2 information did you provide? Did you explain what you  
3 are doing? Because these words mean different things to  
4 different people. And, you know, what I think  
5 transparent means may be completely different from what  
6 somebody in the APAC thinks transparent means.

7           So there is data available, there are analyses  
8 available, but you do have to be very careful with the  
9 way they're structured and the way they're analyzed.  
10 Academic research should be viewed with just as much  
11 skepticism, I think, as anything else. I have been an  
12 academic for more than 30 years and done a fair amount  
13 of this research as well. But it is something that you  
14 have to be careful about, and transferring it to  
15 regulation, oversight, enforcement is not an easy task.  
16 There's no question about that.

17 Chairman, you had some comments or --

18           (Off microphone discussion)

19           MEMBER SONDHI: Okay. Anne.

20           MEMBER SIMPSON: Anne Simpson, CalPERS. I was  
21 just sending a little note to my team and I'll give you  
22 the results if they answer. In this audit quality

1 framework, it's already been mentioned by Barbara and  
2 others that one of the most important things is off the  
3 table.

4           It's not even to be talked about, which is the  
5 structure of the business model and the constraints that  
6 imposes on quality. Also I think issues like  
7 competition, tenure, which is why we support rotation.  
8 So I would love to know what you would write about that  
9 if you were asked just to have a long footnote on the  
10 subject, so that's a question.

11           The other thing is maybe an observation which is  
12 that in this audit quality framework, the clients are the  
13 shareholders, people like CalPERS. And I'm struck that  
14 it is, you know, rarer than hens' teeth to find a  
15 shareholder vote to not reappoint the auditor, even when  
16 some pretty shocking things happen. So I recall this  
17 season we voted against the reappointment of the auditor  
18 at Walmart, being most concerned about the progress of  
19 the investigation on allegations of significant  
20 corruption.

21           And also at HP where not once, twice, but three  
22 times there had been a huge writedown after an

1 acquisition. And if I recall correctly, the SEC imposed  
2 their current auditor on HP because of conflicts of  
3 interest around HP, trying to find the consulting  
4 business of the previous auditor. Anyway, what a tangled  
5 web we weave. The point is what is the recommendation  
6 for shareholders, because if we see regularly 99.99999  
7 percent votes in favor from the supposed clients, the  
8 users of the financial statements, then really we're  
9 putting all the burden on the shoulders of the regulator.

10 And we're great supporters of what PCAOB is  
11 doing. There's a lot we can do, like the transparency  
12 proposal we're looking forward to, the great work of your  
13 group. But at the end of the day, what is it that  
14 shareholders should be doing? Do we, can we take these  
15 audit quality indicators and, actually if we could hoof  
16 the vote up against auditors when there was a poor job  
17 I think it would concentrate minds wonderfully and at the  
18 moment -- I will get some numbers for later in the day  
19 so you can see.

20 You know, could we have a section in this which  
21 says this will all work much better if the owners of  
22 companies were to step up and vote and use their proxies?

1 So two thoughts really: could we have a footnote on the  
2 external environment, what should we be thinking about  
3 to make it a better environment for improving audit  
4 quality? And what is the to-do list for the  
5 shareholders, because we do have votes and I wonder how  
6 they can be used more effectively? Thank you.

7 MEMBER SONDHI: Thank you, Anne. I'll get back  
8 to those, but I'm going to let my team members comment  
9 and, Lynn, would you like to go first? He's never been  
10 asked this question before but --

11 MEMBER SIMPSON: I'm sure Colorado's leading the  
12 way.

13 MEMBER TURNER: Yes, I voted with Anne, so.

14 CHAIRMAN HARRIS: Actually let me just step in  
15 for one sec because, you know, we're ten minutes or 12  
16 minutes away from break time, which is 11 o'clock, so why  
17 don't we try and keep everybody to three or four minutes.  
18 I certainly want to recognize, well, I guess Lew's tent  
19 card went down. But I also want to give --

20 (Laughter)

21 MEMBER SIMPSON: He just gave up.

22 CHAIRMAN HARRIS: Or keep it back up, but I want

1 to make sure that people who have not been heard from  
2 have the opportunity to be heard from. And then, Greg,  
3 I think in all fairness, I'd like to hear your wrap-up  
4 in terms of what you've taken away from this and also I'm  
5 interested in what's doable in short term.

6 MEMBER SONDHI: Okay, very good. So, Lynn, if  
7 you would.

8 MEMBER TURNER: Yes, I just hearken back to the  
9 Treasury Committee report on this matter which is what  
10 got all this rolling, along with the letter that the  
11 Treasury Committee received on it. The Treasury  
12 Committee did recommend that there be something included  
13 here on the business model in the annual report from the  
14 firm, so there is some on that, and a lot of discussion  
15 about difficulty. Probably 90 percent of those measures  
16 that were up on the board are already measured by the  
17 firms, so I don't understand all the discussion about  
18 difficulty because 90 percent are already measured by the  
19 firms.

20 But there was the point about abnormal accruals.  
21 I get concerned when I see that one up there because  
22 that's a financial reporting issue and I think you have

1 to keep the financial reporting issue separate and  
2 distinct from the audit numbers.

3 And I think the best indicator on abnormal accruals,  
4 whatever that might be, is the PCAOB inspection reports,  
5 because they're the people that get in and are able to  
6 see those type of things. And getting data out of the  
7 inspection reports I think is probably the best indicator  
8 of quality on the audit of those abnormal accruals.

9           So I'd be very careful about getting into a  
10 financial reporting quality issue as opposed to an audit  
11 quality issue.

12 But, again, the biggest point is most of these things are  
13 already measured by the firms internally, so all this  
14 discussion about difficulty I see as being unwarranted  
15 because most of them are already measured.

16           MEMBER SONDHI: Thank you. Michael?

17           MEMBER HEAD: And I guess-- I'm Mike Head. My  
18 thoughts really focus around a little bit what Steve was  
19 ending up with, is for this to be doable it can't be the  
20 regulator, be it SEC or PCAOB, gathering all this  
21 information and disseminating it in the true sense of  
22 creating it. The firms are already monitoring and



1 tracking the large percentage of this in the  
2 administration of their own internal quality programs,  
3 and I think this initiative needs to be more about what's  
4 necessary to be publicly disclosed?

5           Maybe it has to be included in the footnote of  
6 the financial statements subject to audit, as was said  
7 before, and the firms need to be providing it to the  
8 PCAOB and their clients, and the audit committees need  
9 to be monitoring those. I think the guidance from PCAOB  
10 is how can that be consistently structured and applied  
11 so that it's consistent information available to the  
12 investors to use so they can compare apples to apples,  
13 not trying to create it, but provide guidelines for  
14 consistency so investors can use it and mandate it.

15           MEMBER SONDHI: Thank you, Michael. Norman.

16           MEMBER HARRISON: Thank you, Tony. I'll be very  
17 brief. This is Norman Harrison. I wanted to link back  
18 to Joe Carcello's comment a few minutes ago about issues  
19 around riskier audits, riskier companies, industries for  
20 which there are more technical rules, more complexity of  
21 the audit process. You'll note in our list of categories  
22 of recommended indicators there are three, as Tony

1 indicated in his presentation, that we recommend be  
2 disclosed or reported by major industry group.

3           And I think that raises another interesting  
4 question for the Board, you know, one we've discussed  
5 here on prior occasions, one that I know is under  
6 consideration in other categories here, and it relates  
7 to the issue of transparency of financial results by the  
8 Big Four. I think there is some recognition that one of  
9 the risks of the structure of the profession or the  
10 industry as it exists today, is that depending upon the  
11 industry the issuer is, in there may not necessarily be  
12 a Big Four.

13           There may be a Big Three or a Big Two depending  
14 on what industry you're in, the level of expertise  
15 required, the technical rules around your business,  
16 whether it's natural resources or pharmaceuticals, you  
17 name it. Each of the four Big Four firms may not be  
18 equally equipped or bring comparable levels of expertise  
19 to your particular industry.

20           One data point that would be interesting, and  
21 whether it arises in this context or in a separate  
22 category of issues relating to audit firm transparency,

1 would be some disclosure around the percentage of fees  
2 that firms have earned by industry, the issuer, because  
3 in that data point, and particularly in a year-to-year  
4 comparison, you get some sense of what the market thinks.  
5 How has the market voted with respect to levels of  
6 quality, expertise, technical competence among the firms  
7 on an industry-by-industry basis? So I'd just throw that  
8 out for consideration.

9 MEMBER SONDHI: Thank you, Norman. Robert.

10 MEMBER TAROLA: Thanks, Tony. Robert Tarola.  
11 Well-done, group. I may be the only one in the room  
12 that's having trouble trying to figure out how I would  
13 use this information as a chair of an audit committee or  
14 director of a company. First of all, in my way of  
15 thinking, quality information is relative. So it's going  
16 to create winners and losers, perhaps. Secondly, I  
17 believe that quality can be more effectively achieved  
18 through the systemic issues that Barbara raised, Joe  
19 raised, Mercer raised, where the system is designed to  
20 be more effective, as opposed to an individual activity  
21 being deemed more effective by virtue of some measures.  
22 And, moreover, my fear is that these measures may

1 focus the effort on the current balance sheet and not  
2 necessarily on the sustainability of the enterprise or  
3 the achievement of goals, objectives and strategy, which  
4 is also a very key element of what directors are  
5 concerned about. And auditors, in some way, play a role  
6 in helping assess the achievability of those objectives.  
7 So I guess I'm encouraging more of a higher-level view  
8 of quality indicators to improve the system, the  
9 structure, more so than determine whether or not, you  
10 know, an accrual was relevant or auditable.

11 MEMBER SONDHI: Thank you. And, Lew, would you  
12 like to --

13 MEMBER FERGUSON: Yes, I was going to make a  
14 couple of comments, and I start off by saying that I  
15 completely agree with Lynn, that much of the stuff that  
16 we've put up here is already being measured by firms.  
17 They measure everything, including, probably the body  
18 temperature of all their paid employees every day, but  
19 they have this immense amount of data, and you can run  
20 infinite numbers of correlations between data and  
21 different kinds of indices.

22 The problem with that, is that correlation is not

1 causation and in order to understand whether the  
2 correlation really means anything, I think you've got to  
3 get much more deeply into the behavioral things that  
4 underlie those correlations. And that is not something  
5 that I think people are asking very creative questions  
6 about. I think one of the things regulators can do, as  
7 we get big bodies of data from numbers of firms, we may  
8 be able to look at this comparatively and see why is one  
9 firm different from another, what those differences are.  
10 What do they indicate? What do they tell us about  
11 possible differences in ways of operating?

12           And we don't really get that data yet, partly  
13 because we don't ask for it. We're beginning to, and I  
14 think as Greg Jonas does his project we will do that.  
15 But I'm skeptical of just talking about gathering data  
16 and correlating it, coming up with correlations. I don't  
17 think that really leads to things that are terribly  
18 interesting. Just one anecdote too about how if you  
19 change the rules you can change behavior. The United  
20 Kingdom, the Financial Reporting Council this year put  
21 out a rule basically saying that you have to retender  
22 your audit every ten years, and you can keep the current

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1 auditor but the audit committee then has to explain why  
2 it did it.

3           And in talking to the U.K. regulators, when they  
4 did that their expectation was that people would,  
5 particularly big companies would retender or reappoint  
6 the same auditor and explain. That is not happening.  
7 For whatever reason, these big audit committees do not  
8 want to explain why they're keeping their auditor. And,  
9 for example, the auditor of HSBC Bank has been changed.  
10 The auditor of Lever Brothers is being changed. It looks  
11 like the auditor of Royal Dutch Shell may well change.  
12 It's really quite interesting to see, when you put it to  
13 the audit committee to explain why you're keeping your  
14 auditor in a long-form report, they tend to change  
15 behavior.

16           MEMBER SONDHI: Thank you, Lew. Steve, I'm going  
17 to -- but before, just one last comment. I --

18           CHAIRMAN HARRIS: There are two things. First of  
19 all, comment as you see fit. We'll give you time. But  
20 then if you could also, for my final question, in terms  
21 of try and give us some focus on what you would consider  
22 our priorities, because I'm very goal oriented. I like

1 to accomplish things, you know, within a time period  
2 which is reasonable. And then I'd like, Greg, for you  
3 to wrap up your thoughts as you see fit, so thank you.

4 MEMBER BUETTNER: Steve.

5 CHAIRMAN HARRIS: Oh, I'm sorry, Bob, absolutely.  
6 No, go ahead. No, absolutely.

7 MEMBER BUETTNER: Bob Buettner. I guess I'd be  
8 in the minority here but my belief is that a tight focus  
9 on the granular quality indicators, actually, is very  
10 important. And you mentioned that you had originally  
11 come up with something close to 70. To be honest, I  
12 think the more the better. As an investor who is  
13 frequently looking for companies that I believe are  
14 either manipulating their accounting, or adopting the  
15 most liberal interpretation of an accounting statute, I'm  
16 all about the micro and the focus and the quantitative  
17 indicators.

18 I think the market does a phenomenal job of  
19 providing a lot of that information as well. It's  
20 obviously not something that could ever be incorporated  
21 into an audit, but I think those micro-indicators are  
22 extremely important to surface the frauds and the

1 accounting misstatements that we, as members of this  
2 committee, hope to prevent, because obviously there are  
3 deep investor losses that are associated with many of  
4 these events. So it does sound like the minority view  
5 here among the members, but I would say that those  
6 quantitative elements in looking at potential financial  
7 statement reporting or misreporting are extremely  
8 critical.

9           MEMBER SONDHI: Thank you, Robert. Let me just  
10 summarize, and then respond to Steve's question. I  
11 certainly think that we ought to be collecting a lot of  
12 this information. I am under, however, no illusion that  
13 we're necessarily going to get it right the first time  
14 or maybe the second time. I think it is going to take  
15 a lot of work. In response to both Joe Carcello and Lew  
16 Ferguson, my comment about being careful and skeptical  
17 about academic research was precisely about the confusion  
18 between correlation and causality.

19           I am mindful about that and I think that Greg is  
20 going to have to work awfully hard to ensure that he  
21 remains careful about that as well. Having said all of  
22 that, I also would mention that as Lynn has pointed out



1 many of these things are being measured already, if not  
2 90 percent or more of them. It is not a question of the  
3 cost. It is not a question of, you know, whether it can  
4 be done. The issue is how is it that we're going to use  
5 the information, and how is it that we're going to help  
6 people make better decisions?

7 I remain-- unfortunately we don't have enough  
8 time, but I am mindful of Judge Sporkin's question as  
9 well. We have talked about process. We have a lot more  
10 indicators that we raised and discussed and we're more  
11 than happy to share those with Greg and his team. We've  
12 tried very hard to do it but I don't view this as being  
13 done just because, you know, there's a limit on how much  
14 time we had to talk about this today. I'm open to  
15 suggestions and to continuing this process.

16 With respect to one other point that has been coming up  
17 around here and that is whether the indicators  
18 recommended or listed here are indicators of financial  
19 reporting quality. That is an age-old issue as well.

20 People are always talking about where to draw the  
21 line between audits and analysis and so on. We're  
22 talking here, I believe, about a circumstance where we

1 need to find a way to combine these. As Robert said,  
2 investors need this information. I don't care if I use  
3 a financial reporting quality indicator to understand an  
4 audit better. What I'm talking about here is that we  
5 need to look at these and ask ourselves, can we develop  
6 good indicators of outputs and results to provide  
7 information content, predictive ability in our audit  
8 quality, keeping in mind benefits and costs? But this  
9 is a process. This is a start and we need to do this and  
10 we need to be very careful and very creative about how  
11 we use that.

12           The last point, Steve, to your question about  
13 what to do. I think that we need to focus on audit  
14 quality. That does not mean we get rid of, or not talk  
15 about, the indicators that deal with audit firm quality  
16 or with the audit process. Clearly they are components  
17 of this. But the focus has to be on audit quality. It  
18 is more difficult. I think it's the output-based  
19 indicators with the kinds of characteristics that I have  
20 mentioned here that we need to focus on. And thank you  
21 very much, all of you, for listening.

22           CHAIRMAN HARRIS: Greg Jonas.

1           MR. JONAS: Just some closing comments. This is  
2 Greg Jonas. First, on the comforting side, you know, the  
3 staff's nightmare for sessions like this is that the  
4 group talks about fundamentally different things than the  
5 staff has concerned itself with, and I am comforted that  
6 the types of things that you are grappling with are the  
7 same types of things that we are grappling with. That  
8 said, I think you've certainly added a lot to our  
9 understanding of the specific things that you have in  
10 mind and some specific ideas for metrics that we will  
11 certainly take forward.

12           Some main points that I got out of this were,  
13 first, that the engagement-level metrics are at least as  
14 important as firm-level metrics and that those  
15 engagement-level metrics are as important to get to  
16 investors as they are to audit committees. Second, your  
17 focus on results: I am reminded of, you know, faith,  
18 hope and love and the greatest of these is love. So we  
19 have people, process and results and the greatest of  
20 these is results. You've made that point quite clearly.  
21 And certainly your plea for having results metrics that  
22 are forward-looking and predictive, we, too, have longed

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1 for those and any ideas on that front beyond what you've  
2 already presented are most welcome. I think that's the  
3 most challenging area of this process.

4           Final observation is there are two other projects  
5 at the PCAOB underway that are tightly aligned with the  
6 audit quality indicator project that hasn't come up yet,  
7 but I wanted to mention them before we parted. First  
8 there is Marty Baumann's effort in standards to update  
9 the quality control standards. This is, of course, how  
10 does an audit firm know that its audit practice is of  
11 high quality and under control? And then a second  
12 project aligned to this is in our inspections division  
13 and a wonderful project on root-cause analysis. When  
14 firms' audits are done very well or when they are done  
15 badly, what is the underlying reasons?

16           And working with the firms to articulate those,  
17 I believe that that's the flip side of root-cause, of  
18 audit quality indicators. I think done really right,  
19 audit quality indicators are really addressing root-cause  
20 issues. And there was a lot of conversation today about  
21 the importance of incentives and trying to use AQIs in  
22 part to align for a fundamentally challenged incentive

1 system. And quality indicators that get at incentives,  
2 I think, are one example of root-cause type indicators.  
3 So with that, I cannot thank you enough for this very,  
4 very valuable input. This has been wonderful.

5           CHAIRMAN HARRIS: Tony, I also, once again, want  
6 to reiterate my thanks to you for taking on an  
7 extraordinarily difficult subject matter area. I want  
8 to aggressively encourage you to keep in touch, and your  
9 working group, with Greg. You are the Investor working  
10 group or Advisory Group representatives to the Board.  
11 This is a high-priority issue. When Nina outreached to  
12 all members in terms of what working group they wanted  
13 to participate in, this issue scored very highly. So for  
14 all of those who deferred to other working groups, thank  
15 you for deferring. We look forward to hearing from you  
16 very shortly.

17           And, Norman, Michael Head, Lynn, Damon and Gary,  
18 thank you very much for your input and we look forward  
19 to an ongoing, continuing discussion with you, presumably  
20 through you directly with the group, and Greg Jonas, so  
21 thank you. Mr. Chairman, do you want to say anything  
22 now?

1           DIRECTOR DOTY: Academic studies. I have, for my  
2 sins, been reading Cass Sunstein and other economists and  
3 behavioral scientists. And they do go into some  
4 interesting notions that pick up on what Peter was  
5 saying, that there are co-beneficiaries of regulatory  
6 systems. Co-beneficiaries are often very important and  
7 sometimes, as Peter Nachtwey said, quite difficult to  
8 measure what the benefit is in quantitative terms for  
9 those co-beneficiaries. But what I take away from what  
10 the group has come up with is something Greg Jonas just  
11 touched on.

12           There is no doubt that, in your view, the audit  
13 quality indicator project will not be a success unless  
14 it recognizes and produces a system or an approach that  
15 is useful for co-beneficiaries, not only the auditor, not  
16 only the audit firm through root-cause analysis, not only  
17 the audited firm through the audit committee, but also  
18 the investor community in terms of making it, as Anne  
19 Simpson says, more effective in dealing with what the  
20 audit committee knows than what the auditor has done and  
21 knows.

22           This is very ambitious, very ambitious, but it

1 does show why we need the audit quality indicator  
2 project. And I think you have complicated, in this  
3 session, you have complicated what Greg Jonas and his  
4 team might have done and you have kept the Board honed  
5 in, if I may use a term that has been misused in this  
6 town before, honed in on what, in fact, this project  
7 should yield by way of results, and that is very helpful  
8 to us. Thank you all. Time for a break.

9 CHAIRMAN HARRIS: Let's take a break until 11:25  
10 and we will start promptly at 11:25. Thank you.

11 (Whereupon, the foregoing matter went off the  
12 record at 11:08 a.m. and went back on the record at 11:26  
13 a.m.)

14 CHAIRMAN HARRIS: Our next topic deals with the  
15 PCAOB general and inspection reports. And, Mr. Chairman,  
16 if we could get your attention as well, that would be  
17 terrific.

18 (Laughter)

19 CHAIRMAN HARRIS: I only have this opportunity  
20 maybe once or twice in my career, but what the heck.  
21 I'll take it. But as many of you know, the PCAOB issues  
22 both individual inspection reports and general reports

1 which provide a summary and analysis of results from  
2 inspections of either a specific audit issue or a  
3 category of firms.

4 Improving the timeliness, content and readability of  
5 inspection reports is another near-term priority of the  
6 Board and in advance of this meeting, we provided all of  
7 you with a brief discussion paper on this topic, along  
8 with questions for you to consider. And I want to now  
9 turn this topic over to the Director of our Division,  
10 Registration and Inspections, Helen Munter, and the  
11 Deputy Director Santina Rocca. They're very receptive  
12 to the comments. I think they do a terrific job and,  
13 Helen and Santina, please divide it up as you see fit.  
14 And we also, as I stress, welcome the input from the  
15 Investor Advisory Group. Helen, thank you.

16 MS. MUNTER: Great. No, thank you. This is a  
17 great opportunity for Santina and I, on behalf of our  
18 whole division, to be here and engage with you on the  
19 topic of inspections and inspection reports. We've been  
20 doing inspections for over ten years now so we've seen  
21 a lot of audits and we have issued a lot of inspection  
22 reports. We do about 250 inspections every single year,



1 so that's 250 firms and a whole lot more issuers that we  
2 look at in the course of what we are doing domestically  
3 and abroad, large firms, small firms, large issuers,  
4 small issuers.

5           How we approach our inspections has certainly  
6 evolved over the last ten years and how we approach our  
7 inspection reports is evolving, and that evolution is  
8 much more recent. Brian mentioned in his opening remarks  
9 that the Board came out with key priorities at the  
10 November budget meeting last year and many of those key  
11 priorities touched on our division. We've been working  
12 very hard on what are our key priorities and I think  
13 we've had some good success. We've had some real  
14 accomplishments this year.

15           We had a key priority related to remediation and  
16 with respect to remediation in the largest firms,  
17 completing our assessment and bringing a recommendation  
18 to the Board on certain firm responses to Part 2 of our  
19 inspection reports that were somewhat older. We've made  
20 good success on that and we hope by the end of this year,  
21 we believe we'll be in a position where the aged  
22 responses have been analyzed by us and a recommendation

1 brought to the Board for determination. We've had a  
2 project related to analysis and we've spent a lot of time  
3 working on our information and our data gathering in  
4 order to be able to complete analysis and use that  
5 analysis to help inform our communications to firms, our  
6 communications to the public and to support the Board and  
7 other divisions in what they are doing, whether it's  
8 speaking publicly, developing new standards, et cetera.  
9 Analysis is something that we will always do, that we  
10 will always spend a lot of time doing, but we've made  
11 some good progress this year. And the number one  
12 priority at the Board on their list last year was related  
13 to inspection reports. It had two prongs. It was  
14 timeliness, and content.

15           And on the timeliness front, I'm happy with where  
16 we are. We've cleared our backlog of triennial reports.  
17 There will always be some reports that take a  
18 particularly long time to issue and that's okay. I think  
19 that's really part of the process. It's part of a  
20 special set of circumstances when you're doing 250  
21 reports a year. But our large firm reports we issued  
22 starting in May of this year and we've been on a clip of

1 issuing one a month. And I think bringing predictability  
2 to that process so that firms know when to expect their  
3 report, the market knows when to expect reports to come  
4 out, is very important, and will help certainly with the  
5 transparency of that.

6           With respect to content, we have been very  
7 active. One of the things that we did in our 2012  
8 reports, and you've seen this if you've read any firm's  
9 inspection report for 2012, large or small, is we've  
10 included some additional information with respect to  
11 standards, and with respect to the specific standards  
12 violated or found to be deficiently performed in the  
13 course of the audit that we looked at.

14           We took the initial approach of saying we thought  
15 it would be helpful to a reader to a firm, to understand  
16 that information presented in a tabular format. We're now  
17 working on another iteration of that, and saying is there  
18 more information with respect to the standard and the  
19 work that was performed that would be helpful to add to  
20 the narrative description of the findings? And that's  
21 a project that we're working on. We'll see the impact  
22 of that in 2013. But when it comes to content, and given

1 the number of reports that we're working on, I think it's  
2 important that we view these changes as evolutionary, and  
3 we incorporate them based on all of the feedback that we  
4 can receive from the various constituencies that we have  
5 out there.

6           In addition, of course, to the firm-specific  
7 reports that we do, we also issue general-purpose  
8 inspection reports. We've had an opportunity to get  
9 feedback from a number of different groups this year  
10 already. We've met with our academic conference. We've  
11 met with the SAG. We've presented at small business  
12 forums and sought feedback from participants in the small  
13 business forums. And now we're thrilled with the  
14 opportunity to be able to speak with you and get a real  
15 investor perspective on content of both general-purpose  
16 inspection reports, as well as the firm-specific  
17 inspection reports. And this is really our first large-  
18 scale outreach on firm-specific inspection reports, so  
19 the timing of this meeting is ideal. It allows us to  
20 kick off that process.

21           It was interesting to sit through the AQI session  
22 just now. There was a lot of discussion about reports,

1 and what people would like to see, especially in terms  
2 of transparency as to how we discuss our reports. I  
3 think there are aspects of firm-specific inspection  
4 reports that are in the Part 2, which is initially not  
5 public, for any individual firm, where we do speak very  
6 directly to the firm, and this is particularly true for  
7 the largest firms. We have a very direct communication  
8 about prioritization of the issues we've identified,  
9 provide a sense of urgency about which items need to be  
10 addressed the quickest and the discussion and dialogue  
11 that we would like to have with the firms on that.

12           We've also provided guidance to all firms, and we  
13 send out this guidance when we send a firm their  
14 inspection report. We've just completed this guidance.  
15 It helps them understand how we, as staff, treat the  
16 process of remediation and what we consider as we're  
17 evaluating a firm's specific remedial action. And then  
18 we offer up, as we have for years, engagement with any  
19 firm on the topic of remediation. Whether it's a large  
20 firm or a small firm, they get a contact person that they  
21 can approach throughout the 12-month period that they  
22 have to prepare their response to the confidential

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1 portion of the report.

2           And we're ready, willing and able to engage with  
3 firms in that process, hoping for a very successful  
4 remediation and a true moving-the-bar on audit quality  
5 as a result.

6 So we sent around this paper; I hope everyone had a  
7 chance to read it. We put forth about ten questions so  
8 we have lots of topics of discussion that we would love  
9 to get some feedback on.

10           As Steve said, we are very open. We would really  
11 like to understand ways in which the report is useful to  
12 you currently, ways in which it could be more useful to  
13 you currently. And I think it's helpful to focus on the  
14 fact that the general-purpose report is a very different  
15 tool than the firm-specific inspection report and they  
16 both have utility, I think for different audiences. But  
17 the general-purpose reports do allow us to talk about  
18 trends, allow us to focus on items such as the  
19 implementation of a new audit standard.

20           We're working on two such reports currently and  
21 I think those will be helpful to auditors, helpful to  
22 academics, to understand some of the statistics related

1 to what we have seen and what that means in terms of  
2 trends. Of course, with respect to a firm-specific  
3 report, in the public section of the report the  
4 discussion is very, very focused on the specific  
5 deficiencies that we identified where the firm failed to  
6 support its audit opinion. And we use that terminology  
7 and we define what we mean by it and I think adding that  
8 definition to the report, in terms of how we define audit  
9 failure, is helpful. It's helpful to a reader. It's  
10 helpful to someone who's trying to put it in context as  
11 to what does this mean. And then we, of course, have  
12 Part 2 of the report which really is directed very  
13 specifically at the firm and is meant to drive their  
14 specific remedial action for these defects or potential  
15 defects in their system of quality controls.

