UNITED STATES OF AMERICA
DEPARTMENT OF THE TREASURY

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ADVISORY COMMITTEE ON THE
AUDITING PROFESSION

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MONDAY, FEBRUARY 4, 2008

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The meeting came to order at 1:30 p.m. in the Town and Gown Ballroom of the University of Southern California, 665 Exposition Boulevard, Los Angeles, California, Donald T. Nicolaisen and Arthur Levitt, Jr., Co-Chairs, presiding.

BOARD MEMBERS PRESENT:
ARTHUR LEVITT, JR., Co-Chair
DONALD T. NICOLAISEN, Co-Chair
ALAN L. BELLER
MARY BUSH (via telephone)
RODGIN COHEN
TIMOTHY P. FLYNN
ROBERT R. GLAUBER
KENNETH A. GOLDMAN
GAYLEN R. HANSEN
JEFF MAHONEY
BARRY C. MELANCON
RICHARD H. MURRAY
GARY PREVITS (via telephone)
DAMON A. SILVERS
SARAH SMITH (via telephone)
WILLIAM D. TRAVIS
LYNN E. TURNER

OBSERVERS:
ROBERT H. HERZ
MARK W. OLSON
ZOE-VONNA PALMROSE

TREASURY OFFICIAL:
ROBERT K. STEEL

PANELISTS - PANEL I:

DAVID B. BURRITT, Chief Financial Officer and Vice President, Global Finance and Strategic Support Division, Caterpillar Inc.

CYNTHIA M. FORNELLI, Executive Director, Center for Audit Quality

BRIAN JAMES JENNINGS, Chief Financial Officer, Energy Transfer Partners, L.P.

PHILIP M.J. RECKERS, Professor of Accountancy, Arizona State University

BARRY SALZBERG, Chief Executive Officer, Deloitte L.L.P.

GILBERT R. VASQUEZ, Managing Partner, Vasquez & Company, L.L.P.

PANELISTS - PANEL II:

JOHN P. COFFEY, Partner, Bernstein Litowitz Berger & Grossman L.L.P.

RICHARD FLECK, Global Relationship Partner, Herbert Smith L.L.P.

JOSEPH A. GRUNDFEST, W.A. Franke Professor of Law and Business, Stanford Law School

DENNIS JOHNSON, Senior Portfolio Manager, Corporate Governance, California Public Employees' Retirement System

EDWARD E. NUSBAUM, Chief Executive Officer, Grant Thornton L.L.P., and Chairman Grant Thornton, International Board of Governors

D. PAUL REGAN, President and Chairman, Hemming Morse, Inc.

PANELISTS - PANEL III:

ANNALISA BARRETT, Vice President and Senior Research Associate, The Corporate Library, L.L.C.

PAUL G. HAAGA, JR., Vice Chairman, Capital Research and Management Company

BRAD KOENIG, former Managing Director, Goldman Sachs

NEAL D. SPENCER, Managing Partner, B.K.D., L.L.P.

GLENN W. TYRANSKI, Financial Compliance, NYSE Regulation Inc.

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(1:30 p.m.)

CO-CHAIR NICOLAISEN: All right. It seems like we're at the appointed time -- 1:30. Good afternoon. I'm Don Nicolaisen, one of the Co-Chairmen of the Committee. Sitting next to me at my right is Mr. Arthur Levitt, who is also co-chairman.

Greetings, particularly to our Committee members. Thank you very much, all of those who were able to travel out to Southern California. We appreciate that. We appreciate the opportunity to be on the campus at USC. This is one of the great universities and one of the universities that I personally believe has amongst the best accounting programs in the world.

I say with a little bit of glee, because I have been on the Board of Advisors to the Leventhal Accounting School for almost 20 years. So I think it is top rate, and we are delighted to be back on campus.

So Zoe-Vonna Palmrose, one of our members here, is smiling. She is on the faculty at USC and is, I'm sure, delighted to be back. Randy Beatty, I saw you earlier in the audience -- if you're there, maybe you could raise your hand -- representing USC. He was here. Maybe he drifted off someplace.

MS. PALMROSE: He's teaching.

CO-CHAIR NICOLAISEN: He's teaching, okay.

We have a few of our Committee members who will be participating by telephone, and that's okay. I think that will be good. We're missing Ann Yerger. Ann had her baby last night, I understand a little baby girl named Libby. And from what we understand, everybody is healthy and doing we'll, so we congratulate her.

With that, I think it's now time for us to get started with the agenda for the day. We're going to conduct it in three separate sections, each at 90 minutes. We are going to hold fast to that 90-minute time commitment in order to ensure that we have an opportunity to deal with all of the things that we want to talk about during the day.

We have instructions that everyone should pay attention to. We will, during the course of the day, have a five-minute rule for just about everything. So five minutes for each of our guest presenters to provide their opening comments, then five minutes for each of those who care to interview or have a discussion or ask questions of the panelists to do so. And we're going to hold fast to that, so that we have an opportunity for everyone to participate.

If you see us waving our arms or getting nervous, it's because you are over that five-minute limit, and we will take action. We intend to enforce that.

We will have an opportunity for each of the Committee members, if they choose, to do followup questions with the panelists, and we would appreciate panelists' willingness to be part of that process by responding to us at -- within an appropriate period of time.

So let me start today with our first panelist, who is Cindy Fornelli. She is the Executive Director for the Center for Audit Quality. And, Cindy, if you'd like, your five minutes begin.

MS. FORNELLI: Thank you. Chairman Levitt, Chairman, Chairman Nicolaisen, members of the Committee, Secretary Steel, Treasury staff, and observers, good afternoon, and thank you for the opportunity to testify on behalf of the Center for Audit Quality.

The Center was established one year ago to encourage an open discussion of ways to improve audit quality with all stakeholders in our capital market. Our members are U.S. public company auditing firms that are registered with the PCAOB.

We have approximately 800 members and are led by a Governing Board that includes leaders from eight public company auditing firms, the American Institute of CPAs, and three public board members who represent perspectives from the investor, issuer, regulatory, and academic communities.

My written testimony covers several critical areas that deserve the attention of this Committee. But given the focus of this particular panel, my brief comments today will focus on people.

Quality audits begin with well-rounded auditors. Therefore, it is essential that we have an adequate supply of skilled professionals to meet the growing needs of investors and the challenges of public company audits, as well as the qualified educators to teach them.

Today, the vast majority of the nation's public company audits are the responsibility of approximately 50,000 men and women. That means the nation's public company auditing workforce, including roughly 50,000

-- I'm sorry, 5,000 partners, doesn't come close to filling the University of Phoenix Stadium that housed last night's Superbowl.

That is a lean workforce for the six largest firms to audit approximately 7,000 publicly-traded companies each year, and it underscores the importance of attracting a core of auditors who are better prepared than ever before to deal with increasingly complex transactions and a growing variety of financial instruments.

To that end, the six largest firms spent a combined $70 million pursuing new staff during fiscal year 2007. That translates into $5,000 spent in recruiting each new hire. And the firms' investment in people is complemented by a commitment to training that exceeded $680 million last year alone.

All told, the profession devotes about 50 cents of every dollar in revenue to personnel-related expenses, not including partner compensation. College and university instruction is an equally important part of the human capital equation.

Complicating the profession's recruiting challenge is a well-documented decline in the number of academically qualified accounting faculty. The shortage of faculty stems from two realities -- the rising number of retirements and the decreased number of Ph.D. graduates moving into faculty service.

There are several ongoing professional efforts to address this challenge. For example, the AICPA Foundation, along with the 80 largest accounting firms, are working to raise more than $17 million to fund additional Ph.D. candidates at participating universities. And at the Center, we are reconstituting a Research Advisory Board to sponsor and assist academic research.

How might the Advisory Committee

help us meet the human capital challenges? We ask you to consider alternatives to traditional classroom instruction to satisfy a portion of the 150-hour rule. Just to be clear, I am not suggesting a lessening in the number of hours, but the consideration of practicums or internships to expand the real-world experience of future auditors.

We ask you to look into an increase in the number of H-1B visas, to expand the pool of auditors and enhance global capability of audit teams. We ask you to encourage a collaborative effort among the business community, the profession, regulators, and academics, to help ensure that the accounting curriculum is keeping pace with developments in business transactions, international economics, and financial reporting.

We ask you to encourage accreditation bodies to revise their standards to allow the employment of more audit professionals, either active or retired, as adjunct professors. And we ask you to consider solutions to liability risk. Some of the best and brightest might be deterred from entering the profession due to that risk.

There are differing perspectives around liability caps as one possible solution, and others will be discussing their perspectives with you. As you engage in that discussion, we also ask you to call for more moderate reforms to the legal process that can go a long way toward lessening the risk. Two examples are caps on appellate bonds and the right to appeal a denial of a motion to dismiss.

Your consideration of the recommendations outlined in my testimony, and those of others, will serve to enhance the public company audit profession and audit quality. Working together, we can foster even greater investor competence in the public company audit process, and, by extension, our capital markets.

I thank you for your time and attention, and I wish you all the best in your important work.

CO-CHAIR NICOLAISEN: Excellent. Thank you very much.

Our next speaker, next panelist on the Human Capital Panel, is Brian James Jennings, Chief Financial Officer of Energy Transfer Partners, LP.

And, Mr. Jennings, you'll see a light that will go on there shortly. It will be green when you start, and that's your five-minute clock.

MR. JENNINGS: Would you like me to wait until the green --

CO-CHAIR NICOLAISEN: No, no. Please start. You can get a headstart.

MR. JENNINGS: Chairman Levitt, Chairman Nicolaisen, members of the Advisory Committee, fellow panelists, and other guests, I'm working today through a cold, so hopefully you'll be able to bear with me.

My name is Brian Jennings. I currently serve as the Chief Financial Officer of Dallas, Texas-based Energy Transfer Partners. Energy Transfer is a New York Stock Exchange-traded master limited partnership, principally engaged in gathering, processing, and transportation of natural gas. We're a member of the S&P 500.

While we are not a household name, through our ownership of both intrastate and interstate pipelines, we are one of the nation's largest natural gas transmission companies. Each day we transport in excess of nine billion cubic feet of natural gas in pipeline systems that stretch currently from the California border to East Texas.

In 2008 alone, we will invest approximately $2 billion building gas pipelines and processing facilities, and expanding critical energy infrastructure in this country.

On behalf of myself and Energy

Transfer, I want to thank the Advisory Committee for inviting me to share my thoughts on human capital issues facing the accounting profession, and ultimately the impact of those issues on entities such as Energy Transfer.

I must preface my comments by stating that I am not a Certified Public Accountant. I feel somewhat undergunned here. However, I serve as a Chief -- I have served as the Chief Financial Officer for the past six years, including my current position at Energy Transfer, and my previous position as Chief Financial Officer of Devon Energy Corporation. In addition, I'm a member of the Board of Directors of Arch Coal Corporation, where I serve on the Audit Committee.

I hold a degree in petroleum engineering from the University of Texas, and a master's in business administration from the University of Chicago's Graduate School of Business.

The perspectives I will share today

on the current state of the accounting profession reflect not only my experiences serving as the Chief Financial Officer, but also my experiences serving on the Audit Committee of a public-traded company.

I was asked today to comment on skills, education, and training that I seek in the external audit staff, as the Committee considers critical human capital issues in the accounting industry. I have been very fortunate in my professional career -- a career which now spans three decades -- to have worked with many talented and professional audit staff.

I hope to share with the Committee my experiences of audit excellence and discuss with the Committee the skills and capabilities I expect our external auditors to deliver. From that discussion, I hope to explore with the Committee the challenges and opportunities facing the profession today.

I do want to take a moment to

commend this Committee for its willingness to discuss human capital issues. The issue is not, however, unique to the accounting field as we face critical shortages of accountants, engineers, and scientists in my business. These shortages, while manageable today, represent in my view one of the nation's greatest economic challenges.

I look for our external auditors to bring to each audit and quarterly review they complete, the comfort letter they provide, a broad-based and thorough understanding of our business and the accounting rules that govern our financial reporting.

The energy business is complex and rapidly changing. In addition to understanding the complexities of our business, I expect our external audit staff to maintain that understanding against a backdrop of complex accounting rules and rule changes.

In addition to accounting skills and business understanding, we expect our external auditors to bring to every engagement the highest ethical standards, and they do.

Our partnership provides to the market with each financial reporting event disclosure that captures for current and potential investors a complete and thorough review of our business strategy, business risk, and our financial performance.

We provide financial disclosure that is consistent with current accounting policies while remaining useful to investors seeking to understand our financial position. I look to our external auditors, as does our Board and our investors, to ensure the integrity of our financial reporting and disclosure.

The depth of experience of an external audit team and what they bring is critical to its ability to provide value-added insight to the audit function. That experience must include familiarity with our company and familiarity with our industry. We want our external audit team to have the confidence to look behind the financial reports and schedules to the critical accounting policies that we adopt and their impact on our financial report.

We expect our external audit team to bring their collective experience and their firm's collective experience to the table to ensure the decisions we make are reasonable and well tested. Bottom line: we expect our external audit firm to be knowledgeable of our company, knowledgeable of our industry, and experts in the accounting policies that govern our financial reporting.

We believe to capture this critical skill set with an external audit -- we believe we captured this critical skill set with an external audit team, including the lead audit partner who is experienced and deeply staffed.

The challenge for the accounting profession is to meet our experience, knowledge, and continuity requirements.

Our partnership as consumers of audit services, and the accounting profession as the provider of audit services, face two critical challenges related to ensuring the continuity of the external audit team. The first challenge to the audit team continuity relates to the five-year lead audit partner rotation requirement mandated with other important financial market reforms following the passage in 2002 of the Sarbanes-Oxley Act.

The second challenge to external audit continuity is the consequence of mandatory rotation on audit partner retention and career development. In two of the three audit situations I have been involved in the past four years, I have experienced lead audit partner reassignment. In each case, we are very pleased with the lead audit partner's leadership skills, technical capabilities, and professional integrity. The reassignment decision in both circumstances was mandated by

PCAOB lead partner rotation requirements.

For companies located in large markets, those well served by a wide range of audit firms with large experienced audit staff and audit leadership, the transition may be relatively seamless. For companies located in smaller markets, or companies in specialized industries such as energy, the rotation requirement may cause a significant gap in technical and sector experience.

The rotation requirement, while well intended, may place the small market companies at a significant disadvantage in securing for their investors the highest quality external audit services.

In considering the impact of audit partner rotation on human capital challenges that face the audit profession, I drew upon my experience and challenges that confront my own industry. In the energy industry, employers in this decade have faced a myriad of workforce issues. We have an aging workforce.

We have experienced dramatic and sustained industry cycles. We have transformed our sector through frequent consolidation.

In turn, we created an industry that for a generation failed to recruit and hire new employees with critical skills. Like many businesses, we have of course to compete today for new employees with a view of employment and career goals that differ greatly from our core babyboomer workforce.

One issue in particular that has resonated with our newest generation of our employees was the difficulties we have faced with employee transfer and relocation. We could spend an entire session discussing the implications of generational differences in the current workforce.

Many excellent studies and books have been written that explore the consequence of these issues. Most would agree that a new generation entering our workforce and making employment decisions is placing significantly greater value on the quality of their lives, and the quality measurement often includes where and how they work.

For many employers, transfer and relocation -- synonymous in my generation with promotion and success -- is declining in favor of dual careers, family requirements, and location preference. I believe the five-year rotational requirement will ultimately impact external audit employee development and leadership retention.

Mandatory reassignment may ultimately be a disincentive to those that consider the audit career path as a consequence of the uncertainty that reassignment creates. That uncertainty may drive talented audit professionals out of the business. Sector specialization may ultimately be impacted by the individuals who seek to maximize career flexibility.

I believe that audit partner rotation will have a greater impact on small to mid-sized public accounting firms, and, consequently, small to mid-sized publicly-traded companies, as their markets may not support the scale necessary to ensure seamless rotation.

CO-CHAIR NICOLAISEN: Brian, can you wrap up fairly quickly?

MR. JENNINGS: I have been a strong proponent of the benefits that the adoption of Sarbanes-Oxley has delivered. The adoption has a profound impact over the quality and integrity of public accounting and financial reporting.

As we begin to reexamine the long-term consequence of Sarbanes-Oxley and PCAOB regulations, I hope you will give important reconsideration to the mandatory rotation requirements. In the long run, we will be better served by a talented and robust accounting profession that attracts and retains the very best employees and leaders.

Thank you.

CO-CHAIR NICOLAISEN: Thank you very much.

We will yield the floor next to Philip Reckers, who is Professor of Accountancy at Arizona State University. Welcome to USC.

MR. RECKERS: First of all, I also want to thank the Committee for inviting me to share my ideas here. I'll limit my comments basically to three things -- recruiting undergraduate and master's students, recruiting Ph.D.s, and the illusion that there are quick, easy fixes to the problems.

The educators who have appeared before you, and the other educators I deal with, and the numbers we have do not support contentions that there is an undersupply of accounting majors today, or that there is a brain-drain of the best and brightest. The numbers don't support that. If there was such a shortage -- when things are rare, the prices go up. They have not.

I do think there is a disaffection, a dissatisfaction with academics, and we don't pump up the reputation of the profession adequately, so that our profession -- accounting -- is getting more students from families who are middle income and above. We have always wanted to be like law schools and medical schools that didn't just attract from the lower economic strata. The blue collar worker has a great work ethic, and that is who we attract nationwide, and it hasn't changed much in recent years.

Some disciplines in business have. Finance is changing, so they are attracting. You're going to ask, "Why?" And some of the reasons very simply are what our students do and how much they do when they get that first job. They don't like some of the work they are assigned, and they get a lot of it.

Second, the profession has taken it on the chin in the last 10 years. Their reputation has gone down. It has not gone up on campuses.

So we've got -- and the third thing is we have progressively locationalized education in our colleges. We have become more and more teachers of rules and code sections, and students don't want to just memorize and learn rules. And they are continually put down by other majors, who tell them they are making decisions, and accountants are just bean counters who memorize rules.

And these same influences are there with respect to attracting Ph.D. students. Everything else being equal -- and everything else is pretty much equal -- when you look at a student who is going to invest in doctoral studies and accounting versus finance, versus marketing, how come they are doing better than accounting in attracting Ph.D. students?

And, again, part of it is we have a diminished reputation. We don't want to hear it, but there are fewer people who want to be associated with a profession that's in the newspaper and the headlines all the time in a negative way. And they don't like teaching the stuff we're being asked to teach -- rules and code sections, more and more and more vocational.

Faculty are partially at fault for this. We have bowed and changed our curriculum to where we are more and more like vocational schools and less and less like institutions of higher education. And we've got to stop that from continuing. Even our own faculty, more and more of our existing faculty will flee to teach in MBA programs because they find the curriculum more challenging.

Quick fixes -- there are no quick fixes. Somebody who tells me among the quick fixes for the Ph.D. shortage is we'll just bring more practicing professionals into the classroom, full-time or part-time adjuncts, they'll teach more -- people who tell me we're going to fix education by setting up a government commission who is going to mandate accounting curriculum, what that tells me primarily is they don't understand higher education. These quick fixes, then, are going to do more to exacerbate the problem than they are to help it.

What we need to do in the short run is find some way to induce existing faculty who are about to retire to postpone retirement for a few years, so we have time to get some of the other efforts underway and yielding benefits. We need to change the economics. It is too costly on the individual to get a Ph.D. in accounting and to go into education.

We have to improve the reputation of the profession, so that people want to be associated with it. And we've got to quit -- we've got to reverse the trend of vocationalizing our education and return our schools to institutions of higher education. Hopefully, the movement to our principles-based accounting, away from rules-based accounting, will facilitate that.

I'll stop there. I'll be happy to answer questions at that point in time.

CO-CHAIR NICOLAISEN: Great. And I'm sure there will be plenty, and we'll move on to our next -- actually, you submitted a very good, strong, and long piece, and we appreciate that.

And Barry Salzberg, who is Deloitte's CEO, is up next. And he has also presented us with a great deal of information in his submission. So, Barry, we will ask you to follow up. And if you can keep it to five minutes, it would be greatly appreciated. The lights are right in front of you.

MR. SALZBERG: Thank you. Good afternoon. Thank you, Chairman Levitt, Chairman Nicolaisen, and members of the Committee. I really do appreciate this opportunity to be before you and share perspectives about the audit profession and the talent issues that we face.

Our ability to fulfill our role in the capital markets and to the investing public is directly dependent on the quality of our people, who are our number one asset. It is, therefore, important that we focus not only on attracting the best and brightest, but also in retaining and optimally deploying the talent we currently have.

Today, we put a great deal of effort into doing all three. In fact, the profession is widely recognized to have some of the most progressive talent programs among all businesses. I have included in my written submission some recommendations for the Committee to consider, including these four very specific recommendations in the human capital arena.

A national licensing system -- to create a seamless, flexible, and consistent framework for professionals throughout their careers. Such a system should also provide relief from duplicative disciplinary proceedings by states that have no nexus to the conduct at issue.

Adoption of immigration reforms for educated professionals -- this is not a matter of choosing foreign nationals over U.S. citizens. In fact, in a tight global market, we need both. And this will be even more of an issue if we converge to international financial reporting standards, or IFRS.

Improvements to education and training, including improved and expanded curricula and more credit for qualified practice internships, and allowing for more adjunct professors without negatively impacting accreditation, and suggesting that firms with substantial audit practices provide them.

So while each of these items is an important part of the solution to the talent issues facing our profession, they could be overshadowed by another issue that has a much greater potential to harm the profession's ability to attract and retain the best talent over the long term. That is the unprecedented level of risk and pressure currently faced by our professionals.

I am privileged to lead a firm which includes capable, talented, and deeply committed audit professionals, who recognize that their individual actions affect our firm and its reputation and are committed to doing the right thing. Of course, I expect no less, and our clients and their investors will accept no less.

However, the risks and pressures the profession faces greatly impact these individuals, including the risks of a catastrophic civil judgment or regulatory action that can put a firm out of business. Others are more personal, such as the frequency with which a partner must uproot his or her family to comply with partner rotation rules. Add to these the increasing lack of respect for the professional judgments an auditor must make every day.

Consider the impact of the current environment on the confidence of an auditor who is faced with making a judgment on a complex issue. You've entered a profession that requires an extra year of college past the CPA exam, you must comply with multiple continuing professional education and ethics requirements, understand numerous complex rules, regulations, and standards, and have your work reviewed by a regulator, all designed to ensure that you are able to make the judgments necessary to do your job, yet your professional career could lie under a cloud if your good faith and well-reasoned judgments are challenged or even reversed in light of subsequent events.

During the Human Capital Panel of your December 3rd hearing, there was a discussion of the need to inspire young people to view public accounting as a profession on par with law and medicine. I wholeheartedly agree, but this is difficult in an environment where audit firms face catastrophic litigation risk and where professional judgment is not respected as it should be.

Therefore, in addition to our specific human capital recommendations, I urge you to specifically consider four of our other recommendations that will strengthen the profession and impact our ability to retain and deploy talent.

Reforms to the private litigation system, including caps on catastrophic auditor liability and certain reforms to the bankruptcy laws. To develop workable arrangements that would address the impact of regulatory action in the U.S. and globally, that could have cascading effects disproportionate to the conduct at issue. A rule or framework to provide protection for good faith, well documented, professional judgments, and lengthening the partner rotation rules from five to seven years.

We hope the Committee will carefully consider all of our recommendations, those I have discussed here today, as well as others outlined in my written submission. I believe all are both practical and reasonable, and would greatly support the profession's current efforts to attract, retain, and deploy the best talent for the benefit of the investing public.

We are glad to be working with you toward improving the attractiveness of a strong, independent, sustainable auditing profession.

Thank you.

CO-CHAIR NICOLAISEN: Great. Thank you very much.

We will now move on to our fifth panelist, Mr. Gilbert Vasquez, Managing Partner of Vasquez & Company, LLP. If I have mispronounced your name, maybe you could help us with that.

MR. VASQUEZ: You did a good job. I pronounce it Vasquez. Many people have different pronunciations.

CO-CHAIR NICOLAISEN: Right.

MR. VASQUEZ: Thank you very much, Chairman Nicolaisen and Chairman Levitt, members of the Advisory Committee, and guests. I'm a partner in the firm of Vasquez & Company. We've been in business since 1967. We have about 50 people in our firm, and we specialize in performing audit services to nonprofit organizations, both privately held and publicly held, publicly-traded companies.

I'd like to thank you for giving me the opportunity to express my views regarding human capital and the role of minorities in the accounting profession, and especially Latinos. Many times people want to speak for all groups. I kind of focus in on Latinos, because that's what I know. That's what I understand, and I can speak more directly to that.

When I began my career in public accounting, minorities were a non-issue. That is to say, there were no hiring opportunities. I remember very well when I graduated from college there were seven of us that went up for interview, and we all have Spanish surnames. Two others had -- were Japanese. None of us got hired. The Japanese guy, he had a -- he was a straight A student. That's the way it was. Obviously, things have changed, but not as much as they need to change.

When I was serving on an AICPA Committee in 1970, the Committee on Minority Improvement and Equal Opportunity, I asked the AICPA, "How many Latino Committee members do you have?" They couldn't give me an answer. I finally figured out there was maybe one other one besides myself.

That caused me to found what was then the American Association of Spanish-Speaking CPAs. It's now called ALPFA, the

Association of Latino Professionals in Finance and Accounting. And I did that because I found out that -- from AICPA that by having an accounting organization you could nominate up to 15 people a year to committees.

Well, you start in one direction, you go to another. Now we have 7,000 members located throughout the United States, 30 professional chapters, 20 student chapters, and I am very honored to have been recognized as a founder of the organization. I have also served as Past President of the California Board of Accountancy.

Here in Los Angeles County where I live, there's about 10 million people. About 4.7 million of those are Latinos. Yet in our accounting profession nationwide there is only three percent Latino, one percent African-American, and four percent Asian. Obviously, that's not a number that any of us like to see.

Within the 10 top firms here in Los

Angeles County, I have estimated there are less than 10 Latino partners. Obviously, that doesn't sound good and doesn't create a good opportunity for Latinos that want to go into the profession, and, you know, they are a very valuable source of human capital.

What are the issues as I see them? There's a lack of Hispanic candidates that are available in the accounting profession, and in part because they don't understand the accounting profession. They don't really know what it is. I can tell you, I didn't know what it was until I was in my second year of college.

I believe that there aren't enough Hispanic mentors and Hispanic role models to do that. Some of the solutions that we need to look at -- try to reach out to Latinos much earlier than when they enter college, providing for financial literacy programs that are directed at them, looking at scholarship opportunities that really focus on Latinos, especially in the CPA firms that hold stronger internship programs that may be -- reach out in this fashion.

Community colleges -- that is where a lot of our Latinos are, and so we need to -- I think we need to look out at those kinds of opportunities and reach out at that level, to bring people into our profession. I think the AICPA and the accounting firms themselves have to do a better job of promoting accounting. It's a good, exciting profession, but we're in the woodwork. People just don't know who we are.

It's difficult to retain Latinos, I believe, because there isn't enough of them. We try to -- I think each firm wants to get some, so they try to recruit them in different fashions, and so that makes retention I think a difficult process. Mentoring and providing programs internally within the firms themselves I think is important.

I mentioned ALPFA. Fifty percent

of our members are women; 50 percent are men. Fifty percent of our members are students; 50 percent professional. We try to focus in on CPE, professional training, networking opportunities. The Big Four and some of the other firms are there to provide support.

In conclusion, I think that the effort, the outreach program, has got to be enhanced. It's got to be more focused, and, clearly, extra efforts have to be made for firms to recruit Latinos.

I have -- I'm a small firm. I even use the H-1B program. I have difficulties with Latinos and other minorities. Our firm has a cross-section of people, like we all do. But, again, that effort has got to start with our profession, and hopefully it will continue as it has in the past.

Thank you.

CO-CHAIR NICOLAISEN: Okay. Thank you very much.

Just a reminder to those of you who

are participating by telephone on this conference call. If you could keep your buttons on mute until you have something to ask or say, so we'd just appreciate it. We have some background noise.

We'll turn now to our last panelist, David Burritt, Chief Financial Officer and Vice President, Global Finance and Strategic Support Division -- it's a long title -- Caterpillar in Peoria, Illinois. And I think he was snowed in today, so he'll be joining us by telephone.

David, are you there?

MR. BURRITT: Yes, I am, and thank you.

Mr. Co-Chairmen and distinguished Committee members, good afternoon, and thank you for the invitation to provide comments.

With 2007 sales and revenues of about $5 million, Caterpillar is the world's leading manufacturer of construction and mining equipment, diesel and natural gas engines, and industrial gas turbines. Today, Caterpillar has nearly 500 operations in 50 countries, more than 100,000 employees, and there are more than 120,000 dealer employees, and thousands of suppliers doing business on every continent.

Over half of our sales are outside the United States, solidifying Caterpillar's position as a global supplier and leading U.S. exporter.

I appreciate the opportunity to discuss ways we can ensure the viability and resilience of public company auditing and accounting profession. I am pleased that the Advisory Committee and the Human Capital Panel recognized input from accounting and finance professionals. You clearly understand how critical that input is to improving the quality of our auditing function. Thank you for the focus.

In addition to the role of public company auditing, management accountants play a vital role in high-quality financial reporting. Management accountants perform a range of activities that enable an organization to formulate and implement its strategy, drive business performance, and create stakeholder value. These activities start with demonstrated accounting expertise, including transaction processing and financial reporting.

Accountants working throughout the financial reporting supply chain enable external auditors at the end of the chain to do their jobs right.

I've had the privilege to speak at many Institute of Management Accountants' meetings over the past few years. Last June, I accepted the James Bullock Award on behalf of Caterpillar's commitment and continued sponsorship of continual learning for accounting and finance personnel.

I can tell you that a certified management accountant certification, or other professional credentialing, is key for our 1,800 accountants. And we have a credential expertise requirement for our senior leadership team to help ensure long-term, transparent financial reporting and FAC compliance.

I am a Certified Management Accountant and a Certified Public Accountant. Our finance and accounting professionals serve as strategic business partners. They are committed to a standard of excellence grounded in a strong ethical foundation and a lifelong commitment to learning. Although auditors clearly play a vital role in the financial reporting supply chain, that role is at the end of the chain, after the accounting work has been performed.

We can improve the quality of human capital and related outcome audit and overall financial disclosure quality by broadening the mission and principles of this Committee, and other related committees, to include the proper education and certification of internal finance function personnel.

Financial reporting supply chain is only as strong as its weakest link. Technical competency must exist throughout to improve the quality of financial disclosures. According to the U.S. Bureau of Labor Statistics, there are approximately five million finance function professionals in the U.S. They drive business performance in the areas of decision support, strategic planning, internal controls, risk management, audits, and the like.

The Institute of Management Accountants has determined that more than 90 percent of the professionals work inside organizations. Ironically, only a small percentage -- approximately five to seven percent -- works in auditing.

At Caterpillar, we are striving to create an inclusive environment that fully engages current and new employees. We are developing a diverse global leadership team that reflects the markets we serve and the communities where we work. Our goal is to have the right people on our team and to fully recognize, and take advantage of, their unique skills, abilities, experiences, and cultural background.

But we face a challenge as we recruit new professionals. Many new graduates are entering the workforce without the appropriate skill set needed to work in industry. The accounting curriculum at most U.S. colleges and universities focuses on compliance and audit. It does not leverage the quality, risk and performance management and leadership development.

These skills are critical to applying professional judgment on the job and building quality into end-to-end business practices such as financial reporting. Accounting graduates today often are not properly prepared for government, corporate, or not-for-profit practice.

I urge the Committee to broaden its mandate to address these concerns, and we must carefully examine whether the current accounting educational system prepares graduates for careers in the various fields of accounting and how it can be improved in the context of the increasing globalization of business and the onset of IFRS.

Thank you for allowing me to comment.

CO-CHAIR NICOLAISEN: Great. Thank you very much. David, you are going to hang on, I believe, for the rest of this panel.

MR. BURRITT: Yes, sir.

CO-CHAIR NICOLAISEN: Good. Thank you very much.

Let's turn it over now to questions from our Committee members, as we have a custom of doing. We'll begin with those on the Human Capital Subcommittee. Gary Previts is the Chairman of that Subcommittee, and I think he is joining us by phone. Gary, are you available?

(No response.)

Doesn't sound like it, so let's turn to Barry Melancon, who is in the room. Barry, you have the honor of kicking this off.

MR. MELANCON: Thank you, Don.

I guess I would start with Dr. Reckers.

MR. PREVITS: Yes, Don, I am on line.

CO-CHAIR NICOLAISEN: You are. Okay.

MR. MELANCON: Well, I will yield to the Subcommittee Chair.

(Laughter.)

CO-CHAIR NICOLAISEN: All right. Barry yields. Gary?

MR. PREVITS: Yes.

CO-CHAIR NICOLAISEN: Go right ahead.

MR. PREVITS: I have a question,

first, for both Barry Salzberg and for Cynthia Fornelli with regard to their recommendation about practica or internships. And I think what would be very useful to the Committee is to have maybe a stylized outline of how we could begin to develop that program on a national basis.

As you may be aware, in engineering, particularly at our school, in Case, there is a very large co-op program that has been in place for many, many years. It's set up in a different environment, but it has the same goal, which is to value practical experience. But it is run, actually, on a nationwide basis.

There is I think National Science Foundation or some other national foundation funding that makes it possible for the interchange of individuals and the arrangement for, you know, such co-op practices. And I would just suggest that in order to make this thing work it cannot be an unfunded mandate.

It is going to involve resources and effort on both sides of the equation.

My second question is for David. David, you're on the phone also, I believe. David Burritt?

MR. BURRITT: Yes.

MR. PREVITS: I would appreciate the details on the two comments you made about the number of finance professors that have -- finance professionals in the Bureau of Statistics as to the five million number, how that's broken down. I think you said the IMA has determined certain percentages are doing certain types of work.

I would certainly appreciate the details of that analysis. I did not have a chance to look in your testimony to see if it's there.

And then, the -- I think the indication that accounting curricula are essentially focused on auditing and other matters, I would also like to see the -- you know, the analysis that supports that, so that we have that to work from perhaps in contrast to some of the other, you know, pre-conceptions that are out there.

I'd be happy to hear any responses to those two observations.

MR. BURRITT: Okay. We will be providing our written testimony tomorrow, and will be giving you additional detail in the coming days on your specific questions.

MR. PREVITS: That would be helpful. Thank you.

Cynthia or Barry, any comments about the notion of practica and internships?

MS. FORNELLI: This is Cindy. Well, I guess obviously since I'm the only woman on the panel.

(Laughter.)

But we would be happy to work with Barry, the other firms that are part of the Center for Audit Quality, the AICPA, to outline what some of those practica and internships might look like, so that we can share that with the Committee.

MR. SALZBERG: The only thing that I would add to that is that there are a number of additional courses or different approaches to education that can be part of the additional 30 semester hours as part of the 150 hours of college credit that we're talking about that could be focused on different programs like ethics, like taxation, like valuation, other disciplines that are absolutely critical to the performance of a quality audit as part of that additional 150 hours.

And some of those would not require additional funding, would not require additional accounting professors that would be needed.

As far as the practice internships is concerned, I would second Cindy's comments.

MR. PREVITS: Thanks. That's helpful to me. And I might invite Phil

Reckers, who is a member of your panel -- there is a deeper background in some of the details here. Phil, do you have any remarks about these observations?

MR. RECKERS: Well, first of all, I'm sympathetic to the value of internships. As an example, my eldest, who is only 25, took six months off in his junior year and did a co-op with IBM in North Carolina. He also did summer internships with the Big Four. I think these had tremendous value.

He didn't get credit for those that really counted. He got credit, but they didn't count, because an educational institution -- they've got so many courses that are general education, so many business, so many accounting. If you wanted to replace accounting courses, then you've got to take some courses out of the curriculum. And nobody wants to take anything out; they simply want more.

We can do these practica and these

co-ops. They are very valuable. I have known kids that do it. But you don't really get credit for it that counts. You just get more credits than you need, than you can count.

The other thing with these practica is it does take administrative effort. If you scale this thing, who is going to do the monitoring that there is a quality experience that students are getting? You just can't give somebody practica, or send them on an internship and give them college credit without some kind of verification that the programs have quality. And not all programs do.

I will name names of firms, etcetera. But I have a lot of students that go out, and some internships are very valuable, and some cause a student never to go to that firm when they come out to recruit.

MR. PREVITS: Don, that concludes my comments. Thank you for the time, Mr. Co-Chair.

CO-CHAIR NICOLAISEN: All right. Thank you very much.

Barry?

MR. MELANCON: Thank you, Don.

Phil, if I could just drill down a little bit on some of the points that you made. You tended to lay out the hypothesis that we don't have a shortage of people, which I would generally agree with, although that's a today environment. I think we are concerned about, where does it go into the future?

And also, I think that is measured -- if you could comment on that -- is as relates to the -- how filled up the classrooms are today, but there is also the issue of replacing people who are -- you know, the population of issues that is retiring, and that is the question of whether it's sufficient.

But my bigger question is -- you talked about a lot of environmental issues -- starting pay, what is being taught, what is being expected or how hires are deployed in an audit environment or audit firm environment. But -- and clearly sort of encapsulating that entire environment is a movement and a lot of discussion about movement to principles-based standards, which is probably a misnomer. But professional judgment -- you heard Barry talk about professional judgment. IFRS clearly will drive some of that.

How do we -- what would you suggest we do from, let's say, an academic and professional partnership to work on this curriculum issue -- the practicums we just discussed -- to try to change that particular environment, which you sort of pointed to with a lot of different inflection points as being a potential problem. And you threw reputation and everything else into it.

MR. RECKERS: This is one of the most problematic areas I think that has emerged in the last 10 years. The disconnect between the practicing profession and the academic profession is grossly -- is terribly deteriorated. There is almost no members of the AICPA that are educators. There is almost no practitioners in the American Accounting Association anymore.

We all got busy, and we all just started to liaison. So you had a liaison faculty member who dealt with the liaison from Deloitte. Another one who may have dealt with a liaison, because they were chair -- an Ernst & Young chair -- they deal with Ernst & Young -- that there aren't that many points that touch anymore.

I could also probably count on my hand, maybe generously on two hands, the number of national partners who have a good grasp of education, who have served for the AICPA, who have gone out on site visits, who do more than just come in and teach a class, then go home on a Thursday night, who really understand education.

There are some of them, but then

they move on. They get promoted and they go into other things. So we've lost this touch.

We do need to work together. There are a lot of challenges. It is incorrect to assume we've done nothing. We've done a lot in the last 10 years. We need to do a lot more. We're talking about moving, what, to a mixed model where we have more financial valuation, fair valuation.

We're talking about moving to international accounting standards. We're talking about moving to principles-based accounting. We need more -- all of these things, very complex areas. How do you teach them? What do you take out? What do you put in?

How can you synergistically teach more than one thing, and at that same time also teach critical thinking, analytical skills, teaming skills, you name it -- all the things that have to be put there. There's a great deal that has to be put in a very short period of time. So there does have to be discussion. Simple answers aren't going to do it. There has got to be some commitment of time and energy and some relatively deep thought about some of these things.

MR. MELANCON: We heard the point of the practicums, and also this professional judgment notion. Barry, maybe you might want to comment on that. Is that not really a place where, given the disconnect that Phil just described with the academic community and the profession, it seems to me as we move more into expecting professional judgment, as you articulated in your testimony as being something that is trusted and respected in the process, that skill set is going to have to be reinforced, too, because we sort of have a generation that hasn't -- that is now leading engagements and stuff that sort of hasn't been built in that. Is that a place for these practicums to really focus?

MR. SALZBERG: I think that there

are three ways to deal with that. Number one would be that practice internships, providing the actual day-to-day experience and the learnings of a particular audit being conducted for the young folks. So that would be number one.

Number two would be with respect to the recommendation about having audit firms supply additional professors on an adjunct basis to the programs.

And number three would be providing a broader array of programs and changing the focus of some of the classes that are being taught today, to include professional judgment and to include the intangibles not just the rules, which Professor Reckers talked about.

MR. MELANCON: I see that I'm out of time. I do want to just compliment your founding of the ALPFA -- what is today the ALPFA organization. And while we do have a problem in the Latino area, it's at least better than in some of the other minority categories. So thank you for your leadership in that area.

MR. VASQUEZ: You're welcome. And if I can respond, it is much better. In fact, Barry's shop, Deloitte Touche, is our co-sponsor this year. And I was meeting with -- talking to both Tony Bizzelli, their Western Region Managing Partner, and Justin Panea, one of their partners here in the L.A. office, and we estimate that they are going to be spending about a million dollars directly and indirectly on our conference this year. And that is testimony to the type of support that we need to move forward.

CO-CHAIR NICOLAISEN: Great. Thank you very much.

Sarah Smith, are you on the line?

MS. SMITH: I am.

CO-CHAIR NICOLAISEN: Terrific.

MS. SMITH: I have a question for Cynthia, if I may. On your very first page of your testimony, you just -- it was a very small part of what you talked about, but it just intrigued me. You said that faculty should be encouraged to take sabbaticals to spend time at firms.

I wondered if you could expand a little bit on that, and then I'd be very interested in your efforts to deal with that.

MS. FORNELLI: I'm happy to answer that question. I think that we are all looking for ways to have a more collaborative process, as Professor Reckers mentioned. And one thought was that you could allow faculty members, and make it easier for faculty members, to on their sabbaticals come in to the firms and do a program that way, so that it's a two-way street.

We've talked about having professionals go in and teach as adjuncts at the universities. But is there a way also that we might be able to explore having professors going into the firms? It seems to me that, as we look at that, we need to find ways to partnership so that it's a two-way street.

MS. SMITH: Would you be a supporter of that, having faculty spend time within the accounting firms?

MR. RECKERS: I am. I was Director of the ASU School of Accountancy and Information Systems for nine years. And it wasn't easy, but during that period of time I had two faculty members during their sabbaticals go to work for a firm. One was Motorola, and one was KPMG. It wasn't easy, because we -- the way sabbaticals work is a faculty member can have a semester off at full pay, or a year off at half pay.

Now, a semester, three or four months, when I dealt with Motorola and KPMG, they thought that was too short to be meaningful. And I agreed. If we make it a year, now the faculty member has only got half salary. So who is going to make up the other half of their salary, so they can live?

And in those instances, Motorola and KPMG paid half of the salary, so he remained at the same place he entered, and both -- he did a good job with the firm, both of them did good jobs for the firms, and both of them came away with a wealth of knowledge they could bring back in the classroom.

So I am very supportive of it. It's not always easy to do. It's easy to do if you have a school in the big city where they didn't have to travel, if they have family, to another location. And a lot of our schools intentionally and historically have been placed in small cities to keep them away from the marketplace, to isolate students where they can devote their time to their education. So we have a lot of -- a lot of schools, big schools in small towns.

MS. SMITH: And it sounds that as if there were financial support to such a program, that would make it easier as well.

MR. RECKERS: Without the financial

support, it really becomes almost impossible. If you ask a faculty member for a year to take half pay, you know, they've got obligations and commitments they have to pay, mortgages, etcetera, and kids' tuition. It becomes almost impossible.

MS. SMITH: Right.

MR. RECKERS: But it still takes work, because not everybody is interested. You've got to find the common ground where you can add value to the firm and you can add value to the faculty member. But it can be done, but you do have to go at it deliberately. And I would encourage you. I have tried my best to get as many as I could. I got two, and the third one I tried to negotiate didn't work.

MS. SMITH: Okay. And then, one of the things that we had -- along the same lines we've been hearing about is how to get the balance right of the professional experience and doctorates. And what is your current view of the accreditation standards in terms of mix? Do you think that is the best place it could be at the moment?

MR. RECKERS: Well, you've got to bear in mind that I was on the Committee that wrote the standards.

MS. SMITH: Well, that's helpful.

(Laughter.)

MR. RECKERS: So I'm not inclined to favor relaxing the standards. The standards are there for a very specific reason. There is some benefit to be had by adjuncts. They bring tremendous value to the classroom. But there has got to be a mix, and you just can't keep adding them without recognizing the thresholds.

And this is really one of the --

MS. SMITH: In the event -- I mean, and you gave a very good suggestion for dealing with the upcoming crisis of shortage through asking those who might retire to stay on longer. But in this type of shortage, might that not be a way that could open up the field and add people to the faculty?

MR. RECKERS: The problem with it right now is we have used that to take care of the shortage in past years, and we are now at a point where the slack is gone. So we are now up against the margins, or beyond, on the percentage that we can have. And I don't think you want to relax the standards greater than they are. We are pushing the standards. It's a good thing, but there has to be moderation. I don't think we can go further with that.

Some schools haven't tapped into that as much as others. But let me tell you, an awful lot of schools are at the threshold. They're at the maximum.

MS. SMITH: Chairman, that is my questioning.

CO-CHAIR NICOLAISEN: Thank you, Sarah.

We have two other Committee members

who are possibly on the phone. I just wanted to check if you are -- either Ann Mulcahey or Amy Brinkley.

(No response.)

If not, we have about 25 minutes left for this panel, and we'll leave that time available to any of our Committee members or observers or Chairman Levitt, who would care to ask questions.

We've got some background noise. Sarah, I don't know if that's on your phone, but if we can get mute. Appreciate it.

CO-CHAIR LEVITT: Cindy, why wouldn't investors be better served by having management and auditors disclose areas in which there was a significant audit judgment about management decisions and perhaps quantify the impact that might have been made had alternative decisions not been made?

MS. FORNELLI: Are you talking about in the context of the professional judgment framework or --

CO-CHAIR LEVITT: Yes.

MS. FORNELLI: -- professional judgment rule? Well the first thing I will say about that is that I applaud the SEC and their Committee. They also have their Advisory Committee that is looking at that, and it is a very robust process, as is yours. So I applaud them doing that. The profession, academics, and others are involved in that.

But I think what we're seeing is that auditors, more and more as we go to a more principles-based set of standards, be it in AS5, the PCAOB, adopted over the summer, management guidance that the SEC implemented this summer, if we go to a convergence to IFRS, more and more auditors are going to have to use their judgment, and that judgment needs to be respected.