16           So with that, I'd love to open it up to a general  
17 discussion focused on these questions. Given the number  
18 of people and an hour sort of a time frame, I thought it  
19 might be good to just, if people have a response, to let  
20 you respond to the questions. We've got a couple of  
21 people from the division here in the back able to take  
22 notes, so Santina and I are not going to be able to get

1 down everything you say but we do want to make sure that  
2 we memorialize that. So I won't try to go through the  
3 questions one to ten but, you know, if no one raises  
4 their card, then I'll do that.

5 JUDGE SPORKIN: You mentioned remediation. When  
6 do you do remediation versus bringing an enforcement  
7 action, because they seem to be a little bit in conflict.  
8 Am I write or wrong on that?

9 MS. MUNTER: I think enforcement and remediation,  
10 obviously, are two very different tools. And in  
11 enforcement we communicate with our division of  
12 enforcement when we have serious findings, particularly  
13 egregious findings, and they go through a process with  
14 respect to determining which items they would want to  
15 pick up. But whether or not a firm is referred to  
16 enforcement, we still issue an inspection report, the  
17 firm still responds to the inspection report and we still  
18 go through a process of evaluating their remediation, and  
19 I think that's very important, especially given some  
20 overlapping time frames.

21 JUDGE SPORKIN: Yes, but if you look at Chairman  
22 White's speech about small matters count, and in



1 remediation I assume you're finding areas where you could  
2 bring an enforcement proceeding. Am I right? I mean  
3 you're going to be remediating something and I would  
4 assume --

5 MS. MUNTER: Maybe, yes.

6 JUDGE SPORKIN: Am I correct? There would be  
7 questions of whether you want to bring an enforcement  
8 action, because I always used to have that problem, when  
9 you would sit down, try to work it out with a company as  
10 opposed to when you would recommend an enforcement  
11 action. And is it your recommendation or do you bring  
12 the enforcement people in to evaluate the situation  
13 because if you're going to remediate, you could possibly  
14 hurt their enforcement case?

15 DIRECTOR DOTY: It's a rare thing that Helen  
16 Munter needs any help from me and she may not need it  
17 now.

18 MS. MUNTER: I can always use a good attorney.

19 DIRECTOR DOTY: Judge, we maintain something of  
20 a strict observed division between inspection, which  
21 involves remediation of the statute which involves a good  
22 faith, in our judgment, a good faith attempt to resolve

1 a quality issue, on the one hand, and the referrals to  
2 enforcement and then the decision to enforce on the  
3 other. We do enforce against small firms. One of the  
4 most important enforcement decisions we have on the books  
5 is the Gately case in which a small firm simply thumbed  
6 its nose at our inspection process and our demand for  
7 documents.

8           So much of our enforcement program does focus on  
9 non-cooperation, firms which simply want to enjoy PCAOB  
10 status but have no regard for the process. It does not  
11 necessarily require that as a basis, but that's tended  
12 to be many of the cases. We do look for cases involving  
13 something more than mere negligence. We look for cases  
14 involving a reckless disregard of the duties of due care  
15 by an auditor. I am proud of the fact, I've said  
16 publicly I'm proud of the fact that our enforcement  
17 division has spotted those cases and has avoided the  
18 others. I hope that answers your question.

19           JUDGE SPORKIN: No, but is there a dialogue  
20 between --

21           DIRECTOR DOTY: Yes, there's a referral process  
22 that goes on and Helen brings in firms with a trend

1 analysis of how they're going. Are they going up,  
2 they're going down, getting better, getting worse. And  
3 in terms of remediation, we take a look at some of the  
4 issues that were raised today in terms of the resources  
5 available to the firm, its ability to effect remediation  
6 as opposed to a smaller firm which may, in fact, need a  
7 little more time and a little more effort, but seems to  
8 be trying to get it right. So we're trying to make  
9 distinctions between firms that are capable of  
10 implementing an effective remediation.

11 We have out a series of criteria which Helen's  
12 group has fashioned and which makes clear that there must  
13 be change, there must be implementation of the change,  
14 there must be monitoring of the change by the firm and  
15 it must have some effect. That applies to all firms,  
16 without regard to whether they're large or small, but in  
17 terms of looking at what we expect of them.

18 JUDGE SPORKIN: Large and small violations as  
19 opposed --

20 DIRECTOR DOTY: Yes.

21 JUDGE SPORKIN: And not large and small firms but  
22 small violations as opposed to --

1           DIRECTOR DOTY: We will look at small violations  
2 and if they appear to be in derogation of a prior PCAOB  
3 order, or if they are, in fact, a subversion of a firm's  
4 process, that could rise to the level of an enforcement.

5           JUDGE SPORKIN: Would you be doing any kinds of  
6 cases where normally the SEC would be doing one,  
7 financial reporting --

8           DIRECTOR DOTY: We coordinate with the SEC fully.

9           JUDGE SPORKIN: I see.

10          DIRECTOR DOTY: Fully, both our findings and our  
11 inspections. Helen sends to the SEC regularly instances  
12 in which we believe that violation of the auditing rules  
13 has been coupled with a possible failure of full and fair  
14 financial reporting.

15          JUDGE SPORKIN: I see. Thank you.

16          CHAIRMAN HARRIS: And Helen, why don't you  
17 discuss a little bit our remediation process, because we  
18 have taken some recent steps; the statute contemplates  
19 fairly rapid remediation after the 12-month time frame  
20 and you've taken a number of initiatives in that context.  
21 You've also taken some initiatives in terms of firms and  
22 business wanting certainty. You are giving greater

1 certainty to the firms in what the expectations are and  
2 maybe you can spend a minute or two discussing what  
3 you've been doing in that area.

4 MS. MUNTER: Sure. I think in terms of  
5 remediation, and let me talk about the largest firms for  
6 a minute or maybe even primarily, it really begins with  
7 this very direct communication to the firm, to the firm  
8 leadership, in terms of what we see as the highest  
9 priority items for them to address in terms of Part 2 of  
10 their report. And we give a timeline for active  
11 engagement in terms of wanting something back in a very  
12 short time period.

13 And then we have dedicated resources for each  
14 firm team that's associated, has been on the inspection,  
15 understands what the point was. And we go through a  
16 process of meeting with the firm, reviewing draft  
17 submissions, providing feedback on the draft submissions  
18 such that by the end of the 12-month period we have had,  
19 I think, very transparent communication that has  
20 improved. That process has definitely improved in terms  
21 of the transparency of it and the predictability of it  
22 over the last couple of years. Not every finding is the

1 same and the path towards remediation of the different  
2 findings will vary by firm, size, scope and scale issues.

3         Some initiatives that firms will take will  
4 necessarily need more than a 12-month period to be fully  
5 implemented and effective.

6         But in doing our assessment, we are looking at  
7 the urgency and the seriousness with which they address  
8 the matter, the specific action that they took, how it  
9 is supported and how likely it is to succeed.

10         We certainly also consider subsequent inspection  
11 results, but the subsequent inspection results are not  
12 the only thing that we look at.

13         Won't always be able to see in a subsequent  
14 inspection the effectiveness of a remedial action, and  
15 that is not a criteria. We don't delay our decisions  
16 only for that.

17         At times we will need to delay our decisions. I  
18 can see that possibility, but in order to assess a  
19 remedial action we need to see is it going to work, has  
20 it worked, is it functioning as it is described on paper?

21         And testing the effectiveness of some of the  
22 actions I think is a very important part of our oversight

1 process. We cannot just simply read about an action.  
2 We need to do some actual testing of the implementation  
3 of the actions.

4 I think in terms of certainty, at the end of this  
5 year I mentioned that we will have cleared the aged  
6 remediation determination recommendations.

7 And we are moving into, then, a land where we  
8 will be able to bring these determinations, in general,  
9 in a 6- to 12-month time frame to the Board, following  
10 when the remediation open period ends for each firm.

11 It's a long timeline and I fully understand that  
12 between when the audit is done at the end of Year 1 and  
13 then the inspection gets done in Year 2, the inspection  
14 report gets issued, you know, moving in towards Year 3  
15 and then the firm has another 12 months to do the  
16 evaluation.

17 So the timeline can seem very stretched out, but  
18 I can assure you that there's active engagement  
19 throughout that period.

20 So from our perspective in terms of wanting to  
21 improve audit quality, we do believe that the firm is  
22 making progress throughout that process.

1           They know from the day the comment form is issued  
2 what the issues are that we have identified and what are  
3 the areas that we need to work on.

4           And I think, you know, firms have made tremendous  
5 investment in their root-cause analysis programs.

6           And they are doing, in general, a very good job  
7 of monitoring where findings are coming up, not just with  
8 our findings but with internal inspections, with  
9 restatements, et cetera, in order to be able to more  
10 swiftly make changes to their quality control structure  
11 in order to address the problems that have manifested  
12 themselves in earlier audits. So that's a bit about how  
13 we deal with remediation.

14          Size, scope and scale of a small-firm inspection  
15 is obviously different in our processes, whether it be  
16 related to the inspection report itself being generally  
17 briefer or to the remediation process being generally  
18 more streamlined.

19          It's tailored and we don't expect, you know, a  
20 small one-man firm to put in place the same level of  
21 training or the same level of methodology changes, et  
22 cetera, as we do one of the major national firms, so



1 that's the way we approach it.

2           Coming back around to inspection reports, Joe, I  
3 think your card went up before I finished the first time,  
4 so let me come back to you.

5           MEMBER CARCELLO: A couple of comments and  
6 suggestions, Helen, and don't feel like you need to  
7 respond to these unless you want to. I'm just trying to  
8 give you feedback --

9           MS. MUNTER: Thank you.

10          MEMBER CARCELLO: -- because I know there's a lot  
11 of people who want to talk and some of these are on the  
12 inspection report and some of these are broader on the  
13 inspections themselves.

14          But in terms of response to your first question,  
15 you've heard this before but I'll reiterate it again, I  
16 think something that's very important to the capital  
17 markets, to investors, is some indication of is audit  
18 quality getting better or worse?

19          And we just don't know that because of the way  
20 the Board has chosen to risk-base the selection of  
21 engagements for inspection, rather than having at least  
22 some element be random.

1           And so information on whether audit quality is  
2 getting better or worse, I think we need that on a firm-  
3 wide basis, when I say firm-wide, profession-wide basis,  
4 on an individual firm basis and maybe even by audit area,  
5 so the particular audit areas where things are getting  
6 better and other areas where it's staying the same or  
7 getting worse.

8           You talked earlier, or Greg talked earlier about  
9 the causes of audit deficiencies, root cause. That's  
10 just so critical and to reiterate the importance of that.

11           And then a couple of ideas, and maybe you're  
12 doing this already, is to take audits with deficiencies  
13 and match them with audits without deficiencies.

14           And then, again, sorry, Lew, it would be a  
15 regression, what characterizes audits that had  
16 deficiencies? Now, that may not be conclusive proof but  
17 at least it's suggestive. You know, what characterizes  
18 failures versus successes?

19           MS. MUNTER: One of the initiatives that we have  
20 this year, to interrupt for just one quick minute, is  
21 looking in our own root-cause analysis at audits that  
22 were performed well and trying to understand the root

1 cause of, you know, why did this partner, this team, this  
2 office do a particularly good job?

3           So we are beginning an initiative in that area.  
4 I think it's very important. It'll take some investment  
5 --

6           MEMBER CARCELLO: It'll take time, right.

7           MS. MUNTER: -- and the ability to look at it  
8 over time, but I agree.

9           MEMBER CARCELLO: And my last one is considering,  
10 and based on your last comment a few minutes ago maybe  
11 you're doing this, matching audits inspected by the PCAOB  
12 with audits inspected by the individual audit firm and  
13 what is the correlation between the findings?

14           So if the PCAOB found A, B and C, you know, the  
15 particular audit firm hopefully found A, B and C.

16           But to the extent that's not the case, what  
17 findings do the firms have that the PCAOB doesn't have?  
18 That may be a good learning opportunity for you, and vice  
19 versa. What findings does the PCAOB have that the firms  
20 don't have, because that may speak to is their own  
21 internal processes rigorous enough? So again, maybe  
22 you're doing all of these things, but just suggestions.

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1 MS. MUNTER: Yes, yes. No, appreciate that. In  
2 addition to the issuer-specific work that we do on  
3 inspection, we do look at a firm's QC processes including  
4 internal inspection.

5 And what you just described is one of the tests  
6 that we routinely do where the firm has an internal  
7 inspection program, is we reinspect some of what they did  
8 to gauge findings back and forth.

9 Yes, Barbara.

10 MEMBER ROPER: So, Joe just said better and with  
11 more expertise, the main point that I was going to make,  
12 but -- sorry, Barbara Roper, Consumer Federation of  
13 America.

14 It struck me that there is, and you are obviously  
15 already on it, there is a strong sort of tie between what  
16 you all are doing in terms of looking at remediation and  
17 effectiveness of remediation and root causes of audit  
18 deficiencies and the previous discussion about audit  
19 quality indicators.

20 And it seems to me that it would be useful to  
21 look in a sort of fairly systematic way at the things  
22 that you're finding in your inspections of audits that

1 are correlated with and perhaps cause audit failures and  
2 the effectiveness of the remediation because it strikes  
3 me, you know, the whole point of keeping Part 2  
4 confidential, which we weren't so thrilled about when  
5 they were writing the legislation, was that it created  
6 an incentive for remediation.

7           If you could get out of having it public and if  
8 you were strong on remediation, that was supposed to be  
9 a good thing.

10           I'm curious about how effective the remediation  
11 ends up being. So it's a good-faith effort and some  
12 good-faith efforts may work and some good-faith efforts  
13 may not work.

14           And to what extent are you seeing the same kind  
15 of problems in audits after the remediation as you saw  
16 before and how can you dig through that information to  
17 figure out what's working and what's just sort of  
18 papering over a more fundamental problem?

19           So I think that would be useful analysis and  
20 maybe useful in some ways to compile into one of your  
21 more general reports but also, obviously, to feed into  
22 the project on audit quality indicators because in

1 certain areas we know that we're seeing the, I mean we  
2 know because of what we see in the first part of the  
3 report that we're seeing some of the same problems over  
4 and over again, even after there's presumably been some  
5 process of remediation.

6 MS. MUNTER: Yes. Yes, so in terms of  
7 remediation, it is not just a good-faith effort, right?  
8 It is good faith and substantial progress and it's the  
9 combination of those things that is necessary for a firm  
10 to effectively remediate.

11 It does not mean that all problems will be  
12 erased, and audit deficiencies in certain areas can and  
13 do evolve over time. So it's tough to do the analysis  
14 based only on an inspection report as to how effective  
15 a firm's remedial action has been.

16 I made a big note about your point and it's not  
17 the first time that I've heard the feedback.

18 I think, not speaking for Jay, but you're an  
19 advocate of the 4010 on remediation and what has worked  
20 for people and it's certainly on our list of things that  
21 we want to look at, we want to be able to address, so  
22 thank you.

1           CHAIRMAN HARRIS: Also I think on our list is the  
2 issue that you just raised and that is the good-faith  
3 standard and how we ensure remediation in a more timely  
4 manner.

5           I think there are a number of Board members that  
6 clearly want to revisit that because we have had in the  
7 past significant lag times, and to the extent that we can  
8 expedite that process, I think we are going to review  
9 that.

10          MS. MUNTER: So I've been paying too much  
11 attention to this side of the room and I'm not sure the  
12 order that flags went up over here. Should we just start  
13 at the end and come back? Is that okay?

14          MEMBER BUSER: This is Curt Buser. Just to echo  
15 some of Joe's comments, I mean trend analysis, really  
16 important. The more the reports can be specific to firm,  
17 market, industry, also the more helpful.

18          I think if the reports can be more balanced, so  
19 I think it'd be really good to see what improvements are  
20 being made and seen through the inspection process. What  
21 are some of the best practices that the inspection  
22 process is identifying?

1           And then provide some severity on the failures so  
2 that the average reader can, you know, really kind of  
3 help to distinguish between those things that are more  
4 severe and those that are potentially just mundane, so  
5 just some overall thoughts.

6           MS. MUNTER: Thank you.

7           MEMBER CALLERY: Grant Callery. This is, I  
8 guess, more of a question and it sort of goes to both  
9 your function and the enforcement function and from what  
10 Barbara mentioned, alluded to, the split between the  
11 public and the non-public part of things.

12           Is the staff and the Board comfortable with  
13 working under the, and I know these are statutory things  
14 that you can't just say we're going to change it, but are  
15 you comfortable that the balance is okay with what's  
16 public and what's not public and that when you cross over  
17 the line is it the right point in time?

18           You know, just having seen this from a private  
19 sector regulator where the greatest criticisms that you  
20 tend to get relate to transparency, I'd just be  
21 interested if, from your perspective, you're comfortable  
22 that the balances are okay and that when things become



1 public is sort of the right time and the non-public  
2 portion of it is serving the purpose that it was  
3 originally set out for.

4 MS. MUNTER: From my perspective, yes, I am  
5 comfortable. I think that the remediation process is a  
6 tremendous, tremendous incentive to firms.

7 And I think we have seen tremendous investment by  
8 the largest firms in order to address defects and  
9 potential defects that we've identified through our  
10 inspection process.

11 And that is worth a lot and it does mean delaying  
12 a transparent disclosure of the specific findings that  
13 we have had, but the goal of improving audit quality, I  
14 think we're able to move that bar more quickly with a  
15 Part 2 that is initially not public.

16 I'd also say that, you know, yes, I am  
17 comfortable with what we choose to put into Part 1 in  
18 terms of the disclosure and the way we defined what an  
19 audit failure is and provide the transparency about those  
20 specific items.

21 Earlier in the AQI section, and I'm not sure who  
22 brought it up, but someone was describing what they do

1 with their audit committee when they have an inspection  
2 report for their firm.

3           And I thought that's exactly what I think you  
4 should be doing, right, discussing for your firm and for  
5 any other firm, or an issuer that appears to be in your  
6 industry, how did your engagement team address these  
7 points?

8           And where we're able to provide some color around  
9 the findings as we do with the largest firms, I think  
10 that that's a great dialogue to have because who the  
11 specific issuer is is much less relevant.

12           And I know if you're on an audit committee it's  
13 all, you know, you really care about your particular  
14 firm. If you're an investor, you care about where you've  
15 made your investment.

16           But what we're trying to do in terms of looking  
17 at audit quality, we're not trying to find every failed  
18 audit out there.

19           We're trying to find areas where there are  
20 defects in the QC system and focused very much at a firm  
21 level, so thank you for the question. Yes.

22           MEMBER FRANZEL: I'd like to just add to that.

1 I think on the remediation side, the more timely those  
2 remediation determinations are, the more effective that  
3 period is and we've worked through a very large backlog  
4 or we're in the process right now.

5           And I think because we're working through that  
6 backlog, I think this might be a good opportunity for  
7 firms to think about disclosing the status of their  
8 remediations and their remediation efforts as far back  
9 as 2008.

10           You know, did you have a Part 2, yes or no? Did  
11 PCAOB pass you on it, yes or no? Obviously if not, that  
12 would be public. But just to let the public know where  
13 is the firm in the process with the PCAOB? And I think  
14 for the big firms, that would be a valuable disclosure.

15           MS. MUNTER: Lynn?

16           MEMBER TURNER: Sifting through your questions  
17 here, Helen, as far as the audience to these, and  
18 Jeanette was just talking about the public in general,  
19 I suppose most of the public and most investors never,  
20 ever read these.

21           They may see a news article out of Reuters or  
22 someone and that may catch their attention and they'll

1 look at what's in that, but I think it's a very specific  
2 group of people that ever read or look at these.

3           And so I don't think the audience is any  
4 different between the general and the specific firm  
5 reports. The people who read them will probably read  
6 both. People who don't read them probably won't read  
7 either one.

8           But it does tell you about, as you do the report  
9 if you want to get the attention of the average analyst  
10 or whatever, probably has to be a fairly summarized  
11 section up front on the report with some key statistics  
12 because that's probably all they're going to read.

13           They got their day job and they probably aren't  
14 going to go beyond that in terms of reading it for the  
15 most part.

16           I do find the way you post it to the web, you ask  
17 a question about that, I do find the way you post it, put  
18 it out there, to be very useful, very user-friendly, very  
19 easy to get.

20           I think how you do that is excellent, the way you  
21 post it by firm and by year and all, and also the posting  
22 so you can get the U.S. piece of it versus an

1 international piece. I've just found that that is all  
2 very useful.

3           And in talking to some people at large  
4 institutional investors who have actually read or used  
5 it, they've typically found that, I think, to be very  
6 useful as well.

7           In terms of the question on details of actual  
8 findings, I think in general as I read through it the  
9 findings are usually good enough that I can figure out  
10 what was missing in the audit that you were looking for  
11 in the inspection.

12           There have been some times where you used  
13 language that talks about inadequate audit documentation  
14 for this or that where you could perhaps be more specific  
15 to give some indication of what it was that you thought  
16 was missing that the firm didn't get because I do see in  
17 the back the response from the firms and those responses  
18 sometimes, which actually look like they're putting their  
19 thumb in your eye unfortunately, do make it look like,  
20 well, the staff of the PCAOB really didn't know what they  
21 were looking for in that case.

22           And I think, to me, when I read it, it looks like

1 you knew exactly what you were looking for.

2           But if you could give us a little more detail on  
3 that, especially in light of the letters that we're now  
4 seeing come in from the firms, that would probably be  
5 helpful.

6           In that reporting up front, if you'd give us the  
7 number of total audits of public companies that this firm  
8 does, the number and percentage of those that you  
9 actually inspected and the number and percentage of those  
10 where you found deficiencies and then whether or not  
11 that's industry specific or if there are factors.

12           So if you went out that year and you were looking  
13 at valuation, for example, or you were looking at audits  
14 of loan loss reserves or you were looking at an industry,  
15 mutual funds, having that color around the inspection up  
16 front I think would be very helpful and runs to some of  
17 the comments that Joe was making.

18           And that type of summary is what will probably  
19 lead to more investor analysts actually picking up at  
20 least the summary and reading through that because they  
21 aren't going to read through the whole detailed report  
22 for the most part.

1           The company name, you know, needless to say, the  
2 reports lose most their value and utility when you don't  
3 give us the company name.

4           And that, coupled with getting a name of a  
5 partner on the audit, because to Anne's point, most  
6 investors will vote yes unless they see that there's a  
7 problem.

8           But we can't see that there's a problem because  
9 you withhold that information from us and it's  
10 information you have all the capability to give us.

11          Understand there was a policy decision made, but  
12 that policy decision needs to be reversed.

13          And give us the information we need to make an  
14 informed vote. You have it. You're supposed to be  
15 serving the public interest. The law says that in here.

16          You're withholding this information from us, so  
17 that's probably the thing you guys get most criticized  
18 for and I just don't understand why you don't correct it.

19          The remediation, to the points made earlier, what  
20 the firm has or has not done to remediate the type of  
21 problems noted in that Part 1 would be helpful.

22          Understand if it's related to quality control it

1 has to be in Part 2, so that I understand.

2           But there's a lot in Part 1 that doesn't relate  
3 to quality controls of the firm. It relates to basic  
4 fundamental auditing and what's been done.

5           On timeliness, Part 1, I agree you're doing a  
6 much better job and I applaud you for getting caught up  
7 on that.

8           You're getting caught up on the Part 2s,  
9 although, you know, Part 2s were supposed to be held  
10 private for one year, 12 months.

11           And yet you look at the Deloitte report. This  
12 outfit sat on that Deloitte report for between two and  
13 three years and what I saw in actual audit committees on  
14 large companies was Deloitte went back into the audit  
15 committees and told the audit committees that that was  
16 old information, old audits, they didn't need to be  
17 concerned about it. That was their response. That was  
18 outrageous.

19           And yet when you take that long to put it out,  
20 you tee that up and do a great disservice for those of  
21 us who have served on audit committees by doing that.

22           So Part 2, if you can't get that Part 2 out



1 within a relative time after 12 months, there seems to  
2 be a problem.

3           And, quite frankly, none of these firms should,  
4 well, let's put it this way. All of the firms should be  
5 able to remediate those problems within 12 months.

6           If you're a CEO of one of these firms and people  
7 come in and say we can't fix those problems -- I had a  
8 conversation with the CEO of one of them and they were  
9 trying to explain why they couldn't fix it within 12  
10 months. It was ridiculous. They have every capability.  
11 There should never be a Part 2.

12           But if they don't get it out, don't get it  
13 remediated and clearly aren't cooperating with you as  
14 they were in that case, then you need to just pump it  
15 out. I mean that's the job that you're put here for, so.

16           And finally on the points made about enforcement,  
17 understand the issue with lack of enforcement, understand  
18 the issue with recklessness or fraud.

19           But the law did give you a wide variety of tools  
20 and it concerns me that you say you don't bring  
21 enforcement actions for negligence, especially in light  
22 of the points that I thought Chairman White made in her

1 recent speech which were very good that Stanley teed up,  
2 small items do matter.

3           And to send a message, which you've clearly sent  
4 to firms, that we're not going to bring an enforcement  
5 action in the case of negligence, I think is a very  
6 telling story to send and it's not a good one.

7           MS. MUNTER: Ann?

8           MEMBER YERGER: It's always hard to follow Lynn  
9 on anything related to these issues, but I'll share a few  
10 observations that I have from someone from staff who's  
11 at the CII who's much more aware of this than I am. And  
12 I'm Ann Yerger, sorry.

13           This is all about the general reports. First,  
14 just given the fact that investors in particular are so  
15 keenly interested in the auditor's assessment of  
16 management-critical accounting estimates and judgments,  
17 I think any findings or observations that the Board  
18 uncovers would be really helpful in the general reports,  
19 sort of honing in on those areas.

20           This is controversial, but I'll say it.  
21 Comparability is an issue with the general reports and  
22 I think we believe it would be really helpful here if

1 there was more specific identification of the firms and  
2 differences between the firms.

3           And, again, that helps us when it comes to the  
4 voting as opposed to just general-picture observations.

5           We think it'd be really helpful if in the general  
6 reports there was a specific section on guidance to audit  
7 committees, so you could literally provide them a list  
8 of questions, suggested areas, issues of concerns that  
9 they should be asking of their auditors in light of the  
10 things you came up with.

11           And finally in terms of just emphasizing and  
12 echoing the comments on audit quality. I mean ultimately  
13 I think out of the general reports that's what we're most  
14 interested in. Is audit quality actually improving?  
15 It's impossible to know that.

16           We note that the U.K.'s FRC report always  
17 includes this very friendly, sort of bar graphs that any  
18 moron, even me, could look at and get a general sense of  
19 where things are going, trends over three years.

20           I think that would be incredibly helpful if the  
21 Board would consider adding that kind of information to  
22 the general reports.

1 MS. MUNTER: Right, right. So something that's  
2 more sort of an activity report that would summarize  
3 results. The point that you were raising on  
4 comparability in the general report --

5 MEMBER YERGER: It would be drilling down a bit  
6 more in the report. So if there's any key findings,  
7 where there are differentiations between the firms, that  
8 would be very helpful. So less general. Maybe a bit  
9 more specific.

10 DIRECTOR DOTY: Okay, thank you. Mike.

11 MEMBER HEAD: Mike Head. I'm not going to repeat  
12 because I had some of the same issues.

13 But in light of where we ended up or where I  
14 think we are currently, it may change in the future, on  
15 audit rotation requirements, I think having the  
16 flexibility for the issuer to request inspections and  
17 that information being available for evaluation by the  
18 audit committee as part of their assessment of their own  
19 auditor when they are reviewing a firm for re-signing  
20 them up, I think would be nice to be available.

21 MS. MUNTER: I do understand that many audit  
22 committees ask for the comment forms. Many audit

1 committees ask to be informed if their audit has been  
2 selected for inspection and ask for a summary from the  
3 partner as to --

4 MEMBER HEAD: Yes, I agree with that.

5 MS. MUNTER: -- the result of the inspection and  
6 the comment forms, et cetera, and I also generally  
7 understand that firms provide that.