And so that is really the context in which we are talking about the professional judgment rule or framework -- allowing auditors to have that freedom to not be second-guessed. It's a term that I don't really like, because it implies that one was guessing in the first place, but that they have the freedom that their judgment will be respected as long as there are certain safeguards and frameworks around it. And I think that's what the SEC Advisory Committee is very much working toward.

CO-CHAIR LEVITT: Now, in your view, have any of the audit failures to date been attributable to circumstances in which professional judgment was not respected?

MS. FORNELLI: Well, I think that you see in the regulatory context, and certainly in the litigation context, that judgment is not being respected. There have been audit failures that are attributable to many things, and so I don't know that you can pinpoint that they have been because of the lack of respect for judgment, but it certainly is a regulatory burden and a litigation burden.

CO-CHAIR LEVITT: Barry, in terms of transparency, you mentioned that audit committees could make decisions based on information disclosed that's not directly related to audit quality. Could you give us a list of data that bears directly -- you would consider that bears directly on audit quality?

MR. SALZBERG: Are you referring to data of the accounting firms?

CO-CHAIR LEVITT: Yes.

MR. SALZBERG: Yes, I would say that the data that is identified in, for example, the Eighth Directive -- Article 40 for the EU, would be information that would bear on the quality of the audit firms that are distributing the information.

So there's a list of that, and I would say that those would be items that would, in fact, bear directly on that question.

CO-CHAIR NICOLAISEN: Great.

Gaylen, you were next, then Ken.

MR. HANSEN: Thank you. If I could ask you, Barry, I -- you had called for national licensing, and I wonder if you could expand a little bit -- Dr. Carcello, in our December -- or in our earlier meeting in December -- he discussed that or he brought that subject up also, and I'm not sure if you are talking about that on top of a CPA license, or from a mobility standpoint, or the whole gamut, keeping in mind that we have CPAs that are practicing tax, consulting, they're in industry. I mean, the field is extremely broad. Or are we just talking about the auditing profession specifically?

You know, who should bear the cost of that? Who should regulate that, provide the examination, the monitoring, and so forth? So, you know, I don't know to what extent you could maybe elaborate on -- because it's one thing calling for a national license. It's another, you know, do we have something more specific than that.

You had also mentioned -- you had talked about the current multi-state jurisdictional matters and some states not having a nexus and trying to apply discipline. I can say that, as a member of a State Board of Accountancy, we usually don't go after people in other states. But on the other hand, we do have large unusual situations like Enron, where an individual loses their license in one state, can't be expected just to go to another state.

So I'm not sure if you were talking about that or something different. And if you could maybe expand on that, I would appreciate it.

MR. SALZBERG: Well, if I can, maybe the best way to tackle the issue is to deal with a couple of examples to demonstrate the basis for which I have made the recommendation for national licensing.

One would be most recently, a couple of months ago I think, we asked a partner to relocate from his state of residence to another state in order to provide leadership on a major audit client that we have. That individual has been 25 years in our practice, very significant in experience, and he was unable to get the license in that state, because he was short three credits back in his college days.

That is an example of how national licensing could help us further audit quality by being able to drive deployments quicker and more effectively.

Another example on the subject of disciplinary actions -- we have a matter that unfortunately arose in which we were disciplined as a firm, and a jurisdiction within our country opened a disciplinary proceeding against us, and that is a jurisdiction in which the particular matter had no partners and no activity connected. So we are speaking from exact experience, and both of these are within the last year as an example.

So those are two situations that gave rise to our thinking that a national licensing regime could really effectively deal with.

Whether -- getting back to the original part of your question, whether it applies just to the audit profession or other CPAs that practice, I think broadly speaking it affects the issues of permanent deployments. It affects the issue of administration, and I would think that it should apply to all, because I can't imagine -- I haven't given much thought to whether or not you can have a bifurcated national licensing system that applies to one kind of professional as opposed to another that would otherwise be subject to the whole.

So my initial reaction would be for the whole, not an individual segment.

MR. HANSEN: If I could just follow up on that, then -- and recognizing that there are a lot of CPA firms that serve -- and I'm sure yours as well -- serve public as well as private companies, you would cover private practice as well as public company auditing.

And then, on the -- the problem that you had with your partner, most states have a five and 10 rule, including ours, but it is part of the Uniform Accountancy Act. If you practiced five of the last 10 years, you don't have that problem. So I'm not familiar with what happened in your instance, but usually Big Four partners get licensed.

CO-CHAIR NICOLAISEN: All right. Ken? Rick? Lynn? Go in that order.

MR. GOLDMAN: Barry, I was very struck by some of the recommendations you had, so I have sort of related questions on three areas. First of all, on the issue of professional judgment, could you maybe a little bit there relative to, what influence do you think either the SEC or the way the PCAOB is doing their various views has on the potential for professional judgment and how you exert your influence in terms of professional judgment?

Two is I am just curious -- for anyone -- do we -- relative to the human capital, in general, do we think starting salaries have a significant impact relative to the -- having more folks be interested in this profession? And maybe where I'm going with is: do we think salaries need to go up? Just like anything else, supply/demand.

The last question that relates to the question about caps, and some of the other testimony -- would the firms be interested in having more transparency in terms of their financials relative to understanding better the implication of having caps on liability?

MR. SALZBERG: Okay. I think the first question of the three was addressed to me specifically with regard to the professional judgment rules that we were talking about. I would not identify anything specific in terms of SEC or PCAOB.

In fact, it is also the threat of litigation. You can put all of that together in the answer to your question, so I wouldn't focus on inspections, I wouldn't focus on SEC, I wouldn't focus on the litigation environment. It is all of the above.

With respect to human capital in general, which was your second question, starting salaries, would salaries go up? And would more folks be interested? Our analysis of the workforce indicates that today's professionals are looking for a broader array of attributes in an employer that they choose, in accounting no less.

And so today's graduates are looking for companies that are interested in further -- in corporate responsibility that further community involvement, that are more diverse, that has an environment of flexibility, that are more adapted to the -- to their needs as young professionals. And compensation is one of them.

And as long as the competitiveness of the compensation is such, we believe that that is not a major criteria. However, I think Professor Reckers hit it on the button, that today there isn't a big gap between supply and demand of the professionals in our workforce. Tomorrow our analysis would indicate that it would be -- could be potentially significant.

When that occurs, the natural forces of the market will cause salaries to go up. And we are, obviously, prepared to do that, but today the market dynamics are such that that is not a dissuading factor for individuals to join our profession. There are more fundamental issues that are on their minds than compensation.

But that question was addressed to everyone else, so I will stop there for the moment to see if there's other comments.

MS. FORNELLI: If I could elaborate

just a bit on that, with what Barry was saying with respect to starting salaries. The firms have all been given a lot of accolades lately. Business Week named the 100 best places to launch a career. The firms placed very prominently in that.

Working Mother magazine has cited the firms in their list of best places to work. And compensation is one piece of what goes into these surveys and these analyses, but also things like work-life balance, training, education, meaningful experiences in their first year.

So I think that the firms do a good job of making it a meaningful experience to launch and start a career.

CO-CHAIR NICOLAISEN: I think we'll keep it moving. You had one other question there about caps versus transparency?

MR. GOLDMAN: Correct. The only other point I want to -- I do want to make about the professional judgment -- it's hard to address that if you say "all of the above." It's not clear to me who is going to -- how to take the next step there when there's an "all of the above" issue.

And the other one was the impact on -- would the companies -- would the firms be more interested in transparency of their financials relative to helping understand the issue of caps on litigation?

MR. SALZBERG: I would say that we are absolutely willing to share information that would actually help investors and improve audit quality. And so to the extent that we could identify information which I think I've identified in response to Chairman Levitt's comments, we certainly would be willing to disclose that information publicly.

Other information that we would be disclosing, I think in response to your question in terms of the kinds of things that might be helpful in your view, I think could provide a level of confusion to the marketplace as a private enterprise. We are not like a public company. We have a lot of expenses that our partners have.

We have information that is -- we don't provide GAAP financial statements to --

CO-CHAIR LEVITT: That's a tough problem. I mean, you've put your finger on something that is very difficult to have your cake and eat it. I mean, on the one hand we are talking about certain special protections. On the other hand we are saying that competitive factors make it difficult for us to provide you with the insights and the information that might be useful.

I understand what you're saying, but I hope you understand that this does provide almost a conflict in outcome.

MR. SALZBERG: From our perspective, Chairman Levitt, our desire to provide financial transparency, I think depends upon the importance of the information to the assessment of our ability to provide audit quality.

The desire to share public -- private information with the public that is not investing in our firm as owners and partners of the organization is a very different model than we have had, or at least to date.

We have -- the PCAOB that is in existence today, that has the ability to request information from the public accounting firms on this subject, and we are certainly willing to share that information in that context. This is not about anything other than ensuring that information that is public is understood, is appropriately presented, and would not provide a level of concern from a competitive perspective.

So we are willing to share that information, but we believe in an organization like the PCAOB, where that information is confidential and the analysis could be had appropriately, we would be very willing to do that.

CO-CHAIR LEVITT: I guess I am just suggesting that a move toward greater transparency I think would be very constructive in terms of the issues that you are trying to get assistance and public support on.

CO-CHAIR NICOLAISEN: I would agree with that.

MR. SALZBERG: I would agree with that principle as well.

CO-CHAIR NICOLAISEN: We're going to ask each of our questioners to have one question, and then we will circle around if we have more time. We have about seven or eight people who would like to ask --

MR. HERZ: This gets to the question of the interest and familiarity with the young people in the profession. I think I heard Mr. Vasquez say that one of the issues is -- in the Latino community is that among young people there is not that much awareness of the profession and what it does. And I think I heard Dr. Reckers say that on campus the image of the profession is not all that it might be.

And I just kind of wondered, you know, a lot of the things we seem to be talking about seem to be somewhat incremental and evolutionary and, you know, we're sitting here in Los Angeles, the home of the entertainment industry, it kind of strikes me that other professions -- maybe they are more intrinsically interesting, I don't know, medicine or law. But there is no shortage of TV series about them.

I'm not suggesting that we ought to have --

(Laughter.)

-- a show of an Atlanta accountant or a Philadelphia forensic or something like that.

(Laughter.)

But, you know, are there things

that we can do that are more than -- more than incremental, that are more transformational in terms of trying to -- as part of the interest in the profession at an early level and a broad level.

MS. FORNELLI: I'll start. I appreciate your frustration with the lack of quick change on this, but I do think that it is probably an incremental process. I think that we have to take various approaches, and almost a mosaic approach to try to make it attractive to the best and the brightest.

And so one thing that we've started thinking about is: do you get to students earlier? Is it too late when they begin college? Do you need to get them interested in the high school level or the junior high school level? Do you need to make it something that not only is attractive to them, but also attractive to their parents, that they will support them going into the profession?

So we searched and thought long and hard about, is there a one-step approach that will make it more attractive? I dare say I like the idea of your TV show, but short of that I do -- I fear it is kind of an incremental step, and we all need to think about ways to put those pieces together, so that collectively it does make a difference.

CO-CHAIR NICOLAISEN: Bob is volunteering for a starring role in that.

(Laughter.)

MR. SALZBERG: And if I could just add to that, I do think that that is a topic that is very important to us, and we spent a lot of time thinking about. For high school students, for example, we are now devoting a lot of time trying to not only educate high school students about going to college, but where they should go to college and major in.

And that to me -- we have to start that early, because I think that there's an opportunity to increase the number of potential accountants in our workforce by doing so. And so whether it's in connection with going to high schools and making programs directly there, or working on not-for-profit activities that support high schools to drive that, I believe that that's one of the -- but it is a longer term. It's not a quick fix.

CO-CHAIR NICOLAISEN: Okay. Rick? Quick. We're going to go with quick questions, quick responses, if we can, please. We have so many people who want to ask something.

MR. MURRAY: Thank you, Mr. Chairman. It struck me that the frequency with which --

CO-CHAIR NICOLAISEN: Can you pull that mic a little closer?

MR. MURRAY: Frequency with which the subject of professional judgment has arisen and the regret that there is -- if there are constraints on its exercise -- is striking here, and that there is alignment of view that we haven't had on very many issues.

So just a quick test of the panel to see if I have listened correctly, that if there were a way to reduce the constraints on the exercise of professional judgment in the profession's work, we would achieve what Chairman Levitt I think was attempting to refer to in terms of delivering better value to the users of financial statements. We would attract and satisfy better quality professionals, and we would have an ability to create safe harbors for reducing the excesses of hindsight liability exposure.

The question is: does anyone disagree with that as a sense of what this panel has been saying?

MR. TURNER: Well, there's a difference between whether I agree with it or not, but I don't agree with it.

CO-CHAIR NICOLAISEN: Yes, I think we could have a pretty lengthy discussion about this, perhaps best in -- within the

Subcommittee walls to have that discussion. But it is worth having.

Lynn?

MR. TURNER: Mr. Vasquez, I'd just like to echo what Barry said and compliment you on starting that group. And I think that's fantastic, and I hope we can find a way to get you additional investment. And I think Barry should be complimented for the efforts that DT has made in this area, which are really good.

I would say, Barry, I would echo what Don and Chairman Levitt said about the financial transparency. I would note that the package that we got, the financial information in there, if anyone asked me to do financial stability analysis based on that, Dr. Reckers would flunk the course, so --

CO-CHAIR NICOLAISEN: Lynn, can you pull the mic a little closer to you?

MR. TURNER: So I would say he needs to go -- has a long ways to go before he will ever pass Dr. Reckers' class.

With respect to the one question Cindy -- back to the business judgment rule that Richard brought up. I often hear people talk about getting second-guessed by either Mark Olson's organization or the SEC or litigators, and yet when I ask for specific examples no one ever comes to the table with real significant examples.

And so going back to Chairman Levitt's comment, are you aware of any specific examples, especially with the major corporate scandal cases, many of which involve billion dollar errors, are you aware of any specific cases that you can provide us where the auditors were inappropriately second-guessed on those cases?

MS. FORNELLI: I cannot provide that to you.

MR. TURNER: Thank you.

MS. FORNELLI: But I will say, though, that things -- sometimes it's the fear of being second-guessed or the fear of not having your judgment respected, and --

MR. TURNER: But I would suggest -- and each and every day that Ken Goldman sits there as CFO we're certainly -- I guess I was sitting there as CFO. Every day that I was dealing with outside auditors I had the issue of being second-guessed by auditors. They do it day in and day out, and it seems like you're saying they can second-guess us on the management side, but, no, we don't want anyone second-guessing the auditors. And I just don't comprehend that.

MS. FORNELLI: And one thing I do want to say, because I don't want to leave the impression, both the SEC and the PCAOB, under Chairman Cox's leadership and Chairman Olson's leadership, have had this front and center on their minds, have been in the past year working -- looking at this, working with the profession on this, to make sure that their professional judgment is being respected, and that the inspection process is working.

And so I commend both of them and their staffs for that. And I don't want to leave the impression that I don't feel that way.

CO-CHAIR NICOLAISEN: All right. This is one of these subjects that I think we could have quite a bit of dialogue around. It does sound as if there is a different group -- the SEC group -- that is working with it. I don't know that it really falls within our -- the parameters of what we need to address.

I understand the concern that is being raised by the profession. I also would say lack of data -- if you can't provide us with something meaningful as to where this really is a problem, and what the issues are, it is very, very difficult for this Committee to have any real reaction.

The fear of being second-guessed is inherent in the world. We all live with that. The question is: what is it that is really not functioning today? And if you think -- those in the professional community think that it is a subject that needs to be addressed by this Committee, we really need some data.

Damon, I believe you were next.

MR. SILVERS: Thank you, Don. I'm sure it will gratify you to know that I will not ask about that subject.

(Laughter.)

I was interested in the training cost data that was provided in some of the testimony. I would like to see much more comprehensive data on that. Not now, but in a further submission.

My question has to do with -- a number of the witnesses spoke about the sort of unattractiveness of working as an audit firm partner, sort of the pain of rotation, travel issues, second-guessing, litigation fears. I note in the -- and then, there was a lot of discussion about H-1B visas and the need to bring people in.

Even while it seems that the firm's ability to tap our domestic labor pool, particularly when it's not white, seems to, I believe, have some problems. And so my question is: since we have all of these sort of problems with getting people to do audit firm partner work at current compensation levels, what would your plans be? I ask Cindy and I guess Barry this. What would your plans be to bring partners in on H-1B visas? And how many partners have you sought to bring in on such visas to date?

MR. SALZBERG: Most of the H-1B visa situations that we have are non-partners. And so these would be individuals that have worked -- I'm sorry, that have been educated at U.S. universities. And in order to accept full-time employment with our firm, for example, they would need to have a visa in order to be able to do that.

So most of the H-1B issues that we would have identified is at that level. We do not -- none are coming to my mind where we actually bring in partners from outside the country on an H-1B.

MR. SILVERS: My view would be that, given the complaints about life partners that have been made by this panel, and given the compensation levels for partners, that I wouldn't take seriously anything in relation to H1Bs, or in relation to these complaints, until I saw a plan to deal with those issues by expanding the labor pool for partners.

MR. FLYNN: I think, Damon, I think it -- it takes 12 to 15 years to create a partner. You can't go out and find partners. It is not something that happens just because we're going to go find a partner and just hire a partner in the audit practice -- be it from law firms, be it from practical experience.

So there's a balancing here in terms of how we look at the partner credentialing in serving complex multi-national clients in the audit environment.

CO-CHAIR NICOLAISEN: I'm sorry we didn't get to everyone who wanted to ask a question, but what we can do is ask you to submit your questions to the panelists. And we would appreciate responses, and we will share those responses with everyone in a public way.

I wish to thank our panelists for being here with us this afternoon. I think we got off to a fairly lively discussion. I suspect that it could have been more lively if we had a little more time.

We are going to now take a 15-minute break. So panelists, future panelists, those who are in the next panel group, and anyone at this table, please gather behind the iron curtain over here on the right, and we will be back at 3:15 promptly with Panel Number 2 on firm structure and finances.

Thank you very much.

(Whereupon, the proceedings in the foregoing matter went off the record at 3:00

p.m. and went back on the record at 3:15 p.m.)

CO-CHAIR LEVITT: Okay. Are we ready to begin? Is it possible someone could close those curtains so I can see the panelists a little more clearly? Just so it's centered. Thank you.

This panel is focusing on firm structure and finance issues, and the first panelist is John P. Coffey, who is a partner in the firm of Bernstein Litowitz Berger & Grossman, LLP. John?

MR. COFFEY: Thank you, Mr. Chairman. I'll dive right in. I understand the five-minute limit is strictly enforced.

Before I turn to auditors, I want to say a few words about the most important player in the capital markets -- the investor -- without whose money there would be no capital markets. The institutional investor clients that my firm represents understand from painful recent experience that trust in the integrity of the capital markets is fragile, and they view the role of a vigilant auditor as crucial to maintain the integrity of the markets in which they invest their beneficiaries' money.

Accordingly, they believe that any changes which may very well reduce the incentives for auditors to fulfill their rule with gusto must be viewed carefully with objective consideration of the facts for or against such changes, as well as the likelihood of consequences if such changes were adopted.

As set forth in my submission, I believe the case for one such change -- a cap on auditor liability -- has not been made. Moreover, I respectfully submit that a cap would be -- a cap that would make accountants less accountable for their conduct is a decidedly bad idea.

As I'm sure the Committee has thoughtfully considered my written work, I will just touch on a couple of things here. I will start with the assessment of the actual litigation risk to audit firms. I say "actual" because proponents of the cap often unfairly inflate the threat posed by investor litigation.

If the Committee looks past the rhetoric and examines the existing U.S. securities laws, it will see that there are robust safeguards already affording auditors extensive protection, and that the prospect of an armageddon scenario is extremely remote.

In 1995, Congress enacted the Private Securities Litigation Reform Act, which contains a number of provisions that curtail litigation risks for defendants in private action, including auditors. I detailed some of these in my submission; I won't go into them now.

It is my experience that these hurdles present significant downward drivers on the settlement value of cases brought against auditors. These challenges are particularly daunting, given the fault-sharing provisions of the PSLRA. Auditors can almost always point to evidence that management conspired to lie to them, and perhaps even generated false documents in an effort to deceive them.

The PSLRA was intended to weed out weak and frivolous cases, and it has done so. The rate of dismissal of these actions has nearly doubled to almost 40 percent, and auditors are less frequently named as defendants. Recent studies show that auditors have been named in just a handful of cases in each of the last three years.

Analysis of the settlement payments by audit firms also confirms that claims of catastrophic liability exposure are exaggerated. Despite several recent multi-billion dollar accounting scandals at their client companies, audit firms avoided suffering anything close to a catastrophic blow. If audit firms paid at all, it was typically a fraction of what other market actors paid.

One other less obvious point -- thanks to the PSLRA, the lead plaintiff in any future mega case will almost certainly be a market savvy institutional investor. Why is that important? Well, it's extremely unlikely that such a lead plaintiff would insist on a settlement or enforce the judgment that would result in the failure of an audit firm.

On this point I speak not from theory but on my personal experience with Arthur Andersen in the WorldCom trial where just a few days away from a potential multi-billion dollar verdict the institutional investor there settled that in such a way as to not force that crippled firm to liquidate.

Even if one were to quantify, able to quantify a realistic litigation threat of significant size, the question that must be answered is: threat to what? In making a plea for special treatment based on what they claim to be financial peril, it is incumbent on the audit firms to be more forthcoming about their true financial and insurance capacity to withstand a so-called mega judgment.

They have not done so to date, and appear unwilling to do so in the future. That alone should end the discussion.

The concept of a cap on auditor liability is not only insupportable based on what we know -- the true litigation landscape -- and what the firms will not reveal -- their actual financial condition -- it is also a bad idea, because artificial limit -- artificially limiting auditor liability would reduce auditor accountability with potentially ruinous consequences for the economy.

This, again, is not theory. It is reflective of what happened just a few years ago after the PSLRA was passed, and many in the audit profession apparently got comfortable with the idea that their litigation exposure was circumscribed.

The result was a broad flock of corporate debacles, and based on the evidence I have seen in my cases, virtually every one of them could have been stopped in their tracks if the auditors had done their jobs as if they have personal skin in the game.

Finally, as I noted in my submission, I do have one proposal that I think the Committee should seriously consider. It's a little counterintuitive. It's expanding the private right of action to undo what the Supreme Court did last month in *Stoneridge*. Why?

Stoneridge has made the world safer, considerably safer, for those who profit from engaging in deceptive conduct that enables the company to report financial statements that are false. Ironically, while it has made it safer for those bad actors, it has made it decidedly less safer for auditors in at least two ways.

First, by immunizing those who lie to auditors about financial transactions -- remember, that is what happened in the *Stoneridge* case -- the *Stoneridge* decision makes it more likely that people will lie to auditors in the future. That will certainly not make their job any easier.

Second, because team participants are now arguably immune from private suits, the auditor will have fewer faces at the defense table with whom to share proportionate fault under the PSLRA. Who will bear that additional fault? Why, the audit firm that was reckless in not discovering that it was being deceived.

If the Committee is interested, I would be happy to share a real-world current example that involves the audit firm of Grant Thornton in my *Refco* securities case. And I can actually lay out for you how that has negative consequences for that audit firm.

Anyway, thank you for considering my written comments, my oral comments, and I'm happy to address any of these issues, or anything else that the Committee may want to bring up.

Thank you.

CO-CO-CHAIR LEVITT: Would all panelists really keep their eye on the lights, so we stay on target?

Richard Fleck, Global Relationship Partner of Herbert Smith, LLP. Thank you.

MR. FLECK: Chairman, members of the Committee, it is a privilege to be here, and I am grateful to you for the opportunity to make a submission.

I propose to be very brief, and I don't propose to read from or to add to my written submission to this Committee, but I should perhaps explain why a UK lawyer is giving evidence to this Committee here at USC. And I hasten to say it is not to debate U.S. legal issues with those on my left and my right.

I have been involved with the accounting profession for most of my career, at the outset acting for accounting firms, handling litigation, and then in handling many of the transactions that resulted in the present concentration in the market.

More relevantly, I have been involved in the regulation and standard-setting for audit in the UK for some 21 years, beginning in 1986. And I've been the Chairman of the body in the UK that is responsible for that since 2003, being the first non-practitioner to hold that role post-Enron and WorldCom.

And I should emphasize, finally, that it's a pro bono role, and not something that I am remunerated for.

As explained in my submission, I have been involved in developing many of the key discussion papers to the UK, and I would particularly draw attention to those relating to promoting audit quality, the limitation of liability, and the form and content of the audit report. My comments now are directed at what it would take to ensure the future viability of the profession, and I strongly believe that the audit profession is at a crossroad.

When I first came to work in London in 1971, the accountant was at the forefront and the most respected of the professional advisors. Now the order has been reversed, and this is substantially attributable to clients' perspectives of the implication of accounting firms, and I should say investment banks, becoming multi-faceted businesses and the impact that that has had on perceptions of their objectivity and independence.

There are three points that I would like to make in this oral submission, and I will emphasize -- wish to emphasize that they are, to my mind, clearly interrelated.

First, the future security of the

profession depends upon a carefully balanced review of the role of the audit profession. This needs to cover the nature of the audit report and its relevance to modern business and capital markets, and it needs to cover the scope that it -- for value-added assurance in areas that are regarded as relevant by modern society as opposed to just focusing totally and -- to the exclusion of all else on historic matters.

The APB published a report looking at these matters about a week ago, and it raises a number of issues.

Secondly, there needs to be a balanced approach to liability reform that would ensure appropriate financial exposure, which is proportionate to ensure the necessary self-interest in quality on the part of the audit profession, but which on the other hand would remove a level of exposure that is unlimited and wholly unrealistic, but more importantly has the potential to destroy firms that are critical to the effective operation of our financial and commercial markets.

Currently, there needs to be a much more effective relationship between audit firms and regulators -- one that will ensure that regulatory action is protected and stimulative of audit quality, and is not reactive, and on necessity limited to after the event, black or white, regulatory action that has the potential to be detrimental to whole firms as opposed to -- if I may put it this way -- to bad apples.

In the UK, we are looking at all of these issues, and I would be very happy to answer any questions that this Committee may have.

Thank you so much.

CO-CHAIR LEVITT: Thank you very much.

I now yield the floor to Joseph Grundfest, W.A. Franke Professor of Law and Business, formerly a Commissioner of the SEC.

Joe Grundfest.

MR. GRUNDFEST: Thank you very much, Mr. Chairman. This Committee has been doing extraordinarily good work dealing with a set of very controversial, difficult, divisive issues.

CO-CHAIR NICOLAISEN: Joe, if you could pull that mic closer to you.

MR. GRUNDFEST: Absolutely. The Committee has been doing extraordinarily good work dealing with a series of controversial, difficult, and divisive issues. And what I'd like to do in my brief presentation is keep it simple, keep it extraordinarily simple. I can't deal with the complexity of a lot of the questions that have been plaguing this Committee.

The simple proposition that I'd like to share with you is one about which there is essentially no dispute in academic America without regard to the ideological persuasion of the academic who has written on the topic.

And that proposition very simply is that the “out-of-pocket” measure of damages, as applied to after-market trading cases, which constitute the very large majority of 10b-5 cases, there is absolutely no rational relationship to the actual economic harm caused by the fraud, and there is indeed economic harm caused by the fraud.

But it is not rationally measured by the damage exposure to which participants in the market are today subject. And, most importantly, in the very large majority of situations, not all situations, this damage measure will systematically and greatly overestimate the true economic harm caused by the aftermarket fraud.

Let me share with you a very simple example. In a pure after-market fraud case, we have the following hypothetical situation. A company, its auditors, whatever, make a false statement, which causes the stock price to be inflated by a certain dollar amount.

The fraud remains alive in the market for a period of time. A corrective disclosure issues, and the stock market price then declines. The plaintiffs in the cause of action are all shareholders who purchased and continue to hold through the disclosure period, and their damages are measured by the amount of inflation in the stock price, assuming that they continue to hold during the date on which the corrective disclosure actually occurred.

And the argument is that each one of these shareholders was defrauded by an amount that's represented by the inflation. Now, if during this period you have the pure after-market fraud, that means there was no insider trading, and there was no issuance of securities by the company whose stock price was inflated.

In that event, where did the money go? For every dollar that was overpaid by a shareholder who purchased at an inflated price, that dollar didn't disappear. That dollar went to another shareholder who happened to sell into the inflated price, and thereby actually profited from the fraud.

So in other words, ladies and gentlemen, what we have here is a simple measure of wealth transfer that bears no rational relationship to the true economic harm caused by the loss, yet the law takes this measure of wealth transfer of one shareholder who purchased at a high price simply transferring it to another shareholder who happened to sell at a high price, and it causes a measure of loss.

Economists will tell you that that is wrong, and you then multiply that by the total number of shares that uniquely traded during that period, and you get a very large number that people would also consider is wrong.

You add that to the fact that these

types of transfers are randomly distributed to the market, and that the vast majority of investors are diversified, what you wind up with is a situation in which shareholders are forced to bear the costs of a very expensive system of transferring wealth that really is not related to the harm that is caused, and serves, in my view, very often primarily to promote the interests of a fairly large industry that has evolved around the entire litigation process.

And let me emphasize again that I am not for one second saying that any of the fraud that occurs in these markets is justifiable, shouldn't be punished, or what have you. Rather, I am saying that the meter that we use to measure the harm that is caused by these frauds is fundamentally broken, it makes no sense.

If you look at the academic literature in this space, there is essentially not a good word to be heard anywhere in support of this measure. And that if this Committee wants to do something to address the liability to which these auditors are exposed, which in these after-market cases is a fraction -- all right -- of that number. But, ladies and gentlemen, I will submit to you that a fraction of an irrational number remains an irrational number.

The Committee would be able to do a great deal of good, not only for the audit profession but also for the entire litigation process and the economy as a whole.

I yield my two seconds.

(Laughter.)

CO-CHAIR LEVITT: Thank you very much.

I'd like to ask those that are participating by telephone to mute their devices, because we are getting some feedback and static.

The next speaker will be Dennis Johnson, Senior Portfolio Manager for

Corporate Governance, the California Public Employees Retirement System.

MR. JOHNSON: Good afternoon. I'm pleased to be here to represent CalPERS on this panel. I'd like to briefly comment on five points of interest tied to the auditing profession for CalPERS, first being potential auditor liability risk.

CalPERS believes that in order to strengthen the external auditors' objective behavior when performing an audit of financial reporting, audit committees should ensure that contracts between public companies and their independent auditors do not limit the auditor's liability for consequential or other damages, and should not mandate that the company use private alternative dispute resolution to prevent all access to the public court systems.

Topic number 2 -- public company audit firm structure and ownership. CalPERS is currently reviewing its policy position on audit firm structure and ownership. How an organization is structured could define its ability to react and fulfill its mission. Structure not only supports the effectiveness, efficiency, and accountability, for how an organization accomplishes its mission, but also influences the culture and ethical practices of an organization.

One possible way to decrease potential conflict of interest would be to introduce independent boards of directors to the audit firm structure. CalPERS believes that when audit firms also perform non-audit consulting work for their audit clients such non-audit services have the very real potential to impair the external auditors' objectivity.

We also believe that outside ownership has the potential to negatively impact the objectivity and independence of the audit firm.

Third topic -- corporate

governance. The European Union recently adopted reporting requirements for public company auditors related to issues such as a firm's legal structure, ownership, governance, and internal quality control systems. CalPERS supports the role of the SEC in establishing similar reporting requirements for public company audit firms.

We believe U.S. auditors should adopt similar reporting requirements as those for public company auditors under the jurisdiction of the European Union. Currently under consideration by CalPERS is whether or not audit firms should disclose the firm's financial results.

Finally, CalPERS believes that audit firms should be required to disclose key performance indicators to foster greater audit quality.

Fourth topic -- audit responsibility for fraud detection. Of critical importance to investors is the responsibility of auditors to detect fraud and improve the timely communication of these frauds to the company's share owners. I will refer you to our written testimony, which includes quotes from former SEC Chairman Levitt and former SEC Commissioner Roel Campos about the importance of this issue.

The fifth point -- competition. CalPERS believes that audit committees should seek to appoint auditors from outside the Big Four. We believe audit committees should assess how best to achieve audit quality in choosing an auditor.

CalPERS currently uses an auditing firm outside of the Big Four. And in our written testimony, we have provided a lengthy list of public funds who also use auditors outside of the Big Four.

In closing, CalPERS has significant financial interest in maintaining the integrity of financial reporting. Auditors play a vital role in ensuring the integrity of financial reporting.

Please consider our testimony as you move forward with your recommendations. Thank you for giving me the opportunity to present to the panel today.

CO-CHAIR LEVITT: Thank you very much.

The next panelist will be Edward E. Nusbaum, Chief Executive Officer of Grant Thornton, LLP, and Chairman of the Grant Thornton International Board of Governors.

MR. NUSBAUM: Thank you. Chairman Levitt, Chairman Nicolaisen, members of the Committee, Treasury staff and observers, thank you for inviting me to present Grant Thornton's views on the issues that affect the sustainability of a strong and competitive auditing profession.

Grant Thornton, LLP is the U.S. member firm of Grant Thornton International, a major global public accounting organization whose members comprise a vast network of more than 520 offices in more than 110 countries with some 2,200 global partners and 27,000 international personnel.

We are proud to continue competing vigorously to provide audit services for public companies of all sizes, including many of the largest global companies. Grant Thornton serves the public interest through performance built on respect, integrity, professional excellence, and leadership. These values are the lifeblood of investor confidence in America's financial reporting system.

The public accounting profession's unique and privileged franchise must sustain confidence through high quality public company audits that promote the preparation of financial statements that meet the needs of investors. With this in mind, I am pleased to offer our thoughts here today.

First, I would like to touch upon the detection and deterrence of material financial fraud. Recent events in France remind us that some wrongdoers can and will always be able to game the system with sunny effect. As a profession, we must continually enhance our own performance by investing in improved processes, human resources, training and technology, to try to stay ahead of wrongdoers as much as possible.

Many other participants in the capital markets also have responsibility in preventing and stopping fraud. Success requires that the profession engage in a meaningful dialogue with investors, regulators, and others about what else can be done, who can do it, under what circumstances, and with what cost and benefits.

In addition, the leading audit firms and regulators should be required to share with each other their fraud detection experiences and promote research to educate and empower all audit professionals. We ask this Committee to consider developing a process to coordinate the improvement of the prevention and detection of fraud.

Second, we should consider sensible and meaningful improvements to the firm's governance structures that would enhance the quality and vibrancy of public company auditing. For example, Grant Thornton International is now considering including independent members from outside the profession on its international governing board or forming an advisory board.

In addition, we encourage each major U.S. public accounting firm to publish an annual transparency report to provide meaningful quality and governance information to the public along the lines of the global network's annual report scheduled to be released later this year.

The PCAOB also has virtually open access to information about the firms, and can use that access for additional information it deems appropriate.

Third, this Committee's focus on the firm's access to capital is welcomed, but public and private offerings of debt and equity are not the cure all for our profession. At Grant Thornton, capital has not constrained our organic growth. We believe that ensuring a flowing pipeline of top-notch professionals is much more important to sustainability than capital formation.

While outside funding may be helpful, we are concerned that a focus on investor returns, short-term earnings, market and stock fluctuations, and the impact of liability exposure could compromise the public interest and detract from our independence.

Fourth, the risk of catastrophic litigation is unhealthy for the profession, investors, and the capital markets. It hurts our ability to be seen as a viable, long-term profession for the best and brightest people entering our firm. It inhibits our economic capacity and our freedom to structure ourselves to deliver what investors need, and it erodes investor confidence. The companies always will have an adequate choice of auditors.

Grant Thornton supports reform measures that serve the public interest. As such, those measures must meet three criteria. The liability system must recognize that high-level judgments will vary. The system must be equitable to investors and other market participants. And the liability system must support a competitive audit market.

Auditors must continue to enhance their performance and be appropriately accountable for wrongdoing. We would expect nothing less of other capital market participants as well.

Fifth, we ask this Committee to consider developing recommendations for revising certain auditor-independent standards, to enable firms to maintain a structure based on a logical approach to independence that is in the best interest of investors.

Auditor independence is the foundation of investor confidence in the profession, but the current complicated rules-based system is in need of some change. We are concerned that some rules -- for example, the current definitions of audit, client, and affiliate -- create unnecessary barriers to increased competition in the audit market.

The SEC staff makes every effort to remediate independence issues in a timely and balanced manner. But a clear, more specific description of the circumstances that might impair an auditor's ability to conduct a fair and impartial audit, removing insignificant situations that don't harm investors, will enhance auditor's choice.

I also ask this Committee to build upon the work of the SEC Advisory Committee on Complexity and Financial Reporting, and to encourage global standards on every level. In addition, we must all work hard to combat misinformation and misperceptions that currently restrict auditor choice.

I have offered additional suggestions in my written testimony, and would be happy to answer any questions that you may have.

I thank Secretary Paulson, Under Secretary Steel, and the Treasury Department, and the Committee, for the opportunity to appear before you here today. We support your thorough examination of all of these critical issues.

Thank you.

CO-CHAIR LEVITT: Thank you very much, Mr. Nusbaum.

Now, D. Paul Regan, President and Chairman of Hemming Morse, Incorporated.

MR. REGAN: Thank you, Chairman Levitt. Thank you, Chairman Nicolaisen, and other Committee members, and Treasury.

I am glad -- I'm happy to be here

to share my 40 years of experience in public accounting. I am a CPA. I practiced in public accounting for those 40 years.

I have a B.S. and an M.S. in accounting, and I have only worked for two firms -- Peat Marwick Mitchell and Hemming Morse. I am current Chair of Hemming Morse. We're about 105 people and headquartered in San Francisco. I am also past Chair of the California Society of CPAs.

My thoughts here today are my own observations from those 40 years. They don't represent any other organization.

I do want to add that I love the profession. I love working with the accountants in it. I think that substantially all of our profession has been -- have done wonderful work in a very difficult environment.

In terms of why I am here today, I believe, is because of the work that I have done for the past 20 years, which is analyzing

GAAP and GAAS failures and making determinations of whether there has been a GAAP failure or whether there has been a GAAS failure.

I have done that for the Securities and Exchange Commission. I have done that for the Attorney General. I have done that for the FDIC, the RTC, institutional investors, and large financial institutions.

I have done that in many of the large frauds that have been -- that have occurred in the last 20 years -- for example, Parmalat, Enron, Xerox, Sunbeam, PharMor, MiniScribe, many of the S&L and banking scandals of the '80s and '90s.

One of the things that I have noted -- and I want to share with you some of the principal thoughts that come as a result of that experience, which tends to mean in many of the cases I just described we spent 10- to 20-, 30,000 hours of analysis of work papers, analysis of testimony.

I personally spend thousands of hours in working on those cases, and one of the things that I consistently conclude is that the auditing procedures worked. The staff did a good job. They uncovered the problems.

The problems that arose with respect to the audits -- violations were brought to the attention of the partners, issues were communicated within the firm, but the violations weren't communicated to the Audit Committee or to the Board of Directors.

Mr. Turner asked earlier today, what about the second-guessing? What about these issues of judgments? In all of the cases that I just mentioned, and in many others, I have seen no issues of significant judgment which really constituted the reason for the distorted financial statements. It wasn't second-guessing.

One of the reasons why these violations were not properly communicated --

and this is something I ask you to seriously give -- put in the back of your mind is that it is very difficult to be an audit partner. It's very difficult to be an engagement partner.

There is pressure put on you from various perspectives -- within the firm, by the client, bonuses are dependent upon it, people's fortunes are dependent upon it in terms of whether options are in the money or out of the money, whether bank covenants are going to be triggered for defaults, liquidity, people's jobs are at stake. It is an extremely difficult job.

Many of the accounting issues are often not complex. It's the pressures that are brought to the accountant, the human pressures that are put on that accountant, the ethics of the accountant. Sometimes it's within the firm, sometimes it's also from the -- always from the client's perspective.

And to reiterate, one of my

principal conclusions that I'd like you to take away from here is that the auditing procedures that have been developed by the AICPA originally, and now the PCAOB, have been good audit procedures. In the '80s they worked, in the '90s they worked, and in the 2000s they work.

We had failings with some people who weren't able to deal with the pressures that were brought to bear on them, and that's where I think we've had -- we've found the problems.

I think I'll end my comments there. I've still got a yellow light.

CO-CHAIR LEVITT: Thank you very much, and thank you for the passion of your presentation and your pace.

I have to say parenthetically that, having been through this for some years, personally I think that the profession today is better managed, better structured, than any time in my recollection. So I share your general view about the direction the profession is going. How we get there is the subject of this setting and these discussions.

The Chairman of the Committee dealing with firm structure and finance is Robert Glauber. I'd like to ask him to lead off with any questions that he may have. And I would hope that everybody tries to pose the questions succinctly, and that answers are as brief as possible, so that as many people as wish can participate in this very important discussion.

MR. GLAUBER: Mr. Chairman, I will try and respect your admonition.

A number of panelists have talked about the issue of transparency, and there has been I think widespread support of the EU directive on transparency, which particularly concerns itself with audit quality.

And on the issue of financial disclosure, I think there's a disagreement. Presumably, the purpose of financial disclosure would be to serve the public interest. And I'd like to know in particular, since I think that quite definitely Mr. Coffey and Mr. Nusbaum, you believe that there's insufficient financial disclosure.

I'd like to know what more you think there should be and how that would serve the public interest if there were more financial disclosure. And, Mr. Nusbaum, I think your view is there should be very limited additional financial disclosure, and I'd like to ask you on the other side, why would not more disclosure serve the public interest?

MR. COFFEY: Yes, sir. Well, I think you have to start with the premise that auditors are asking for special treatment here by virtue of what's claimed to be a significant financial risk in litigation. I talked at length about what I think the facts are with regard to that risk, but you don't have the second piece of the equation. You don't have enough information about the ability of these firms to withstand it.

You can look at some of the numbers you get from reporting by clients -- the Big Four, for example -- where you see that the revenues have increased dramatically since Sarbanes-Oxley. But we really don't have a sense of how well these institutions could withstand a mega judgment, and I think that they have to be forthcoming on that.

Now, what does that mean? I think it has two pieces. One is the income that they make in a particular year, and what they do with it, because apparently they send most of it out the door to their partners on an annual basis. And the second part is insurance.

I have had some dealings in my cases with insurance, and it's -- even when you're in a settlement context it is extraordinarily difficult to get to the bottom of what's out there.

Now, in a litigation context it's one thing, and I can understand that. I'm not happy with it, but I can understand it. But when you're asking to be treated specially -- investment banks are market actors. You can look at their balance sheet -- issuers, etcetera.

If the auditors wanted to be -- I think I heard the phrase before, if they want to have their cake and eat it, too, they've got to be more forthcoming. The threat is whatever it is. The threat to what? And I don't believe that we're anywhere close to that, and until we get there, along that road, I don't think that this idea of limiting auditor liability should be advanced.

MR. NUSBAUM: Let me answer that question in several aspects. First of all, we've tried -- the profession has tried to provide aggregate information to the Committee to hopefully analyze the profession better and spent a lot of time and effort putting that together, which will hopefully enable the Committee to reach some conclusions and analyze the profession adequately.

In terms of further disclosure for the public interest, I think we all believe -- and certainly I believe -- that we want to disclose things that will help improve audit quality, so things like processes for quality control, firm governance, those kinds of things, many of which are in the EU requirements really help enable the public, the investing public, to analyze and support the quality of the firms.

It's not clear how any further financial information is going to help investors analyze whether or not a firm is a good firm to do the audit or has the quality to do the audit there.

And I might also add, you know, I've heard many people say that the experiences in the UK, we'd all disclose this financial information and the world would not come to an end, and indeed it didn't.

And although I don't think it has changed anything from a public interest standpoint, the only thing that's different is every firm wants to have the highest earnings, so that they can attract the best personnel. And what we see is every audit firm seeking to disclose the highest per-partner compensation and drive partner compensation higher, so that they can attract the best people into their firm.

So our goal is we share the goal to support what's in the best interest of the investing public in those disclosures.

MR. GLAUBER: I think the argument from those who would advocate more disclosure would be that the public interest is served by understanding the safety and soundness of the audit firms with which corporations have to deal, and that further disclosure might support that.

Thank you, Mr. Chairman.

Oh, excuse me. I'm sorry. Mr. Fleck?

MR. FLECK: Perhaps I could give just one very quick input from the UK perspective. I don't think that disclosure of the information is limited to the financial stability. I think it is materially relevant to audit quality in three respects.

One is cross-subsidization, the second is the area of efficiency, and the third is the information it provides audit committees and this helps them in their relationship with the external audit firm and their ability to talk to them intelligently about how they conduct the audit. And they examine or discuss with them the structure of the audit.

MR. GLAUBER: Thank you. Thank you very much.

CO-CHAIR LEVITT: Tim? Tim Flynn?

MR. GRUNDFEST: If I may, just briefly from a litigation perspective, I think we can understand the push and pull, and we just might as well put it all out on the table. Plaintiffs' lawyers obviously would like to get the information, because it gives them an opportunity to calculate a bleeding point. You know, how much can we actually get from this -- how much can we actually get from this particular defendant? How far can we push in these negotiations?

On the other hand, any defendant in any litigation wants to avoid letting the other side know what the bleeding point is, and they would much rather continue to have the conversation over settlement operate around the notion of comparables that were agreed to in other prior forms of litigation. That is the litigation side of the debate, separate and apart from the public policy issues.

CO-CHAIR LEVITT: Tim Flynn?

MR. FLYNN: Thank you. Mr. Johnson, you talked about independent board members, and I think it's something very much worth pursuing. We've got the liability issues, how you actually track them, but setting aside that we could attract independent outside board members, what do you see the role of that board member? Is it just the same type of role that a public company board member would have in a public corporation, or is it a public interest role?

MR. JOHNSON: It would be a combination of both. We would see them representing the ultimate client of an auditing firm, and that would be the share owner of the companies in which they conduct the audits. And then, secondly, they would play an oversight role, an advice and counseling role, for public policy.