8 MEMBER HEAD: And we include that and I agree.  
9 I just think there needs to be another path of option,  
10 and I really don't know what the legal ramifications  
11 might be or might not be.

12 But I think when a company's firm has been  
13 selected or when they're in the sample of what's being  
14 reviewed -- let's say TD AMERITRADE is in the sample for  
15 Ernst & Young.

16 I think your confidentiality and your guidelines  
17 need to allow you to provide all of the findings related  
18 to that inspection to the firm.

19 I think that there should be a way where it maybe  
20 isn't made public-public, but if it's findings on the  
21 inspection specific to the issuer and you aren't  
22 providing what you find about that issue or only way we

1 find that out is through requesting the partner and  
2 getting their comments, that is not going to be the  
3 objective way of getting the information.

4           And I think there should be a way where -- we  
5 already have confidentiality arrangements with our firm  
6 when we hire them. We are sharing information between  
7 the two that's not public anyway. This should be  
8 included as not being a violation of your  
9 confidentiality.

10           And there should be a way to structure that so  
11 you can provide and we can then compare that or get the  
12 -- even if it was you coming and sharing it at the audit  
13 committee with the partner and you both are jointly doing  
14 it and even talking about it in advance, it would be  
15 significant value to the audit committee to have your  
16 perspective versus just the partner's perspective on what  
17 was found by the inspection on the specific issuer.

18           And, of course, it's self-fulfilling on the audit  
19 quality indicator but I think you need to work very  
20 closely with that project and as there are indicators  
21 defined and established that they are included as a  
22 standard examination portion of the inspection report,

1 assuming the firm is gathering the information that you  
2 can then verify what's being provided publicly to you and  
3 investors and others is accurate.

4 MS. MUNTER: Thank you. Jim. No?

5 MEMBER YERGER: This is Ann Yerger again. Mike,  
6 I wanted to follow up on something you said because,  
7 first of all, we're going to cover this in our group's  
8 discussion on audit committee and the issue of AS 16.

9 And I think it's, first of all, terrific that the  
10 Board's been doing a lot more outreach to audit  
11 committees and I think doing a better job training them  
12 and teaching them the things they should be asking for.

13 But I think it's different to have to ask to get  
14 as opposed to be mandated to provide.

15 And I do think that the Board needs to consider  
16 whether there are ways to be mandating disclosure of some  
17 of the information, particularly in the inspection  
18 results, whether it's remediation, even if it's a general  
19 disclosure to the audit committee about what's coming out  
20 from the inspection reports.

21 I think it doesn't go far enough right now to  
22 have a regime where the audit committee's expected to

1 have to ask the questions to get the information.

2 MS. MUNTER: Thank you.

3 DIRECTOR DOTY: A lot of this makes Helen's job  
4 tougher. There is a creative tension, or there is  
5 tension, whether it's creative or not I will leave it to  
6 you, between timeliness and contemporaneity of  
7 information and thoroughness and accuracy and fairness  
8 in the process.

9 Telling you how I look at this in this job, I am  
10 reluctant to put pressure of time on the division at the  
11 expense of quality.

12 I believe they have done a marvelous thing in  
13 clearing the backlog on the firm reports. They have done  
14 a marvelous job in clearing the backlog on remediation  
15 which, of course, can be delayed through appeals.

16 But they have done this so that now you're going  
17 to be looking at firms in which the audit period itself,  
18 the audit inspection itself, was consummated within or  
19 completed within a year of the team leaving the field,  
20 within nine months, six to nine months of the team  
21 leaving the field.

22 That's pretty fast for a process that begins with



1 comments, going back to the firm with comment forms,  
2 getting feedback on the comment forms, resolving the  
3 comment forms, getting these into findings in which we  
4 feel deficiencies either rise or don't rise, Helen feels,  
5 to Part 1 failures to get the requisite assurance.

6           With remediation, you'll be looking at  
7 remediation in which the period they have under the  
8 statute for remediation expired within a period of 12,  
9 15 months at the max.

10           This is an extraordinary feat, I think, of  
11 engineering and of management for a division that has got  
12 to be fair.

13           Can you tell whether audit is getting better or  
14 not across the profession and across the firms? Probably  
15 not. We don't inspect all the audits of a given firm.  
16 We don't inspect all the portions of a given engagement.

17           Perhaps it is the duty of markets, getting all  
18 this information and looking at what other information  
19 is available, perhaps it's the duty of markets to start  
20 deciding whether audit is getting better or getting  
21 worse.

22           Perhaps that also, as Curt Buser points out, may

1 turn on how much information about the audit is getting  
2 out there, how much transparency we can begin to inject  
3 into the audit process, quite apart from what we find in  
4 an inspection. So that's a puzzlement for us.

5           The policy that Lynn points to, I have worried  
6 about the policy on both sides of this question. The  
7 policy is one that is not as clear from the statute as  
8 you might think.

9           But on the other hand, if you compare the  
10 provisions of the statute, it's very clear that Congress  
11 did not intend that we make a decision that all  
12 information would flow straight through to the audit  
13 committee and the public.

14           There is an appropriateness standard imposed on  
15 us in the statute which I think is, that is the electric  
16 third rail. We have to stay away from that.

17           We have to avoid transgressing and becoming  
18 arbitrary and willful in our interpretation of what the  
19 public gets to know.

20           It's why we put out this release about a year ago  
21 on why information exists for audit committees, as Helen  
22 has quite clearly said, to go and get the information

1 from the partner.

2           We have cautioned people that if it's not  
3 available, that if the partner is unwilling to bring his  
4 quality reviewers down, if he's unwilling to do the  
5 things he ought to do, that should be a red flag for the  
6 audit committee and the firm.

7           Ann has the idea of a mandate for firms to make  
8 certain disclosures. I think that's something that, you  
9 know, we should think about.

10           But the policy is not one which I think any  
11 chairman should come in and, you know, will you reverse  
12 on the basis of what is the understandable interests of  
13 the public and what we're finding.

14           I do think that it is very clear from the  
15 experience of ten years that these findings matter to the  
16 public.

17           I think it is very clear that the criticism that  
18 we are bringing against the firms are causing them to do  
19 more than incur expenditures.

20           I was very interested in what Norman and Tony  
21 said about this, that there are differences between mere  
22 expenditures in the form of creating a policy or a

1 program that gets then promulgated and gets monitored and  
2 implemented and real investments which may, in fact,  
3 include changes in the business model to assure greater  
4 independence, professional skepticism, objectivity in  
5 your core staff, to assure that partners don't get  
6 assigned to the wrong jobs after they have been found to  
7 have done a job badly in one case.

8           Those are investments and those are, in fact, the  
9 kind of investments that are hard for a business  
10 organization to make.

11           But it leaves me with the idea of where we are in  
12 terms of enforcement, and to address a point that the  
13 judge made and that Lynn came back to, and that's the  
14 negligence standard.

15           The more than mere negligence, the reckless  
16 disregard of duties, is intended to enable an enforcement  
17 division and a regulatory organization to avoid the  
18 mistake of sanctioning someone in the case in which the  
19 public will shake their head and say there but for the  
20 grace of God. It's the antidote to the there but for the  
21 grace of God standard.

22           It's not the only means we have to encourage

1 individuals and to enforce better conduct by individuals.

2           The fact is that we know that our findings go  
3 home to the firms. We know that the firms now take a  
4 hard look at the partners who have incurred critical  
5 findings by ourselves.

6           We know that people do not look forward. They,  
7 in fact, look at our inspection, forthcoming inspection,  
8 with anxiety.

9           We know that some partners have been sufficiently  
10 anxious about what they know is in the file or not in the  
11 file that they've altered the file in anticipation of  
12 inspection. We know that when that happens they are  
13 sanctioned by us.

14           Judge Sporkin makes the point that sometimes very  
15 small cases that don't involve financial misreporting  
16 involve an important principle of audit, and that we try  
17 to look for.

18           But we also know that the firm management is now  
19 taking the position that you've got to elevate your game  
20 with some of its partners.

21           That is our biggest sanction. If out of Helen's,  
22 if out of her program comes the sense that her findings

1 are absolutely rock-ribbed defensible -- and by the way,  
2 the firms know, and the individual partners know, which  
3 standards and which issues are involved in these  
4 findings. They know.

5       As one who has sat in these meetings, have  
6 listened to the firms, have listened to the members of  
7 the division of inspections defend what they have done,  
8 it is errant misconception to think that they don't know  
9 what they're looking at and they don't know it when  
10 they're calling it.

11       And the firms know that, with the result that  
12 most of the firms now agree with the findings.

13       With that agreement with the findings goes a  
14 commitment of the firm to remediation, and we know that  
15 in many of these cases it is an event that can have  
16 career-determining implications for the partners.

17       So, yes, we want to avoid enforcement in the  
18 there but for the grace of God case. We also want to  
19 avoid prejudicing the career of an audit partner where  
20 there is not a sufficient basis for it in fact.

21       A lot of attention, a lot of time goes into that  
22 because we know at the end of the day when Helen's people

1 make a call, it reverberates through the firm. Hasn't  
2 always been so. It has not always been so.

3 But it is now the case that for a partner in a  
4 firm who is found by Helen to have not had the basis for  
5 issuing an audit opinion, there are serious consequences.  
6 Further affiant sayeth naught.

7 CHAIRMAN HARRIS: Helen, I'd just like to wrap up  
8 with a question, and that is the term failure is used  
9 quite often in our inspection reports and there's some  
10 concern on the part of the profession that we use it too  
11 often.

12 Could you give us your definition of failure and  
13 the fact that we use the term failure in specific  
14 instances to convey specific --

15 MS. MUNTER: Specific instances to convey  
16 specific things. And a recent edit to our standard  
17 report defines failure and it's the failure to support  
18 the opinion issued on the financial statements or on  
19 internal control over financial reporting by the auditor,  
20 so it is well defined.

21 The topic of severity came up, right, and I  
22 understand severity and I understand not every failure

1 is the same but every failure is a failure and is a very  
2 serious matter.

3           And the only items that we put into Part 1 are  
4 those where we have determined that the auditor failed  
5 to support their opinion, the opinion that they issued,  
6 based on the work that they did at the time.

7           It's not a question of documentation and you will  
8 sometimes see in responses talk about documentation. We  
9 consider any evidence that the auditor brings during the  
10 course of the inspection.

11           So if the auditor has a bunch of emails that  
12 never made their way into the file, during the course of  
13 the inspection they will bring them in.

14           They'll bring in their handwritten notes.  
15 They'll bring in whatever other evidence they have to  
16 explain the work that they did at the time, and we  
17 consider it.

18           We don't put AS 3 violations in Part 1 of an  
19 inspection report. That's not our purpose. You can call  
20 it a small thing and say maybe we should, but I think in  
21 evaluating the audit work that was done we're not focused  
22 on only what was documented.



1           We go to the firm's offices most of the time. We  
2 engage with the team, whether we go to their offices or  
3 do it in our offices, and we're dealing with them  
4 telephonically.

5           So everyone has a chance to, you know, fully  
6 support the work that they did during the time we're in  
7 the field, during the time that they are responding to  
8 the comment form.

9           So I personally am very comfortable with where we  
10 have the bar on failure. I think using the word is  
11 helpful, especially now that we have included a  
12 definition in the actual report and so I hope that you  
13 find it helpful. It does represent a very serious item  
14 that we think deserves disclosure.

15           CHAIRMAN HARRIS: And finally, Tony Sondhi, I was  
16 looking at your body language during the discussion of  
17 remediation and the question that comes to my mind, and  
18 I've asked it before with respect to some leaders of the  
19 profession, can you remediate within a 12-month period?

20           MEMBER SONDHI: I'd go back to what Lynn said, it  
21 isn't clear. I don't see why not. I think it makes a  
22 lot of sense. I think it's a serious enough issue and

1 that the auditors ought to bring all their resources to  
2 bear on it and there's no reason why they can't.

3 CHAIRMAN HARRIS: Does anybody disagree with  
4 that?

5 (No response.)

6 CHAIRMAN HARRIS: Barbara, we'll let you have the  
7 last word before the break for lunch.

8 MEMBER ROPER: That's right. I mean one thing is  
9 I think if they can't remediate in 12 months, we have a  
10 right to know that they haven't remediated.

11 So it's not about their having some indefinite  
12 protection against this information being public. If 12  
13 months later they haven't solved the problem, that's  
14 relevant to the market.

15 The other thing I would say is on this issue of  
16 the term failure, I'm glad you use it. I would be  
17 strongly opposed to any effort to water it down and make  
18 these reports more palatable to the firms.

19 I think you need to be clear about what's  
20 happening. If they haven't done enough to support their  
21 audit opinion, that's a failure and we should call it  
22 what it is.

1           CHAIRMAN HARRIS: Thank you very much. And with  
2 that, why don't we break for lunch. Lunch will be served  
3 in the Franklin Park A/B Room.

4           And Barbara Hannigan, the PCAOB's ethics officer  
5 and senior compliance counsel, will be joining us during  
6 lunch to provide a brief overview of the PCAOB's ethics  
7 code. Thank you very much.

8           (Whereupon, the foregoing matter went off the  
9 record at 12:26 p.m. and went back on the record at 1:32  
10 p.m.)

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1 inclusive in this area of governance.

2 I think they sort of flow together, the  
3 incentives and the various things that the firms are  
4 doing, the business mixes that all lead into, you know,  
5 what should we do about this, if anything.

6 And a lot of it, I think, comes back to comments  
7 that Barbara Roper made this morning, and Lynn made, you  
8 know, this 900-pound gorilla in the room of how the  
9 audits are paid for.

10 And so we're sort of assuming the current state  
11 on that. And then we're looking at things that might be  
12 red flags and what are the mitigating events that we  
13 could put in to help.

14 And I think when you look at any of those  
15 mitigating type things, you've got to think about it from  
16 a cross-benefit perspective, you know, how much bang for  
17 the buck are you going to get? Is it really going to get  
18 you where you want to be and at what cost?

19 But I think as we go through the slides, there's  
20 some interesting points here that really sort of point  
21 in the direction of at least we have to keep our eye on  
22 the ball here. Because we saw problems ten years ago,

1 12 years ago, whatever, and is there creep in the firms  
2 of things going in the direction that where the audit  
3 could again find itself not sacrosanct?

4           And it's a difficult balancing because you've got  
5 a large piece of the firms that are doing straight  
6 business and then you've got this public trust piece.  
7 And creating the proper balance, I think, is important  
8 for that.

9           So we'll go through the slides, and as I said  
10 that these are just to sort of stimulate your thinking  
11 and we'd love to -- are there other issues? Are there  
12 other factors out there, other mitigation that can be in  
13 place?

14           So I think the auditor evaluations and incentives  
15 and -- actually, let me talk about our working group for  
16 one second. We had an interesting blend of people. A  
17 number of us are new to this group so we were working  
18 from a clean slate.

19           I'm clearly not an auditor, I'm a lawyer, but I  
20 know about governance in the private sector, regulatory  
21 sector. We've got Curt, who is an auditor by training  
22 and by prior vocation, but who is with a large investor

1 in both the public and private markets.

2           We've got Larry who is an investor with a trading  
3 background. We've got Brandon, who has some similar  
4 background pieces to me in the securities regulatory  
5 world, but is also with a large institutional investor.  
6 And then we've got Joe, who is the fount of all knowledge  
7 and has read everything and hopefully steered some of us  
8 who are less steeped in the mystique in the right  
9 direction.

10           But Curt is our lead off.

11           MEMBER BUSER: Thanks Grant. So really I want to  
12 start kind of, really, what were the observations that  
13 the PCAOB has seen in its inspection process really  
14 related to partner incentives and the partner evaluation  
15 process.

16           And there's a lot of words on that page but, you  
17 know, suffice it to say that at least as of this 2008  
18 report, you know, there continue to be situations where  
19 audit quality did not appear to be a significant factor  
20 in the partner evaluation process or its role in the  
21 process was unclear.

22           And the next page, essentially, is kind of saying

1 the same thing that, you know, it was also noted that  
2 technical personnel who were responsible for audit  
3 quality were reporting to and evaluated by those whose  
4 responsibilities included maintaining and growing the  
5 audit practice. So the clear, obvious conflict.

6 Now as you think about these firms, I mean,  
7 they're businesses. So if you flip the slide, you know,  
8 they're going to need to have metrics in place to drive  
9 successful businesses.

10 And all the firms will have slightly different  
11 kind of performance drivers that they want to measure,  
12 but quality, A, needs to be one of those. And more  
13 importantly, if you'll flip the slide, we think it really  
14 needs to be the key metric.

15 So, you know, to the extent that it's not  
16 otherwise happening, the firms really should not rate  
17 their audit personnel higher than their audit quality  
18 rating. Seems kind of obvious, but some of the  
19 information back would suggest that that may not be  
20 occurring.

21 Partners in other service lines that contribute  
22 to the audit process really need to have the quality of



1 their audit input be part of their evaluation process.  
2 So if you're in the evaluations, you know, service line  
3 or tax or whatever, and you're supporting the audit  
4 brethren that support needs to be valued or measured from  
5 a quality perspective.

6           And last, firm leadership needs to be evaluated  
7 based on the quality of the audit practice. I think this  
8 is especially important as you start to see some of the  
9 firm leaderships no longer coming from the assurance  
10 practice. So as you see shift in kind of where the  
11 leaders are from their historical background, that's  
12 going to be really key.

13           But you also need to obviously define quality.  
14 So our earlier conversation on audit quality indicators  
15 is key. We need to know kind of what is audit quality.  
16 Once you have audit quality theoretically defined, then  
17 you can really write the standards, have that drive  
18 training.

19           To the extent those things aren't linked, that's  
20 a problem. I don't know how you drive audit quality  
21 without standards that are kind of linked back to it.

22           If you think about culture in the firm, the

1 culture has got to be really important both in terms of  
2 driving continuous improvement and celebrating quality  
3 so that you know what the best practices are, but you  
4 also, a basic mindset often in many of the firms, audit  
5 quality or where the value is is within the accounting  
6 knowledge.

7           So people that are really good at solving complex  
8 accounting issues in the national offices, that's  
9 different than the people that are in charge of the audit  
10 methodology. And having that also be of importance and  
11 to the extent that we're going to inspect and need both  
12 to occur well, the firms internally need to have, really,  
13 the status of both of those being equally important.

14           If you flip the slide, you know, some of this is  
15 motherhood and apple pie. I mean the one thing that I  
16 think is hard for some of the firms, it's easy to punish,  
17 you know, bad players or clear negligence.

18           The harder challenge, I think, is to provide  
19 rewards for jobs well done, especially when it's not  
20 always clear that, you know, the non-surfacing of an  
21 issue doesn't mean that it was great, so how do you go  
22 in and make sure what really is the root cause of a good

1 audit and reward those people that are really doing it?

2           It really needs to be assessed by those in the  
3 audit practice. You know, people outside that are  
4 responsible for market share shouldn't be making the  
5 quality determinations.

6           I think the global issue is going to become  
7 increasingly problematic. I mean many of, you know, our  
8 companies operate globally, and so to the extent that you  
9 have a different standard outside of the U.S. as it  
10 relates to how those people are being evaluated, it's  
11 going to be a problem. It's going to show up in,  
12 potentially, deficiencies.

13           And then last I'd say it has to be transparent.  
14 So, you know, really that incentive process within the  
15 firms for both reward and for punishment really needs to  
16 be transparent. Maybe not with respect to the  
17 individual, maybe so with respect to the individual, but  
18 clearly with respect to the behavior, the behavior that's  
19 key, good or bad, and the reaction to it, that's got to  
20 be transparent in order to really drive culture and drive  
21 kind of, really, the way the rest of the firm's going to  
22 operate.

1           With that I'll turn it over to Larry.

2           MEMBER SHOVER: Wow. Larry Shover. I thought I  
3 had an easy topic. You know, I'm not an auditor,  
4 accountant, or a lawyer, and I just realized this is a  
5 very challenging topic. It's half science and it's half  
6 art. Just like trading, successful trading.

7           It's easy to throw stones at the industry, and  
8 I'll try to be half-full, but we do live in a  
9 fundamentally flawed era in regards to auditing in the  
10 sense that I'm under the watchful eye of the CFTC and the  
11 SEC and it doesn't make sense to me how I have to pay for  
12 somebody to watch my books. Maybe we can make some baby  
13 changes.

14          But I wanted to give you a disclaimer so at least  
15 you know where I'm coming from, being not an auditor or  
16 an accountant. Sometimes when it comes to talent  
17 acquisition or attracting talent in the whole space we  
18 think that it's easy just to shrug our shoulders and just  
19 keep the status quo.

20          Some of us want to blow up the whole model and  
21 start fresh and we know that that's, you know, not going  
22 to happen. But I think we can, through agitation and

1 education we can, you know, change something.

2           At the core of my being I just feel like there's  
3 no higher calling, you know, other than being a priest  
4 or a teacher or a doctor, than managing someone else's  
5 money. I really believe that. And I used to not manage  
6 other people's money, it used to be just mine. But now  
7 that I do that I'm very, very interested in all this.

8           So the first thing about, is the profession  
9 attracting sufficient talent? Notice the word  
10 sufficient. I mean I think it is sufficient from  
11 everyone I've spoken with, however, it could be better.  
12 And that's really because sufficient talent's not being  
13 retained in the industry.

14           And it sounds very half-empty because what do we  
15 do to change that. But within the audit practice, versus  
16 migrating to other service lines, I mean that's very  
17 typical.

18           And as I was speaking with Curt this morning, the  
19 trek to becoming a partner in an auditing firm seems to  
20 be a lot longer than in other firms, like in accounting  
21 firms, et cetera. So it's hard.

22           How do you retain top-rated performers within the

1 industry? And that goes to the point of it's hard to  
2 reward people in this industry. And I think it goes back  
3 to the point that we just need to hold other people's  
4 money and watching other people's money in the highest  
5 regard.

6           And I think with that said, I honestly think that  
7 the whole auditing industry should be paid a lot better  
8 than it is, in a way. And money is not going to solve  
9 all the issues by any stretch of the imagination, but if  
10 we do hold things in higher regard I do think that would  
11 be a baby step.

12           How is the audit profession perceived by  
13 management, investors, regulators, audit committees and  
14 auditors? For most of us, including me until I started  
15 managing other people's money, it was just a general  
16 annoyance. You know, just with a lot of fear and  
17 trepidation making sure that we did everything correctly  
18 that they wouldn't find something.

19           We never did anything incorrectly or even close  
20 to being incorrect so I never had to worry about hiring  
21 somebody off the main line, but it was more of an  
22 annoyance.

1           But how has the profession evolved? I think it's  
2 become more relevant as opposed to less relevant,  
3 especially after Bernie Madoff and also the crisis in  
4 2008-2009, and I think a lot of people would agree with  
5 that.

6           The status of the industry has a long way to go,  
7 in my opinion, because although it's been elevated, the  
8 status has been slightly elevated, the compensation I  
9 don't think is there.

10           It's not a satisfaction-type job long term, in my  
11 view, just again, just about rewarding good or bad  
12 behavior. I mean, it's really hard to figure out good  
13 ways to compensate people for good, good work.

14           And lastly, the stress level. I asked a lot of  
15 auditors, including the one that audited the mutual fund  
16 just a few weeks ago, and I get it, the look in their  
17 eyes. It is a very stressful job.

18           Has the audit industry been commoditized? That  
19 along with compliance, absolutely. It absolutely has.  
20 And that's one of the problems, I think, and something  
21 we could work on changing. It is a commoditized product.

22           And how do we want the profession to be

1 perceived? And maybe you think I'm irrelevant or  
2 speaking into the dark, but again if we view other  
3 people's money as it's a humbling experience, and dealing  
4 with that on an every day level, I think the perception  
5 of somebody who's actually auditing your books would go  
6 up as well.

7           Do we know and should we care? Is talent  
8 acquisition and retention being measured? If so, is  
9 there an issue? Now I don't think it's being measured  
10 in any credible way. Maybe somebody here could differ  
11 with that but I haven't seen anything where it's being  
12 measured and I'm not even sure how that could be done.

13           Are surveys being conducted across firms? What  
14 lessons or best practices can we learn to improve talent  
15 in the profession? And that goes back to some of its  
16 compensation. Some of its track to becoming a partner  
17 and having a vested interest in the firm.

18           And should the PCAOB assess the health of the  
19 profession? And I say emphatically, yes, they should.  
20 And I definitely have some ideas off line that could help  
21 with that.

22           MEMBER CALLERY: Okay, so the second piece is the



1 governance issues. And as I said before that a lot of  
2 these first questions flow into, are there governance  
3 reactions? Are there governance structures that should  
4 be put in place that will resolve some of the issues that  
5 we've raised? And Joe's going to start and talk about  
6 the tone at the top and the transparency reports.

7 And there are a number of things that have come  
8 out over the past several years, some of which the U.K.  
9 has been sort of taking the lead on, which go to some of  
10 these governance issues. And one of the questions that  
11 comes up a little later is should we be mimicking them  
12 in some degree to give that opportunity?

13 Joe?

14 MEMBER CARCELLO: Thanks Grant. So we decided  
15 to, in trying to look at tone at the top made an effort  
16 to be as balanced as we could be here. So we examined  
17 the transparency reports, the most recent ones we were  
18 able to get for each of the Big Four. And so you see  
19 various, these are essentially paraphrases but very close  
20 to the actual quote out of the transparency reports from  
21 Deloitte and Ernst on this slide.

22 And in the case of Deloitte, you know, saying

1 that audit quality is the number one priority, saying  
2 that they tie compensation of their partners to their  
3 performance in terms of audit quality.

4 E&Y emphasizing the Tone at the Top and how  
5 that's the responsibility of the senior management team  
6 and that no client is more important than the reputation.  
7 And then KPMG and PwC, again KPMG talking about an  
8 absolute commitment to audit quality and that policies  
9 at KPMG will enable their partners and employees to act  
10 with integrity, skepticism, and objectivity.

11 PwC, again talking about firm leadership, and  
12 it's emphasizing its commitment to quality, top priority.  
13 And then again talking about, in the second bullet there  
14 for PwC, how compensation for people in the firm is tied  
15 to quality.

16 And I would say just anecdotally, my interactions  
17 with the leadership of really all the firms, both when  
18 I was on the SAG and just in other settings, is, you  
19 know, these people generally very impressive and I think  
20 really believe this and try very hard to live it.

21 But negative, clearly there are some negative  
22 signs as it relates to this, and we have some things out

1 of the U.K., particularly the Financial Times and the UK  
2 Competition Commission.

3           And talking about the first quote there really  
4 mirrors what Barbara Roper said earlier and that is, you  
5 know, the basic structure of the profession is such that  
6 it makes it very hard to always put the public interest  
7 first. That investor interest of being neglected because  
8 they only play a small role in hiring audit firms  
9 compared with that of management.

10           Maybe as Anne Simpson said earlier, maybe some of  
11 that responsibility falls on investors. Maybe they're  
12 not getting the information they need to cast informed  
13 votes, but they certainly often approve the auditor  
14 overwhelmingly. And that misaligned incentives mean that  
15 auditors tend to focus on management interests over those  
16 of shareholders.

17           And then there's a paper that we have a number of  
18 quotes from. I've talked about this paper before. It  
19 just came out in the most recent issue of Contemporary  
20 Accounting Research. And it's a pretty amazing paper in  
21 that these authors were able to get access for the actual  
22 proposal documents that were submitted by each of the

1 major firms on two large Canadian companies, one of which  
2 is a public company that's cross-listed in the United  
3 States so would clearly have some effect here in terms  
4 of PCAOB and SEC oversight.

5           And they actually went through, not only  
6 interviewed these people, but went through the written  
7 documents. And so they talk about it as Client 1 and  
8 Client 2. So auditors adopted the mottos and slogans of  
9 Client 1 and Client 2 in their proposals and  
10 presentations because they wanted to show, you know,  
11 we're a fit with your organization.

12           One particular dimension of reputation that  
13 interested Client 1 was whether other CFOs, so when the  
14 prospective client would call around to other CFOs, the  
15 CFO wanted to know is the auditor rigid, which is  
16 undesirable, or flexible, which is desirable.

17           The authors of this paper saw no evidence of  
18 reputation with investors or any third-party users being  
19 in consideration. It didn't even come up. It wasn't  
20 even discussed.

21           Client 1 made it clear that they wanted all  
22 complex accounting issues to be resolved by the

1 engagement partner, and Auditors 2 and 3 responded by  
2 promising that the final and binding decision would be  
3 made by the engagement partner.

4           One firm promised that they, and this is a quote,  
5 they do not hide behind the head office. You know, that  
6 kind of language is very troubling at least to me.

7           No meeting between the perspective auditors and  
8 the audit committee as a whole was held without the  
9 presence of company executives. CFO had to be there, CEO  
10 had to be there, again what does that say? What, I've  
11 got to babysit these people? Next slide.

12           Okay, back to you Grant. Oh, wait, no. You  
13 wanted me to talk about the ads. So let me --

14           MEMBER CALLERY: Yes.

15           MEMBER CARCELLO: We had in addition to this, and  
16 we had it in our first slide deck and then I thought aah.  
17 We did a search on ads that the firms are using and we  
18 found some, and we did what we could to disguise who the  
19 firm was, but I still was concerned that maybe you might  
20 be able to figure it out.

21           So I have a couple of them here, so rather than  
22 being a slide I'll just read the relevant language. So

1 this is an ad in a periodical that probably many of you  
2 have seen.

3 "To ensure success of your most critical SOX  
4 initiatives, you need to hire a service provider that can  
5 help you gain a competitive advantage." So that's kind  
6 of the language that I found interesting.

7 And then another ad, "Whether it's accounting,  
8 tax, or consulting, we're focused on listening to your  
9 needs and then desiring solutions that fit with your  
10 budget, your timeline, your corporate culture and  
11 vision."

12 And again, you know, not that any of those is  
13 necessarily egregious, but I think it does say if you're  
14 willing to say that publicly what are you doing  
15 privately? And what is it saying about who you really  
16 value and where is the linchpin of the relationship?

17 Grant?

18 MEMBER CALLERY: Yes. And so I think as we  
19 looked at these things we started to think about, well,  
20 what are the types of mitigation tactics that can be  
21 used? And one is to have an independent look at what's  
22 going on in the firm, you know, where you can have people

1 who are privy to the information, privy to the business  
2 decisions of the firm, privy to the tactical decisions  
3 of the firm, and to be able to act as a brake if things  
4 start to snowball in the wrong direction with respect to  
5 the audit function within the firm.

6           And there have been a couple of things in the  
7 last five years that have gone in that direction. The  
8 Advisory Committee on the Audit Profession, which was  
9 established by the Treasury Department, had a report come  
10 out in 2008 and it had a number of recommendations on  
11 firm structure and finance.

12           But the one that is most relevant to this is  
13 Recommendation Number 3 which urged the PCAOB and the SEC  
14 to study and enable, as appropriate, the feasibility of  
15 firms appointing independent members with full voting  
16 authority to firm boards and/or advisory boards.

17           Now I note there are certainly a whole range of  
18 issues of putting from partnership law to, you know, some  
19 of the  
20 professional codes of ethics and the like, for putting  
21 people onto the actual governing board of a partnership.  
22 But I think, you know, the advisory board is a

1 possibility, and these people would be looking to focus  
2 on the governance issues and to be able to advise the  
3 firms as to what was happening and be able to keep an eye  
4 on things.

5           In the U.K., the Financial Regulatory Council, in  
6 2010, which was two years after the U.S. study, did come  
7 out with a proposal that applies to the firms that do the  
8 most audits within the U.K. and particularly on the main  
9 market of the London Stock Exchange, and it calls for the  
10 appointment of independent non-executives.

11           And the INEs have roles that are focused on  
12 shareholder confidence in the public interest. They need  
13 to have a body that oversees public interest issues, and  
14 they have a duty of care to the firm. The firm needs to  
15 disclose criteria for assessing INEs' impact on the firm  
16 and their degree of independence.

17           And they have rights to firm information and to  
18 disclose disagreements with the firm, not unlike some of  
19 the Sarbanes-Oxley provisions of reporting up and  
20 reporting out and that type of thing, where there is  
21 ability to not have this stay within the firm and not see  
22 the light of day.



1           So I think, you know, we think that, and I assume  
2 that that is on the PCAOB's agenda somewhere. I don't  
3 think I've seen anything where you've gotten to do  
4 anything formal on it at this point, but I think you're  
5 working through the Treasury Department's recommendations  
6 and there were a lot.

7           And, you know, I think as a group we think that  
8 that is something that you ought to get on the table and  
9 you ought to take a look at and see whether this is a way  
10 to put in a sort of a firewall that will allow there to  
11 be people focused on the public interest and the  
12 investors' perspective, you know, who will know what's  
13 going in the firms to be able to assess whether things  
14 are moving in directions that they shouldn't be.

15           There has been some experience with the U.K.  
16 entities, and Joe actually had some conversations with  
17 people who have had experience with that process, and  
18 he'll tell us a little bit about those.

19           MEMBER CARCELLO: Yes, so as we worked on this,  
20 Grant and I decided that it made sense for me to reach  
21 out to some people in London who've worked with this  
22 pretty closely.

1           So I did reach out and had quite a lengthy  
2 conversation with a senior ICAEW executive about U.K.  
3 firms' experiences with the Audit Firm Governance Code,  
4 specifically with respect to the independent non-  
5 executives.

6           And what I was told is that the firms who  
7 initially who were somewhat skeptical of this, they were  
8 not overjoyed about it, are now quite positive about what  
9 they have done. In fact, they're quite proud of what  
10 they've done.

11           And as I understand it, there's a requirement  
12 embedded in that statute for there to be a review in 2014  
13 as to how it's worked, and the firms are quite anxious  
14 to have that review done because I think they're very  
15 proud of how they've implemented this and the effect.

16           There was flexibility built into that rule in the  
17 United Kingdom and giving firms the ability to implement  
18 the code in different ways. And the implementation has  
19 largely followed how the firms have organized their  
20 organizational structures.

21           So Ernst & Young has chosen to implement this on  
22 a global basis. I think we all know Mark Olson, Jim's

1 predecessor in terms of permanent PCAOB chairman, and  
2 Mark's involved in the E&Y group.

3 KPMG has done it on a European basis. Deloitte's  
4 done it on a U.K. basis, but as I understand it the way  
5 Deloitte's organized in the U.K., they actually own some  
6 firms in the Middle East and so they're kind of scoped  
7 onto that, and then PwC on a U.K. basis.

8 So we had quite a good conversation. And we got  
9 toward the end and I said to this individual, I said,  
10 yes, you know, this is all very helpful, but here's,  
11 really, the important question. Has it changed behavior?

12 And what he said is the firms look at many issues  
13 differently after installing INEs, that the kind of the  
14 lens and how they look at issues, how they evaluate  
15 issues, how they make decisions has changed in his view,  
16 suggesting that behavior has, in fact, changed.

17 Another piece of information, my guess is the  
18 Board already knows this, but in the United States, as  
19 I understand it, Deloitte is moving somewhat in this  
20 direction voluntarily. They have established an advisory  
21 group. It's not exactly the same as what we see here in  
22 the United Kingdom, although they've established an

1 advisory group that Dan Goelzer's chairing and that Phil  
2 Wedemeyer, Arnie Hanish, Sylvana Palmer is all people we  
3 know quite well, and then a fifth person who I don't know  
4 are on this group.

5           And so, you know, maybe the firms will do this  
6 voluntarily and there's nothing for the PCAOB to do, but  
7 the bully pulpit works too. You don't always have to do  
8 things through regulation.

9           Grant?

10           MEMBER CARCELLO: The other thing we did before  
11 I turn it back to Grant is, in the lead-in to this he  
12 talked a little bit about consulting. Certainly, Jim has  
13 given a number of speeches about concern about the rapid  
14 growth of consulting vis-a-vis the much slower growth of  
15 audit, so we decided to look at the numbers.

16           And so these are the numbers across the three  
17 firms, based on their own published information, and this  
18 is for the United States, and you see the split. And,  
19 you know, Deloitte is the only one that never spun off  
20 their consulting practices, the other three did.

21           And so Deloitte reflecting that is quite heavy in  
22 terms of consulting vis-a-vis the other two practice

1 lines. The other three firms given that they've had to  
2 rebuild their consulting practices, clearly still have  
3 those practices not as large as audit, but given the  
4 trend lines in terms of the growth rates of those two  
5 practices, doesn't take a lot of imagination to envision  
6 a future scenario where consulting may be larger than  
7 audit again.

8           So they're just data. Certainly I think the  
9 Board's paying attention to this. One thing though that  
10 may be worth thinking about is it's not clear to me, and  
11 we talked about this a bit this morning at breakfast,  
12 whether all consulting is created equal.

13           And so there are certain types of consulting that  
14 one could argue are more related to the audit skill set,  
15 and in fact one could argue, or in fact if not public  
16 interest services at least quasi-public interest  
17 services: risk consulting, forensic accounting, anti-  
18 money laundering controls, various compliance type  
19 services.

20           And it's certainly not the audit, but there's an  
21 element of public interest associated with those versus  
22 what I would call more pure consulting which might be

1 large-scale, ERP-based systems implementation,  
2 management, strategy consulting, things of that nature.

3 It might be useful, and maybe the Board's already  
4 gathering this information, to have that split for your  
5 purposes if not for public consumption, because again  
6 it's not clear that all consulting necessarily poses the  
7 same risks.

8 MEMBER CALLERY: Right. Well, I guess most  
9 people are sort of informed by their background. And I  
10 may be a little off in the stratosphere here from the  
11 standpoint of not being an auditor or having a lot of  
12 experience, but as I looked at this issue and  
13 particularly the last slide, and again, Joe's caveats on  
14 the last slide are very important ones because the  
15 numbers look like there's a lot of consulting creeping  
16 back in.

17 But it's important to understand what the  
18 consulting is because I think, you know, you've got  
19 complex issuers that the firms need lots of resources to  
20 be able to do a good audit and some of those are in the  
21 consulting side of the world and not the strict auditing,  
22 and so there's a real balancing you need to do about, you

1 know, which is the cart and which is the horse. Because  
2 otherwise you've got to go outside to get those resources  
3 and if you've got them internally, but you can't just  
4 have them for the audit purposes because they've got to  
5 pay the freight, so it's difficult.

6 But as I looked at it, one of the things that  
7 occurred to me is if this balance starts to shift again  
8 in the direction that makes it difficult for audit, is  
9 a couple of things that I have lived through in my prior  
10 life.

11 You look at the way the markets operate and were  
12 structured, they're self-regulatory organizations. They  
13 had and still have multiple functions. They're market  
14 operators and they are regulators of those markets and  
15 the participants in those markets.

16 And I think there is an analogy between the audit  
17 function and the regulatory operations piece of those  
18 organizations, and then the non-audit function in the  
19 market operations.

20 And this really came to the fore back in the mid-  
21 '90s when NASDAQ was growing wildfire and became a very  
22 dominant part of what was then NASD, and in fact too

1 dominant. And we had a run-in with the SEC and an  
2 administrative proceeding against NASD coming out of what  
3 was then the price-fixing issues in NASDAQ.

4 And I think that there was a feeling, and there  
5 was a long 21(a) report that the Commission wrote that  
6 talked about the lack of independence, the lack of the  
7 separation of the functions and the cart, in fact, was  
8 leading the horse if NASDAQ was the cart.

9 And the Commission hasn't given up on those  
10 issues. I think in 2004 they issued a concept release  
11 on self-regulation where it raised some of the same  
12 issues. It's, you know, as competition grows are these  
13 conflicts that are built into these kind of separated  
14 things exacerbated?

15 Has internal separation of functions worked, and  
16 can conflicts like this be effectively managed through  
17 governance changes? Which sort of goes back to the prior  
18 discussion of the independent non-executives, is that  
19 enough? And the Commission is looking at it again. I  
20 mean Commissioner Gallagher is very interested in the  
21 whole structure of SROs.

22 And so I think that those kinds of conflicts are



1 going to be talked about and written about again, and I  
2 think that they are at least a sort of a learning piece  
3 for thinking about the way an audit function works within  
4 a larger accounting firm.

5           And with that I believe is the end of our  
6 presentation. So we would open it up for discussion of  
7 anything that any of us have talked about. And Brandon,  
8 do you have any wrap-up points that you'd --

9           MEMBER BECKER: No.

10           CHAIRMAN HARRIS: Well, you certainly raised a  
11 large number of issues. I'm not quite sure where to  
12 start, and I think others will have questions of their  
13 own. I don't know whether to start with the issue of  
14 culture, which you raised at the outset, to talk about  
15 that.

16           But the term, the audit becoming commoditized is  
17 beginning to be used all the time now. I'm not sure what  
18 that means, and I'm not sure what the implications are  
19 for the PCAOB and what our role ought to be in terms of  
20 overseeing such commoditization in terms of looking at  
21 the prices that are associated with commoditized  
22 professions.

1           So if you could talk a little bit about the  
2 commoditization first and the culture second or the  
3 culture first and the commodization second, I'll start  
4 with that.

5           MEMBER BUSER: So I'll try. When I think about  
6 commoditization I really think about it becoming just  
7 that. It's the lowest price focused on price. It's the  
8 view that the auditor is the bean counter. It's the view  
9 that the auditor really doesn't have anything that  
10 meaningful to say. Now obviously that's not true, but  
11 it gets into the whole concept of how is the profession  
12 perceived?

13           Now it's easy to talk in generalities, you know,  
14 one-size-fits-all, but that's in where I think the  
15 pressure does come to measure. And do we know kind of  
16 how is the profession doing? How is it perceived?

17           What's the status of an audit partner within an  
18 audit committee meeting or within a board meeting to the  
19 extent that their voice matters, or doesn't matter?  
20 These are important questions because it speaks to the  
21 ability, you know, why should the junior person within  
22 that firm choose to stay if, you know, they're not

1 relevant? It goes back to the culture of the firm and  
2 the like.

3 I mean, so I think the prior conversations, we  
4 all want the profession to be strong, to be able to  
5 communicate the hard messages, to be able to stand up for  
6 the public interest, and I think those things can be very  
7 exciting and really what will attract people to the  
8 profession.

9 I don't believe it's all about compensation, but  
10 dollars need to be on the table. And if I have a choice  
11 between maybe going into a consulting practice or  
12 auditing controls, hmm, what might be more fun? That's  
13 the hard part here.

14 I mean, this isn't an easy, one-size-fits-all,  
15 but it is about kind of, you know, what keeps this stuff  
16 interesting and retains status? And it's very easy, I  
17 think, for the firms to say, well, the inspection process  
18 creates undue stress.

19 It contributes possibly, but it's all these other  
20 factors around relevancy of what's being done and it's  
21 very easy to kind of discount the auditor as the bean  
22 counter.

1           CHAIRMAN HARRIS:  If I could, I'll now turn it  
2 over  to Grant to moderate the questions since,  
3 recognizing the tents.  But if each of you could focus  
4 on what you view the role of the PCAOB to be with respect  
5 to either culture, commoditization, or otherwise as you  
6 reflect on your remarks that would be helpful as well.

7           MEMBER CALLERY:  Well, I guess I think of it as  
8 sort of in, and not necessarily, specifically in the  
9 rulemaking function or whatever, but the sort of an  
10 overview of the profession and whether there are avenues  
11 that the firms ought to be pursuing, somewhat the bully  
12 pulpit, your ability to have conversations with the firms  
13 as you work with them to see.

14           I think there needs to be drilling down into some  
15 of these issues.  I mean, you look at that chart and you  
16 say, okay, these percentages look a little scary.  Does  
17 it mean that the audit function is becoming the poor  
18 stepchild of the consulting and other functions?  And  
19 that is the commoditization.

20           Is it really, are the companies just going out  
21 and saying, give me a bid and I'm going to buy the lowest  
22 bidder?  But I think a lot of it, particularly in the

1 transparency reports, put out some information about the  
2 firms, but I think you can get a lot more detailed  
3 information to see whether a chart like that is something  
4 to worry about or something not to worry about.

5           And so I think you have a unique position to be  
6 able to gather information from the firms to then, you  
7 know, make more informed decisions rather than knee-jerk  
8 decisions based on something that looks, you know, on its  
9 surface like an issue.

10           MEMBER BUSER: You know, it's easy to have these  
11 conversations in the fact-free environment. So that's  
12 really where my request to the PCAOB is, is let's get  
13 some facts. And I think the firms have a lot of this  
14 information so it's really a matter of kind of, you know,  
15 requesting from them and then making some evaluations  
16 around it.

17           I also think on the slide that was raised on kind  
18 of percentages, you know, i.e., tax, audit, consulting,  
19 the other piece that speaks to commoditization is what  
20 I would refer to as the make/take ratios.

21           So if I'm a partner in the audit practice, am I  
22 taking home more than I'm making for the firm or how does

1 that ratio work? And if I am taking home more than I'm  
2 making or if I'm just purely making less than my other  
3 service lines it's a problem.

4 And we've lived that story before and so we ought  
5 to be mindful of that. And that seems like something  
6 that ought to be measurable, that we ought to be able to  
7 track and kind of understand.

8 And that I think speaks a little bit to the  
9 commoditization, right, because if the audit practice is  
10 not that profitable, relative to the others, what's the  
11 market saying about it? And some of it gets to, you  
12 know, are the audit firms selling assurance or are they  
13 just kind of, you know, how aggressive are they in kind  
14 of going out and creating new assurance products and  
15 taking that on?

16 And I'd like to see them kind of step up and do  
17 more in that area. Now that's probably beyond what the  
18 PCAOB can do, but it's part of where I think, you know,  
19 the profession in terms of assessing the health of the  
20 profession, it's important.

21 MEMBER BECKER: I would only add that I do think,  
22 Grant alluded to it earlier, that there is a close

1 connection between the audit quality indicators we talked  
2 about this morning and then seeing those feed into the  
3 governance process.

4           And it does seem to me that the Board can help  
5 through the inspection process. Make sure that there's  
6 a connection between those two things. It's harder for  
7 me to see the Board qua the Board necessarily increasing  
8 the fees that the assurance function generates. It's  
9 just not well structured for the Board to do that.

10           But it can try to focus on whether or not those  
11 quality indicators are going into the evaluation of  
12 individual partners and their compensation and if there's  
13 a realistic governance process that incorporates that.

14           MEMBER CARCELLO: Steve, I'll add a few things,  
15 too, because you asked for suggestions for the things the  
16 Board could do. So, you know, one thing is efforts to  
17 make the audit more valuable. I think the Board's trying  
18 to do that with the audit report. I think they're trying  
19 to do that with audit quality indicators.

20           I talked about earlier this morning the need to  
21 work more closely with the SEC and the FASB to really  
22 understand how investors are making decisions, what

1 information they're using, and what role there is for  
2 auditors to provide assurance around that information.  
3 A tie as part of the inspection process to make sure that  
4 firms are really tightly linking compensation and  
5 advancement to quality.

6           There's been a discussion in the AQI project of  
7 surveys, potentially, of people inside the firm. And  
8 that can be useful, but if you really want to know what  
9 the culture is like in an organization, survey people  
10 who've left. That will tell you the truth.

11           Quality control standards, Marty's working on  
12 that now. Again the importance in those are firm  
13 governance. The importance, potentially, of INEs, maybe  
14 that's not through a rule but that's through again the  
15 bully pulpit.

16           And then fees. Again maybe you guys monitor  
17 this, but if there's a 30 percent or a 40 percent decline  
18 in the fee, automatically to me that's going to be  
19 inspected. And I would make that transparent, because  
20 what you do by doing that is you probably put a floor  
21 under a decline in fees. All of a sudden you're not  
22 going to see that anymore.



1           MEMBER CALLERY: Okay. Well, why don't we do the  
2 reverse of what we did and start over here and work our  
3 way around the table this direction.

4           MEMBER TAROLA: Thanks Grant. Extremely  
5 interesting subject. Just a little background. I sit  
6 on two audit committees and I'm an CFO of an  
7 organization, and with respect to that organization we  
8 just went through a process to pick another auditor.  
9 Rotation was desired and a fresh look was important.

10           But not a single firm that proposed talked about  
11 the quality factors. It was all about the cultural fit  
12 factors, the competence fee of accounting, or tax, or  
13 risk management or whatever issue they thought was  
14 important to us. None of them talked about the quality  
15 factors. And I noted at lunch with some folks that you  
16 don't see the firms competing on quality.

17           So to your question, Steve, if there's a way for  
18 the PCAOB to make quality indicators or quality factors  
19 not just transparent but unbiased, so that the buyer of  
20 the service could evaluate quality along with other  
21 factors because the audit will become a commodity if  
22 quality is not part of the decision making process.

1 It'll just be price or, you know, more the social  
2 factors.

3 And we picked an auditor that we thought was both  
4 reasonably priced and high quality, but we had to dig to  
5 find the quality factors. They didn't bring them  
6 forward.

7 MEMBER CALLERY: Barb?

8 MEMBER ROPER: So a couple of things. One of the  
9 things that struck me in the Tone at the Top and the  
10 quotes from the various firms, I don't know if any of you  
11 have looked at all at the Department of Justice's lawsuit  
12 against S&P Credit Rating Agency, Standard & Poor's?  
13 They made exactly the same kind of assurances that, you  
14 know, we have the highest standards, objective, ratings.  
15 And they get into court, they're challenged in court and  
16 they said, but that was puffery. No, I mean that's their  
17 first defense. That was puffery. No one really took  
18 that seriously.

19 And that's how I look at those kinds of quotes  
20 is, you know, seriously, that is a very easy sentence to  
21 write and doesn't necessarily mean anything about the  
22 actual culture in the firm.

1 I would commend for your reading pleasure a  
2 recent study from FINRA on conflicts of interest. It  
3 deals with a similar situation in that it's dealing with  
4 broker-dealers who have a number of inherent conflicts  
5 of interest in their business model, a business model  
6 that's pervaded by conflicts of interest, and then  
7 addresses a range of issues about how they are expected  
8 to identify, manage and mitigate those conflicts of  
9 interest.

10 And one of the things that comes through when you  
11 read about this is, there are certain inherent conflict  
12 of interests. There's an inherent conflict of interest  
13 in this business model for auditors. But they make  
14 choices that make those conflicts worse.

15 So if you compensate based on your success in  
16 attracting business, or if you punish creating conflicts  
17 with clients because you're too tough or what-not, you  
18 are taking an inherent conflict of interest and  
19 magnifying it many times, so it's much more harmful.

20 And I'm not sure, you know, I don't know this  
21 area as well as I know the broker-dealer area, but in the  
22 broker-dealer area they make lots of choices that magnify

1 the conflicts of interest.

2           And what I think is interesting about the FINRA  
3 report, which is designed to be a report that the firms  
4 can use to drive them toward better practices with the  
5 promise that FINRA will be there looking for  
6 improvements, is that it forces you to think very  
7 consciously about identifying the conflicts, what are you  
8 going to do to manage them, what are you going to do to  
9 mitigate them, and I think it makes it at least somewhat  
10 more difficult to make the choice to justify the choice  
11 to make them worse.

12           And so I think there is potential in that model  
13 for something that the Board could do that would be  
14 concrete. I mean, this study is obviously the product  
15 of a number of interviews, you know, extensive interviews  
16 over a period of time with the firms to examine the sort  
17 of state of play within the firms, and it looks in  
18 specific areas where they think, you know, conflicts of  
19 interest are particularly relevant, including  
20 compensation practices as one, and identifies best  
21 practices.

22           And I think it's something that the Board could

1 look at certainly with the larger audit firms but, you  
2 know, doing a similar kind of a evaluation with a similar  
3 goal of driving toward better practices in the firms.

4           JUDGE SPORKIN: This deal with the underpricing,  
5 I think you can deal with it on the question of  
6 independence. In other words, if you are pricing your  
7 audit at a price which some standard would say is not  
8 feasible, that it's too low, then that I think raises an  
9 independence question. How are you going to be able to  
10 deal with it?

11           And something what, you know what Levitt did on  
12 the independence issues when he was at the SEC. At least  
13 you could be, even if you're not the decision maker in  
14 independence, you clearly could do the study and send it  
15 to the SEC because the SEC can do that.

16           But I think there's some of these things that you  
17 can say if the conflict is so great there is an  
18 independence issue. The government as you know has an  
19 anti-deficiency rule that people can't contribute to the  
20 government.

21           And I think it's going to be hard to do, but I do  
22 think an auditor that is engaged in practices which would

1 compromise his ability to be able to write a clean  
2 opinion does raise the issue whether how independent the  
3 auditor is.

4           MEMBER BUETTNER: I think this Committee did  
5 excellent work, so thank you for your time and efforts.  
6 My comment directly addressing your point, Steve, what  
7 can the PCAOB do?

8           I think this idea of the INEs, which is something  
9 that I was not really aware of prior to your  
10 presentation, is extremely interesting. I think anytime  
11 that you have an independent set of eyes come in with a  
12 metric that is focused primarily on quality as opposed  
13 to market share or revenue per partner is probably the  
14 best way to disinfect against any bad practices that  
15 might be occurring at the time.

16           So my questions to the committee might be where  
17 are we, we meaning United States and specifically the  
18 PCAOB, where are we in studying the potential adoption  
19 of INEs here?

20           And then again to your point, Curt, it's great to  
21 discuss things when it's not factually based, but do we  
22 have any tangible facts aside from sort of the suggestion

1 that behavior has changed that would create greater  
2 impetus behind adopting INEs in the United States?

3 MEMBER CALLERY: I think that question would go  
4 to that end of the table at least as to where the PCAOB  
5 is with respect to the INEs.

6 DIRECTOR DOTY: It's not been lost on us that the  
7 firms are moving in that direction, and some of the  
8 representatives of that movement are here. There's also  
9 been, I think, significant attempt at the top of the  
10 firm, the global firms, to start presenting the global  
11 network as a more coordinated, less disparate and  
12 dysfunctional business enterprise itself and that has to,  
13 in part, with the efforts of Lewis Ferguson and other  
14 colleagues from around the world who are sharing a lot  
15 of information about how the global network --

16 MEMBER CALLERY: I mean, it would seem to me just  
17 intuitively that if this is now in place for the large  
18 firms, and I think it's for eight firms in the U.K., and  
19 if the reaction that Joe got in the conversations as to  
20 the positive nature of it, you know, trickling that down  
21 to the U.S. operations may not be as painful a move as  
22 you might otherwise think, and that maybe with that

1 background, you know, there may be more receptiveness to  
2 it.

3           DIRECTOR DOTY: I tend to see the heads of U.S.  
4 audit firms as being a very special class. I think they  
5 are on the whole more alert and more intent on getting  
6 to a position like this than they have been in a long  
7 time.

8           I think one of the things the Board has  
9 accomplished, without me being here, but one of the  
10 things they accomplished before I came is to begin to  
11 make the firms aware of what it meant to be a regulated  
12 enterprise. And it changed in some ways the attitude of  
13 the leadership of the U.S. firms for the better.

14           MEMBER CALLERY: I can't see all of the upright  
15 cards. Lew, I think yours is the next.

16           MEMBER FERGUSON: I have an observation and a  
17 question for you all. One of the things that I thought  
18 was interesting about your information here is it shows  
19 that the firms, or at least accounting firms when they  
20 compete for business, don't compete on quality.

21           But if you think about that and you think about  
22 them as rational business people, what they are doing is,



1 in fact, selling to the clients exactly what they think  
2 the clients want to hear. That the clients are not  
3 asking for audit quality.

4           So I think we have to be aware that we live in a  
5 world here where a lot of business executives regard the  
6 audit as a regulatory necessity. It's a requirement and  
7 therefore you get it done as cheaply as possible.

8           You know, it's interesting. Brazil, which now is  
9 in its second or third year of having audit rotation  
10 required every six years, as a whole in Brazil I've been  
11 told that audit fees have dropped by more than 30  
12 percent, and some of the big audit networks are now  
13 raising questions. Can we even do business profitably  
14 in Brazil?

15           But my question to you is, if it is the case that  
16 auditors are sending, are giving information to their  
17 clients that they think the clients want, how do we  
18 convince the purchasers of these services that they need  
19 to be asking for different things as well?

20           This is not just about requiring the auditors  
21 doing things, this is also about teaching the consumers  
22 of these products what the audit does and why you really

1 ought to care about audits. So the question right back  
2 to you all is how do we do that?