MR. FLYNN: But doesn't that oversight role possibly create some kind of conflict? If their role is to look at the safety and soundness of the institution in response to the shareholders, how do they balance that, then, with looking at -- you know, that they have then -- also have the public interest, the investors, that are not part of the ownership or part of the structure of the organization?

MR. JOHNSON: We wouldn't see that as being any different than the public policy role that directors may play at an automobile company or at an energy company or at a consumer products company or pharmaceutical company. There's a matter of public policy that these board members must take into consideration as well in exercising their duty as board members.

MR. FLYNN: So you're looking at carrying out their professional responsibility is -- in terms of their role as a public company auditor?

MR. JOHNSON: That is correct.

MR. FLYNN: Mr. Coffey, if you could look at, just for a second -- and, you know, there's lots of stuff in the litigation issue and debate about litigation, catastrophic, and other things. One of the things that -- in our system today is ultimately the decision is to take a case to trial and have a jury look at the case.

Can you give some insight from your experience how many cases actually go to a trial? And if, in fact, certain cases are brought today with the view that maybe they will never go to trial because involvement -- therefore, you might bring cases today that you wouldn't bring if that trial -- if that jury trial was a real possibility at the back end?

MR. COFFEY: Well, I guess let me give you a little bit of my personal experience. I have taken two -- I've gone to trial twice against auditors, both were Arthur Andersen -- for the *Baptist Foundation of Arizona* trial in 2002, which was the largest nonprofit bankruptcy in history, and that was an audit malpractice case brought on behalf of the estate, and, of course, WorldCom, where we went to -- against Andersen for five weeks until just before we closed and they settled.

It's my personal perspective every case I bring I intend to try, and I'm preparing for trial every day. Obviously, 98 percent or more settled. Maybe it's even higher in the securities context. And I think it's because there are some very, very experienced counsel on both sides who are able to counsel their clients as to the value of cases.

And it's extremely risky for defendants to go to trial. It's extremely risky for plaintiffs to go to trial. So most folks end up being equally unhappy and settling.

I don't think -- I think the point of your question was: do you bring a case even though you won't try it? No, I wouldn't do that. One of the things that has filtered through this discussion here and in other forums is the idea that the cases that really put an audit firm and other defendants at risk are somehow non-meritorious.

It is very difficult to get a case over a motion to dismiss, particularly against an auditor that the Supreme Court may clearly -- that you have to come forward, before you get any discovery, with cogent and compelling allegations that the auditor had a fraudulent state of mind.

Now, thankfully that rarely happens. But it does happen, and I know that I happened to deal with diverse auditor episodes in recent years, but it does happen. And so when you have a situation where there is significant liability exposure for an auditor, it is because the auditor didn't do -- did something very badly.

And so -- but generally speaking, cases settle. The reason the two cases I mentioned that I took to trial went to trial -- one, *Baptist Foundation of Arizona*, each side had a very strongly held but dramatically different view of the value of the case.

In *WorldCom*, it was all about -- and we told -- you know, we had already recovered $6 billion from other actors. But we said to Arthur Andersen, "You claim to be broke. Prove it." And it took five weeks of chasing around a courtroom before they finally agreed to show us their books, right? And this is a crippled company on the verge of bankruptcy -- if we wanted to do it.

MR. FLYNN: But that was after they stopped practicing, right?

MR. COFFEY: It was after they stopped practicing, yes. And -- but rather than put them into bankruptcy, we looked at their books and ended up settling for $65 million.

MR. FLYNN: If you look at our litigation environment in the U.S., and you superimpose upon that a more principles-based IFRS accounting world, how do those two things come together, and how do you think that really works? Will it just drive us right back into a rules-based world, because the system won't allow the principles-based in our litigation system to work in concert?

MR. COFFEY: Well, I really haven't studied that very much. You know, my reaction to rules versus principles is, you know, the difference between a town deciding that the speed limit should be 30 when they say 30 miles an hour, and then putting up, you know, "Just don't go fast."

I mean, there are problems with transitioning from rules where you have bright lines, where you give the auditor the ability to say, "You can't do that" in an environment where I have seen enormous pressures brought to bear on auditors, so that management can do what they want to do.

Ultimately, in the litigation context, I think it would be -- it gives the auditor I think a better defense than if it's

-- if they broke a bright line. If it's a gray line, I think it would make it more difficult to hold them accountable. On the other hand, it's probably an environment where if they've exercised their judgment that would be appropriate, that it would be tougher to hold them accountable.

MR. FLYNN: I'll yield. We have two more panelists who want to comment. I won't ask more questions.

CO-CHAIR LEVITT: Again, I'd ask -- I would ask the panelists for brevity, and I'd ask the questions to be brief.

Yes, quickly.

MR. FLECK: Might I just quickly comment on rules and principles and say that I certainly don't believe that principles are as soft as is implied. I always try to explain to people that principles are rules that are directed as achieving objectives. And you either achieve that objective or you don't achieve that objective.

Rather than the rules-based approach which said -- tells you how to do it, and I just would ask you to bear in mind that test, which I think is so important.

MR. GRUNDFEST: Very briefly, the data are clear that fewer than one percent of the cases that are filed actually go to trial. A great deal of experience suggests that one of the reasons for that is the very large adverse result in the event you are defendant and you lose a trial when you are exposed to the out-of-pocket damage measure. The numbers easily run into the billions of dollars.

Exhibit A, you had a look at the recent trial of JDS UniPhase. There, there were 24 counts of alleged material misrepresentation or omission. The plaintiffs in that case were seeking damages that under the out-of-pocket measure would constitute $20 billion, clearly would bankrupt every defendant and the company as well if they would have won on all 24 counts and if their damage theories were accepted.

The jury came back and held in favor of defendants on all 24 counts. Plaintiffs in that case got nothing. A very, very rare case of one of these situations going to trial. Also indicating that even if you get past the motion to dismiss and summary judgment, that does not indicate that the claim really has merit. It certainly has threat value, but even if tried to a jury does not mean it has merits.

CO-CHAIR LEVITT: Gaylen?

MR. GRUNDFEST: To put it fairly, on the other side of the fence, there was a verdict in Apollo, $200 million for plaintiffs.

CO-CHAIR LEVITT: Gaylen?

MR. HANSEN: Thank you.

CO-CHAIR LEVITT: Gaylen Hansen?

MR. HANSEN: Thank you. Mr. Coffey, I understand that you spoke almost entirely to cap limitations and liability, but

I wonder if you had any feeling or opinion about ADR techniques and whether they are appropriate, other type of trial limitations like period of time that you have to bring the suit, that sort of --

MR. COFFEY: Well, I'm a believer in the jury system, and I think that jurors almost always get it right. I mean, I was a federal prosecutor for a while. I tried a lot of cases. And in my view, the jury gets it right. And, unfortunately, in other areas, the securities areas, it's by perception.

And based on what I've heard in my conversations with people who practice there, that investors are generally not treated as well as they might be in the jury system. And so I don't think it's a good idea.

I think that, you know, this -- talking about the trial bar, and I read these editorials about the trial bar. And in my experience -- and it just may be me, but in almost every case where I've been in the courtroom there has been a defense lawyer there as well, and usually more of them, and they are better paid and better funded, etcetera. They are working pretty hard.

And so you have two gladiators in the courtroom, and in my experience juries get it right. And apparently they got it right in Apollo -- or, excuse me, in JDS UniPhase -- which, as I hear Joe, had a larger damage claim than in WorldCom. We didn't even ask for that much in WorldCom.

And so I would -- I do not believe ADR is right either for investors, and it's hard to figure out how you would do that in an open market case or in the case of audit retention letters. I think that, again, that would be diluting the incentive for auditors to do the job that is so critical to our capital markets. And, again, our recent experience is such that terrible things can happen when auditors don't do what we count on them to do.

MR. HANSEN: Thank you.

And, Mr. Grundfest, I've got a question for you. You talked about the limitations in the out-of-pocket model, and it sort of reminded me when I was in college and there was always a discussion about whether the books of the world balanced or not. And it sounds to me like in your mind they do balance.

MR. GRUNDFEST: Well, someone has a pencil who is keeping --

(Laughter.)

MR. HANSEN: But my question for you is -- and you did talk about the problems with the out-of-pocket, what you called model. Conceptually, how would you measure damages if you don't measure them that way?

MR. GRUNDFEST: I was afraid someone in the room would ask the obvious question. You'll notice my written submission doesn't go there, because I just sort of figured that I could take the high ground and say that everybody agrees that this piece of the system is broken.

And if we could get this group to agree with that relatively non-controversial proposition, that the current out-of-pocket damage system that can generate the $20 billion number that we saw in JDS UniPhase, that that is fundamentally flawed, and we need to go to something else. That would be I think a major step forward and a major contribution that this group could make.

And, again, in an area that is very controversial, finding one point on which you can get very broad support and build from that point is, in my experience, a very valuable thing to do in the policymaking process.

All right. Now, to attempt to answer your question -- there is just about as much disagreement in the academic community over what to do about this problem as there is agreement over the existence of the problem, its magnitude, and its serious adverse consequences.

At one extreme -- one group suggests that there be a schedule of penalties, payments, damages where you would look at the magnitude of the pricing distortion, the period of time, the amount of capital that was actually distorted, and come up with a formula that came to the formulas that already exist in the Securities Act of '33 and the Exchange Act of 1934.

Another approach which is at the opposite extreme in terms of ambiguity -- and the approach I just described being very precise, last approach being more ambiguous -- you would actually ask the courts to determine what economic harm was really caused by the mispricing separate and apart from the wealth transfer in a situation where investors sell into the fraud and make money because of the fraud, which equals the amount of money lost because of the fraud.

There you would take evidence about

whether other companies responded in terms of, you know, their prices and their activities in the market, whether employees were induced to join the company, because there were false representations to them that their stock options would be worth a great deal, whether lenders or suppliers of equipment took warrants or provided terms and conditions that would have been different from those that would have existed had proper financials actually been presented.

It would be more akin to the damages that you would calculate in commercial litigation. It would raise a different set of complexities. In some situations, in all candor, it could raise -- generate numbers that would be as large, if not larger, than the out-of-pocket measure.

Consider, for example, the MCI WorldCom situation where AT&T, it's publicly known, changed its corporate strategy because they couldn't figure out how to complete with

WorldCom.

So, you know, that approach isn't one that is designed to drive the numbers up or down. In some situations, it could actually give bigger numbers. It is one that would try to get at an economically accurate answer.

CO-CHAIR LEVITT: Thank you. These are complex issues, and asking you to keep the answers simple -- please, concise.

Rick?

MR. MURRAY: Mr. Chairman, one question for the panel, beginning with Mr. Coffey -- I think the answer is going to be concise. Mr. Coffey, you started with the unquestionable assertion that reliable audit quality is essential for investor interest.

And then, with appreciated candor, I think you said the sustainability of the audit firms capable of delivering that essential product really lies in the prudent judgment of the savvy investors who bring claims which could destroy those firms and the willingness of those investors to settle at prudent levels.

I am aware that your firm has met that standard, and I congratulate you and appreciate it.

I have two questions that go beyond the behavior of your firm. Claimant specialists very often are heard to describe this phenomena as let's not kill the goose that lays the golden eggs. My concern runs first to: what happens when the goose has a depleted egg supply and only one or two left? Will the same prudence likely have controlled the savvy investor?

And, secondly, with respect to the very different world of foreign investors, private equity, and now sovereign wealth funds, particularly sovereign wealth funds who come from parts of the world where respect for the importance of audit is not as well developed as in other communities, can we responsibly rely as an act of faith on those prudent self-controls to preserve the availability of quality audits for the capital markets?

And I'd ask that of you and Mr. Fleck and the other panelists.

MR. COFFEY: Yes, sir. Well, I was pointing out the role of the institutional investors is sort of a last-ditch circuit breaker. That is not often focused on. That is not to say that that's a principal line of defense, because it's not. There are, as I point out in my paper, all sorts of obstacles between the audit firm and catastrophe. You've got heightened pleading standards under the PSLRA, which have resulted in 40 percent of these cases being thrown out the ones that are even brought. Some are not brought.

Then, you have to come up with the fraudulent intent. You have to have cogent and compelling evidence of this. And then, you have a very significant point which is the proportion at fault. And as someone who has debriefed yours, after the *BFA* trial and after *WorldCom*, and tried each of those cases many times to mock juries, I can tell you -- I'm not happy to say this in front of Mr. Nusbaum, because he may repeat it back to me in the *Refco* case at some point, or his lawyers may.

(Laughter.)

But these are significant downward drivers. You have to persuade -- you know, you sit in -- you are in a jury -- in the courtroom, and you don't say, "They lied." You say, you know, "They didn't catch the lie, and they were lied to and they had counterfeit documents." And those are all things that really, really reduce the exposure of the audit firm. And, again, this presupposes some pretty significant bad conduct by the auditors.

Now, when it comes to non-securities cases, the private equity cases, I think, again, that is more where you get to -- you know, I am less comfortable opining on that, because I am not involved in those cases as much. But it is hard to imagine -- again, in the absence of knowledge about what the threat is to, what is the financial wherewithal of the firm, it's hard to imagine any of those cases being of such magnitude to put a firm at risk.

It may be painful, and I can tell you that as someone who represents institutional investors, if we think an accounting firm has done bad things, we want to make it a painful result. But it's hard to imagine in those non-securities cases there being such a magnitude that it would put them at risk.

Again, the point I make is that after a whole series of wickets, you get down to that last circuit breaker, which I believe was demonstrated in *WorldCom* and would be in any mega case, an institutional investor, that understands the importance of each and every accounting firm we have left, and would not want to see that number reduced.

CO-CHAIR LEVITT: Rick, is that --

MR. COFFEY: Did I answer both your questions? I know I didn't do it specifically for either one, but --

MR. MURRAY: I take the Fifth on that.

(Laughter.)

I would be curious if others on the panel have a different view.

MR. NUSBAUM: Well, I'll just -- I mean, I -- if the question is, is there a real risk of catastrophic loss, I mean, the answer is yes. I'll be brief.

MR. GRUNDFEST: With regard to the last-ditch circuit breaker argument, if the circuit breaker doesn't kick in at the level of actually getting a settlement, then in my experience when you take it to trial, you basically put the pedal to the metal, and you ask for damages and the like that would bankrupt everybody. Exhibit A, the JDS UniPhase trial.

With regard to proportionate fault, you know, if a proportionate number -- a proportionate percentage of an irrational number is still an irrational number.

CO-CHAIR LEVITT: Bill Travis?

MR. TRAVIS: Let's start with Mr. Fleck. We've talked today about the diminished brand of the audit profession. You've made some reference to that in your remarks, and in your paper you said -- you raised the question whether there is tension between running a multi-faceted business and providing a professional service, highlighting the words "objectivity" I think in your words.

Can you talk a little bit more about your views of that issue?

MR. FLECK: Very briefly. Thank you for that. I think that -- that there is computational authority certainly on my side of the Atlantic. On a number of occasions, it has probably not helped the future of the profession -- one by encouraging competition in a way which has not put an equivalent amount of protection on the values of the important components of professionalism and integrity. And, secondly, obviously through the concentration in the marketplace.

But what I have noticed throughout the 30 years that I've been involved in this is that increasingly clients view accounting firms in the UK as people who provide a multitude of services, and not as professionals whom they want to turn to for the level of independent advice and judgment, which they did when I first started working in London.

And the result, as I said earlier, nowadays I very rarely go to a board meeting and have a senior partner from an accounting firm present when they make a serious decision about whether to proceed with a transaction or make a judgment about the future of the business.

And I think that is a tragedy for the profession, because there is no question that if you are operating at that level, it enhances your approach to integrity, it enhances your self-respect, self-esteem, it enhances your ability to recruit the right people, because it is a job which has real self-respect and job satisfaction.

And I think this is an incredibly regrettable development over that 30-year period.

MR. TRAVIS: Are there any studies going on in the UK or Europe on this issue?

MR. FLECK: Well, in a sense there have been, because after the Enron/WorldCom sagas, we had the consultancy in -- which the UK government set up, which looked very carefully at which practice areas were incompatible with the audit function.

And in the UK, we produced a

completely new suite of ethical standards which looked at each and every non-audit service, and prohibited a number of them -- even though that -- with a smile on my face I say we are a principles-based jurisdiction.

We still prohibited quite a number of them, because we thought they were fundamentally incompatible with the role of an auditor. And each of those was judged by reference to the -- the position of an auditor, what you're doing in the audit process, not just simply at large.

MR. TRAVIS: Okay. Ed, in your paper, you make two recommendations. One, you suggest that the Advisory Committee encourage public recognition of other global networks, and you also make a suggestion that the Advisory Committee require audit firms to share fraud detection.

Those sort of things are interesting. I'm curious why those recommendations ought to come from the

Advisory Committee as opposed to being considered in the CAQ.

MR. NUSBAUM: Well, first of all, we address the public recognition of other networks. I think the -- this Committee, when it issues its findings and reports, will make a major statement about the profession. And that statement will be heard throughout the United States and throughout the world.

And so it's important that whatever statement is made applies to the entire accounting profession, and all of those many auditors, hundreds of firms, that serve public and audit public companies, and hopefully serve investors.

So it's not a matter of four firms or five firms or six firms or seven firms or eight firms, and the eight firms that serve on the CAQ -- certainly, the CAQ is represented -- representative of all of the public company auditors.

But we want to encourage this

Committee to be very careful in its recommendations to embrace the concept that there are many major accounting firms, many of which have global networks in hundreds of countries, that audit public companies and serve the public interest. So that's really the essence of that recommendation.

The second recommendation really goes beyond just what the Center for Audit Quality can accomplish by itself, and that is on fraud. We believe that, you know -- and it's virtually impossible to catch and detect all material fraud. It's just like police will never stop all criminals; auditors will never stop all fraud.

But having said that, it's the responsibility of the profession and beyond the profession, the entire capital market system, to try to reduce the likelihood that a material financial fraud will occur and not be detected.

So we think that the auditors,

working with other participants in the capital market system, preparer organizations, regulators, and so forth, should work hard to research and develop new techniques, to share ideas, and to improve and increase the likelihood that material financial fraud will be prevented or detected.

And so we are asking the Committee to embrace that concept.

MR. TRAVIS: Okay. Thank you.

CO-CHAIR LEVITT: Thank you very much.

Lynn Turner?

MR. TURNER: Thank you, Mr. Chairman.

To be short, I'll ask you each a question. And then, after I've asked it, you can think about it, and the other ones can start answering.

CO-CHAIR NICOLAISEN: Lynne, get closer to the mic. The reason why I'm asking people to get closer to the mic is this is webcast and it's -- for those not in the room, it's hard to hear.

MR. TURNER: Sorry, Don.

Let me start with Dennis. The question for you, Dennis, is you note in your remarks that you use Macias Gini, a well-known local regional firm around here, which my own experience has been very favorable with in the past. But if a firm changed from a major Big Four firm to a firm like a Macias Gini, or like a BDO Seidman, or Grant Thornton, would CalPERS view that as a negative, just because they are moving from large down to small? And how would you view that in the marketplace?

Let me ask everyone the question.

Richard, in your testimony you had some very good remarks about the audit report and audit quality. Question for you is: are there specific things we should think about in terms of expanding or changing the audit report? I was intrigued by some of the comments you had. And what are you looking or thinking about in that respect over in the UK?

Paul, you mentioned the fact that many of these frauds, the auditors found it, never reported it. In retrospect, looking back at those, is there any one thing that could have been done that isn't being done, or that would help ensure that those things get brought to the Audit Committee or investors rather than staying behind closed doors, and, quite frankly, getting the problems -- get the firms into problems which can turn into the type of problems that Ed talked about?

For Joe and for John, what impact are the court decisions having that were made in *Dura Pharmaceuticals* a few years back, now *Tellab*, and of course the other day *Stoneridge* -- what impact would those have going forward on the amount of litigation? And on that litigation, what is the impact of having a lead plaintiff now under PSLRA in terms of the quality of the litigation?

And last but not least, for Ed, the

question is: again, you bring up the business judgment rule, and I'll ask you the same question I asked Cindy earlier. In the major frauds that we've seen, the major corporate scandals, are you aware of any of those where the auditor's judgment was inappropriately challenged?

MR. JOHNSON: Since I was the recipient of the first question, I will answer first. In terms of how the market would respond to companies going from a large auditing firm to a smaller auditing firm, we think, really, the response by the market really gets captured in the explanation that is given by both the company and the auditor for the change.

And this is something that, to the extent possible, we would encourage this panel to look very closely at, to strengthen the rulemaking in this regard so that companies are able to provide a very detailed story, if you will, about why there is a change in auditors, so that the share owners in the company can be well informed and not operate with the perception of either something positive or negative potentially driving that change.

MR. FLECK: I'm frantically writing.

(Laughter.)

I think we're trying to achieve two things. We are trying to shorten the audit reports and get rid of the boilerplate that's -- the first whole page of the audit report that is, frankly, of very little value to any reader.

It is being built up -- an attempt to try and educate people, those people that read it. It plainly can't be educational.

Second is that I think it would be much clearer about the message that is being given. One of the great worries I have is that most people don't actually read a written report at all. As soon as they know it's an audit report, they turn to the next page. That seems to me to be rather unsatisfactory, and I think there are two elements to be addressed there.

First is to focus on the three parts that we have that are -- that go to make up an audit report or the auditor's report. The first is: did the accountants comply with the accounting framework? The second is: has the company complied with relevant rules and regulations to the extent that the companies -- the auditors are required to report, either by exception or positively in that regard? And the third is an overarching judgment about whether the account is fairly presented or shown in fair view.

And the third thing, which is in relation to that, is that I hoped the -- much better sections of an opinion that address areas where people believe that they should be drawing shareholders' reports -- attention to matters. And I actually don't believe it is adequate just to do that by saying, "See note 33-1/2."

(Laughter.)

I'd like to see them put a little bit more -- with more responsibility being adopted by the auditors on the face of the report.

MR. TURNER: Joe and John?

MR. COFFEY: Do you want academia or real world first?

(Laughter.)

MR. TURNER: Well, since I've been in both, it doesn't matter.

(Laughter.)

MR. GRUNDFEST: John, it's for you. Go ahead.

MR. COFFEY: Well, I hate to give the last word, but I will.

(Laughter.)

MR. GRUNDFEST: That's what you get for calling me an academic.

MR. COFFEY: The recent cases

definitely have an effect. *Dura*, which requires the plaintiff to plead a definite link between the alleged fraud and the drop, has had an effect. I had a significant case thrown out last week at the summary judgment stage, after a lot of jury work, because despite the fact that the judge was presented with evidence that this company had lied to their auditors, two sets of auditors, and the SEC, paper documents to get out of an SEC investigation, did not find a sufficient link to the drop. Threw the case out. It will appeal, but it's having an effect.

Stoneridge gives me a chance to talk about my example. In the *Refco* case, there are a number -- it's one of the biggest, most amazing frauds in history -- 45 days from IPO to bankruptcy. There was an audit firm involved -- Grant Thornton. I won't get too much into the facts other than the receivable that was hidden at the end of every reporting period was multiples of the annual pre-tax income of that company.