3           MEMBER CARCELLO: Grant, let me take a first shot  
4 at that. I actually think, Lew, you've identified the  
5 essential issue, and arguably along with the issue that  
6 Lynn said this morning is probably the biggest issue  
7 facing the profession.

8           The problem is, I view that issue largely as an  
9 SEC issue and possibly a Department of Labor issue. And  
10 so there's two essential problems. One is, I think in  
11 way too many cases audit committees are not acting even  
12 remotely consistent with the spirit of Sarbanes-Oxley.  
13 And Anne and her team, I think, will have more to say  
14 about this later.

15           And unfortunately, that's for Brian, I don't see  
16 him and don't know where he is, but that's for Brian and  
17 his friends down there by Union Station. It's not really  
18 for the PCAOB.

19           The other problem is, I think in way too many  
20 cases, and this is what Anne said earlier, Anne Simpson  
21 said earlier, way too many cases, the people who are  
22 managing the money for every single person in this room

1 in terms of their retirement, if you have a 401(k) or a  
2 403(b) or a SEP IRA or anything are not really, in my  
3 opinion, fulfilling their fiduciary duties as it relates  
4 to oversight of the audit and oversight of financial  
5 reporting as careful owners.

6 And CalPERS does, Anne, but I think there's a lot  
7 of people in the investor space who just abdicate too  
8 quickly. And, Lew, until those two things get fixed  
9 we've got an issue.

10 MEMBER CALLERY: Okay, we are sort of at the end  
11 of our time. Steve, can we do quick rounds down --

12 CHAIRMAN HARRIS: No, I think what I'd like to do  
13 is go around and have everybody -- I think we'll just  
14 skip the break because this is good and I want to get  
15 people out on time. I want to get the general  
16 discussion. We'll skip the break and then we'll go right  
17 to the audit committee's at 2:50.

18 So we'll take five minutes off of Anne's. Why  
19 don't we go around the table and finish up this  
20 discussion and give everybody, you know, three minutes.

21 MEMBER CALLERY: Okay. Well, we keep moving  
22 backwards because we were all the way over here.

1 CHAIRMAN HARRIS: No more tent cards on this  
2 subject, and then we'll just go around --

3 MEMBER CALLERY: Okay. Why don't we pick up  
4 where we left off over here, and if everybody can be as  
5 crisp as possible with their comments that would be good,  
6 and then we can get through the group.

7 Tony?

8 MEMBER SONDHI: Thanks Grant. I'm going to  
9 respond to the question that Steve raised earlier which  
10 I think is connected to what Lew was just saying, and  
11 that is, you know, why is an audit a commodity?

12 And one of the things about a commodity is that  
13 there's, the two characteristics are low profitability  
14 and little, if any, difference in quality. What happens  
15 in the marketplace, normally, is that when you get a  
16 commodity, but if there's a market, somebody comes in  
17 with a higher quality product. For example, organic  
18 food, and certain kinds of chips, for example,  
19 semiconductor chips.

20 So fundamentally what it brings us to, why isn't  
21 there a market for high quality audits? And as Anne  
22 Simpson said very early this morning, you know, there

1 must be something that investors aren't doing right  
2 because we are the ones who ought to be demanding those  
3 higher quality audits.

4 I mean, I happen to really, really like organic  
5 food, for example, so I go search it out. So if my  
6 money's at stake, which it is as Joe just pointed out,  
7 then somehow the investors need to be finding a way to  
8 push this.

9 CHAIRMAN HARRIS: Grant, out of respect for our  
10 plenary authority why don't we recognize Brian, to keep  
11 on the good side of the SEC.

12 MEMBER CALLERY: He's just knocked down his  
13 identity.

14 MR. CROTEAU: Thanks. Well, Joe, I know it's  
15 hard to see each other from this far away, but I just  
16 wanted to respond to Joe's comments.

17 And certainly I take his points relative to the  
18 PCAOB's oversight authority versus SEC's relative to  
19 audit committees, but at the same time I didn't want it  
20 to go unsaid that the PCAOB, I think, has made a lot of  
21 progress in terms of thinking about how they still can  
22 enhance the roles that audit committees have without

1 necessarily having the direct oversight authority,  
2 including making sure that audit committees are armed  
3 with appropriate information about the inspection process  
4 and trying to do more relative to the inspection process  
5 and communicating with audit committees and audit  
6 committee chairs on a voluntary basis through the  
7 inspection process.

8           Obviously there's a new audit committee  
9 communications standard that was recently finalized, and  
10 that's not to say that there's more that can't be done  
11 because I think there is. And I think a lot of it does  
12 involve the need for close coordination between the  
13 organizations.

14           I just wouldn't want this group to feel they  
15 shouldn't and couldn't share any ideas at all that they  
16 have relative to how things could be improved because we  
17 do have the opportunity to certainly be working together,  
18 the two organizations, and there are things I think the  
19 PCAOB can and have already done. And so I think it's  
20 just important to acknowledge that.

21           MEMBER HEAD: This is Mike Head again. And this  
22 is such a passionate topic, especially for those of us

1 that are raised and our profession was a CPA and an  
2 auditor, so I'm going to try to keep my comments concise  
3 and just make some observations without letting that  
4 emotional side get involved, because it's hard to  
5 separate those two things being a 35-year CPA.

6 But first, there's nothing wrong with a  
7 commodity. A lot of companies make a lot of money by  
8 having tighter margins and high volume in something that  
9 they have a unique skill set at and being able to do  
10 that.

11 The word "commodity" for some reason is being  
12 thrown around as a negative when I would call it a niche,  
13 a specialization, an industry expert, a subject matter  
14 expert in that they're providing high quality audit  
15 quality at a very affordable price, because they do it  
16 very well, very effectively, very efficiently and do it  
17 a lot.

18 And if you start trying to do things that aren't  
19 your core competency then you start not being as good,  
20 and I think those are positive attributes not negative.  
21 So I would be cautious to worry about if auditing is a  
22 commodity or not. I hope it becomes a high quality

1 commodity that our audit professions are proud of  
2 providing, okay.

3           So that's kind of an emotional statement, but I'm  
4 proud to be an auditor and I think I want to do it  
5 efficiently and effectively at the lowest price I can so  
6 the investors and my clients get the most value for an  
7 effective audit at a very, very high quality. So that's  
8 kind of that comment.

9           And I think what you're seeing differently in the  
10 percentages once you peel that onion back, is these firms  
11 are complying with their independence rules. Therefore  
12 I'm less worried about consulting occurring, because it's  
13 got to be occurring on non-audit clients if it's not  
14 considered acceptable audit/client services.

15           And I don't think they're violating the rules, I  
16 just think that it provides a cultural opportunity to  
17 attract and retain very specialized people that you can't  
18 spend and develop that specialization a hundred percent  
19 of the time on the auditors, so then they use that skill  
20 set to keep them honed and subject matter experts on  
21 other non-audit consulting work that allows them to  
22 continue to be subject matter experts to be drawn on, on



1 the audit clients that they're not doing the consulting  
2 work for.

3           And again, I see that as a very positive not as  
4 a very negative thing. And it provides cultural career  
5 opportunities for those individuals that don't  
6 necessarily want to always do the audit work that is  
7 slightly different, not as sexy, maybe not what we get  
8 up and aspire to do every day sometimes. And that's okay  
9 too. There's nothing wrong with that.

10           Probably the last observation that I would make,  
11 which is an alternative to the independent INEs and  
12 things, and we talked about it earlier and we thought it  
13 was an inherent conflict, and I think both the audit  
14 firms and the issuers, the companies, would not  
15 necessarily be opposed to it.

16           Why do we not consider, why does the PCAOB not  
17 consider taking on the responsibility of assessing fees  
18 that would be used to hire the auditors and take that  
19 conflict out of the formula for the clients that the  
20 auditors are performing, and then use the audit quality  
21 indicators as an inspection process with the hiring and  
22 firing, if they felt it was appropriate, as a way of

1 ensuring audit quality is of the highest?

2 My CFO at my company cares about the relationship  
3 and the service they're getting and how they're being  
4 treated and that they have the best auditors, as long as  
5 he felt it was, I think -- and I know him pretty well.  
6 I've known him for several years.

7 I think if he didn't think that would cause an  
8 inefficient fee assessment process and that it would  
9 inherently cause fees to go up but it could be managed  
10 in a very efficient way, I don't think he cares if the  
11 company is paying for it, paying directly to the firm or  
12 paying it to PCAOB.

13 I think he worries about losing control of it  
14 being an efficient way to hire auditors versus  
15 inefficient, not who has the power. Now maybe I'm wrong  
16 on that, but those are kind of my off-the-wall thoughts  
17 and comments and I hope I didn't show too much emotion  
18 with that.

19 MEMBER CALLERY: Lynn?

20 MEMBER TURNER: First, just to dispel this  
21 misnomer around the table that the margins on audit work  
22 are less or significantly less than margins on

1 consulting, the Commission in its rulemaking in 2000 did  
2 get a study on that.

3           It was done by Rick Antle at Yale University and  
4 the firms all participated in that and it clearly  
5 demonstrated that the highest margin, Brandon, was  
6 actually on the audit work, not on the consulting work.  
7 So --

8           MEMBER BECKER: That was 2000, you said, Lynn?

9           MEMBER TURNER: Yes. And that was when they had  
10 their big consulting practices. And I think that may  
11 still be available out on the SEC's website. I don't  
12 know if it's still out there or not. It was at one point  
13 in time.

14           So the notion that the audit practice is a low  
15 margin product is just wrong and there's no evidence to  
16 support that other than you see it pop up in newspaper  
17 stories from time to time with no supporting evidence.

18           Second of all, the audit has not become a  
19 commodity, the audit has been a commodity for over four  
20 decades now. It became a commodity when in '76 to '78  
21 time frame the CFTC and DOJ removed the barriers on  
22 competitive bidding and a number of other barriers that

1 the profession had had, and that immediately drove it to  
2 a much lower pricing models when the CFOs went out and  
3 started doing competitive bidding.

4           And so the notion of commoditization is not new,  
5 and I agree with Mike wholeheartedly that's not  
6 necessarily a bad thing. Computer servers, that's a  
7 commoditized product.

8           Many of the chips are commoditized product.  
9 We've commoditized stockbroker fees and, you know, it's  
10 just a matter of pricing. And for most CFOs they aren't  
11 going to see a big difference in picking one of the Big  
12 Four as long as they get a partner that has some industry  
13 expertise and knows what they're doing.

14           Why wouldn't you, especially when as the CFO  
15 you're responsible for the budget and the line item in  
16 the budget, why wouldn't you go to the lowest price  
17 because stockholders are asking you to make the numbers  
18 for the year? It's exactly what they're incented to do.

19           So to Lew's question about how are you going to  
20 educate the CFOs, I wouldn't waste my time because it  
21 ain't going to happen, not the way the system works. In  
22 fact, I spoke about two years ago to a group of about 250

1 to 300 CFOs, CFO Rising, a big FEI event, CFO event that  
2 was out in Vegas.

3           And we did a survey of the participants in the  
4 audience and it was driven by the fact that audit fees  
5 had been dropping at the time, some significantly, some  
6 which were discussed at the SAG at the time. And the  
7 question was raised of those in the audience whether or  
8 not it had actually been the audit committee involved  
9 with hiring and setting fees or whether it had been the  
10 CFO, the controller people inside the company.

11           And of the 250 to 300 in the audience, I think  
12 there was six that were counted where the audit committee  
13 had done it, and the rest of it had all been negotiated  
14 by people with inside the company.

15           So the reality is, is SOX is not being complied  
16 with because it's supposed to be the audit committee  
17 doing this, and there's absolutely no, zero enforcement  
18 of that provision of SOX by the SEC. And until that  
19 happens that ain't going to change.

20           So that's going to keep you in a commoditized  
21 product, and it's all those things I agree with Joe that  
22 having the PCAOB come out and say, if you end up being

1 the low company in the industry with the lowest audit  
2 fee, yes, we're going to come look at you, which is  
3 common sense. I mean that's not rocket scientist stuff.  
4 That would send a clear-cut message that perhaps you  
5 don't want to be the low guy on the totem pole.

6           And again the market, just said, there's no  
7 difference between the four big firms and that's  
8 acknowledged so then it just isn't going to change.

9           As far as governance goes, I think the EU and the  
10 U.K. have taken some good initial steps in terms of  
11 requiring more transparency about how the process works.  
12 I think that is key, and I think key to the way the firms  
13 operate in the culture, since Jim Doty raised the  
14 question of culture, is the selection of that CEO.

15           He's voted on by the partners. He's voted on to  
16 drive draws up. You don't elect a partner to run your  
17 firm if you're going to see a drop in your draws. You  
18 want someone to draw it up and then that partner selects  
19 the top ten to 20 people around him and that CEO is  
20 setting their compensation.

21           And all that compensation is driven by  
22 profitability within the firm, and it's because that's

1 what the partners want. And that's just the way people  
2 behave. But until you bring some transparency to that  
3 process and the implications it has for quality, you  
4 aren't going to change the behavior.

5           And this is one place where regulation and  
6 transparency, probably more transparency than anything,  
7 is going to be important. And I think that also relates  
8 to the INEs.

9           People who have been around the profession know  
10 that in the late '70s there were hearings on the  
11 profession and the notion of independent boards was put  
12 forward, and Arthur Andersen and maybe one other firm at  
13 the time went out and started creating an independent  
14 board. After a number of years it went away though  
15 because it wasn't regulated.

16           So if you don't do any regulation you shouldn't  
17 expect them to stick. It didn't stick the last time and  
18 it won't stick this time either. But more importantly  
19 it becomes a question just is like with public company  
20 boards, how do you select the INEs?

21           And almost every time we've seen the firms pick  
22 people in an INE or similar oversight role, they go out

1 and pick people that are very close to them, people that  
2 they've paid significant fees to or money to, to do  
3 research for them or other areas, and it's basically  
4 putting a bunch of yes-people on your INE.

5           And as we've seen with corporate boards, when  
6 CEOs do that, if that's the process that you've got, it's  
7 a wasted process. In fact, it's a terrible process  
8 because people expect something and it's very misleading  
9 as to what they're actually going to get. So that's my  
10 thoughts.

11           MEMBER SILVERS: We've spent a lot of time on  
12 what a commodity is, but I think it's worth probably a  
13 moment more. I think typically when we talk about  
14 commodities we talk about simple things that can't be  
15 differentiated.

16           And as it's been pointed out, smart business  
17 people try to turn commodities into something that's not  
18 a commodity, and you can get margin out of that. The  
19 most commodity-like commodities are literally, you know,  
20 in a raw iron, right.

21           On the other hand it's been like wheat. We've  
22 seen people be able to turn into not a commodity. That's



1 what Monsanto's been busy doing for the last 20 years.

2 A lot of people are mad at them for doing that.

3           The audit is a strange thing it seems to me, and  
4 it has to do with the fact that the customer's not the  
5 customer. And so different supposed customers have  
6 different relationships to the audit, some of which are  
7 commodity-like and some of which aren't. All right.

8           The management, I think, fundamentally in a sense  
9 sees it as a commodity. It's a letter, and the letter  
10 says the same things to all companies. And we've had a  
11 discussion about that and whether we want that to change  
12 extensively, and in an effort to kind of force the  
13 customer to accept something other than a commodity.

14           And so there's a powerful force in this that to  
15 the extent the management is the actual buyer of audit  
16 services, to the extent that the audit committee does not  
17 do its job as Lynn was suggesting, then there's a natural  
18 inclination for the whole process to become commoditized.

19           But obviously what the audit is supposed to be is  
20 not a commodity. It is supposed to be an extremely  
21 complex and skill-dependent service, you know, comparable  
22 in certain ways, for example, to the practice of medicine

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1 or engineering or, some of us in the legal profession  
2 would hope, the law. It's supposed to be that.

3           And investors and the general public, and I think  
4 it's really important, I think, to talk in the aftermath  
5 of the crisis that produced the PCAOB and the financial  
6 crisis that we're still sort of in the midst of in  
7 certain respects, it's important to recognize that the  
8 public is a customer here in addition to investors.

9           Investors and the public expect the audit to be  
10 not a commodity, to be this complex judgment-driven and  
11 integrity-filled process. And yet of course the  
12 investors, the public is not the customer, now the audit  
13 committee is supposed to be the customer.

14           And I tend to believe that in the aftermath of  
15 Sarbanes-Oxley that despite what Lynn said that in many  
16 cases there are audit committees that are trying hard.  
17 They're trying hard to be a real customer. But this is  
18 contested terrain, all right.

19           And the reality, at least in my very limited  
20 experience of what the audit process looks like from the  
21 inside is, is that, you know, you're trying to get to  
22 yes. The management of the company and the audit

1 committee is trying to get to yes, is trying to get that  
2 letter.

3           And thus there's kind of -- if there's a tension  
4 between commodity and non-commodity, there's actually a  
5 more fundamental goal-related tension there as well,  
6 which is that the investors and the public kind of want  
7 the truth, and typically insiders, Board, management, I  
8 think, in almost all cases, and audit committees.

9           And I don't mean by saying this to suggest that  
10 this is unethical or represents unethical conduct. I  
11 think it represents organizational reality. People are  
12 trying to get a job done. They're trying to get to yes  
13 so the business can function.

14           And so when they look, to the extent that they're  
15 not looking for a commodity, to the extent that they're  
16 not looking for just a stamp, they're looking for an  
17 audit firm that will be a partner, this is why audit  
18 firms market themselves as partners, that will be a  
19 sophisticated, knowing, understanding partner.

20           That's really different in many respects from  
21 what investors and the public are looking for. Now what  
22 does that suggest about the PCAOB's role? Oh, let me say

1 just one more thing about commodification.

2           We don't have data here in this presentation  
3 about margins and, you know, at the time that the PCAOB  
4 was set up there was a view around the enactment of  
5 Sarbanes-Oxley that the audit was being used and managed  
6 entirely as a kind of, I mean according to this study  
7 Lynn cited it wasn't a loss leader, but there was kind  
8 of a feeling it was being used like a loss leader to  
9 leverage consulting business.

10           And the data here just on revenues is worrisome  
11 in that respect, because even to the extent that the  
12 advising and consulting is not advising and consulting  
13 directly to audit clients, the tax business looms very  
14 large and you start to wonder looking at this about what  
15 is really going on inside the economics of the firms, and  
16 we don't know. The revenue really just is, it doesn't  
17 really tell you the real story.

18           So what's the role of the PCAOB in this? I think  
19 the answer to that really shows the way in which the work  
20 of this committee and today's agenda is an integrated  
21 whole. Because I think there are two issues that the  
22 PCAOB needs to focus on in relation to this problem.

1           And just to restate, the problem here really  
2 comes from this kind of, the fact that the people doing  
3 the buying of this service are not exactly the people who  
4 are looking to benefit from it. And that problem is a  
5 problem beyond the PCAOB's ability to fix in terms of  
6 authority.

7           So what can the PCAOB do? I think there are two  
8 things. The first is really what this presentation is  
9 about, which is the question of internal governance. And  
10 the PCAOB is in a position to understand within the major  
11 audit firms what are the internal systems of rewards?  
12 Because what I just described, right, that there is a  
13 dynamic that sees the audit as literally, you know, a  
14 stamp.

15           There's a dynamic that sees the audit as a  
16 problem solving function where the problem is, how do I  
17 get the stamp? And then there's the audit as a real sort  
18 of system of professional accountability. What are audit  
19 firms rewarding their employees and their partners for?

20           And this is something that clients, I think, have  
21 no ability to discover on their own, and it's a little  
22 unclear how much of it can be made public in any regime.

1 But the PCAOB, I believe, has line of sight into that and  
2 needs to police that.

3           And then the second issue, which is really the  
4 audit quality indicator issue which we're about to come  
5 to later today, is how can you get enough data into the  
6 hands of the people who are actually the beneficiaries  
7 of the audit, the investors and the public, to be able  
8 to kind of deal with, so they can act as effective  
9 instruments of accountability in relationship both to  
10 kind of helping and encouraging audit committees to do  
11 their jobs, and in terms of being able to directly,  
12 particularly across clients, speak to audit firms  
13 themselves?

14           Do you want to call time?

15           CHAIRMAN HARRIS: Grant, let me use my authority  
16 as the chair here, and with all due respect to Mercer and  
17 Anne, we're behind the schedule now. And what I'd like  
18 to do is get back on the schedule with the understanding  
19 that during the general discussion period you'll be  
20 recognized and I think we will also forfeit the breaks.  
21 People who want to get up and down during the discussion  
22 period should feel free to do so, I think, with your

1 forbearance, Anne.

2           And Grant, I want to thank you very much. You've  
3 taken on a very tough subject matter and, you know,  
4 together with Brandon and Curt and Joe and Larry, I think  
5 you've given us an awful lot to think about and to  
6 contemplate, and I want to thank you very much on behalf  
7 of the PCAOB.

8           So Anne, our final working group topic for today  
9 concerns auditor interaction with audit committees. And  
10 audit committees clearly play an important role in  
11 protecting the interest of investors by assisting the  
12 boards of directors in fulfilling its responsibility to  
13 oversee the integrity of a company's accounting and  
14 financial reporting processes and audits. And to  
15 accomplish this objective the audit committee must hear  
16 from the auditor about the audit and the issues  
17 identified during the audit.

18           The PCAOB recognized the importance of the  
19 interaction between the auditor and audit committees when  
20 it adopted AS 16, Communications with Audit Committees,  
21 last year, and Board members Hanson and Franzel have been  
22 particularly active in this area and the topic remains

1 an ongoing priority and focus of the Board, and it is  
2 also a subject of considerable interest at the  
3 International Forum of Independent Audit Regulators which  
4 Board Chairman Ferguson chairs.

5 And so with that Ann, I turn it over to you.

6 MEMBER YERGER: Just really quickly, it seems  
7 appropriate that we would start this morning with the  
8 audit quality indicators conversation and end our formal  
9 remarks discussing audit committees, because ultimately  
10 right now, given the relative dearth of information about  
11 audit quality that's available to the public, it's the  
12 audit committee that's our line of defense when it comes  
13 to a high quality audit.

14 Certainly audit committees have changed  
15 profoundly since the 1970s, which is when I think the  
16 stock exchanges first mandated that companies have audit  
17 committees, and the Sarbanes-Oxley Act greatly expanded  
18 the requirements for audit committees regarding  
19 composition and duties, and I think it's fair to say the  
20 investor expectations of audit committees are very high.

21 So as I said earlier, we really wrestled with how  
22 can we enhance the audit committees' performance? And



1 I hope Brian comes back because we took the liberty of  
2 expanding a little bit beyond just the PCAOB's authority  
3 to touch on issues that are also more directly relevant  
4 to the SEC.

5           Initially we were going to split up our time and  
6 have folks comment afterwards, but I'm thinking we should  
7 just go through as quickly as possible, our slides, and  
8 then open it up for comments.

9           So with that I'm going to pass first to Pete and  
10 Bob who tackled the issue of the audit committee  
11 composition, particularly that of the financial expert.

12           MEMBER TAROLA: Thanks Ann. I'll lead it off and  
13 then Pete can chime in. This is the definition of an  
14 audit committee financial expert. And I'm not going to  
15 read it to you but I'm going to start pointing out the  
16 capitalized ORs.

17           So an audit committee financial expert is to have  
18 an understanding of financial statements and GAAP, is to  
19 have an ability to assess its application, and is to have  
20 experience with these matters.

21           Preparing, auditing, analyzing, and to get that  
22 experience directly, or, and here's where the first "or"

1 comes in, or by supervising someone who does it directly.  
2 Also has to have an understanding of internal controls  
3 and of audit committee functions.

4 Ann, are you controlling this? Okay, next one.  
5 And here's what's interesting from our point of view in  
6 terms of the background of a person that's supposed to  
7 do all that.

8 That person should have experience as a CFO or as  
9 a principal accounting officer or as a controller or as  
10 a public accountant or as an auditor or similar  
11 functions, or in supervising people that do those  
12 functions or experience overseeing or assessing the  
13 performance of companies or public accountants or  
14 auditors or evaluating financial statements. And lastly,  
15 or other relevant experience.

16 So the point we're bringing up here is, if you're  
17 counting on the audit committee financial expert to know  
18 auditing or auditors or even GAAP, it's pretty nebulous  
19 as to whether or not this definition would get you  
20 someone like that in all cases.

21 MEMBER NACHTWEY: This is Pete Nachtwey. I'll  
22 just add one little anecdote because I shared this with

1 the rest of my subcommittee members, which something my  
2 brother always says when he's confronted with can he have  
3 ice cream or hot fudge. He says he doesn't want to be  
4 subjected to the tyranny of "or," he'd like to explore  
5 the power of "and."

6           And so I think the point Bob and I were trying to  
7 get across here a little bit is, you know, don't have to  
8 have all of these qualities, but you probably need to  
9 have more than one in each of the categories, and  
10 specifically when it comes to a committee on a large  
11 complex company where the audit, not only the external  
12 auditors but the internal auditors are reporting to the  
13 committee, to not have somebody who has got direct audit  
14 experience is probably a challenge.

15           It's in a GAAP, It's certainly one that I know  
16 our Board looks at when nominating governances is looking  
17 at financial experts for our audit committee and making  
18 sure somebody does have direct audit experience.

19           MEMBER YERGER: So Brian, since you're back we'll  
20 sort of note to you. It's been ten years almost since  
21 that standard has been formalized, and I think we look  
22 forward to the feedback from the group. But I think the

1 question is, is the definition right for today and at  
2 this time? Do we get the right fix, staffing and sitting  
3 on the audit committees?

4           Okay, next issue really quickly is auditor  
5 communications with audit committees. Now this is really  
6 the only topic we tackled that is particularly germane  
7 to the Board here, and there have been standards for  
8 auditors to communicate to the audit committee for many,  
9 many years.

10           In March of 2010 the Board proposed a new  
11 standard for these communications. After a public  
12 comment period it repropose a proposal, a standard, and  
13 the Board adopted the new standard last August.

14           AS 16 largely restated what was in place before.  
15 It's in effect now and the goal is to promote effective  
16 two-way communications between audit committees and the  
17 auditor. I'll make a side note that I think a really  
18 important supplement to sort of the rules, and I'm not  
19 a lawyer, I think, has been your outreach to audit  
20 committees, your guidance to audit committees.

21           Many of them as we noted from the prior slides  
22 are not experts either, and the more guidance you can

1 give them in terms of how they can do their job better,  
2 I think, is a very good thing. So I commend you for that  
3 work and I encourage you to strongly continue that.

4 In the interest of time I'm not going to go  
5 through all the elements of AS 16. I'm just going to  
6 note that, and you can read these. I'll flip through the  
7 two slides and they're in your binder as well. They  
8 center on a few areas.

9 First is the company's engagement of the audit  
10 firm. Second, the inquiry of the audit committee about  
11 matters relevant to the audit. Next, more about the  
12 audit strategy and approach including accounting  
13 policies, practices and estimates, significant and  
14 unusual transactions, and the audit firm's evaluation of  
15 the company's financial performance and other key  
16 findings.

17 Our questions here is can these disclosures be  
18 enhanced? I think my practical side is a new standard  
19 has just been adopted. I think it's ridiculous to  
20 suspect that the Board would want to reopen this a year  
21 later.

22 But I will note that in approving AS 16, at the

1 same time the Board released guidance regarding auditor  
2 communications to audit committees particularly regarding  
3 the inspection results.

4           And I think an area maybe worth exploring is  
5 whether additional guidance could be issued by the Board  
6 in conjunction with some of these areas that aren't maybe  
7 captured here, but that as we discuss, investors might  
8 find of value, or you think would add value to the audit  
9 committee.

10           And with that let me pass to final --

11           CHAIRMAN HARRIS: And first of all, I want to  
12 introduce, I think all of you know Marty Baumann who  
13 heads up our Standards Division and I want to have him  
14 have the opportunity to interject as he sees fit. So  
15 Marty, if you want to make any comments about what's been  
16 expressed so far, please go ahead.

17           MR. BAUMANN: Yes, thank you very much. And I  
18 think AS 16 did a lot in terms of improving the  
19 communications and in very important ways.

20           But to your point, AS 16 lists also other places  
21 in the standards where there are required communications  
22 outside of what's in AS 16 itself, and as we continue to

1 look at other auditing standards, for instance, the  
2 related parties standard, auditing related party  
3 transactions, which have been serious indicators of  
4 fraudulent transactions over the years, in that proposed  
5 standard and in the reproposal we've indicated that there  
6 are requirements to communicate with audit committees  
7 about related party transactions and the auditor's  
8 assessment of those.

9           So as we're looking at new standards, and the  
10 related parties is a perfect example, we will continue  
11 to improve upon auditor communications with audit  
12 committees.

13           MEMBER YERGER: Great to know. We'll close our  
14 formal presentation with more to you, Brian, and this is  
15 going to be about audit committee communications to the  
16 public and investors.

17           MEMBER BULLARD: I took a kind of opening look at  
18 the issue of audit committee disclosure, and what I'm  
19 going to do is just talk a little bit about some of  
20 things that are currently disclosed and then how to think  
21 about this issue. What is the current state of voluntary  
22 disclosure in various shareholder proposals, and then

1 talk a little bit about location issues.

2           This is not an exhaustive list, but it's the, I  
3 think, the main focus of audit committee disclosures.  
4 And it's not so much for reading other than what strikes  
5 me about this is, as I described before, there are things  
6 that could be considered to be the conditions of a good  
7 audit and then there are things that are really the meat  
8 of the audit which would be significant issues, problems  
9 raised, how they were resolved, how the committee dealt  
10 with those issues.

11           And that generally is not a topic for audit  
12 committee disclosure, although if I were an investor  
13 those would be things I'd want to know the most about.  
14 Again, because these are always somewhat attenuated  
15 relationships between audit quality, whereas problems  
16 that are actually exposed and discovered by the auditor,  
17 raised, rectified, discussed with the committee and then  
18 disclosed to investors would seem to be the most  
19 important driver of how you are to evaluate your auditor.

20           The next question is, you know, how would we  
21 approach the question of requiring an audit committee to  
22 do anything since the Board is the Board and clearly has



1 limited jurisdictional means?

2           And if the question is the one on the left, one  
3 could argue that this isn't really a Board issue at all  
4 in that it is not in the business of requiring audit  
5 committees to do anything. If on the other hand the  
6 question is, what is it the Board believes that  
7 shareholders should have in terms of information, I think  
8 you could reasonably take the position that if they need  
9 information you could only have the authority to require  
10 an auditor to disclose things and disclose them publicly.

11           One of the things that's a pending proposal is to  
12 require auditors to disclose their tenure publicly, and  
13 that is obviously something you could also require an  
14 audit committee to do indirectly by saying to the  
15 auditor, well, you can disclose this list of things  
16 publicly yourself, but you don't have to if the auditor  
17 committee does so and discusses its treatment of those  
18 issues in meetings with the auditor.

19           I know I'm sounding a little bit like a tricky  
20 lawyer, but I think that is done and I wouldn't hesitate  
21 to take that approach. But it might seem a little  
22 aggressive. So that's sort of one way to think about the

1 issue in terms of what the Board could actually do.

2           Another issue was what's happening currently in  
3 the marketplace, and what you see here are some Ernst &  
4 Young collected examples of common disclosure. They  
5 looked at 89 of the Fortune 100 companies and these were  
6 the top voluntary audit committee disclosures often in  
7 response to shareholder proposals.

8           These numbers have gone up in 2013, and obviously  
9 some of them are expansions of required disclosure and  
10 they supplement, essentially, a mandatory disclosure such  
11 as non-audit services, but they're kind of an  
12 illustrative sense of what's happening without any  
13 intervention by a regulator.

14           Next, I thought it was interesting to look at the  
15 shareholder proposal issue because this is an example of  
16 the Brotherhood of Carpenters' proposal to, I think it  
17 might have been Dell that the SEC as it has done with  
18 virtually all of the audit committee disclosure  
19 shareholder proposals found to be a matter of ordinary  
20 business operations, which as a legal matter is a legal  
21 basis for a company to exclude it from the proxy.

22           Interestingly, the SEC has also taken the

1 position that if there is a significant social or  
2 economic or other policy basis for including something  
3 even though it is relating to ordinary business  
4 operations that can be basis for requiring the company  
5 to include it.

6           Now if I were thinking as a lawyer that's the  
7 tack I would take. I look at a couple of letters by  
8 submitters, they haven't really argued that point. But  
9 it is interesting that, you know, we have a lot of public  
10 policy that is requiring the disclosure by these  
11 committees of information, which clearly suggests to me  
12 there's a strong public policy issue here.

13           And in fact, you've got an example of the PCAOB  
14 is considering requiring the disclosure of audit tenure,  
15 clearly a public policy matter that rises to the level  
16 of being required by a regulator.

17           It seems odd to me it's not a significant enough  
18 social policy that a shareholder should not be able to  
19 put it on the proxy and simply make a request to the  
20 Board to disclose this information.

21           I don't know whether that's something that the  
22 Board would be interested in commenting on, but it seems

1 there's certainly some socially significant policies  
2 within these lists, and you could argue that either the  
3 Board is taking on ordinary business operations in its  
4 rulemaking or the SEC has got it wrong as to what is an  
5 ordinary business operation.

6           And then the last slide, this is more sort of  
7 concrete, less fact-free as Curtis might say. This is  
8 really attributable to the Ernst & Young report. It made  
9 the very good point that a lot of these required  
10 communications are voluntary, are appearing all over the  
11 place.

12           This is a chart that shows five examples of  
13 voluntary audit committee disclosure, and you can see not  
14 only are they appearing in different places, there really  
15 is no rhyme or reason to where they decided to put  
16 certain disclosure.

17           So it certainly might be a useful initiative to  
18 at least give some guidance or impose some requirements,  
19 so that if you wanted to find the information that's  
20 worth disclosing it would all be in the same place.

21           And then the final slide is another example of  
22 the same issue. Where do you find things that are

1 required to be disclosed? You're required to provide a  
2 link in the proxy statement to the audit committee  
3 charter.

4           As you can see it's about a 50/50 split between  
5 whether that is specifically in the audit committee  
6 report or somewhere else in the proxy statement. So you  
7 have to look for it one or the other place, in the first  
8 place.

9           And then second, the link is to three different  
10 places when you finally click on it, and in a couple of  
11 those cases it's not to the actual charter itself. So  
12 I don't think, that's a politically challenging position  
13 to take to think that maybe we should look at if  
14 information is going to be disclosed it would be most  
15 useful if it were one place and it took you to the actual  
16 document that you're supposed to be able to receive.

17           I think that was fast enough, and that's all I've  
18 got.

19           MEMBER YERGER: That's it. We tried to keep it  
20 quick. It's the end of the day, and now honestly we'd  
21 just love to get your input on some of the issues we  
22 raised, your feedback. As I said at the beginning, we

1 had more information and questions for you than actual  
2 firm recommendations.

3           MEMBER HANSON: Just a question for those here,  
4 and thank you for the presentation, Ann. It was really  
5 good and insightful and consistent with a lot of things  
6 I've been hearing from some of the audit committee  
7 members I've been talking to in the discussions in other  
8 venues.

9           So those of you that sit on audit committees,  
10 what stops you today from doing more or all of these  
11 voluntary disclosures and more?

12           MEMBER TAROLA: Actually, nothing really. It's  
13 often kind of balancing the legal requirement against the  
14 objective of perhaps full disclosure. And I think with  
15 those two choices many companies would stay with the  
16 legal requirement.

17           CHAIRMAN HARRIS: Well, Brian and then Anne.

18           MR. CROTEAU: Thanks Steven, and thanks, Ann,  
19 very much for the presentation. I want to just make a  
20 couple of remarks along the same lines as Marty did,  
21 notwithstanding the AS 16 was recently finalized.

22           They're still very interested in feedback and

1 still plan to think about the disclosures auditors make  
2 in communications, auditors make to audit committees.  
3 I think it's important to highlight from an SEC staff  
4 perspective, it's an area that we continue to be focused  
5 on.

6           The staff in my group have continued to spend  
7 time doing a lot of what you're doing, thinking about  
8 what is the range of what we see in audit committee  
9 reports and monitor what's going on around the world.

10           In fact, it seems daily lately there seems to be  
11 activity around the world that is very much focused in  
12 the same regard. I think, yesterday, the U.K.  
13 Competition Authority report contained an interesting  
14 outcome which is the shareholder vote on the  
15 acceptability of the audit committee report.

16           I'm not sure what the implications of that vote  
17 are or how that actually will be implemented, but just  
18 to make an illustrative point that we're monitoring these  
19 things around the world, considering them and considering  
20 the range of the audit committee reporting that we see  
21 today.

22           And so we really very much appreciate the

1 feedback in this area and ideas and suggestions. And so  
2 just want to encourage the continued thinking and  
3 suggestions in this space like Marty has done from an  
4 auditing standards perspective.

5 CHAIRMAN HARRIS: Anne Simpson?

6 MEMBER SIMPSON: Thank you. I am about to sound  
7 like a broken record all over again. I think the reason  
8 that the voluntary disclosures aren't made is because  
9 investors aren't asking for it, and unfortunately if  
10 there is a proposal we have this bizarre situation where  
11 the auditors are working for the shareholders but the  
12 shareholders are not enabled to put forward a proposal  
13 asking for something different if that's what they need.

14 So I do think that's a problem that really needs  
15 to be addressed. There's another consequence of it being  
16 considered routine business and that for not for  
17 shareholders to bother their heads with is the fact that  
18 broker votes can be loaded into the bucket of "yes" when  
19 auditors are voted.

20 So by calling this routine a couple of things  
21 happen. One, we can't put proposals in, and I think  
22 that's a real problem. And secondly, broker votes get



1 cast with the management's recommendation.

2           So I promised I would ask at the office back at  
3 home what happened this season, so in the Russell 3000  
4 my team can only find one auditor that didn't get a  
5 majority of their vote that was imperial. And because  
6 this is a decision to ratify an earlier decision by the  
7 management, it's not clear what that vote would do  
8 anyway.

9           So again, so my refrain, my song is get the  
10 shareholders for whom this work is ultimately being done,  
11 we're the prime user of financial statements. We need  
12 audit to work effectively. Put us in a position to do  
13 our job and I'm sure much else will follow.

14           But right now we're really in an awkward position  
15 where we can't really see what's going on and we can't  
16 hold auditors accountable and we can't file proposals,  
17 and then broker votes get thrown in and can tip the  
18 balance even when there needs to be change.

19           CHAIRMAN HARRIS: Barbara Roper and then Mercer.

20           MEMBER ROPER: It struck me when we were looking  
21 at this, the sort of like huge disconnect between what  
22 we say auditors have to communicate to the audit

1 committee and the qualifications of audit committee  
2 members to assess the information that they are required  
3 to get.

4           And so yes, I recognize that it's not the Board's  
5 responsibility, but since Brian's here I'll bend his ear  
6 on this again, is that that to me is looking again at  
7 that financial expert requirement, it seems to me to be  
8 crucial.

9           When they were drafting Sarbanes-Oxley and they  
10 decided to make the decision to rely on the audit  
11 committees to perform this crucial function that's really  
12 essential to maintaining the independence and ensuring  
13 that the audit is conducted for the shareholders, struck  
14 me at the time as a slender reed on which to build our  
15 reform process.

16           Because the first responses of audit committees  
17 in the wake of Enron was to send around, start adding,  
18 like, language to their audit committee reports about how  
19 they don't review any of this stuff and they're relying  
20 totally on management and, you know, it's not our  
21 responsibility and we don't have the expertise. I mean  
22 there was this little standard language that some law

1 firm was shipping around.

2           And if the sort of existing body of committees  
3 was, you know, their response was to disavow  
4 responsibility, it's going to take a huge cultural shift  
5 to change that. And I know we've seen some cultural  
6 shift but I'm not sure it's quite that huge.

7           And then, you know, it requires really remarkable  
8 expertise to perform that function effectively and I  
9 don't think we got there. That definition got watered  
10 down when the rules were being written.

11           So I think that definitely needs to be revisited.  
12 And that that, you know, I'm not altogether convinced  
13 that this works anyway as long as, I mean it's the other  
14 big unfinished business of SOX is that we didn't really  
15 reform corporate boards, and the way corporate boards,  
16 corporate directors are selected to ensure that they're  
17 more answerable to shareholders.

18           And so until you break that kind of logjam and  
19 get boards that actually represent shareholders instead  
20 of being sort of self select, you know, by management to  
21 not make waves, I don't know how this process works.

22           CHAIRMAN HARRIS: Mercer, we're looking forward

1 to you bringing us right back to what's in our  
2 jurisdiction. So between Mercer and Joe and then --

3 MEMBER SIMPSON: I think aimed at me, and I think  
4 --

5 CHAIRMAN HARRIS: No, no.

6 MEMBER SIMPSON: -- what you could -- no, no.  
7 That's okay.

8 CHAIRMAN HARRIS: Listen, what we're doing is  
9 we're beginning to expedite the process so --

10 MEMBER SIMPSON: Understood.

11 CHAIRMAN HARRIS: -- people can take the needed  
12 break that they want.

13 MEMBER SIMPSON: Let the record -- understood.

14 CHAIRMAN HARRIS: We want to keep within the  
15 context of what we're doing and then we want to open it  
16 up, since I promised everybody, you know, at the end.  
17 I didn't say there would be a free-for-all in terms of  
18 the general discussion.

19 You all put a couple of things down on the list.  
20 I will tell you what's on the list and then we can go  
21 through that. But in any event, take it away, and then  
22 we'll go around the table, finish this one off, take a

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1 ten-minute break and then go to the general discussion.

2 MEMBER SIMPSON: Okay. So my point here, the  
3 self-help for the PCAOB, what can you do that's within  
4 your remit. But you are a creature of the SEC and what  
5 you can't do, which is necessary for you to fulfill your  
6 mission, we would ask that the recommendation be that the  
7 PCAOB recommends to its continental --

8 DIRECTOR DOTY: We avoid the metaphor of  
9 "creature," Anne.

10 CHAIRMAN HARRIS: Mercer?

11 MEMBER BULLARD: Thank you. Thank you for the  
12 chance to comment on my comments. This keeps coming back  
13 to, I think, Lew's point that audit committees I expect  
14 to be rational actors and act in their best interest.

15 And I think the answer to, you know, why they  
16 wouldn't include these is, if I put on my lawyer hat I'm  
17 going to tell them to take as little risk as possible,  
18 stick to the law and nothing more, and if they do more  
19 than that I'm going to go, if I'm a good lawyer, find  
20 what the lawyers are writing in response to this and use  
21 exactly the same boilerplate language. That's what the  
22 smart lawyers do and they're the ones you would want to

1 go to first in complying with this. That's  
2 commoditization in the legal world.

3         If you want to change what audit committees are  
4 doing especially in response to marketing that clearly  
5 shows that what they're looking for is signaling that the  
6 auditor will be flexible is you have to give them an  
7 overriding incentive to create some other result. Now  
8 whatever you want that to be then you have the incentive  
9 fit the result.

10         So if what you want is an auditor that is going  
11 to aggressively dig out problems in the accounting, then  
12 you have the audit committee require to disclose the five  
13 biggest problems that the auditor found. Not to disclose  
14 significant problems if they exist because that creates  
15 an incentive for there to be no significant problems, and  
16 again hire the auditor that won't find them.

17         You require that they list five things, and the  
18 auditor is going to have to come up with five things.  
19 Now that creates perverse behavioral incentives. Maybe  
20 the auditor will make up five things just to fill the  
21 five slots. But at least you've got something out there  
22 and they may be trivial, but that is how you really cut

1 to the jugular of the issue of how to manage market  
2 conflicts.

3           But I mean, Jay, my response is you'd be crazy to  
4 jump on these voluntary proposals, putting on, you know,  
5 counsel to the audit committee hat, because you are  
6 asking for nothing but risk. And I think the risk  
7 minimization is going to drive most of these decisions.

8           So if the audit committee has to list five  
9 things, now the risk is my auditor's going to find me  
10 five things and if the sixth thing is the one the SEC  
11 busts me on and I didn't have it in my top five, I'm in  
12 trouble.

13           So if you really want to create a market that's  
14 going to work you have to be hard-hitting in that way and  
15 completely change their incentives. Because I don't  
16 expect them to follow the spirit of the law. I expect  
17 them to follow what their lawyers say is going to be the  
18 safest way to proceed.

19           CHAIRMAN HARRIS: Norman?

20           MEMBER HARRISON: Thank you Steve. Thank you Dan  
21 and the working group. Great presentation, a lot of  
22 issues in here. I'll be brief. It's just a point again

1 on an issue I've raised earlier pertaining to disclosures  
2 around the independent's review process.

3 I'd strongly second the observation Damon made  
4 during the last presentation about the slide from the  
5 prior group that showed the allocation of fees among  
6 practice or service line in the earlier presentation.

7 You know, the tax numbers are not insignificant,  
8 and my sense has been for some time in an era of  
9 increasing pressure on firms or companies, on firms from  
10 their clients with respect to audit fees that, you know,  
11 some trade-offs have occurred pertaining to tax services,  
12 whether it's the tax provision or return preparation or  
13 other areas where's there's some recapture of fees that  
14 are given on the audit side.

15 You know, when I think of Sarbanes-Oxley, if I  
16 describe it or distill it to one word, the word is  
17 "independence," right? I mean that is what the statute  
18 is all about. That's why you all are seated at the head  
19 of the table. That's why we're all here.

20 And it seems to me that in this one area where  
21 the rubber meets the road, where there are required  
22 circumstances in which an auditor has to come forth and



1 seek permission to provide non-audit services to an  
2 issuer, we as investors have very little transparency or  
3 visibility into what actually happens.

4           And to your question about, I mean the mandatory  
5 disclosures now are with respect to the policies and  
6 procedures for approval of non-audit services, I would  
7 be a strong advocate of an additional requirement that  
8 the actual results of those reviews be disclosed every  
9 year in some manner to describe the number, the nature  
10 of the services, the rationale for the approval or the  
11 disapproval so that they become mandatory and consistent  
12 rather than voluntary. And it ties in earlier to the  
13 discussion about that the quality indicators where we  
14 would urge you to gather that information at the firm  
15 level.

16           DIRECTOR DOTY: Proxy statement or auditor report  
17 or someplace else altogether? Where would you want it?

18           MEMBER HARRISON: I don't know that I have a  
19 strong view. I would think the proxy statement would be  
20 a good place because it goes to the question of the  
21 candidate's independence and the number of times that an  
22 issue has arisen regarding non-audit services or required

1 a consultation to occur, I would think.

2 CHAIRMAN HARRIS: Joe, you've got the last word  
3 on this subject.

4 MEMBER CARCELLO: Thanks Steve. I debated  
5 whether to say anything or not because I doubt you'll do  
6 this. But I do think it's primarily an SEC issue. But  
7 you said, you know, you want us to give recommendations  
8 on things that the PCAOB can control who says we think  
9 about these things.

10 And we're talking about the audit committee,  
11 we're talking about the expertise. And Barbara is right.  
12 If you go back and you look at the original SEC rule  
13 proposal on 407, it was much more consistent with what  
14 I think people would think is a true expert, and then the  
15 business community screamed very loud and very long, and  
16 the SEC changed it dramatically.

17 But we were talking about expertise. We're  
18 talking about, we didn't really talk about independence,  
19 but there's an increasing body of literature that says  
20 economic ties have been banned. But if I'm a CEO and I'm  
21 a bad dude I just put social ties on there. And there's  
22 a very, very burgeoning body of literature around that.

1           And, in fact, some previous SEC commissioners  
2 have been quoted as saying rather than the board picking  
3 top management, top management picks the board, and  
4 there's a lot of evidence to that.

5           And so there's issues around independence.  
6 There's issues around expertise. There's again a  
7 burgeoning body of literature on how board members are  
8 selected, and when the CEO plays a heavy role in the  
9 selection of board members the effectiveness of the audit  
10 committee not only is reduced, goes away completely.

11           So how does that tie to the Board if the Board  
12 wanted to pursue this? If you go back and you look at the  
13 exposure draft, and I'm bringing up a bad word, we'll  
14 give the Board here shivers, of AS 2, there was a  
15 rigorous discussion of things like expertise. There was  
16 a rigorous discussion of the nominates governance  
17 committee and how people got on the board in the first  
18 place.

19           And I've brought this up in the past when Doug  
20 was still around on the SAG, and he said, you know, that  
21 just got killed. That got killed by the business  
22 community. It got killed by the SEC. Because there was

1 this perception that the PCAOB was encroaching on the  
2 governance space and that's an SEC space.

3           So, you know, I understand the reality but these  
4 are real challenges, these issues. And so if the PCAOB  
5 can't deal with it the SEC needs to look at it.

6           CHAIRMAN HARRIS: Well, Ann, thank you very much.  
7 It was a quick presentation, but having said that it was  
8 an extremely thoughtful. And also you should know that  
9 this issue of communications with audit committees is  
10 coming up in the international forum as well, the Forum  
11 of Independent Audit Regulators is bringing this topic  
12 up in April at the plenary session.

13           It is not confined with respect to jurisdiction.  
14 It's something that the GPPC which the leaders of the  
15 profession will be working on with the Investor Advisory  
16 Group. The issue that will come up will be what  
17 investors want from audit committees, what audit  
18 committees want from auditors and what auditors would  
19 like from audit committees.

20           So this issue of audit committee communications  
21 has traction internationally. So this slide deck will  
22 be important and will be shared with respect to the GPPC

1 counterparts, which are the leaders of the profession,  
2 and I think we'll have some traction with respect to  
3 what's brought up at the IFIAR meeting in April, and that  
4 has been recommended by the leaders of IFIAR, which is  
5 Lew Ferguson is chairman, and the vice chairman, Janine  
6 from The Netherlands.

7           So thank you very much for this presentation.  
8 We'll take a 15-minute break, and want to be back  
9 promptly at 3:45 for, I'm sure, will be an interesting  
10 discussion on a number of issues. Thank you.

11           (Whereupon, the foregoing matter went off the  
12 record at 3:33 p.m. and went back on the record at 3:50  
13 p.m.)

14           CHAIRMAN HARRIS: In terms of this final general  
15 discussion session, I emailed all the Investor Advisory  
16 Group members, tasked them what topics they wanted us to  
17 discuss. And they indicated the auditors reporting  
18 model, audit transparency, the status of the PCAOB's work  
19 on the ACAP recommendations which is, I think everybody  
20 knows ACAP refers to the report of the Department of the  
21 Treasury's 2008 Advisory Committee on the Auditing  
22 Profession, the global agenda, which is something that

1 Anne Simpson raised, oversight of audit committees, and  
2 the possibility, although I think there was enough  
3 communication that we're probably not going to bring up  
4 a fair value accounting.

5           Since the first two topics are under  
6 consideration by the Board, we've made it clear that all  
7 comments will be transcribed as have the comments of this  
8 entire session. But those first two topics deal with the  
9 auditors reporting model and audit transparency.

10           And I should say that I anticipate that this last  
11 hour's discussion will be relatively free-flowing with  
12 members discussing issues as they see fit. And hopefully  
13 we'll have time before we break for everybody to bring  
14 to our attention what is most on his or her mind.

15           So having said that whether or not we want to  
16 start with audit transparency or the audit reporting  
17 model, whoever wants to start with that subject matter  
18 or either of those raise your tent card and we'll start,  
19 Ann, with you first, and then we'll just recognize people  
20 as they put up their tent cards. So Ann Yerger?

21           MEMBER YERGER: This is Ann Yerger, one of the  
22 two Anns named here. Well, yes, let me make one comment

1 regarding just auditor report, and it sort of links on  
2 to our prior conversation.

3 I know we were talking a lot about audit  
4 committee disclosures to investors, but I do want to  
5 stress that certainly the council and personally I'm in  
6 favor of an enhanced auditor report to the public.

7 I appreciate the benefits of sort of that  
8 pass/fail model that's in place, but I think there's  
9 terrific, important information that the auditors have  
10 that I think should be disclosed to the public.

11 Second, let me comment on the issue of auditor  
12 transparency. I think that there is no simpler or less  
13 expensive reform that should and could be put in place  
14 than requiring the disclosure of the name of the partner  
15 on the engagement. I think nothing sharpens the mind  
16 more than a signature.

17 I know we all have to sign documents, public or  
18 not, and I pay a lot of attention to that. I think it's  
19 an incredibly important reform and I urge the Board to  
20 move forward with that. Thank you.

21 CHAIRMAN HARRIS: Anne Simpson?

22 MEMBER SIMPSON: Thank you. I'd like to fully

1 support what Ann Yerger has just said. I think the  
2 question of transparency on the audit, it's hard to  
3 understand who would object to this. Who would not be  
4 willing to stand and be held accountable for their own  
5 work?

6 I recall us having similar discussions around  
7 boards of directors 20 years ago about knowing who the  
8 board were, what their background was and so forth. It  
9 seems to me just exactly as we were talking about, the  
10 accountability to shareholders which is in real need of  
11 being strengthened. That sense of personal  
12 accountability is extremely important. So we fully  
13 support this and we actually think it will sharpen the  
14 discussion in an extremely useful way.

15 On the auditors reporting model we'll be putting  
16 in comments. I think, you know, you will remember, I  
17 think it was the first meeting that I came to we looked  
18 at the auditor report, was one of the issues in the  
19 working group that I participated in.

20 And my party piece of the day was to illustrate  
21 the problem we had as shareholders by reading you the  
22 audit report from Bank of America before, during and



1 immediately after the crisis. And there was not one dot  
2 or comma different.

3           So I think if we can't use the audit report to  
4 communicate on critical issues, and many of them are  
5 listed out in the consultation, then really this is  
6 becoming an exercise in pushing paper around. So  
7 accountability will be sharpened with transparency, and  
8 quality will most definitely be improved with this new  
9 scope to the audit.

10           DIRECTOR DOTY: With transparency there has been  
11 an issue raised in the comment process over the original  
12 proposal as to whether it was either useful or necessary  
13 or appropriate to have the engagement partner disclosed  
14 in the audit report, whether the same results could be  
15 achieved by having a separate form, a Form 2 filing or  
16 a special form that we would devise which would be filed  
17 either annually or within a certain period of time  
18 following the completion of the audit that would contain  
19 this information.

20           That raises also the question of whether you just  
21 stick with the auditor's name, the engagement partner's  
22 name, or whether you include more extensive information

1 about his or her qualifications and the audit team. Are  
2 there any views you have on that?

3 MEMBER YERGER: I would strongly prefer that  
4 there not be a second or another filing. You know, the  
5 more you make folks hunt and peck for something, I think  
6 the less valuable it is. I don't know why you would add,  
7 you know, make something more complicated that really  
8 doesn't have to be.

9 I don't object, frankly, to having additional  
10 information disclosed regarding the background or  
11 expertise of the individual. I think that can be helpful  
12 as well. But I do think just having the name is a good  
13 data point. I think it sharpens the mind and I think it  
14 also can give the audit committee good information as  
15 well to compare.

16 MEMBER SIMPSON: Yes, I agree with that. I mean  
17 an auditor should be proud of the work they're doing.  
18 And in the same way that we know more now about the  
19 people who serve on the boards, it's entirely appropriate  
20 to have that sort of information about the auditor and  
21 the audit partner.

22 This is entirely complementary to the

1 improvements we'd like to see to the audit report itself.  
2 So if transparency is the watchword, you know, we hope  
3 the wind is in your sails. We certainly, as the users,  
4 the prime users of this information, fully support what  
5 the PCAOB's hoping to achieve.

6 MEMBER BUETTNER: And Steven, I would just say --  
7 sorry, just to jump in on the back of that. I would say  
8 that if you are going to disclose additional information,  
9 the tenure, that particular engagement partner's tenure  
10 is actually relevant and important information and should  
11 be included.

12 CHAIRMAN HARRIS: Well, as I say, since this is  
13 the equivalent of a comment period as well, you're being  
14 transcribed, what are your views in terms of the  
15 identification of the engagement partner and the  
16 identification of other auditors involved in the  
17 engagement?

18 MEMBER BUETTNER: I would agree. I think the  
19 more information, frankly, the better, and I would think  
20 that to put that on a separate form probably complicates  
21 the issue as well. It should be relatively easy to find.