Okay. We've sued GT. They are still in the case. When it comes to the third parties that facilitated hiding the receivable, the Supreme Court says, "We can't sue them." We are fighting the fight of our lives over the law firm in which a partner has been indicted for papering those transactions.

I believe, because our papers are in, that we should win. But there are very significant law firms on the other side saying we should lose, and we may. What is going to happen when we go to trial in that case? Because I -- that's the case I intend to try.

You're going to have GT sitting at the table sharing blame with the bad guys inside the firm. But the folks who helped -- who actually facilitated this -- hid the receivables -- won't be at the table, and I would submit can't be on the jury verdict form.

So when the jury is asked to say,

"Okay. How much do you get for the CEO? How much do you get for this CFO?" and then, there is GT by itself, it is going to be a fraction of what the other folks are. I'll concede that here in the open.

But clearly whether -- it would be somewhat smaller if you had sitting on the jury verdict form the names of the third parties that hid the receivable, the law firm that papered it. *Stoneridge* says, "Too bad, Grant Thornton." So this is going to have an effect.

Lead plaintiffs, your other question -- it has definitely had an effect. Most -- 14 of the 15 largest settlements in history have been with institutional investors, and here is what's happening. The recoveries are getting better. It's ironic when you look back to when the PSLRA was advocated, one of the major arguments was the recoveries are too small. Now people want to tinker with it. Why? Because the recoveries are too big.

Second, you have institutions that are keeping -- are controlling the lawyers. You have fewer law firms on these cases. They are driving attorney's fees down. Joe, the next time you write an editorial for *The Wall Street Journal*, please write it as if it's 2008, not 1994, when it comes to attorney's fees.

And so -- and they are also getting corporate governance in a lot of these cases, which is making the capital markets safer tomorrow than they were yesterday as a result. So the institutional lead plaintiff, I have my issues with the PSLRA, but that was a stroke of genius. And it really has made a very, very important difference.

MR. GRUNDFEST: Perhaps a somewhat different perspective, with regard to the Supreme Court's decision in *Dura*, what *Dura* actually did was it prevented an extension of the law based on a decision of the Ninth

Circuit that was out of step with every other circuit.

Had the Supreme Court decided differently in *Dura*, then the law would have been dramatically expanded in terms of allowing plaintiffs to bring cases with a much weaker nexus between the alleged misrepresentation and harm that was caused to anybody.

Therefore, the way I would look at their decision is it preserved the status quo rather than cut back on any right that the plaintiffs actually had. It slapped down a Ninth Circuit decision that was out of pace with all of the other circuits.

Second, with regard to the *Stoneridge* decision, here, you know, with all due respect to John, I think many people in the plaintiff's bar consciously mistake the holding in *Stoneridge*. There is no other way to put it. *Stoneridge* does not allow anybody to commit a fraud. It does not vindicate any action. It doesn't give anybody a safe harbor from any action.

All it says is there is a certain category of actions that can be pursued by the United States Department of Justice and also by the SEC, but you cannot have a private implied right of action to pursue those individuals.

So going, for example, at the law firm that Mr. Coffey is discussing in the *Refco* matter, the partner in that law firm has been criminally indicted and faces the prospect of losing essentially all of his net worth and of going to jail for a material period of time precisely for the activity that Mr. Coffey is complaining about.

Now, Mr. Coffey's additional complaint may well be that he cannot also bring a private claim and recover money for his clients and get a percentage of that claim, but that is a very, very different proposition of law, and I do wish that the plaintiff's bar would be a little bit more accurate in this area.

Nobody is saying that any of this conduct is at all legal. The conduct, you know, if it occurred as alleged is clearly illegal. The SEC can and should go after it. The Justice Department can and should go after it, and they both have.

The issue is: can you expand the implied private right of action? Important going for --

MR. TURNER: Not to cut you off, but --

MR. COFFEY: Well, can I just point -- that in *Stoneridge* the SEC did not go after them, I mean in the very case itself, just as far as --

MR. GRUNDFEST: Well, actually, there was a parallel case involving --

CO-CHAIR LEVITT: Can we get the final question answered?

MR. GRUNDFEST: Very simply, I

think it's too soon to tell. I think there is ambiguity in the way the Supreme Court wrote that decision. I would like more experience to see what happens at the District Court and the Court of Appeals level before expressing a view.

MR. TURNER: Paul?

MR. REGAN: Just in case anybody has forgotten the question that I was asked, it was, given that when I testified earlier I indicated that the issues involved in these substantial frauds were on the table for the auditors, and they failed to communicate it to the Audit Committee and to the Board of Directors.

I am on audit committees, and I like to spend time privately with the auditors. I think the rules are in place. It's a bit like the audit standards I've talked about, the auditing procedures and audit standards. They are in place.

I think there are no more rules

that you need to have in place to make that happen, but what there needs to be is an appropriate level of risk for when it doesn't happen, that the auditor needs to have clearly in mind that will happen has a result of a failure to communicate.

And there is one other thing, and I think this is -- this will be controversial. But one of the other things that I've seen in the audit failures that I work on -- the GAAP and GAAS failures -- is that if there is firm rotation it causes management and the auditors to be much more careful and much more rigorous in not tolerating stretches or not tolerating inappropriate GAAP, because firm rotation is a much more risky event to the firm and to the issuer.

I think audit rotation has done that on occasion -- audit partners' rotation, excuse me. But I've seen too many instances where that has not worked, that has not stopped the fraud. Firm rotation has done that, and that happens in other countries in the world.

MR. NUSBAUM: Well, Lynn, I'm glad you didn't ask me about *Stoneridge* --

(Laughter.)

-- business judgment and professional judgment framework. As you know, I am on the CIFR Advisory Committee/Subcommittee that is making the recommendation on the professional judgment framework.

And that framework, although hopefully it might have an impact on the 1,800 restatements that occurred during the course of the year last year, was not really designed because of legal liability. In the professional judgment framework, at least as it's coming out of the SEC Advisory Committee, what is intended is to improve financial reporting and reduce complexity for financial reporting.

And so the basis for that was

starting with companies, not with auditors, but with companies to have them try to do a better job considering accounting alternatives and looking at the various alternatives, and then documenting those alternatives that they picked and the judgment and basis for that selection.

And then, having the auditor come in and review that and work with that judgment/framework to make sure that documentation is adequate and that all of the different accounting estimates and alternatives were properly considered.

And then, the regulators review it as well. There is never an intent that the auditors shouldn't audit it. There was never intent that a regulator shouldn't review it. But instead, to try to have better judgments, have better judgments documented, and enable the auditor and the regulator to use that judgment and come up with better financial reporting.

Now, hopefully, if that works, maybe we will see less restatements. Maybe we will see better judgments made. Maybe we will see -- hopefully we will see the ability to make more principle-based standards such as IFRS and other judgments.

And hopefully our audit staff, as well as companies, accountants, and regulators, will feel like -- more like professionals and embrace judgment. But it was not intended to reduce legal liability, but instead to focus on better financial reporting, and we support this.

MR. TURNER: No specific examples.

MR. NUSBAUM: No, I don't think that's what it was intended for. So, you know, we never --

MR. TURNER: My question was, were you aware? Okay.

CO-CHAIR LEVITT: Thank you.

Jeff Mahoney?

MR. MAHONEY: Thank you, Mr.

Chairman.

Mr. Nusbaum, in your written testimony, your testimony indicates that competition in the audit market may be increased by comprehensive disclosures about the reason for auditor switches.

Last fall, the Council's membership approved a policy supporting better disclosures for auditor departures, and we recently sent a letter to SEC Chairman Cox and the heads of the three stock exchanges supporting rulemaking to address this issue.

Can you briefly comment on why you believe better disclosure about the reasons for auditor departures may be an appropriate means of enhancing competition in the audit market?

MR. NUSBAUM: Well, first of all, you know, Grant Thornton, and I think hopefully the entire profession, embraces more transparency around a variety of things. And we think that the 8-K requirements should be expanded, and that companies should disclose the reasons for changing auditors. We think that is in the best interest of investors.

Why all this competition? Because it enables investors and audit committees to better understand why companies are switching auditors, and is -- as Mr. Johnson has pointed out, the fact that there are many audit firms, indeed hundreds of audit firms, that could do those audits, and embraces that concept. So we think it's in the -- not only in the best interest of investors, but it's in the best interest of competition and the profession.

MR. REGAN: Mr. Mahoney, I'd like to make a comment on that. One of the things that I think you folks ought to give some thought to is that if there -- you keep audit partner rotation, if an audit partner is early rotated off of an issuer, there ought to be a disclosure, and there ought to be communication from the partner who was rotated off early as to why he was -- he or she was rotated off early, because in many instances that -- there's controversy there.

CO-CHAIR LEVITT: That's it?

MR. MAHONEY: Thank you.

CO-CHAIR LEVITT: Mary Bush on the phone has a question. Mary?

MS. BUSH: Yes, thank you. My question is for Ed Nusbaum. Can you hear me?

MR. NUSBAUM: Yes.

MS. BUSH: Okay. You mention in your paper, you talk some about the federation style of ownership, and that thought is being given in various circles to other forms that might make sense. I wonder if you could comment a little further on your views about the federation style and any comments you might have on other proposals that you might have heard.

MR. NUSBAUM: Well, first of all, I think all of the major accounting firms are structured for the most part the same. That's global networks with member firms in each country.

And we think that that form of structure works, and that the global networks are pushing for consistent audit approaches and consistent audit quality using the same tools on a global basis. Certainly, that is the basis for Grant Thornton.

We are, in our written comments, concerned about the idea of accounting firms going public, but certainly firms have some capacity for doing that, and it could work. We're concerned about that.

We think that all of the different possibilities of ownership should be explored, and we think that the global structure today enables firms to use a consistent audit approach and embrace quality on a global basis as we do at Grant Thornton International, and I think all of the major firm networks do.

MS. BUSH: And capital, you say, is not an issue, not a constraint.

MR. NUSBAUM: Well, any capital,

you know, is always -- it's always nice to have more capital rather than less. I think that's a fair statement.

But first of all, in terms of Grant Thornton's organic wealth, our ability to add people and add clients, certainly capital is not an issue, because, of course, we just -- we're not that capital intensive kind of business. We have receivables, we have computers, we have some furniture, and we have some lease-hold improvements. It's not that complicated.

Certainly, if you wanted to do massive acquisitions, capital might be necessary. But, of course, with the risk of catastrophic litigation, it would be extremely difficult I think to raise capital in most markets.

MS. BUSH: Thank you.

CO-CHAIR LEVITT: Okay. We ran a little bit over time. I'd like to suggest that we reconvene at five minutes after 5:00

for the next panel. This has been an extraordinarily informative panel. It has been very, very helpful to us, and we are grateful for your participation.

Thank you so much.

CO-CHAIR NICOLAISEN: Could you indulge one --

CO-CHAIR LEVITT: Yes.

CO-CHAIR NICOLAISEN: -- more question? Damon has a question.

CO-CHAIR LEVITT: Okay. One last question.

MR. SILVERS: Thank you, Arthur, for your kindness.

First, you know, Professor Grundfest is I think the -- sort of the accumulator of the leading data on securities litigation. We have some information from the profession on that, but it seems to have conflated class actions, trustee actions in bankruptcy, and actions by clients.

I would appreciate if your folks,

Professor Grundfest, would give us a breakdown of actions brought in each category over the years, damages in each category.

MR. GRUNDFEST: We are happy to do everything that we can. I'll tell you everything that we have done is pretty much already in the public domain. We don't keep secrets. Generally, we do something, we put it out there.

I just might make an observation. There's a statistic that we publish that is so often misunderstood that I think we have to go back and put some more caveats around it, and that has to do with the number of audit firms that are sued.

What we track on the initial filings -- all right -- we don't track the ultimate amended complaint, and it is true -- Mr. Coffey's citation to our data that there are only, you know, one or two audit firms named that have been sued is correct, but only in the initial complaints.

There is a larger number of audit firms that are then sued after you get a certain amount of discovery and you can amend.

MR. SILVERS: I really don't want to have this now. I'd like to get this fleshed out in data form.

The question I had was, really, to Dennis Johnson and to Mr. Regan. My impression is that investors in the area of litigation are actually most focused not on recoveries and whether those are fair or not, and whether the damage measure is the correct damage measure, but rather on the deterrence issue.

I think both of your testimony has touched on that a little bit, and particularly Mr. Regan's testimony about the intensity of the pressures in the other direction on audit -- on engagement partners. And I hope that each of you could comment a bit about deterrence, its value, whether you think our current litigation system, combined with regulation and oversight, provides sufficient deterrence, and what the down side on deterrence might be of weakening that system.

MR. REGAN: In my working in this profession for 40 years, and in many of the investigations, I believe the PSLRA did have the result of emboldening bad acts, because it made it more difficult for detection, and it made it more difficult for -- the risk of audit failure became less.

So I think PSLRA revealed that. I think Enron, WorldCom, and the others brought new light and awareness to the risk.

One of the things that -- in my answer to Mr. Turner I indicated that one of the things which needs to be in place for continued good audit procedure is that there is -- there continues to be healthy respect for the risk of audit failures, because it's too easy to side with management. The pressures are enormous to side with management. They need to be rewarded for doing that.

So I think it -- you need to have that risk alive and in place. Now, does that mean you need to be exposed to catastrophic audit failure, and another firm going out of business? I hope you can protect that from happening, because I don't think that is good for the country. I don't think that's good for the capital markets.

But many of the litigation -- much of the litigation that we work with is not on behalf of a class of shareholders. It's on behalf of a bank that lent money to an entity based upon overstated assets. They are discrete, there are particular liabilities which are easily quantified and determined, and they are not catastrophic.

So I encourage this Committee to continue to put into the capital markets the risks of audit failure on the backs of auditors. I know -- you know, that's hard for me to say, because it -- you know, I thought

-- I continued to believe that Arthur Andersen was a spectacular firm, and 99.99 percent of the people were very good and capable, hard-working people. And I think the firm paid a terrible price, probably more than it should have. But there needs to be an appropriate amount of risk for not doing your job when you're an auditor.

MR. JOHNSON: Deterrence is a very valuable asset, if you will, for a long-term investor for CalPERS. We have investments totaling $240 billion and over 8,000 companies. We do not have the ability to buy and sell in response to bad acts at public companies. And so any activity that can be put in place to improve behavior and to deter the conduct of bad behavior we think best serves investors, and long-term investors in particular like CalPERS. And there certainly is more work to be done in this regard.

CO-CHAIR LEVITT: Okay. Thank you very much. We will be back promptly at 10 minutes after 5:00.

(Whereupon, the proceedings in the foregoing matter went off the record at 4:55 p.m. and went back on the record at 5:10 p.m.)

CO-CHAIR LEVITT: Can I please ask everyone to take their seats? Do we have all our panel members here?

Okay. The first panelist is Annalisa Barrett, Vice President and Senior Research Associate from The Corporate Library, a partner of close friend Nell Minow.

Annalisa?

MS. BARRETT: Thank you very much for inviting The Corporate Library to speak to this Committee today. Should I go ahead and start?

CO-CHAIR LEVITT: Yes, but close to the mic.

MS. BARRETT: Okay. Yes, we thank you very much for the opportunity to speak with you today, and we actively promote the importance of transparency of information presented by U.S. companies, because we believe that better transparency permits better oversight and decisionmaking by investors.

In fact, our founders -- Bob Monks and Nell Minow -- have spent their careers establishing and fighting for the rights and responsibilities of investors, and transparency is required for these rights and responsibilities to be exercised effectively.

We strongly agree with the overarching principles set forth in the committees working outline, to create such an outline related to the audit process and the audits that contribute to investor confidence in financial statements by ensuring that financial statements are reliable, complete, and timely.

The audit process and the audit should contribute to the transparency of financial reporting for preparers and investors. We hope that the information provided by The Corporate Library here today and in the packet submitted to you would help the Advisory Committee to know the goals based on these important principles.

In August 2007, my colleague Paul Hodgson wrote a report examining the audit profession over the last 50 years. The report includes information on the fees U.S. public companies have paid outside advisors, outside auditors, as well as its share of the U.S. market held by auditing firms.

For the purposes of this discussion, I will focus on the findings related to change in market share among audit firms in the United States.

In the auditing paper, The Corporate Library conducted an analysis of the Big Four firms which remained after Arthur Andersen departed the market, and it also identified non-Big Four firms with clients among companies studied. The study includes

1,293 companies for which we have data between 2001 and 2006. And, therefore, it provides a very accurate picture of the changing market share of the audit firms included in the study.

The percent of companies audited by firms other than the Big Four or Five, depending on the year, has increased over the last six years. In 2001, 2002, and 2003, only two percent of the companies in the sample used firms which were not in the Big Four or Five. In 2004, the percentage increases to three percent. In 2005 and '06, it is five percent.

There are 22 non-Big Four firms which have a presence in the marketplace as of the date of the study in June of 2007, and among those Grant Thornton, BDO Seidman, and McGladrey & Pullen have the largest market share. And there are 19 other firms with very small market share -- under three percent.

All of the data in this report

tells us there is a high degree of concentration among auditors. We've got something we're all familiar with and comfortable with, but to have the data there to tell us that is helpful.

The question is whether or not this is good for the auditing process, and whether it allows audits to contribute to the transparency of financial reporting, and, therefore, investor confidence. And we think the answer is no.

In our view, investors would be better served if the audit market was not dominated by a few large firms. If there are more big firms providing audit services, then the potential for entrenchment would be lessened.

When we evaluate -- we at The Corporate Library evaluate the effectiveness of boards of directors, we take into consideration the level to which management and/or the boards of directors are entrenched and potentially holding too much power or not considering new ways of approaching their business or serving shareholders.

The potential for entrenchment is also a risk for auditors. In fact, while we do not support or advocate mandatory audit firm rotations for all companies, we have supported a requirement at certain companies which calls for the audit firm or partner to be rotated every few years. This is recommended when the board has a history of tolerating entrenchment, either among its members or among the leadership of the company.

If the board has not been able to spot the risks associated with entrenchment in the past, the company may be better off having an audit firm or QC policy in place.

We also suggest that all companies provide comprehensive disclosure regarding their policy on rotation of audit firms or partners and their procedures for ensuring auditor independence. Additionally, we support the harmonization of global accounting standards, as long as such standards continue to require a high level of transparency.

All U.S. companies should disclose how they are preparing for the global conversion to the accounting standards and related changes. Not only would global convergence of accounting standards allow for more ability for shareholders to compare financial information across borders, it will also open the auditing market in all countries and provide a more diversified pool from which to select an auditor.

More details regarding the information that I summarized very briefly in the beginning is available to you, and I have given Kristen the information regarding the report.

I hope that this is helpful information, and please let me know if you have any specific questions.

CO-CHAIR LEVITT: Thank you very much.

The next speaker will be Paul G. Haaga, Jr., Vice Chairman of Capital Research and Management Company, and former Chairman of the ICI, the group representing the investment companies of America.

Paul?

MR. HAAGA: Thank you very much, Chairman Levitt, Chairman Nicolaisen. I really appreciate the opportunity to appear before you today.

I want to thank a couple of my colleagues -- Brian Bullard, the former Chief Accountant of the Investment Management Division; Mel Spinnella, head of our Fund Accounting Department -- who are here with me, and Elizabeth Mooney, who is a Research Analyst focused solely on helping other research analysts read and understand financial statements -- for helping me with my testimony.

We come at this -- the accounting profession -- from different directions. Our management company, Capital Research, is an audited, though not public, company. The mutual funds are, of course, public companies, and they have auditors in a very specialized area. But I think the most important area that we come at this, and what I'd like to focus on today, is that we are consumers of financial statements.

We are the largest active manager of equity securities. We have about a trillion dollars in equity securities under management. In our organization, we rely very heavily on the audited financial statements of the firms in which we invest, and are probably our biggest concern.

We were delighted to be able to testify before the SEC's Committee on the Improvements in Financial Reporting.

If you only hear one thing from me today, hear this, please. And that is that it's critically important that investors be engaged in all aspects of the consideration of improvements, not just in accounting standards but also in the accounting practice, dealing with conflicts and other matters, litigation issues relating to accountants. We are critically important consumers.

We represent the investing public in that, and we really appreciate your involving us, and we'd like to be involved as investors in a more formal way in some of the committees that do deal with this.

Okay. This is -- the panel is about concentration and competition. Let me just -- I'll give you a couple words, and then we'd be happy to answer questions. We do not see a problem with the current situation in terms of competition. Four firms is -- four big firms is not a lot, but we don't think that the potential consequences of the loss of one of those firms would justify a too big to fail -- or too few to fail more properly --

standard.

We also think the emphasis on competition is probably misplaced when it is focused just on keeping fees down. I think audit committees do a very good job of keeping fees down and wouldn't want to promote competition simply for the purpose of competing over fees. We think our fees are reasonable, and our view would be that the companies in our portfolios pay fairly reasonable fees. In fact, we wouldn't mind seeing larger fees if it would increase the scope of the audit and be better at detecting fraud.

Secondly, we would -- while we support some important changes to the litigation environment, we would not -- at this time at least -- support caps on fees. We are looking to strike a balance between the -- sort of the in terrorem effect --

CO-CHAIR LEVITT: Caps on fees, or caps on penalties?

MR. HAAGA: Excuse me. I'm sorry. Caps on liability for auditors. Excuse me. Thank you. I apologize. No caps on liability for auditors.

Finally, we think that the biggest improvements that could be made here are in the governance and transparency area. We would support independent boards for audit firms with independent nominating committees that chose their own members.

We would also support more transparency in disclosure or reasons for change in partners, disclosure of any liability limits, or mandatory alternative dispute resolution procedures, engagement letters. Most important of all, we would like to see more disclosure regarding estimates and the judgments that were made about them particularly when there were differences of opinion.

And, finally, I'd just like to -- I've heard a lot in the previous panels about

IFRS and U.S. GAAP versus IFRS. When I asked my colleagues who are analysts a straightforward question, "Do you have a -- is it more effective when you look at U.S. audited financial statements versus non-U.S. audited financial statements, can you get more out of them as an analyst?" Their answer consistently is "U.S.," so I would be cautious about wholesale adoption of non-U.S. standards.

Thank you.

CO-CHAIR LEVITT: Thanks a lot.

The next speaker is Brad Koenig, former Managing Director and head of Global Technology Investment Banking at Goldman Sachs.

MR. KOENIG: Thank you. I was at Goldman Sachs, and, as was mentioned, was head of the investment banking technology global effort for over 15 years, and as such I worked with many venture capital-backed companies, all the way through billion dollar companies at various stages of development, and also represented hundreds of companies in underwritings, whether it was initial public offerings or IPOs or follow-on offerings of equity debt convertible.

And the perspective that I have been asked to comment about is the perspective of an underwriter on this issue of concentration and competition. So our focus as an underwriter is that we present to the investors information which is accurate and complete and fair, and so in that way we rely very heavily on the auditing profession, and it's vital that that profession and that service remain strong and vibrant and competitive.

We are also concerned very much about our liability management as an underwriter, and also very importantly with our reputation. In terms of the data, as the General Accounting report -- the GAO report shows, that for much larger companies there is very heavy concentration. For companies over $500 million in revenue, about 95 percent of those companies used Big Four accounting firms. And then, at less than $100 million, about 22 percent use non-Big Four public accounting firms.