22 CHAIRMAN HARRIS: Norman?

1           MEMBER HARRISON: Very quickly on this question.  
2 First of all, I violently agree with everything that was  
3 just said on the other side of the room. But to take it  
4 a step further, as some may recall I was on the working  
5 group last year that dealt with the issues around the  
6 audit report, and of course we raised this issue at that  
7 time.

8           It's an important transparency issue, but it ties  
9 in as well to other things we've talked about today  
10 including this issue of whether there is or perhaps why  
11 there isn't competition for audit services that's based  
12 on quality.

13          I think that ownership and putting identities  
14 with work product, I think, moves us a step in that  
15 direction. And it may have some beneficial aspects for  
16 compensation issues as well. So I just wanted to point  
17 out, I think that it's an important issue for the reasons  
18 that both Anns provided but that it ties into a number  
19 of things we've talked about today.

20          CHAIRMAN HARRIS: It's extremely important that  
21 we get the temperature of investors on this issue because  
22 oftentimes the assertion is made that we only have

1 comment letters from the profession.

2 I mean the profession's comment letters totally  
3 outnumber the comment letters that come from investors  
4 or representatives of investors or people who are  
5 associated with investors. So, you know, to the extent  
6 that you can flush out your arguments either pro or con  
7 on these issues, it's important to get it on the record.

8 Mike?

9 MEMBER HEAD: Mike Head. And as far as the  
10 additional auditors report, obviously I was on the  
11 similar subcommittee last time and still feel an  
12 auditor's discussion and analysis supplemental report  
13 would be very valuable.

14 And I guess based on what you just said I have no  
15 problem with a supplemental filing. I would just then  
16 require whoever the lead engagement partner is that is  
17 on the supplemental filing has to sign and be shown on  
18 the opinion in their name. I'd give them both instead  
19 of one or the other.

20 CHAIRMAN HARRIS: Lynn?

21 MEMBER TURNER: The getting the auditor's name,  
22 I think, would be very good. In fact, I'm shocked that

1 this thing's been debated for 40 years and finally it  
2 looks like maybe someone will actually do something about  
3 it.

4 I agree, well, I mean put it this way, I don't  
5 think it matters whether you have a separate ADNA or you  
6 included in the filing the 10-k or whatever filing it is  
7 itself, what I'm concerned about is the information and  
8 getting the information that you need and I care less  
9 about, you know, which page it's printed on.

10 With respect to information that would be useful  
11 to and impact on someone voting on whether or not to  
12 retain the auditor, I think that stuff clearly ought to  
13 go into the proxy because that's when investors are most  
14 likely to be looking at it and where they're most likely  
15 to look at it when making that vote. So I think it  
16 probably ought to go in there. I wouldn't do a separate  
17 filing out beyond that.

18 As far as information like tenure and that as  
19 long as it's factual, I think that is good. I asked our  
20 CIO at Copara to survey all of her analysts and portfolio  
21 managers, and one concern that they came back and  
22 expressed was asking the auditor to provide information

1 that would be perhaps turned into spin or hype. They  
2 were very concerned about that. They wanted it to be  
3 factual information and information that the PCAOB or  
4 someone at least periodically could test and see that it  
5 was actually accurate. So at least in that group they  
6 were very concerned about that at Copara.

7           So factual stuff like here's the tenure of the  
8 auditor, here's the experience the audit partner has in  
9 auditing that industry, that type of stuff is factual and  
10 it would be very helpful.

11           CHAIRMAN HARRIS: Damon Silvers?

12           MEMBER SILVERS: Yes, I again want to speak to  
13 this question of identifying the partner. Like Lynn, I  
14 mean I've been on many bodies that have advised doing  
15 this over a period of years and it just continues to  
16 surprise me it's not done, particularly against the  
17 context of, for example, the fact that individual  
18 attorneys sign SEC filings.

19           The fact that in general we demand a great deal  
20 of individual disclosure in disclosure systems generally.  
21 This is true with respect to boards of directors, to  
22 corporate executives. Corporate executives have to

1 individually sign financial statements.

2           This is true in, to take a somewhat far-afield  
3 example but one which I'm somewhat familiar with, in the  
4 regulation of labor organizations. I mean a great deal  
5 of information is publicly available about me. I'm just  
6 an employee.

7           And so the idea of sort of some level of personal  
8 identification in relationship to important gatekeeper  
9 functions strikes me as just totally old hat, and I don't  
10 understand why this is controversial, and it's just long  
11 overdue.

12           And it ties to what we were discussing earlier.  
13 I mean throughout today in terms of the problem of  
14 commodification, the problem of audit committees not  
15 necessarily doing what they're supposed to do, the  
16 minimum that the PCAOB ought to be doing in this area is  
17 arming the various actors in this process so that if they  
18 choose to want to do their job seriously they have the  
19 basic information necessary to do it. And I would say  
20 the most basic information is knowing who's in charge of  
21 the audit.

22           Now I think there is, in addition, I think there



1 is something that has not gotten a lot of attention here  
2 which is the question of who really is, whether we really  
3 have a consistent view of quote, who is in charge of the  
4 audit.

5           And the Big Four audit firms and now their global  
6 networks, is it truly meaningful, what does it mean to  
7 say that one of them is in charge of the audit without  
8 identifying specific human beings?

9           I think if we were talking about, you know, a  
10 Victorian partnership, you know, a handful of people  
11 sitting in an office together, you might be able to say,  
12 well, it's a meaningful thing to say that those five  
13 people or those ten people are in charge of an audit.

14           How many tens of thousands of people represent  
15 the institution of PwC or E&Y and is it meaningful to  
16 identify them as responsible collectively? I don't think  
17 it is.

18           And oddly enough, when we talk about auditor  
19 rotation currently we focus on partners. And the idea  
20 that we focus on partners there but then don't tell  
21 anyone who the partners are, it doesn't make any sense  
22 to me.

1           And so, you know, look, there's always going to  
2 be a certain amount of pushback here, but this seems sort  
3 of like a minimum thing for the PCAOB to move forward and  
4 adopt.

5           And then I'll make then a comment about the  
6 auditor reporting model for a moment and just a general  
7 piece which relates to what a number of people said about  
8 the danger of boilerplate in any revisions of the auditor  
9 reporting model.

10           Again, having seen a number or requirements for  
11 disclosure turn into meaningless mush, it seems to me  
12 that if you're going to try to get more information in  
13 a meaningful way out of the audit process that then again  
14 informs and potentially empowers a variety of actors that  
15 surround the, including the audit committee itself, but  
16 the actors surrounding the audit committee to try to  
17 improve audit quality, that those disclosures really have  
18 to either be specific, testable facts of the kind that  
19 I think people have discussed here already today, it was  
20 the subject, I think, of Ann's presentation, or they have  
21 to be kind of processes of requirements that for lack of  
22 a better word compel either the auditor or the audit

1 committee to disclose sort of the things that essentially  
2 involve grading on a curve.

3           The example of, tell me the five hardest things  
4 you had to deal with in the audit process, the five  
5 toughest decisions, the five most marginal things, a  
6 process that doesn't allow you to say, oh, we don't have  
7 any. We're all fine here.

8           I can't help but just saying that, you know, the  
9 president of the AFL-CIO just came back from his first-  
10 ever trip to China. No president of the AFL-CIO has ever  
11 been to China since 1955 when the AFL-CIO was  
12 established. If you think about the dates involved  
13 you'll understand why.

14           And he had a great trip, but he was constantly in  
15 the process of asking people in various settings, so does  
16 anything ever go wrong here? Do you all ever have, you  
17 know, does the mine ever cave in? And the answer was  
18 always, oh no, no, no, no. Never, never, never.

19           Now we all understood that this was part of a  
20 ritual back and forth. We don't want to reproduce that  
21 kind of ritual back and forth in what we're doing here.  
22 And the way in which I think you avoid that is by not

1 allowing, oh, there's no problem to be an answer.

2 MEMBER HANSON: Joe Carcello?

3 And let me ask the people who have commented to  
4 also respond to the liability issue associated with the  
5 partner identification.

6 MEMBER CARCELLO: Like the other people who've  
7 spoken, I also had a couple of comments about both of  
8 these. And in terms of the liability issue, I'm not an  
9 attorney so there's people in this room who are in a  
10 better position than I to talk about that.

11 But in terms of the audit report, let me just  
12 give you a very brief quote which I'm sure you've seen.  
13 "I believe the audit is at a tipping point. The audit  
14 report at present is hopeless."

15 Now that wasn't Damon, that wasn't Lynn, that  
16 wasn't either of the Anns. That wasn't me. That was Sir  
17 David Tweedie, okay, former Big Four audit partner, a  
18 former chairman of the IASB.

19 You know, this is as an establishment profession  
20 as you can get, and I could give you a bunch more quotes  
21 like that. So I think it's clear that there's a need.

22 I went back and I reviewed the transcript of the

1 September 2011 roundtable, and people who are opposed to  
2 your rules always pull out the bogeyman, right, Damon?  
3 Unintended consequences. If I've heard that once I've  
4 heard that dozens of times.

5           Here's a quote from Paul Haaga at the Capital  
6 Group. "The mere fact that there's more to say than pass  
7 or fail we think would give," and there was broad  
8 consensus on this within the Capital Group, "we think  
9 would give auditors a stronger hand. They would win more  
10 arguments and we think that would be a good thing."  
11 That's an unintended consequence. All unintended  
12 consequences aren't necessarily bad. In fact, that would  
13 be a good unintended consequence.

14           In terms of auditor transparency, there's a  
15 growing body of literature that finds that, in fact,  
16 identification or signature is helpful. Much of that  
17 literature the Board has seen.

18           As others have already said, CEOs, CFOs, chief  
19 accounting officers have certified Ks and other documents  
20 for years without huge problems. Most of the developed  
21 world require the partner to sign or be identified,  
22 virtually all of Europe, China, Australia. Has not been

1 a problem.

2           And I'll close with another quote from a very  
3 bright person. "Common human experience suggests that  
4 when an individual is publicly identified with a  
5 particular activity that identification usually leads to  
6 a higher degree of care and focus." I agree.

7           CHAIRMAN HARRIS: Mercer Bullard?

8           MEMBER BULLARD: Sure, just a couple of comments  
9 on the, you know, on the liability issue. Often you hear  
10 liability risk used as if it is always a bad thing. The  
11 issue with liability risk is, is it a good liability  
12 risk, and then creating the liability is going to create  
13 net social benefits, but you always almost hear it as  
14 inherently negative.

15           I'm all for reducing liability risk that doesn't  
16 create net social benefits, but this is one I think you  
17 certainly would. And it also reflects a trend that  
18 you're probably aware of in that cohorts have been  
19 complaining about holding corporate entities liable and  
20 no individual's engaged in the contact for which they're  
21 being held liable.

22           Another problem has been true for quite some

1 time. You have corporations in many cases paying  
2 damages. The corporation itself pays the damages to  
3 shareholders, who of course the shareholders of the  
4 corporation paying it, and no individuals are held  
5 liable.

6 You have the SEC now saying it's not going to  
7 take no-admit, no-deny settlements anymore and pointing  
8 out it's going to go after individuals. And this is  
9 precisely what we need to do.

10 We need to make individuals responsible, because  
11 in this sense corporations are not people. Corporations  
12 can't take action without an individual having taken that  
13 action. So I think that putting the name and the face  
14 on the action will have this behavioral modification  
15 effect, it also will be the kind of liability risk that  
16 you want.

17 And I think it also, to Anne's point, it really  
18 needs to be in the main source of information about the  
19 audit. You know, there's a general collective action  
20 problem that shareholders have in getting involved in  
21 anything. And a big part of the collective action is the  
22 information costs, and every time you increase the

1 information costs you make it much less likely  
2 shareholders will engage and be active, because as a cost  
3 efficiency issue it's just not worth it.

4           And in talking to reporters this is constantly an  
5 issue. They will not write good stories if the  
6 information is not easily available.

7           And, you know, going further, this is an issue  
8 that I've been sort of arguing with the SEC about for  
9 more than a decade is, it's not clear to me why  
10 information is not provided in a way that when you go on  
11 useful websites it's provided where you can click a  
12 button and get all the combinations of information that  
13 you want that would be relevant.

14           And in the mutual fund world, for example, you  
15 should be able to compare ten funds and see their fees.  
16 In the context of issuers you should be able to compare  
17 the auditors. You should be able to compare who's been  
18 with what firm how long, who have been the auditors on  
19 different projects, what's the disclosure that is related  
20 to PCAOB inspections.

21           And you see the government using virtually none  
22 of that technology in order to make information really



1 useful, and that is what would really make it actionable.

2           DIRECTOR DOTY: Mercer, you may have to write  
3 that to a legal argument on liability up in a comment  
4 letter. December the 4th, 60 days, it gives you until  
5 February. You'll have plenty of time to do this at the  
6 University of Mississippi. But we're going to need the  
7 comment, the legal argument on intended and unintended,  
8 good and bad litigation costs in the file.

9           CHAIRMAN HARRIS: That was not a set-up, Mercer.  
10           Norman?

11           MEMBER HARRISON: Sorry to come back to it, but  
12 actually I had two things, one of which I think Mercer  
13 and Ann have eloquently described on the issue of  
14 liability.

15           I would second the notion that what the ideal and  
16 a probable outcome of engagement partner accountability  
17 for the content of an audit report and public visibility  
18 with respect to the conduct of the audit, I would think  
19 would be a risk mitigation tool not a risk aggravation  
20 tool.

21           Secondly, I'm not a litigator, but at the end of  
22 the day when an accounting firm is sued over an allegedly

1 blown audit, I mean they're the deep pocket. I don't  
2 know that adding, the identity of the partner comes to  
3 life early in the litigation.

4           Any event through discovery, I don't get the  
5 whole thing, to be quite honest with you, about that adds  
6 anything of any material with respect to litigation risk  
7 or to risks of judgments or outcomes.

8           The other thing I wanted to mention briefly, and  
9 I was putting my board down when the thought popped into  
10 my head that when Damon gave so many good analogies I  
11 want to offer one more for everyone who's been or is a  
12 litigator.

13           I'm sorry the judge isn't here, but many of us in  
14 this room have at one point or another in our lives  
15 served as an expert witness in civil litigation. And  
16 it's not a perfect analogy but it's close, where we've  
17 been asked to examine a body of evidence and to apply  
18 judgment and experience to it and render an opinion on  
19 one or more issues.

20           And certainly under the Federal Rules of Evidence  
21 we sign the reports, we don't sign our firms' name to the  
22 reports. And then we are often challenged as to whether

1 we possess the requisite expertise or not and a judge has  
2 to decide and we're deposed and there is sometimes an  
3 exhausting level of review and transparency disclosure  
4 on the contents of our report.

5 I'm not suggesting that same level of increase  
6 should apply here, but again it goes back to this notion  
7 of when someone holds themselves out as a professional  
8 it's hard to find many other examples where the  
9 individual's name isn't on it.

10 It really goes back to the issue we discussed  
11 earlier in our group's discussion of audit quality  
12 indicators where I made the point that we're in that  
13 context assessing or measuring or evaluating conduct.  
14 It's the same thing here.

15 The opinion was ultimately reached and rendered  
16 by a human being who had authority or responsibility for  
17 conducting an audit process. It was not reached and  
18 rendered by a limited liability partnership, a fictional  
19 legal entity.

20 Now I'll put my board down. Thank you.

21 CHAIRMAN HARRIS: Barbara Roper?

22 MEMBER ROPER: First of all, I agree with

1 everything Mercer said and plan to cosign his letter when  
2 he writes it.

3           We were talking last night, we were kind of  
4 joking around about the fact that my sister and I have  
5 always said that fear of embarrassment has propelled us  
6 towards success. The fear of, you know, of embarrassment  
7 keeps us from ever having gone to class not prepared, you  
8 know, whatever.

9           I think it's sort of a frivolous example, but  
10 people behave differently when their name is on there.  
11 People speak differently when they're making an anonymous  
12 comment in the blogs or when their name is attached to  
13 a comment.

14           We know in a variety of context that this does  
15 affect people's conduct, and it affects people's conduct,  
16 I think, in this way precisely the way we want to affect  
17 it, which is to make them think more seriously about just  
18 exactly how comfortable they are with the opinion they're  
19 rendering.

20           And so I mean, I think the benefits of this  
21 proposal are self-evident. We've been talking about it  
22 for years, and I think, you know, I would strongly

1 support the Board moving forward in that area.

2           CHAIRMAN HARRIS: Anne, I'm not going to  
3 recognize you now because I know that you want to talk  
4 about the global agenda, and we'll -- well, then if you  
5 don't we'll recognize you now and then you can talk about  
6 the global agenda. But that was one of the items in the  
7 email correspondence that you put on there. But talk  
8 about whatever and then we'll --

9           MEMBER SIMPSON: True enough, but I'm a  
10 nonresident alien so I'm honor bound to talk about other  
11 places. No, this was, you said, Steve, that you wanted  
12 people who had spoke in favor of transparency to address  
13 the question of liability, so I'm briefly going to do  
14 that.

15           I agree with what's been said that these  
16 corporate forms, be they joint stock companies or  
17 partnerships, the corporate forms have a lot of purposes.  
18 But these are not moral agents and cannot be held.

19           So whichever Lord Chief Justice, way back when,  
20 said, you know, corporations have neither a body to kick  
21 nor a soul to condemn to eternal damnation, at that point  
22 we're then back to people. And whatever has been said

1 about political donations and political speech about  
2 corporations being persons is nonsense.

3           So if we want to change behavior, the corporation  
4 is not something that will behave differently. It's  
5 people that will behave differently, and behavior does  
6 change under observation.

7           If there are concerns about liability it is not  
8 to be addressed by drawing a veil over the people who are  
9 responsible. If there are issues around litigation and  
10 liability they need to be dealt with on their merit, but  
11 this would not be the channel I would suggest.

12           CHAIRMAN HARRIS: Okay, Lynn, then Damon.

13           MEMBER TURNER: Two points, one to your question  
14 of liability and then one back to the basic audit  
15 reporting model and your proposal that the staff have  
16 recently put out.

17           First, on the liability issue. In the state of  
18 Colorado, engineers and architects, you can add those to  
19 the list of people who have to sign in their own personal  
20 name, in addition to the CPAs who give expert reports,  
21 the boards and all those people.

22           In fact, when you come down it, the auditors

1 signing these audit reports are about the only people  
2 that don't have to put their name down. Everyone else  
3 does. And they're the only ones, and there's no good  
4 reason why they should be given special privilege  
5 whatsoever.

6           And on liability, I chaired at the board of  
7 trustee committee at Copara that oversees our litigation.  
8 I can't fathom us deciding whether or not to sue a firm  
9 based upon who an individual partner is.

10           It's going to be based upon whether or not there  
11 was an audit report rendered when, in fact, the belief  
12 is that it was a failed audit and a clean opinion wasn't  
13 warranted.

14           And in every case I've ever seen go into  
15 litigation no one sued, first and foremost, the partner  
16 and left the firm off the thing. It's ridiculous to even  
17 propose that. It's always going to be the firm that gets  
18 sued.

19           You go into discovery and immediately upon  
20 discovery what's the first thing you find out? The  
21 partner's name. So the notion that there's audit risk  
22 associated here because of liability is a figment of

1 someone's imagination and dreams. It just isn't  
2 supported by actual fact.

3           And in Colorado, and I've checked this with the  
4 state Board of Accountancy, you're liable as an  
5 individual whether you sign in the firm's name or your  
6 own name. So it doesn't affect liability in that respect  
7 in any way, fashion, shape or form. So there is no  
8 argument on liability on this that is factually based.

9           The second issue on the audit reporting model on  
10 the proposal that a comment, I guess, is due in December,  
11 and it's good that something's got out there that people  
12 can discuss and comment, I'd just say there has been an  
13 issue thrown up with respect to that proposal.

14           And depending upon how people look at it, and  
15 I've gotten different reads from different people, that  
16 proposal may or may not be fatally flawed. And the issue  
17 is whether or not that proposal as written would require  
18 disclosure of the items set forth, and there's some good  
19 items there that are set forth, but whether or not  
20 disclosure's required based upon the professional view  
21 of the auditor or is based upon what the auditing  
22 standards themselves would require to be identified as



1 significant matters.

2           And when the ISB did the old ISB Standard Number  
3 1, that standard was written and said you have to  
4 disclose to the audit committee, what, in the  
5 professional view of the auditor, is deemed to be  
6 something that the auditor would believe would impact on  
7 their independence wasn't required to be disclosed from  
8 an investor perspective or perspective of the standards.

9           And what we saw when the standard was written  
10 that way was the auditor's continued to violate black and  
11 white independence standards but didn't put it in the  
12 standards letter itself, and came back and always said,  
13 well, in our professional view.

14           So it became an unenforceable standard when it  
15 was written that way because auditors always came back  
16 and said, well, it doesn't matter what the standard said  
17 because it's what in our professional view was. And so  
18 the ISB Standard Number 1 turned out to be basically a  
19 fatally flawed and worthless standard.

20           Bill Allen is someone you might recall tried to  
21 fix it. He wrote a letter shortly after it was issued,  
22 after he and the other three members recognized the fatal

1 flaw, but it never got it fixed and it's never worked.

2           There's been many, many instances of black and  
3 white violations that never were told to audit committees  
4 in that black and white letter.

5           So depending upon how you've written it, if  
6 you've written it to say in the professional view of the  
7 auditor this is what they would have to disclose, that  
8 document is fatally flawed and will never work. And  
9 we've got that experience behind us.

10           If it's written from the perspective of, here are  
11 the significant matters you would have to disclose if the  
12 auditing standards would deem those to be significant  
13 matters, then you're okay. And I've heard different  
14 interpretations of that standard.

15           DIRECTOR DOTY: This is a very valid point, and  
16 I think the limiting case you lay out, Lynn, is one that  
17 the proposal avoids. The proposal requires a discussion  
18 of what were the difficult auditor judgments, the  
19 difficult issues of supporting opinion, the complex  
20 issues.

21           It further goes forward to say if you decide  
22 there are none you must explain why. You must document

1 how you got to the decision that there were none. And  
2 it goes further to say that it would be not expected that  
3 there would be many audits in which the auditor could  
4 conclude there were no critical accounting matters.

5           It directs the auditor to decide and to discuss  
6 what were the critical audit matters on the basis of, I  
7 think, a stated as well as implied assumption that almost  
8 any audit involves some critical audit matters.

9           And the documentation is required of the decision  
10 either way to exclude, if you exclude something that  
11 normally would have been reported to the audit committee  
12 you've got to explain why. You've got to document the  
13 reason why that would not be a critical audit matter in  
14 this case.

15           MEMBER TURNER: But are those critical audit  
16 matters determined in accordance with the standards, or  
17 critical audit matters determined in the professional  
18 view of the auditor? And that's the question.

19           MR. BAUMANN: Well, Lynn, you know, this is a  
20 lengthy discussion that we could have and it's probably  
21 beyond this room and we'll appreciate your comment letter  
22 when it comes in and we'll address it.

1           But clearly, as Jim just mentioned a moment ago,  
2 the critical audit matters we indicated would be things  
3 that the auditor documented under AS 3 requirements, for  
4 documentation requirements.

5           Would likely be things that the engagement  
6 quality review are under AS 7 had looked at as the most  
7 significant judgments in the audit. Would likely be  
8 things that the auditor communicated to the audit  
9 committee in connection with AS 16.

10           And went on to say as Jim indicated, if you have  
11 such matters that would appear to meet critical audit  
12 matters, and have those attributes of having been  
13 discussed with the engagement quality review and  
14 discussed with the audit committee, documented as a  
15 difficult matter, consulted on with the national office,  
16 and it's not disclosed as a critical audit matter, then  
17 the auditor has to document on the work papers what was  
18 the rationale why that was not a critical matter.

19           And that documentation, we believe, would be  
20 subject then to inspection to understand is that a  
21 reasonable rationale why that wasn't a critical audit  
22 matter. So I think it's somewhere in between where

1 you're saying, is it directly driven by the audit  
2 standards or judgment?

3           There's definitely judgment involved, but that  
4 judgment is linked to existing auditing disclosure  
5 requirements in communications with audit committees,  
6 documentation requirements under AS 3 and things that are  
7 reviewed by the EQR under AS 7.

8           MEMBER TURNER: So are you saying, Marty, that if  
9 the auditing standards would deem whatever the matter was  
10 that it should have been a significant matter? For  
11 whatever reason the auditor decided not to make it a  
12 significant matter then that would be a deficiency in the  
13 report?

14           MR. BAUMANN: Yes. I am saying that once again  
15 if this is a matter that when somebody looks at it and  
16 sees the AS 3 required documentation of the most  
17 difficult matters, and there's a whole list of AS 3 of  
18 what has to be documented, the most difficult subjective  
19 matters in the audit, then looks at what was reviewed by  
20 the engagement quality reviewer, and the same matters  
21 that matter was a high priority for the engagement  
22 quality reviewer, what was discussed with the audit

1 committee, the same matter was communicated and was a  
2 significant discussion matter with the audit committee,  
3 if that matter does not make it into a critical audit  
4 matter, I think it would be very difficult for an auditor  
5 to justify how they concluded that that was not a  
6 critical matter.

7           MEMBER TURNER: Yes, but I don't think that  
8 things will get to that point, Marty. We saw that with  
9 the ISB-1 thing. The bottom line was it didn't get to  
10 that point of being discussed with the audit committee  
11 and that was the problem.

12           MR. BAUMANN: Well, that would be a violation of  
13 AS 16 then, if things are missed and not discussed with  
14 the audit committee that should be, and I think that  
15 would be something we would inspect against as well.

16           So if people are omitting required disclosures to  
17 the audit committee, that itself is a problem and then  
18 we could have an inspection finding with respect to that  
19 also.

20           CHAIRMAN HARRIS: Lynn, let me jump in for a  
21 second. Two things. First, we do look forward to your  
22 comment letter. Second, I do think you raise a very

1 valid question with respect to the objectivity of the  
2 standard and to the extent that there's judgment and  
3 whether or not there could be tightened. You have five  
4 Board members with five different viewpoints on it, so  
5 I think you ought to reduce your comments to writing  
6 which I think we'll review very carefully.

7           Damon, you know, go ahead, and then Mercer. And  
8 then I would like to, because, you know, we're going to  
9 be approaching the end of the session, I did raise other  
10 issues that were brought to the attention of the Board  
11 in terms of what other people might want to bring up.

12           But to the extent that anybody has an issue that  
13 they want to bring to our attention, I want to go right  
14 the way around the room and spend the last 15 minutes,  
15 you know, for you to tell us what you want us to hear,  
16 and to the SEC as well.

17           I'm sorry. Brian, your card is up so we'll  
18 recognize you and then we'll go to Mercer.

19           MR. CROTEAU: Well, thanks, and it does relate to  
20 the point we were just talking about, so I'll take the  
21 opportunity. I think it's a great discussion we're  
22 having relative to what would be a critical matter, and

1 certainly there's an open comment period.

2 I think one of the important questions to think  
3 about, really, is the criteria for what is a critical  
4 audit matter sufficiently objective or should it be any  
5 more objective than it is? And I think the PCAOB's asked  
6 some thoughtful questions in the release around that.

7 Certainly Marty's described the documentation and  
8 others have described the documentation requirements, you  
9 know, the question can be asked to whether documentation  
10 requirements are enough to overcome what some might view  
11 as a more subjective definition to begin with.

12 So very interested in comments as to whether  
13 there's improvement that can or should be made to the  
14 definition of a critical audit matter in the first  
15 instance, but I think the PCAOB's at least been very  
16 thoughtful in trying to put forth an initial proposal in  
17 that regard. But I think it's an area that could benefit  
18 from some focus and public comment.

19 MEMBER HANSON: Mercer?

20 MEMBER BULLARD: I'm just trying to figure out  
21 the dynamics here. So it sounds like there are scenarios  
22 in which the auditor will be exercising discretion, and



1 whichever way they go is going to determine whether they  
2 have to disclose something as a significant issue.

3           And if that's true, why wouldn't the disclosure  
4 requirement give them a very strong incentive not to take  
5 those steps? In other words, decide differently, not  
6 bring something to the committee precisely because that  
7 will trigger a different requirement where they don't  
8 want disclosure.