The data that I presented and was sent out to the Committee previously reviewed companies that were undertaking initial public offerings. So that is the new population of companies that is entering the field of public companies. And the time period reviewed as 2002 through 2007, so it was from the period of the adoption of Sarbanes-Oxley and the Enron fallout until the present.

And over that time period, there have been 817 initial public offerings in the U.S. over $20 million in size. And of those, 713, or 87 percent, had Big Four accounting firms that presented the audit, and 104, or 13 percent, were audited by non-Big Four.

And of the non-Big Four, of the

amount, that 104 that were conducted by non-Big Four, three firms, the three that were mentioned earlier, accounted for over 50 percent of that total. So the overwhelming proportion of companies that went public had audits that were completed by non-Big Four -- by Big Four companies.

Interestingly, the non-Big Four share has over time increased from a small one or two or three percent in 2002 and 2003 to over 20 percent in 2007. So there is a shift.

Some observations from the underwriter's perspective -- first, in terms of the firm's internal evaluation and business selection criteria, we did not differentiate between any of the Big Four. So if there was any Big Four that was present on an underwriting, we felt that represented the Good Housekeeping Seal of Approval, and we were very satisfied to that.

We did recommend -- make recommendations, clients were considering retaining various auditing firms, and they employ their own criteria in terms of price, service, expectation, relationships, and so forth.

So in our internal evaluation we were completely comfortable if a Big Four firm was providing the audit, and so it was a 10 on a scale of one to 10. If it was a non-Big Four firm, as we learned in business school and also our Goldman Sachs corporate finance training, that presented a potential red flag. And so the onus on the team to do incremental due diligence and get comfortable with the financials was higher and was elevated.

And more importantly, if the financials were very clear and simple, and it was a non-Big Four, then that would be maybe a seven on a scale of one to 10. But if there were issues with the financials, that would make it almost a three or four on a scale of one to 10 in terms of degree of difficulty. So that was something that was also important.

It's important to note that the audit themselves, in our view -- in my view was not really a marketing issue, so the investors -- if a firm like Goldman Sachs or Morgan Stanley or a very reputable global firm was doing the underwriting, the investors would assume that the financials were, you know, fairly and accurately represented.

So in terms of why a company would -- why would a company not choose a Big Four? And the answers are varied, but it may be historical relationship, it may be cost, it may be a local presence, it may be better service and turnaround. The Big Four I think tend to be viewed as really run out of the national headquarters and are lacking in responsiveness.

An interesting note is that now in Silicon Valley, whereas 10 or 15 years ago almost nobody outside of the Big Four at the time, whether it was the Big Six or the Big Eight, was retained by venture capital startup companies. Now it is estimated to be about three or four in 10.

The selection of the auditor is a very competitive process, and when a company is getting ready to go public there is a lot of competitive interest on the part of the firms. But once the selection is made of an auditor, I would say the competitive leverage almost disappears. It is very difficult to change auditors.

There is a stigma attached. It can be -- so there is a huge incentive on the part of auditors to be ultra conservative, and there is I think some frustration on the ability to get turnaround, especially if there are some issues involved, and that it is felt that the accounting firms may tend to emphasize a regulatory perspective versus service perspective.

Thank you.

CO-CHAIR LEVITT: Thank you very much.

Next presenter will be Neal D. Spencer, Managing Partner of B.K.D., LLP.

MR. SPENCER: Chairman Levitt, Chairman Nicolaisen, and members of the Committee, thank you for the opportunity to address the Committee today.

With revenues of approximately $320 million and 1,900 total personnel, B.K.D. is the tenth largest accounting firm in the United States. We currently audit approximately 85 SEC registrants, including 30 employee benefit plans.

While the opinions I express today are those of B.K.D., the issues I will address are those faced by a number of local and regional firms every day as they look to expand their public company audit practice.

While competition and concentration in the audits of small public companies has improved, there is still significant concentration among the large and mid-sized public companies. The impact to the capital markets of the departure of another large accounting firm would be significant.

Regional and local firms would be able to pick up a number of these audits of small and mid-sized clients from the failed firms. But many of the smaller firms do not currently have the resources, nor perhaps the desire, to audit large publicly-traded companies.

A number of barriers do exist for smaller firms to expand the participation in public company audits. These include resources, as we've talked about earlier today, institutional bias, insurability, and most importantly liability.

While each of these barriers is very real and very significant, the most significant deterrent is clearly liability. This is where I will focus my oral remarks.

Audits of public companies, especially large public companies, carry much greater liability exposure than those of smaller non-public companies. Catastrophic risk or risk that a single failure could bring down an accounting firm is also exponentially higher in audits of public companies.

For many regional and local firms, public company auditing is a small percentage of both total revenue and total profitability. As a result, the risk of catastrophic loss is limited.

To further avoid risk, many firms like B.K.D. are very selective in the public companies that they accept as clients. When firms like B.K.D. consider expanding their public company audit practice, we must decide whether we are willing to accept catastrophic loss, and, therefore, bet the farm for what may never be a substantial part of our firm's practice.

In the current litigation environment, many firms may decide that the risk-reward equation is simply out of balance, and decide that they are not willing to expand this practice. We believe that many regional firms like B.K.D. and other local firms are interested in expanding their public audit practice, but generally, for smaller, lower risk type clients.

In recent years, audit firms have been increasingly looked upon as insurers rather than auditors. While audit failures have occurred, auditors should be held accountable for bad audits. Auditors should not necessarily be driven out of business for failure to detect fraud and for honest, isolated mistakes.

We believe a limitation of the dollar amount of professional liability claims, such as a multiple of audit engagement fees, would encourage more firms to expand their public company audit practice, be less conservative in their client acceptance, and be more willing to audit larger public companies.

This fundamental change is

necessary to level the playing field and provide adequate incentive for more firms to increase their participation. Liability reform would help firms limit exposure to catastrophic risk, maintain insurability, address some of the institutional bias, and reduce overall audit costs.

While this proposal does not address all barriers to entry, it does provide significant incentive for firms to expand their presence in public company auditing. With liability limited, firms would be more likely to devote the resources and the infrastructure to support a public company audit practice.

Some might argue that eliminating the risk of catastrophic loss potentially lessens an auditor's rigor in performing consistent quality audits. However, there are several other factors in place to ensure that auditors are conscientious and focused on audit quality. These include -- the cost of litigation is still high, our professional reputation, the PCAOB oversight and enforcement, the possibility of SEC sanctions, the ability to obtain ongoing professional liability insurance, and our firm's governance and culture.

I appreciate the opportunity to address the Committee on these issues of concentration and competition, and look forward to your questions.

CO-CHAIR LEVITT: Thank you very much.

Final panelist is Mr. Glenn W. Tyranski, Financial Compliance, of the New York Stock Exchange Regulation, Inc.

MR. TYRANSKI: Good afternoon, Chairman Levitt, Chairman Nicolaisen, Under Secretary Steel, and the members of the Committee. Thank you for the opportunity to testify before the Advisory Committee on the Auditing Profession on the subject of concentration and competition in the auditing profession.

I am a Senior Vice President in Financial Compliance at the NYSE, and I have been at the Stock Exchange now for 12 years. Our group is the principal accounting and auditing liaison with our listed company base. We also ensure the integrity of the NYSE's list by the development and enforcement of financial listing standards.

We also play a public policy role as it pertains to current accounting and regulatory developments. Prior to my 12 years at the NYSE, I was with KPMG out in Long Island as a senior manager for 12 years.

NYSE Euronext applauds the leadership and the Committee's efforts on the various issues confronting the auditing profession, all of which are enormously important to our capital markets. The role and regulation and oversight of independent auditors are, of course, of fundamental significance to each of our listed companies

-- 2,600 at last count -- as well as those companies that list overseas with our Euronext affiliate.

The NYSE has been a leader in standards relating to the use of audited financial statements, both in requiring its listed companies to provide investors with annual audited financial statements, and later in requiring its listed companies to have audit committees comprised only of independent directors.

More recently, pursuant to the Sarbanes-Oxley Act, all listed companies have been required to have independent audit committees with respective responsibilities. At the same time as the Sarbanes-Oxley legislation was focusing on the audit process, the NYSE was adopting a set of enhanced corporate governance standards, requirements for its listed companies. These requirements focused mainly on independent directors and board processes, but also contained significant requirements focusing on the Audit Committee, generally its purpose, use, and responsibilities.

In addition to these requirements, the standards also included several recommended best practices, mostly related to how the Audit Committee would be expected to pursue its responsibilities. Typically, the NYSE chose to utilize a recommendation rather than a requirement when to do more would risk micromanaging the Audit Committee as well as the board, or risk potentially robbing the board or the Audit Committee of the flexibility to respond appropriately to different kinds of circumstances.

An example of this is found in our corporate governance rules, Section 303, which requires that the Audit Committee receive an annual report from the auditor on several specified issues relating to quality and independence.

After reviewing this report, and

the independent auditor's work throughout the year, the Audit Committee will be in a position to evaluate the auditor's qualifications, performance, and independence, as well as the review and evaluation of the lead partner on the account.

It seems clear that there has been a perception in the market for many years that a certain group of auditing firms, amongst which it is appropriate for a substantial public company to choose from -- the Big Four. This is not a dictate.

Certainly, NYSE regulation -- for example, we have never required that a listed company have a Big Four auditor. It is merely, in our view, a perception, much like a certain kind of law firm is required for the going public process or to a particular kind of underwriting firm.

We do think that the expectation that a company must use a big auditing firm is beginning to erode, as one would expect given the very constrained number of big firms. At the NYSE, we have noted an increase in the number of next tier national and regional firms beginning to do public company work.

While it is true that approximately 94 percent of the NYSE's operating companies are still done -- audited by the Big Four, that is down from about 98 percent from a few years ago.

There have been a number of developments, in our view, over the last few years that have led to this audit firm turnover. These developments include the dissolution of Arthur Andersen, the passage of Sarbanes-Oxley, the creation of the PCAOB, SEC investigations, mandatory partner retirement provisions of the Big Four, changes in affiliation, practices of the international member firms, and the increase in accounting restatements.

Companies may, of course, initiate a change in audit firms on a voluntary basis for many good reasons. And certainly, on the flip side, audit firms are taking those risk policies also on the opposite side as they look at their list.

It's important to note that choice to change auditors is one that does involve costs and other resources. The firm, of course, to be SEC compliant would have to make sure all relationships meet those requirements. On the flip side, from an audit claim standpoint, the client may have to rearrange other advisory services that they have with other firms in order to consider potentially changing.

Notwithstanding these hurdles to changing auditors, our experience has shown that auditor rotation is in fact occurring. Other companies do have a choice among audit firms in which to select. The reputation of the Big Four remains very strong, but many national and regional firms are beginning to gain market share amongst public companies.

We support the Committee's goals to foster this trend and promote choice and competition among the firms. It is our experience that the best practices highlighted earlier involving Audit Committee evaluation are helping to encourage good practice behavior with the audit committees and increasing the role of firms other than those in the Big Four.

Thank you again for having us, and we are happy to answer any questions.

CO-CHAIR LEVITT: Before I turn this over to the panel, I have one question for Mr. Koenig. With your experience with regard to smaller publicly owned companies, would you like to see those companies finally embrace the internal control provisions offered by Sarbanes-Oxley?

MR. KOENIG: Well, I think that they have been forced to embrace the practices. And even though the provisions are very costly and potentially onerous, especially for small and medium-sized companies, I think having some relief would be very strongly welcomed, although I think there is also a strong recognition that many of the provisions of the Act are in the public interest.

CO-CHAIR LEVITT: The question I'm asking is: do you think investors are better served with those companies following Sarbanes-Oxley or not?

MR. KOENIG: Well, I think that it's -- that's kind of a cost-benefit analysis. I think investors are -- if the bar is very, very high, I think that they are well served, but I also think that there are many companies who are choosing not to go public because of how onerous the burdens of those requirements are.

And so I think having some moderation would strongly encourage companies to go public, and also would provide very welcome relief, even if the bar is a little bit lower.

CO-CHAIR LEVITT: The Chairman of the Subcommittee, Damon Silvers.

MR. SILVERS: Thank you, Arthur.

First, on behalf of the Subcommittee, I'd like to thank each of you for coming today and for very thoughtful and informative testimony.

Let me try to pose a question to each of you. Ms. Barrett and Mr. Koenig, each of -- you all said some things that sort of put together are kind of puzzling in a way. Mr. Koenig, I think you said that in the perception of the underwriters that the smaller firms raised a red flag because there was a sense that they might be sort of easier, lighter, they might have a lighter touch, and that that was a concern, if I heard you correctly.

Ms. Barrett, you said -- and I think a number of other investor representatives have said so -- that it would be better should there be -- that there should be more competition, that the smaller firms should have more business effectively.

In the context of -- I'm not trying to make those two statements match, and, in particular, I'm not trying to make them match with respect to the fact that there is a kind of a principal agent problem in the company auditor relationship from the investor perspective.

That is a long-winded question. I hope you will keep it in mind while I raise the other ones with the other panelists.

I'm afraid those signs are coming glaring in my eyes, and I can't hold names in my head that well. But, Mr. Spencer, you argue that audit firms -- small audit firms are being sort of deterred from entering into the public company market because of the threat of litigation and liability, and that it is a riskier thing to audit a public company than to audit a private company.

Let me suggest to you the following example, and you tell me why it doesn't apply. I am an architect, and I'm a really kind of simple architect, and I build things that have no more than five pieces. So they kind -- it's easy to see them. It's easy to see whether they fall down or not.

I want to build big buildings, skyscrapers. That's a really risky thing to do from the business of, you know, little tiny things, right? You know, I build -- say, for example, I build fishing shacks, and now I want to build skyscrapers. That's really risky. I have to be a much, much more sophisticated architectural firm, a lot more people, insurance, capital, all that kind of thing to do that.

There are some obvious reasons why we wouldn't want to have the guy who could only build a fishing shack build a skyscraper. Why is that not -- what am I missing about auditing?

To Mr. Tyranski, you went through the -- you talked about your perception, the Exchange's perception that there is greater change in fund choice of audit firms, and issuer choice of audit firms, NYSE listed issuer choice of audit firms, that incrementally is growing.

Can you talk a bit about what, in your view, what in the Exchange's view would accelerate that on the part of firms and, in particular, on the part of investors who may have -- who may look with a jaundiced eye upon unfamiliar audit firm names.

And, finally, Mr. Haaga, you expressed at the beginning of your testimony somewhat passionately the concern that investors be heard in these processes. That's a concern I'm certainly sympathetic with. Could you perhaps say a few words about why you felt it necessary to tell us that? Do you see investors not being heard somewhere in the discussion of auditing and accounting issues?

And, if so, where?

MS. BARRETT: Can I start?

MR. SILVERS: I guess we'll start with you.

MS. BARRETT: I have one comment to address the question of the incongruence between the two study findings and comments. I think that it might center around the assumption in the current state of the industry, which is small firms versus big firms.

And if that weren't the case, if there were many, many firms of varying degree of size and distribution, you wouldn't have as much question about whether the small firms are more lenient and the larger firms are less lenient. That would be the issue. The issue would be amongst all of the firms of more similar size.

And so I think that that would be the ideal structure is where you get to a large group of companies of similar size, of similar capability, of similar resources, and similar willingness to take on liability necessary to be in this business, and that would give companies the opportunity to choose from a larger pool of large to medium-sized firms with the capabilities to audit them appropriately and to share appropriate information with investors.

MR. KOENIG: So I just -- I know I meant to imply -- and I must have implied that the procedures or practices or quality of the audits by a smaller firm wasn't fair. I didn't at all mean to imply that. Simply that the Big Four are representative of a brand and a Good Housekeeping Seal of Approval, and so in the technology profession market there is a saying that one corporate executive never gets fired for hiring IBM, even if a smaller company has better products and services. So it's in that spirit simply that the market and underwriters feel much more comfortable with the brand of these large global established and experienced firms.

MR. SILVERS: Let me just say that I appreciated your testimony very much, and your candor I thought in describing the way people -- bankers think about this is a great help to the Committee. What I wanted to get at is the question of whether competition really produces or does not produce, and I am sort of open-minded on this -- really does or does not produce -- competition among issuers picking auditors really does or does not produce a higher quality audit.

And I'm just curious if you have any --

MR. KOENIG: I think it's a very competitive process. When companies are selecting auditors, I think that the firms get geared up. It's generally a fairly comprehensive evaluation. There are criteria that are drawn up. The Board gets involved. The Auditing Committee gets involved, and my experience is that it's a very thoughtful and competitive process when the selection is actually made.

MR. SILVERS: So, you know, that's not quite what I asked. Your opinion is that this is the Competition Subcommittee, we actually have a lot of competition.

MR. KOENIG: At the time of selection, there's a lot of competition. I think the competition completely reduces dramatically once that selection is made, because of the difficulty and stigma associated with change.

MR. SILVERS: With changing. Thank you.

MR. SPENCER: Let me try to address the issue of small firms trying to enter into the public audit practice. I think there are several things obviously beyond liability that all firms have to think about. One is your international reach. A lot of these companies go cross-border, and even firms like B.K.D. struggle when you think internationally about how you meet the needs of the clients that we serve.

The structure to support an SEC practice is not cheap. Our firm has been looking at our public accounting practice for a number of years, and, in fact, we have been looking to add partner-level caliber to our firm to focus 100 percent of their attention on our SEC practice.

Third complexity -- the rules, as you all know, are very complex. The SEC does not publish a lot of guidance. A lot of their guidance comes from Committee meetings and other informal ways of getting the information out, and the Center for Audit Quality does a good job of getting that information down to us, but we don't sit at those meetings.

And when we have issues, questions that we might have, we just can't pick up the phone and call somebody in the SEC. So there are barriers, clearly, to smaller firms getting into the SEC practice.

MR. SILVERS: If you don't mind, I'm still not clear as to why it is that a smaller firm ought not to have to deal with the liability issues associated with taking on greater risks.

MR. SPENCER: Why they would not want to --

MR. SILVERS: Why you would wish to change the public policy structure, such that a smaller firm wishing to take on greater risks, all right, shouldn't be exposed to those risks. I don't understand why that wouldn't be the case as in my example would be the case for anybody else trying -- whose business model involved taking on greater risks.

MR. SPENCER: Well, clearly, I think that's one of the issues we address at our firm every day. We have not committed to expand rapidly our public audit practice. We are very conservative in the type of clients that we want to take on.

Quite frankly, we're not going to audit large public companies. You are not going to see B.K.D. audit Wal-Mart, GE, those type of companies. But there is a niche for a firm like B.K.D. in some of the industries that we serve where we can do an adequate job of auditing those type of companies.

MR. SILVERS: It appears to me that the data would suggest that firms such as yours are gradually creeping up that -- gradually climbing that ladder, right, as they become -- as you add resources, you add capabilities, you add brand, which I think in many ways is Mr. Koenig's point.

MR. SPENCER: Very important.

MR. SILVERS: That that incremental process -- that firms are actually succeeding at that incremental process. I think this Subcommittee is very interested in how do we foster that, how do we encourage that without doing things that are dangerous in relationship to investors in the markets. If there was a paradigm here, I think we're trying to get our arms around it.

And then, I think that goes to my question to the final one, final panelist.

MR. TYRANSKI: On the acceleration issue -- and as you said, it's beginning to change. The glacier has moved a little bit. I think you have to kind of focus on where in the process do you see that change? I think the changes that we've been experiencing certainly at the New York Stock Exchange with already public firms, moving for a lot of good reasons, as I said in my piece, and -- but you're still not necessarily seeing that at the IPO spot, at that initial piece.

And I think, you know, part of that again is perception. You talk about how to get more name recognition out there. I guess we could start with the Academy Awards. Maybe Pricewaterhouse -- it's time for them to rotate off.

(Laughter.)

So I think that's part of the issue is name recognition, and for us it's really for already existing public companies who have seen a lot of the regional and national firms picking up the work from New York City. So when we look at -- when you're going public, when most of Silicon Alley and West 17th Street was going public three or four years ago, much like what the West Coast experienced -- not necessarily any revenues and a whole lot of seasoning -- did they really need a Big Four firm to do that work? And say, yes, I order you that you have zero revenue. You probably could argue no, but that goes back to who is making the decision.

MR. HAAGA: Okay. Thanks. Quite frankly, I've been here all afternoon waiting for a concrete suggestion and coming back with the Pricewaterhouse --

(Laughter.)

We're not going home empty-handed.

You asked about investors being

heard. I have long implied that investors are not being heard. We are being heard -- I think I'd like to suggest a little more formal representation on things like the boards of the -- of FASB.

Number two, I think we may be defining "investors" too broadly to include anybody who sort of represents the public interest. Those people are wonderful and can certainly speak on many of the issues. But in the case of public interest groups and even institutional investors who are indexed, they are not picking stocks based on what they read in a financial statement.

And so I think if you sort of -- if you cut through the group of shareholders and found some that are really using the financial statements to -- for something as important as choosing investments on behalf of their shareholders, you might get a little richer quality of analysis.

CO-CHAIR LEVITT: Thank you.

Mr. Cohen?

MR. COHEN: Thank you, Mr. Chairman.

One question I would like to address stems from actually an earlier panel where Chairman Levitt remarked there was a passionate plea dealing with the pressures which accountants are confronted every day -- pressures from their clients, pressures from within the firms themselves.

I would open this up to any of the panelists as to what could be done to reduce those pressures? And I will throw out one specific issue. I mean, it's fortunate having Cap Research, which has a very strong reputation as a long-term investor.

One question -- one partial answer may be that the quarterly earnings pressures are such that penny a share makes such a difference that perhaps something can be done in that area.

MR. HAAGA: Everybody is thinking

but me, so I think I'll start at least with the answer. We would love to do something about quarterly earnings pressure. I think one of the things that could be done about it, and one of the things we try to focus on in -- both in investing and in voting proxies is the compensation drivers of that excessive focus.

We like to look at what -- you know, I think management have become obsessed with their stock price, in part because their compensation is so leveraged to it. So we look very hard at what are the incentives to management, and I wish other people would do so, too.

Encouraging long-term investing, encouraging the payment of dividends, will create a little bit of a longer-term focus. But to get back a little bit to the quality of life for the auditors, I don't mean this critically of the PCAOB but -- or, frankly, of the SEC and NASD, but we in the mutual fund business have gone through a difficult time following up on some regulatory problems that we had. So have the accountants following up on some problems that they had in Enron and WorldCom.

There is a natural tendency for regulators to become hostile in those situations, and to look to punish wrongdoing. And I think there is often -- being its human nature -- an assumption that comes out of that that the -- whether they be the accountants or the mutual fund advisors or others who are on the receiving end of those enforcement matters, are bad people who are intent on wrongdoing and that the regulatory environment, instead of being a quality control environment, becomes a hostile environment in which we are looking for people to make mistakes.

I think both the accounting and the mutual fund professions are coming out of that. I think it's natural, so I don't want to lay a lot of blame, certainly not personal blame, on anybody. But I think if people could simply recognize that, then I think the accountants would have a more enjoyable time being accountants if their regulators were -- made sure that they emphasized quality control more than finding bad guys.