9           Or is it objections, there's no discretion for  
10 them to make those because it sounds like they're taking  
11 it up the chain was one thing you mentioned. If I'm the  
12 auditor I'm not going to take it up the chain if it means  
13 I'm going to get public disclosure out of that. So how  
14 does that dynamic work?

15           MR. BAUMANN: Well, again I think it's rather  
16 than getting into a lengthy discussion about this item,  
17 I think it's important to read the proposal, read the  
18 standards and raise questions if you think that the way  
19 that it's crafted leaves the ability for an auditor to  
20 not disclose things and to not meet the spirit of what  
21 we're trying to get at here.

22           So I'll support what Brian said, and that is we

1 worked really hard to get a standard that we think would  
2 improve disclosures to investors about what's critical  
3 in the audit. It's hard to mandate those things that  
4 were most difficult to the auditor because it's whatever  
5 was most difficult to the auditor in those particular  
6 circumstances. So you can't say what they'd be, it was  
7 what was difficult in that particular audit.

8           So as Damon said before, name the five things  
9 that were most difficult. Well, we could put a number  
10 five on it. We actually thought about that and we asked  
11 questions, should we have a minimum number? So that  
12 actually was a question in the release that would help.

13           Should there be any situations where you would  
14 not have critical audit matters? That's another  
15 situation, another question we asked. So there's lots  
16 of ways in which people can comment to us that listen,  
17 you can make this tighter in your final document by doing  
18 X, Y, or Z. And I think that's very valuable comment to  
19 get that.

20           But that's sort of the way it's structured. And  
21 we had a conversation way back when, Damon, you and I  
22 together and at the SAG also about, Marty, just have them

1 disclose the five toughest matters. And that's sort of  
2 what this is.

3 But we are looking for valuable comment about how  
4 to make this crisp and tight so that this really does  
5 achieve the objectives and that matters aren't avoided  
6 by, well, I'm not going to communicate this to the audit  
7 committee because then it will look like it's too  
8 critical.

9 So you're right. We want to avoid those  
10 consequences, but we want to think about all those  
11 things. And if in the proposal, if there are ways in  
12 which people think that it can be fixed and made even  
13 better, we're looking forward to those comments and we'll  
14 move forward on that. We certainly want to have a strong  
15 standard here that greatly improves the audit report.

16 MEMBER HANSON: Damon, did your card go back up  
17 or --

18 MEMBER SILVERS: It was up before.

19 MEMBER HANSON: Oh, I'm sorry. Oh, I thought I  
20 heard you before. By all means, go ahead.

21 MEMBER SILVERS: Well, I had two things. Now  
22 after Marty spoke I've got three. Look, at first it was

1 in response to your question about liability. I want to  
2 just even intensify what Lynn said.

3 I don't understand the argument about liability  
4 from the auditing firms. As Lynn pointed out it is a  
5 trivial matter in litigation to get the name of the  
6 partner. And the notion that somehow the lack of  
7 disclosure of the name in non-litigation situations is  
8 going to promote, that that's somehow protection against  
9 litigation, I think is not a serious argument.

10 And I would urge the PCAOB to the extent that  
11 auditors are making a litigation argument, and this  
12 doesn't even get into Mercer's point, I'm just saying I  
13 don't get what the argument is. And I think the PCAOB  
14 needs to sort of insist people who make this argument be  
15 specific as to what they think exactly is going to  
16 happen. But I think if you follow the thread of that  
17 logic through a little bit you get to a deeper issue.

18 So if litigation's not the point, what is the  
19 point? Why do investors want to see this name? And the  
20 reason is precisely because you want to be able to engage  
21 in types of accountability that don't rise to litigation,  
22 and you want to facilitate that on the part of investors

1 who may not have the muscle to get it on their own.

2           Because I think, in addition to the fact that  
3 litigation can get that name, okay, if you hold three  
4 percent of a company's stock you can probably get that  
5 name. It's probably not that hard, in fact, to get that  
6 name.

7           What's absent though is in this regime, the  
8 existing regime we have, is the sense of a level playing  
9 field in the securities markets that is what, in fact,  
10 the audit report is all about in the first place.

11           I mean why, you know, we've had this conversation  
12 today and people have talked about what is an audit  
13 report for? Well, increasingly, I think, and I think Joe  
14 said this earlier that there's a real danger here of the  
15 diminishment of the value of the audit report in general.

16           And what's going on right now, and it's visible  
17 to me in terms of at least what is now, you know, ten  
18 years of this body's existence and going back to the  
19 period before this body was created, this body being the  
20 PCAOB, that what has increasingly happened, I think, is  
21 that the securities markets have become for a variety of  
22 different reasons, and a lot of people have talked about

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1 high-speed trading as part of this but that's not the  
2 only driver of this, the securities markets have become  
3 increasingly hostile to the involvement of investors who  
4 lack enormous scale and enormous resources.

5           If you have enormous scale and enormous  
6 resources, there's a sense in which maybe you don't need  
7 an audit report. You can send your own team of financial  
8 experts in to talk to a public company.

9           You've got a variety of ways, if you've got that  
10 kind of scale. You know, if you're at Black Rock you can  
11 have that conversation, closed doors, demand whatever  
12 metrics you want to get whatever you get and make your  
13 own conclusions.

14           Maybe for any given public company there are 20  
15 investors who can do that. Everybody else is kind of  
16 left in the dark. As financial statements have become  
17 more complex, as the ability of firms to essentially play  
18 games with financial statements has grown, and in  
19 parallel, as trading processes have become less friendly  
20 to smaller investors, you have an overall drift away from  
21 a level playing field in the markets. Identifying  
22 auditors by name is by no means a solution to this

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1 problem broadly writ, but it pushes back on it a little  
2 bit.

3           DIRECTOR DOTY: I've got to ask you, is this  
4 about making small investors feel good about large,  
5 complex and impersonal markets or is it about having them  
6 think they have information that other people have and  
7 feel better about it that way, or is there something of  
8 use to them?

9           Of what utility is it for them to have the  
10 information given the situation they're in, which you and  
11 Ann have so articulated?

12           MEMBER SILVERS: I think it's a very fair  
13 question, and I think that there are two answers that go  
14 beyond feel-goodism here. I think the first is, is that  
15 it will be possible for a wide variety of actors,  
16 academic actors, providers of public, the press and other  
17 sort of providers of public analysis to look at the pay-  
18 driven individual partners across companies that is, and  
19 tell investors things that are meaningful.

20           The second thing I think is possible is, is that  
21 I think there is a landscape between, really, the small  
22 investor, the individual investor, there's a landscape

1 between that party and the very largest players who have  
2 the resources and the market leverage to extract  
3 information sort of willy-nilly from companies.

4           And those, if you look at the history of  
5 corporate governance reform in the United States, it's  
6 often been those investors who have pushed the envelope  
7 on things and, you know, using publicly available data  
8 as opposed to what they can extract as a private party.

9           I think that was certainly true in the initial  
10 push for auditor independence, in the push around Board  
11 independence. A number of those funds are ones, this is  
12 certainly true of a lot of funds that are collectively  
13 bargained in one or another. I don't think this is a  
14 transformative move in relation to any of these dynamics,  
15 but I think it pushes it the right way. And I think it's  
16 not feel-goodism.

17           CHAIRMAN HARRIS: Well, I want to begin the wrap-  
18 up period here and just start, Brandon, with you and just  
19 go right the way around in terms of any final parting  
20 shots that you would like to leave the Board with in  
21 terms of what we should be doing to improve audit quality  
22 and protect investors.



1           MEMBER BECKER: Well, I do think that the  
2 signature makes a lot of sense, the same way we do it  
3 with mutual fund portfolio managers and the like where  
4 the SEC has been much more aggressive. I discount the  
5 liability issues for the various and other sundry  
6 reasons.

7           The context of the discussion today though, I  
8 think, really goes to the audit quality indicators in the  
9 morning, getting those built into the governance process.  
10 Because as Curt highlighted and as various have referred,  
11 basically the relevancy of the audit, getting more of  
12 that quality and ultimately going to the quality of  
13 earnings so that there is more value extracted rather  
14 than check the box from the audit would be valuable.

15           I should say, however, that while greater  
16 transparency to the audit is important, we would be  
17 worried if we lost the pass/fail. We think that we would  
18 not want to see the greater transparency degrade the  
19 pass/fail. I don't think it needs to, but I did want to  
20 at least highlight our concern along those lines.

21           CHAIRMAN HARRIS: Curt?

22           MEMBER BUSER: So I think the audit quality

1 initiatives are key. I think that, you know, what I'd  
2 like to see happen is the PCAOB start to get in a  
3 position where it can comment on, you know, what we see  
4 in improvements in audit quality and what's the state of  
5 the profession and be able to answer a lot of the  
6 questions that are unknown about the quality of the  
7 people that are carrying this out. So I think we need  
8 to know, kind of, is the profession having the right  
9 people in place or not?

10 CHAIRMAN HARRIS: Grant?

11 MEMBER CALLERY: I think I'd like to see the  
12 Board take a further look into some of the issues, the  
13 governance issues that we talked about where you do have  
14 access to information. Because I think a lot of the sort  
15 of presumptive reactions that people have were based on  
16 very surface level knowledge and that you really ought  
17 to delve into it and see whether there's "there" there,  
18 and then move accordingly from there.

19 CHAIRMAN HARRIS: Grant, we certainly welcome you  
20 to the Investor Advisory Group.

21 MEMBER WALSH: Yes, I've been trying to think  
22 about how investors will react to a lot of what we've

1 talked about today, and I think it's hard to imagine a  
2 situation where investors go in and short stocks of  
3 companies whose audit partners have shown mistakes in the  
4 past and buy really strong audit companies.

5 I don't know that that's going to happen, and  
6 before we get to that point we'll see trading cards with  
7 auditors on the face, and I think at that point you  
8 really do end the worry about commoditization.

9 But I really do have a sense that we need to get  
10 to more information, and I don't know how the market will  
11 use what we've talked about with audit quality indicators  
12 or how they're going to use identification of the  
13 partners responsible for the audit, perhaps the  
14 identification of the audit committee chairman.

15 I don't know how it will be used, but I think  
16 that there's an invisible hand that will ferret that  
17 information out and it's a process and we'll get better  
18 at this, and maybe we have 70 indicators that we disclose  
19 Round 1, it turns out that there 35 that are helpful.  
20 The market will figure that out and migrate towards those  
21 indicators.

22 And so I'm all in favor of more information

1 rather than less, even if we don't know how it'll be used  
2 or which ones are going to be the most helpful. But I'm  
3 very encouraged by what we're talking about today.

4 CHAIRMAN HARRIS: Thank you.

5 Damon?

6 MEMBER SILVERS: Since the chairman caught me in  
7 my train of thought I left out my comment from Marty.  
8 I'm just going to make that. I think it's quite  
9 dangerous to have even with the caveat that you don't  
10 expect to see very many of them, I think, in the  
11 reporting model, it's very dangerous to have an option  
12 of saying no, we don't have any serious issues.

13 I think it raises this issue of then all of  
14 sudden auditors are, it becomes tricky to push issues in  
15 the internal process, I think, if you do that. I stand  
16 by what I said to you when however long ago that you were  
17 citing, which is put a number on it, one, two, three,  
18 five, whatever that number is and everyone has to  
19 disclose what that is. Every audit has an issue. It's  
20 not possible to have an audit without an issue.

21 CHAIRMAN HARRIS: Norman?

22 MEMBER HARRISON: Nothing new to add other than

1 to thank you all for having us and for inviting us to be  
2 participants. And I'll say only we've covered a lot of  
3 ground today, not only in the panel-specific discussions  
4 but certainly here at the end.

5           And, you know, I think when you take a step back  
6 you realize that the issue of quality is the silver  
7 thread that connects it all and then the need to define  
8 it, to measure it, to report it and to use it as a tool  
9 for improving or providing safeguards around audit  
10 quality, I think there's further work to be done.

11           So by way of parting comment I'll say that rather  
12 than show up again next year, you know, see where we are,  
13 I'm happy to continue being supportive in any way I can  
14 as the staff moves forward.

15           CHAIRMAN HARRIS: Thank you very much.

16           Tony? Tony Sondhi?

17           MEMBER SONDHI: Thank you. I'd like to simply  
18 emphasize what I thought was the two main things I said  
19 this morning. One is that as Norman just said, audit  
20 quality is the critical issue.

21           But if you develop indicators that are based on  
22 audit firm quality and audit process and not focus on

1 audit quality, I think we're going to miss very  
2 significant opportunity. I think it's absolutely  
3 critical that we focus on audit quality.

4           The second point I want to make is that what the  
5 discussion today showed is that there are concerns. I  
6 understand that the sort of the nexus where the output  
7 based indicators meet, financial reporting quality and  
8 some of the other issues that Lynn and some other people  
9 have raised, and Joe, I think, I think that although that  
10 nexus is a difficult one, I think that should not get in  
11 the way of developing really good audit quality  
12 indicators. And being very firm, the complexity  
13 shouldn't get in the way.

14           CHAIRMAN HARRIS: Bob?

15           MEMBER BUETTNER: I hope this is not off-topic,  
16 but as you said you were hoping to get what was on our  
17 minds at this time. My question are something that I  
18 think at some point I'd like more explanation on was the  
19 issue around the Chinese reverse merger issues.

20           And most specifically, in fact, this might just  
21 go to harmonization of global accounting standards, but  
22 the differentials that existed between the Chinese

1 accounts and the accounts that were ultimately reported  
2 here, I think the collapse that we saw and the investor  
3 losses that we saw across a wide range of those companies  
4 was really a black mark on the U.S. capital markets.

5           And so, really, my questions are more around,  
6 one, how was this allowed to happen? In other words,  
7 that these companies were able to, sort of, from an  
8 accounting and audit perspective slip under the radar?  
9 And then secondarily, are there processes that we can put  
10 in place to ensure that situations like that do not recur  
11 again?

12           DIRECTOR DOTY: Audits were ostensibly performed  
13 where we have reason to believe now there was no work  
14 done. In some cases by registered firms within China,  
15 in some cases by registered firms in the United States  
16 which were relying on firms in China.

17           That situation has received a lot of attention  
18 both in the area of enforcement, which will continue as  
19 an interest that we have, but also in our relations with  
20 the People's Republic we are continuing to press for a  
21 joint inspection regime.

22           I think that unless we could get to a position in

1 which our division of inspections can go to China and can  
2 satisfy themselves about the quality of the audits that  
3 are being used to issue securities or trade securities  
4 in the secondary market here, we will have to move toward  
5 deregistration of firms and that will have, of course,  
6 implications for markets. It'll be something that we  
7 will have to work out with our colleagues at the SEC.

8 CHAIRMAN HARRIS: Anne Simpson?

9 MEMBER SIMPSON: Yes, I had two points, one of  
10 which I think Robert has referred to. So CalPERS invests  
11 in 47 markets worldwide and regulation is a global game.  
12 It's not just of account audits, it's accounting,  
13 securities law, capital adequacy for banks, you name it.

14 And what struck, although there are the  
15 multiplicity of regulators, the core of the regulatee is  
16 the Big Four, maybe plus two. So the work that you're  
17 doing to cooperate and coordinate is really important,  
18 but I hope it's also a weather eye to the fact that these  
19 public agencies are stumbling over themselves and each  
20 other dealing with four business networks.

21 And I don't know what the solution to that is,  
22 but that is something I would have talked about. So I



1 really encourage that work that you're doing and thank  
2 you very much for it. If there's anything more we on the  
3 investor side can do to support you please let me know.

4 And the other thing, my closing comment is that  
5 with regard to audit, shareholders are weak and ill-  
6 informed. And you can do something about the ill-  
7 informed part and our friends at the SEC can do something  
8 about the weak part.

9 So I hope that we can make progress on this,  
10 because all this good work on quality and disclosure and  
11 all the rest of it, if we can't, you know, both speak  
12 softly but carry the big stick, if there's no stick, if  
13 we can't move in as the shareholders, it would be Teddy  
14 Roosevelt in style, it won't work.

15 But thank you for what you're doing. We greatly  
16 appreciate it. I think the PCAOB is doing tremendous  
17 work. We very much value what you do. Thank you.

18 CHAIRMAN HARRIS: Ann Yerger?

19 MEMBER YERGER: Well, let me echo the thank you.  
20 This is an energized Board and we really appreciate it.  
21 You've been bold, I think, recommending and proposing  
22 reforms, and I think on behalf of investors and the

1 Council we really appreciate it.

2 I would urge you to maybe get one easy or  
3 seemingly easy win and that's the auditor or the  
4 engagement partner transparency. I think it just seems  
5 like that's not a complicated reform and it would be  
6 great to push that across the finish line.

7 I think the second point is as everyone else has  
8 said, this is all about audit quality. I think the work  
9 that you're doing on audit quality indicators is  
10 profoundly important so I commend you to move forward  
11 with that, but also to not let the perfect be the enemy  
12 of the good.

13 I don't know that there's one perfect  
14 prescription for how to do this and this could get  
15 analyzed forever without a resolution. I think it's  
16 important to move along. I do believe public disclosure  
17 of audit quality indicators is very important.

18 I do think it's an interim step issuing some  
19 guidance, additional guidance to audit committees so they  
20 have a better arsenal of questions to be asking on audit  
21 quality, I think could be very helpful as well.

22 CHAIRMAN HARRIS: Mercer?

1           MEMBER BULLARD: I just would probably emphasize  
2 that the way I see the quality issue is really something  
3 bigger. It's more of a value-added issue. It's not so  
4 much quality to prevent fraud, it's to make the case for  
5 public companies. Because from the securities law  
6 perspective, you know, what I see is, 15 years ago there  
7 was twice as many companies on the New York Stock  
8 Exchange as there are now.

9           Over the last couple of years more money was  
10 raised in private markets in IPOs -- than in IPOs. You  
11 see Facebook trading on private markets millions of  
12 shares a day, so liquidity is not going out the window  
13 is a reason to an IPO.

14           You have the JOBS Act that's now eliminated, and  
15 this is the first meeting since the SEC adopted rules,  
16 eliminated the general solicitation in advertising which,  
17 I think, will have a geometric effect on the  
18 advantageousness of private offerings.

19           JOBS Act has also expanded the number of  
20 investors that require you to go public and also excluded  
21 certain investors from being counted, and the SEC takes  
22 a very liberal view as to how you count pass-through

1 entities toward that and that will also another reason  
2 you'll have fewer public companies.

3           It's hard to know where this is all going to go.  
4 The trend is pretty clear, but I think the brand that is  
5 the public company, especially with steps that have  
6 essentially made what it means to be a public company be  
7 different things for different companies, 404 here, 404  
8 not there, has really put the public company brand at  
9 risk.

10           And if you want to look at a specific threat to  
11 the importance of honest accounting, look at the filing  
12 of confidential registration statements, where I looked  
13 at about the last ten that have been done and you see  
14 three to eight confidential filings. And these were  
15 prompted, this rule was prompted by a company that you  
16 all recall went public and had repeatedly to go back to  
17 its registration and correct what were pretty blatant  
18 accounting abuses.

19           If you were to go into those confidential filings  
20 and you did a lot of work you'd probably find the same  
21 thing. And that is, you know, this is a market that is  
22 becoming more and more for retail investors only.

1           If you are going to go public now, it seems to me  
2 the biggest reason to do so is to sell to the least  
3 sophisticated group, because you will have gotten all the  
4 money you needed out of institutional investors and  
5 accredited investors before you go public. Because, you  
6 know, one of the key classes I teach is the pros and cons  
7 of an IPO, and most of the pros are disappearing.

8           CHAIRMAN HARRIS: Pete?

9           MEMBER NACHTWEY: Thanks Steve, and thanks to the  
10 Board for putting this group together and reaching out  
11 to us for input, and more importantly, maybe the staff  
12 for doing all the hard work to pull it off, so much  
13 appreciated.

14           Maybe three quick comments I'll canter through.  
15 One, I do agree audit quality indicators is a key thing  
16 coming out of the discussion today, but I think it has  
17 to be married up with heightened expectations for audit  
18 committees because there's got to be two levels of this.

19           One that I think the PCAOB is ideally suited for  
20 of looking at firm level quality, but where the rubber  
21 meets the road is individual audits and audit committees  
22 are going to be in the best position to really judge, are

1 they getting quality, both people, the scope and the work  
2 plan that's put in place?

3           And then hat in hand with that has to come kind  
4 of heightened focus on what's a financial expert  
5 particularly for saying the auditors, the external  
6 auditors and the internal auditors are reporting to the  
7 audit committee, making sure we have somebody who is able  
8 to, on those audit committees, really manage that work.

9           Second topic, and I'm mindful of something. Curt  
10 will know the author of this statement, but everything's  
11 been said just not everybody's said it, but I'll jump in  
12 on the audit opinion, audit reporting model.

13           One, I do agree around the transparency on having  
14 audit partners. I don't why that would be any different  
15 than the professions that Lynn listed or responsibilities  
16 that people like I have to certify financial statements  
17 that we submit to the SEC.

18           On the other hand I think we've got to also be  
19 mindful of the dichotomy that we can't be aghast when we  
20 see marketing material with firms saying well, the  
21 individual signing partner has responsibility. So we've  
22 got to be careful a little bit of what we wish for, and

1 I think at the end of the day be mindful of the fact that  
2 we are, when we're buying an audit from a firm we're  
3 buying the firm and that's what we want. But I do agree  
4 it crystallizes the focus of that partner who ultimately  
5 has the signing pen.

6           But there were a couple other aspects of the  
7 reporting model. The critical accounting matters I do  
8 think can be an interesting expansion, but I think we've  
9 got to be practical about it. So how does that marry up  
10 with management's disclosure on critical accounting  
11 policies and estimates?

12           I would envision there would be a pretty parallel  
13 set of disclosures there, so if it's just duplicative do  
14 we get anything or do we just put more cost and time into  
15 the process of getting audits and financial statements  
16 prepared?

17           So, you know, whether we kind of road test that  
18 or find some way to say what's the practical aspects of  
19 it, then how do we make sure it doesn't end up being  
20 heavily lawyered, and no disservice to the legal  
21 profession but they're going to represent their clients,  
22 in this case the Big Four.

1           If we end up with 50 pages of boilerplate in  
2 their audit opinions and we can't find the pass/fail,  
3 which I think when I think I talk to our portfolio  
4 managers and analysts who are managing \$650 billion of  
5 investor money, the thing they want to know at the end  
6 of the day, did they pass or did they fail? Because I  
7 don't have enough time to go through all the rest of the  
8 aspects.

9           And then last but not least, being the author of  
10 the fair value accounting, and I won't spend a lot of  
11 time on it, Steve, because I know it's an issue we could  
12 we spend eons on, but just to be clear on what I think  
13 the issue is there, which is the procyclicality of fair  
14 value accounting combined with the false precision that  
15 when you take numbers out to two decimal places and it's  
16 fair value and it's judgments and estimates on top of  
17 judgments and estimates it's important that, I think,  
18 somehow we have investors understand a), that level of  
19 imprecision, and b) the procyclicality that's just as bad  
20 in an environment that's being fueled by quantitative  
21 easing as it was in '09 and '10 when there was a dramatic  
22 cycle down. So enough said. Thank you.

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1 CHAIRMAN HARRIS: Barbara Roper?

2 MEMBER ROPER: I think at some point in all of  
3 these meetings I say that the audit only has value to  
4 investors if it's conducted with an appropriate degree  
5 of professional skepticism. And we have seen a  
6 persistent problem with insufficient professional  
7 skepticism which, I think, is arguably the main driver  
8 of low audit quality.

9 So I would sort of review each of these issues  
10 we've talked about today through that lens of to what  
11 degree is there potential through whether it's audit  
12 quality indicators or whatever, to drive a higher degree  
13 of professional skepticism in the conduct of audits?

14 And toward that end, I actually think it's the  
15 issues that Grant's subcommittee was working on in terms  
16 of incentives and governance where there's rather a  
17 largely unexplored potential for further progress in  
18 terms of driving toward a more independent and skeptical  
19 audit.

20 CHAIRMAN HARRIS: Bob Tarola?

21 MEMBER TAROLA: Yes, thanks Steve. I guess I  
22 want to say I hope that you don't marginalize the audit

1 committee. They're the primary body responsible to the  
2 shareholders. And I'm going to also be in favor of a  
3 pass/fail model, an auditor report for that very reason,  
4 is that if there are difficulties in auditing and  
5 enterprise let the audit committee explain those  
6 difficulties. The management of the enterprise has an  
7 obligation to do good accounting and disclose how they  
8 did it.

9           So if an auditor just comes behind them and says  
10 they did good accounting, we audited it and we're happy  
11 with it, I'm not sure what the benefit of that is. But  
12 if you have the audit committee explain how they  
13 monitored that audit with respect to those difficult  
14 issues, I think the investors, I think the system works  
15 better. Let me just say that.

16           I am in favor of transparency of the signer of  
17 the audit opinion. I think that there should be no  
18 difference between that signature and that of a CFO on  
19 the financial statements. And also I think if you're  
20 going to support the audit committee's role then you also  
21 have to look at the qualification question.

22           CHAIRMAN HARRIS: Thank you Bob.

1 Joe Carcello?

2 MEMBER CARCELLO: Yes. In the interest of time  
3 I think we're talking about the right things. I think  
4 the Board's looking at the right issues. I just would  
5 second what Ann Yerger said, let's get some things across  
6 the goal line.

7 CHAIRMAN HARRIS: Judge Sporkin, we've just gone  
8 around the table concluding and we've asked everybody for  
9 their final comment in terms of what they would most like  
10 the Board to address in terms of improving audit quality  
11 and investor protection.

12 I know you've mentioned 10A in the past but  
13 whatever you want to wrap this up with would be most  
14 appreciated, as long as you keep it under five minutes.

15 JUDGE SPORKIN: No, I've just got a few seconds.  
16 I agree with Chairman Doty's view on the signature on the  
17 audit. I think that the person who has done it has got  
18 to sign it. I think that should be a no-brainer.

19 The only other thing I think you, I didn't hear  
20 what whether there was much discussion, but 10A of the  
21 Securities Exchange Act is an extremely important  
22 provision, and I would like to see some emphasis on that

1 provision. Because I do believe that it is not being  
2 followed the way the drafters of the provision want it  
3 to be followed. So I would hope that you would put that  
4 on your agenda. Thank you.

5 CHAIRMAN HARRIS: Judge, in terms of the  
6 transparency, since there are transcript, this is, you  
7 know, an open release, why do you support it?

8 JUDGE SPORKIN: Well, when I say it's a no-  
9 brainer is why shouldn't the person who has been involved  
10 sign it? I don't understand why there should be any  
11 question. It seems to me that if he knows he's got to  
12 sign it he knows it's got to be credible.

13 I'll tell you this as a lawyer that when I sign  
14 a pleading in court I want to make sure that it has what  
15 I wanted. There have been pleadings that I have, even  
16 though I've been co-counsel in cases, there have been  
17 pleadings that I have refused to sign because it didn't  
18 have what I thought it should have.

19 And it seems to me the accountant will have to  
20 make sure that he believes in it before he puts his  
21 signature. He's not going to put his signature on  
22 something that he has any question with. He's just not

1 going to sign it.

2           CHAIRMAN HARRIS: Are there any final closing  
3 comments that Board members would like to make, then I'll  
4 just make a very brief one? No? Well, in that case I  
5 want to thank everybody for what I considered to be an  
6 excellent meeting.

7           We very much appreciate the leadership of the  
8 working group members, all the members on the working  
9 group, the entire membership of the Investor Advisory  
10 Group, and I personally especially want to thank Nina  
11 Mojiri-Azad and Tope Folarin.

12           Pete, you hit a home run. You mentioned that  
13 this is not possible without really extraordinary staff  
14 support. And I'm very lucky because I've had that  
15 support. And so Nina, wherever you are I want to thank  
16 you. And Tope, I want to thank you.

17           And Joann, you set the marker and I can think  
18 we're carrying the ball forward with respect to our  
19 Investor Advisory Group. So thank everybody for  
20 participating.

21           (Whereupon, the foregoing matter was concluded at  
22 5:06 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: Investor Advisory Group

Before: Public Company Accounting Oversight Board

Date: 10-16-13

Place: Washington, DC

was duly recorded and accurately transcribed under  
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Court Reporter

**NEAL R. GROSS**

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