MR. TYRANSKI: I would -- on the quarterly side, I think that's a fair point. I was at the FEI's New York meeting a couple of years back, and when the then-Chairman McDonough of the PCAOB gave the keynote address, at one point he actually appealed to the audience to stop putting so much emphasis on quarterly reporting and really look at it over the course of the four quarters in the entire year.

So that is one point I think from a pressure standpoint. The other piece is complexity, and Bob Herz, from the FASB, had his paper I guess two years ago on just how complicated it has gotten for not only inside accountants but obviously the outside accountants.

And I think the new guidance that has come out on restatements, kind of codifying the age-old adage that there are good restatements and bad restatements, will hopefully ease some of the pressure of some of those restating. So there's going to be mystic fallout not only to us but to the customer.

And the other piece I think from a pressure standpoint is, again, the continued emphasis on always hitting the time limits and, you know, the existing SEC reporting timetable now, at least from what we hear from CFOs, it's not so much the annual that proves to be difficult. It's the quarters and getting that done and out as quick as they have to know.

CO-CHAIR LEVITT: Mr. Goldman?

MR. GOLDMAN: I've got a couple of questions and comments. Paul, I think you said, if I heard correctly, that per se you wouldn't feel there's a problem if it went down from four to three firms, and that we shouldn't be worried about too big to fail. And so I'm not sure if I heard that correctly or not.

Then, my next question would be, if that's true, when is too few? Is two too few? One too few? So that's one question.

Brad, I was wondering in terms of your firm and other firms, is there a perception -- yes, you mentioned there's a perception of a Big Four, non-Big Four, red flag, not a red flag. Is that shared with -- I'm not sure if you call it an Investment Committee or a Credit Committee, is that shared sort of high up in firms like the firm you are with, so it isn't just on the people on the street, but it gets back in the firm itself?

Neal, I thought one of the comments you made was actually to me enlightening, and I will maybe add a little different perspective on it. But it is the catastrophic issue. And I'm not going to use the example that he used, but I do worry that in -- you know, in the real scheme of things, you do look at the risk-reward, because it makes sense to take on public companies.

And that leads me to the other sort of question or comment. My sense is one of the reasons why some of the concentration is not quite as extreme is some of the Big Four are dropping what they perceive to be high-risk accounts.

And by dropping those accounts, the other Big Four aren't picking them up, and so part of the reason why there's a lot of unintended consequences, part of the reason why you're seeing a little less concentration today is because you see some of the non-Big Four picking up clinical accounts being dropped by some of the Big Four.

And also, another question is: do you sense -- Brad, do you sense there is a difference in rigor of the non-Big Four versus Big Four, either in terms of the audit itself or the type of people you hire?

And one last question I meant to ask -- Paul, when you look at, from Cap Research's point of view, the companies that you invest in, Big Four/non-Big Four, does that create a red flag for you or your firm in terms of at least asking the question: why would a company that could have a Big Four doesn't have a Big Four?

MR. HAAGA: Let me clarify. I think it would be a very bad thing if one of the large firms, current large Big Four auditing firms were put out of business or went out of business. That would be a bad thing.

I think the only worse thing would be if we now told them that we would guarantee them that no matter what they did, or what happened, or what their finances looked like, or anything else, that there was no way we would allow them to go out of business.

So it's -- really, it's balancing the two disasters, but I -- but make no mistake, I think it would be a very bad thing if we had fewer than four.

I do trust the marketplace, though, to be -- have some resilience. I think the profession and the clients showed a lot of resilience in picking up after the Arthur Andersen thing. That's not to minimize that and/or to suggest that I think it was a good idea that they were put out of business. I don't think it was. I think it should have been handled another way. But I think things would be resilient. I just wanted to get to that balance.

In terms of the -- just sort of the Good Housekeeping Seal of Approval, I guess we would look at if someone did not have a Big Four, I'd want to know what kind of a company it was. If it were a major multi-national firm with multi-national operations that were relying on a specialized, more localized accounting firm, you would wonder how they were getting an audit of all of their businesses.

On the other hand, if it were a specialized firm that could deal with -- or could be adequately dealt with -- many of our smaller cap companies in which we invest are audited by non-Big Four firms and do quite well. I'd also want to know sort of how they got there.

If they started like with that firm and grew to become a small public company with that firm, that would be different from if they got rid of their Big Four firm and went to it. So there is more to it, but I don't think that we would automatically worry about a non-Big Four audited public company unless they were huge and multi-national and it was just impossible to imagine them being audited by somebody smaller.

MR. KOENIG: Maybe I can follow up

to the question about what our internal Commitments Committee process was. The dynamic of our business selection practice was that the team and the department or group, the industry group that was running the client relationship, would go out and do very, very significant due diligence on all aspects of the business including having audited statements.

And we would then prepare a comprehensive memo, which would go to the Commitments Committee, which was comprised of about a dozen very senior partners from around the firm, around the world. And in the memo there were required to be a section about the audit and the financials.

And being responsible if there was a non-Big Four, we would always highlight the fact that there was a non-Big Four that was presenting the audit, and that would result in a very extensive focus and question on the part of the Commitments Committee which was precluded by the team actually doing a very, very substantial amount of work directly with the auditors, with the Auditing Committee, understand what the history of the engagement was, why it -- if they could have selected Big Four, didn't they select, what was the basis of the relationship, and so forth.

And so, again, I am not aware of any situation that we actually put down a piece of business because there was a non-Big Four, but the level of scrutiny and focus was greatly elevated.

MR. SPENCER: Let me address the comments you made about the Big Four dropping high-risk accounts. That's really not what we saw. When Sarbanes-Oxley came along, there were tremendous opportunities for all of the firms under the Big Four. But what we saw, at least in our market, which understand is in the heartland of America, the Midwest, was not the dropping of high-risk public audits.

It was privately held companies,

quite frankly, those that fit in our footprint very well, those type of clients that were looking for superior service that they were not getting from the Big Four, because the Big Four's attention was clearly going to be focused on the public environment.

So we didn't see that in our marketplace.

CO-CHAIR LEVITT: Thank you. Mary Bush on the phone.

MS. BUSH: Yes. This question is --

CO-CHAIR LEVITT: Can you speak up, please?

MS. BUSH: Yes. Can you hear me now?

CO-CHAIR LEVITT: Yes.

MS. BUSH: This question is for Paul Haaga and for Brad Koenig. Let's assume for a moment that we were to lose another one of the Big Four. What I would like the two of you to do, if you would, is to sort of project forward with me as to what would be the fallout for the markets of losing another firm.

In doing so, you might sort of reflect back on what happened when Andersen went out of business. But kind of the focus of my question is: what should we be thinking about in order to avoid disruption in the capital markets, maintaining investor confidence? What were some of the things that you saw last time in terms of -- I mean, just simple things like the production of financial statements that created problems for your business that we, as the Committee, the Treasury, and regulators need to be thinking about.

MR. HAAGA: Thanks, Mary. Losing another big firm, you know, my main concern, what I would focus on the most is how we lost the member of the Big Four whom we lost. If they just all decided to retire at once, that would be one thing. But that's unlikely.

I think it would -- to make it happen now, given the Arthur Andersen experience, it likely would have been caused by a massive failure and a very significant either internal fraud or failure to observe fraud. And I think that -- the cause, rather than the outcome, would be the -- what would be most disruptive to our markets. So I would -- and our investment -- our investment practice.

So I'd focus more on that than on the actual how do you deal with the outcome of having only three.

MS. BUSH: And because it was -- sort of destroyed trust in terms of other financial statements that had been produced for a wide range of other companies, is that what you --

MR. HAAGA: Yes, correct. And Arthur Andersen had -- I'm probably being too generous, but they had a rogue office.

MS. BUSH: Right.

MR. HAAGA: And they were indicted, my understanding is, without a lot of consultation with other regulators and public bodies. I don't think that would happen again absent some massive, almost unimaginable, circumstances. And I would hope we would catch it before they needed to go out of business.

So I'm -- maybe I'm going too far in questioning your premise, but --

MS. BUSH: No, no, no. No. Listen, I hope we would catch it, too. I agree. Is this Paul talking?

MR. HAAGA: Yes.

MS. BUSH: Okay, Paul. Hi. I agree with what you said earlier. I also do not think they should have been put out of business. I think the rogue offices and rogue people should have been put out of the company. Losing the firm is not what I personally think should have happened.

What I am really more interested in

is when something like that happens suddenly, and they are working on -- a firm is working on the audits for a number of companies and working on other kinds of businesses, other kinds of business, and they are not able to complete those audits, somebody else has to be found to do it, that takes time. They might be in the middle of IPOs or just equity issuances in general.

What kinds of problems does it present for your analysts or investors and for the capital markets in general? And that last part is directed to Mr. Koenig.

MR. KOENIG: Okay. Well, first of all, with the proviso that I'm not an expert on the structure, competitive structure of the accounting profession, there are 5,000 NASDAQ and New York Stock Exchange listed companies I think where the market value is over $100 million.

So at some point, maybe when you went from eight to six to five, at some point it didn't really threaten overall competition. But my feeling is that at much below a level of four that would begin to severely threaten public competition.

I think the experience that we had in the wake of Enron was that -- near paralysis at many companies who were involved in transactions where Arthur Andersen was the auditing firm. And so luckily that proved only temporary. Many of the professionals who had had long relationships and knowledge of the company ended up going to other firms.

And so the disruption was minimized, but there was paralysis and then of course the entire -- the rest of the professionals, the accounting professionals, became very, very conservative, and also, again, to this point of responsiveness, the risk aversion when an event like that happened just really increased very significantly.

And the inability to take local action without very extensive consultation with the headquarters really made things very, very difficult and time-consuming.

CO-CHAIR LEVITT: Mary, Alan Beller has some thoughts on your question.

MS. BUSH: Thank you.

MR. BELLER: Mary, in addition to what was just said -- and I agree with it in terms of disruption -- when the first rumors of Andersen's indictment -- possible indictment surfaced, the SEC basically in complete secrecy drafted a set of emergency temporary rules that would be available if Andersen was in fact indicted, and what people expected would happen would happen.

Obviously, there could be no publicity about that, because it would have an effect -- produce the results that --

MS. BUSH: Right.

MR. BELLER: -- was a problem.

MS. BUSH: Right.

MR. BELLER: When the indictment was announced, those rules were announced within about 48 or 72 hours. What they basically did -- and they did not solve the problem that Mr. Koenig is talking about about freezing the capital markets, because nobody was going to go to the markets without audited financial statements.

There were several thousand companies that Andersen audited. The market, in fact, caught a break, because Andersen -- if the indictment of Andersen had taken place six weeks earlier than it had, you would have been in the middle of the audit season for the year-end companies. As it turned out, Andersen was indicted after most of the audit work for most of the year-end companies had been done, and audits could be produced by Andersen as it was in effect winding down.

The temporary rules really provided two things very basically. One, they gave companies the ability to file unaudited financial statements for a period of time which would allow them to replace Andersen if they either had to do that or chose to do that without violating the reporting requirements. Again, as was said earlier, I don't think anybody was going to get to the market on that basis, but at least they weren't violating the rules when they filed their quarterly and annual reports.

Secondly, companies and Andersen were put -- were -- an obligation was added that they in effect had to disclose, in connection with their filings, whether Andersen had fallen so far away that it was unable to complete the audit or the review work that was ongoing.

Those emergency temporary rules are probably expired but still on the books somewhere.

MS. BUSH: Thank you very much.

CO-CHAIR LEVITT: Bob?

MR. HERZ: Yes. This question is for Annalisa. I think in your written submission you suggested that going to global standards might actually foster increased competition in the audit market, and I'm just interested in you elaborating a little bit further on those thoughts.

MS. BARRETT: Well, I think that as the U.S.-focused firms and the U.S.-focused concentration is expanded to include companies that can audit IFRS financial statements, then there will be more competition, more firms, and they will be more available to do those financial audits.

MR. HERZ: I've heard kind of the reverse argument to a certain extent, that if we did it too quickly in this country, that the only people that might be able to service those companies would -- companies would be the Big Four, or the Big Six as they now call them, the people who have people that are based abroad that are already experienced in IFRS, whereas U.S. regional or even national firms might not have that expertise at hand yet.

MS. BARRETT: What I'm referring to is other companies in other countries who are able to do auditing here in the United States as well.

CO-CHAIR LEVITT: Ken? Gaylen? I'm sorry.

MR. HANSEN: Yes. If I could -- I have a couple of quick questions. I want to direct this to, Brad, you talked about the Good Housekeeping Seal of Approval. It has been discussed a lot, and I was intrigued by your rating scale. And certainly you are entitled -- you know, everybody is entitled to have their own way that they rate people.

But it would seem to me that that would be, as I believe, Neal, you indicated, an institutional or a market bias. And I just wondered, in terms of following up with that, I have often been told one of the reasons why smaller firms are not selected is because they don't have a sufficient amount of insurance available. And I don't know if that is any of your criteria.

And then, another question that I would have, which is probably more significant than that, is, do you or have you ever used the PCAOB inspection reports in really analyzing and screening firms? And if not, why not?

And then, I had a question for you, Paul. You talked about the concept of a centralized national standard-setter, and indicated there was a number of different entities that are involved in independent standard-setting.

It seems to me that most of the underlying principles of independence are very similar. But I was just sort of wondering what you think a national standard-setter of independence, what would that look like? And would it handle private companies and public companies, both, or what did you really have in mind?

MR. HAAGA: Should I go with that

one? I think a national standard-setter -- my sense is that we are moving in that direction, that you are right, there are not greatly different standards in -- by the different bodies and by the states versus the federal.

I guess what I'd like to say is that we need to get the rest of the way there, because there are still a few areas in which, particularly relating to the scope of an audit, there are some different rules in conducting an audit -- but the actual conduct of an audit, that there are different rules in different states, as I'm told by my colleagues.

So I think the more important part of our -- the uniformity comment really related to the license and making it easier particularly in a national industry like mutual funds to make it easier for people to -- partners and others to practice in different states.

MR. HANSEN: Mr. Koenig? Brad was

going to answer a question.

MR. KOENIG: Okay. I was just going to respond to the question. First of all, the scores I indicated, 10 of 10 for a Big Four, seven of 10 for a non-Big Four, and then three of 10 if there was a complication or an issue involved -- those are not audited. Those were --

(Laughter.)

-- really meant just to give you a qualitative feel, not relating to the quality of the work or the team or the firm, but merely as a brand and rating on the Good Housekeeping Seal when we would do our business due diligence and go to our Commitments Committee process.

It was simply indicative of having the highest standard of auditing review and practice. So it really was not in any way meant to reflect a difference in quality.

And on the question of the PCAOB, no, we did not utilize that.

MR. HANSEN: Any particular reason?

MR. KOENIG: No.

CO-CHAIR LEVITT: Mark?

MR. OLSON: Thank you. Two questions. First, to Mr. Haaga, in your -- in the written submission, you refer to FAS 157, and you said that the implementation was -- made it significantly harder on audit firms by suggested audit approaches by the PCAOB.

Could you elaborate on our -- on our suggested audit approaches?

MR. HAAGA: Yes. I think what happened on that -- as my colleagues who were involved in it relayed to me -- was that there was a specific audit approach, bulletin I guess it was, that came out from the PCAOB that talked -- and this particularly affected mutual funds, that said something to the effect that if a firm is relying on a service, evaluation service as almost all mutual funds do, particularly in the fixed income area, then the auditors have to look behind the --

what the service does and how it gets its prices, how it determines its prices, and I think that was -- both the timing of that and the seeming breadth of the requirement were disruptive to the accounting firms.

MR. OLSON: So you're interpreting that as new guidance.

MR. HAAGA: Well, it was certainly a new -- it was perceived as a new gloss on what their responsibilities were.

MR. OLSON: We have gone to some effort to make sure that we were summarizing existing audit standards. So I am interested here if that's the result of your analysis or if you're repeating what clients might have told you.

MR. HAAGA: Well, I'm not an accountant, so -- but I am a client, because we are a -- we are managed mutual funds, and the mutual funds have had to -- this standard applies to us, just as -- it applies to mutual funds just as it applies to an operating company.

And I'm sure that there was an effort on the PCAOB's part to -- not to surprise people, but it did, and it -- maybe they weren't listening, but I know that when that standard came on they were surprised and they had to go look -- that they had to go look beyond what the services were providing.

MR. TURNER: Paul, let me just say -- and I sit on the Board of the Mutual Fund as an ICA member, and we had the same issue. But I must say where markets are coming out I think it is absolutely true.

You may want to go back to your people, because there was nothing really new in that whatsoever, and it was just repeating what was already, and had been for a long, long time, existing GAAP with those reports. So you may want to go check on that one.

MR. OLSON: One more question of Mr. Spencer. Let's assume that you -- that a firm smaller than the Big Four decided, for strategic reasons, to address all of the litigation and other issues that are problematic. If you were to make a strategic decision that you wanted to be at the end of a time certain at a size similar to a Big Four, what would be the strategic issues that you would be addressing?

And let me tell you why I'm asking it. There is a question as to whether or not it is possible to generically grow into the company of the current Big Four. And so I'm asking the question: what are the strategic issues that it would take in order to do so?

MR. SPENCER: Well, there's a couple, but let me first comment that it is almost impossible for a firm the size of B.K.D. to grow into the Big Four. The gap between Number 4 and B.K.D. is in the billions.

MR. OLSON: But that's --

MR. SPENCER: Right.

MR. OLSON: But what are the -- but

can you just enumerate what the critical barriers are to keep that from happening?

MR. SPENCER: Well, clearly, I think number one is your international reach. We are part of an international association of accounting firms. We don't -- that international group is not representative of all of the countries across the globe. So, clearly, that would be one huge barrier.

The complexity of the rules is clearly another. We would have to invest in many more resources in our home office to support and monitor the ongoing activities of the SEC, and so forth. Those would be two of the biggest reasons.

MR. OLSON: Okay. Then, to follow up, do you anticipate seeing a new -- the marketplace helping a non-Big Four firm become a Big Four in size any time in the near future?

MR. SPENCER: I think there's a couple of firms that are positioning themselves to be the next Big Four.

MR. OLSON: So you --

MR. SPENCER: Yes.

MR. OLSON: -- it's within the realm of possibility that in the marketplace that could happen.

MR. SPENCER: Sure.

CO-CHAIR LEVITT: Thank you.

MR. TRAVIS: I might add, Mark, that I think one of the other key strategic issues would be industry expertise, as outlined in the GAO report. I think that's a significant strategic issue that would have to be addressed. And not just acquiring it, but training and developing and all of the tools and things.

Neal, a quick question for you, just to shift gears a bit. We've heard -- we've talked a lot today about transparency. And you have an excellent audit firm. As part of your practice, the SEC practice has 85 or so clients, so it's a relatively small percentage of your firm's practice.

Can you share your views about transparency and what would make sense from your perspective?

MR. SPENCER: Yes, sure. It's not that we're opposed to transparency. I think the question is: what do you want to know? Clearly, when you look at B.K.D., as you just mentioned, less than five percent of our revenue is generated from public company audits.

So when we look at transparency, the question of: what is a firm's insurance ability? How much insurance does a firm carry? That would probably be something that we would be willing to share. How much capital we maintain in our firm is probably something that we would be willing to share.

But how important is it to share partner compensation? There are so many factors that range when you talk about partner compensation to leverage of a firm, to structure of a firm, that those numbers vary all over the board. And for a firm like B.K.D. that spends 95 percent of its time outside the public company audit arena, that would cause some competitive disadvantages to a firm like us.

MR. OLSON: Thank you.

CO-CHAIR LEVITT: Barry?

MR. MELANCON: Just real quick to Neal. You mentioned the global association twice, one earlier and once in response to Mark's strategic question on growing. And I'm conscious of the time, so let me preface this and just see if you would agree with this.

There is a theory that says that how the Big Eight grew in the '60s, etcetera, the environment in which they grew, through global activities, etcetera, that the difficulties for a next tier -- if you want to focus on a larger firm than yours today -- is much different, and, therefore, is sort of a built-in impediment to that actually occurring. Would that be a fair statement in your mind?

MR. SPENCER: That would be a fair statement.

MR. MELANCON: And could you just describe, very briefly, some of difficulties through your association that you are facing today, and what that might look like, just to give the Committee a taste of what a global association of a firm your size might be like.

MR. SPENCER: Well, the challenges that we face is -- even though all of the members of PRAXITY, that's our international affiliation, we have member firms in countries and they go through a rigorous membership application.

But you still don't know the type of quality work they do until you actually ask them to do some work. And even in our association that has some very good firms in it, we have had issues, as we've gone across the U.S. border, to deal with some of those accounting issues that our companies are dealing with in Mexico and Europe and other places. So it is clearly a challenge.

CO-CHAIR LEVITT: Last two questions.

MR. BELLER: Thank you.

CO-CHAIR LEVITT: We are wearing down. I don't see --

(Laughter.)

MR. BELLER: I have a question for Mr. Spencer, and I guess also Ms. Barrett. I want to tease out a different transparency thought that you shared, and this is the transparency of the auditing and accounting, or especially the accounting literature.

There has been a lot said recently about the issues of GAAP hierarchy, and the different, somewhat disorganized way in which GAAP is expressed by the FASB, by the Commission in the context of simplicity of accounting standards and reporting.

I guess I want to get at it a

little bit from the competition side, and that is, is the profession and/or investors better off -- beyond the GAAP hierarchy, you've got a variety of sort of non-authoritative pronouncements that take on the aspect of authoritative pronouncements, all the way down to, you know, speeches by professional fellows at AICPA conferences.

You also have, frankly, greater access by the Big Four to the FASB and to the SEC than the rest of the profession. Are investors and the profession better off with that status quo? There is, after all, more information somewhere, and it may ultimately trickle down from the high priest and priestesses to the rest of the world.

Or, as a pure competition matter, is that something this Committee should be thinking about? Does transparency help from a competition point of view in ways that outweigh perhaps the fact that there would be less information out there somewhere?

MR. SPENCER: Yes. I think from a competition standpoint, I think transparency, simplification of all of the accounting standards that we are trying to deal with, would certainly help from a competition standpoint. I think all of the firms spend an enormous amount of resources trying to understand what comes out in terms of rules and regulations.

And, quite frankly, look at the differences between firms, they interpret them differently. And so the more simplified you can make the rulemaking, I think the better off we are all going to be, and more consistent we'll be in reporting to the public.

CO-CHAIR LEVITT: Lynn?

MR. TURNER: Just real quick for Paul. When reading through your testimony --

CO-CHAIR LEVITT: Can't hear you.

MR. TURNER: Sorry. For Paul -- when reading through your testimony on auditor independence, I wasn't sure exactly what you were getting at. And I wasn't sure whether you were saying we should water down the auditor independence rules in some areas or not. Could you just quickly --

MR. HAAGA: Yes. It was more of a cautionary note I think. I wouldn't water down the independence rules. I think that over the years there have been -- and I think the SEC has addressed some of these -- there have been some Draconian consequences.

The one -- just thinking of one anecdotally in which we were involved and which the -- one of the Big Four firms was auditing our mutual funds, and somebody in the Cincinnati office married someone who had a 401(K) plan in our funds, and we had to go -- I was embarrassed to go before our Audit Committees to get permission to deal with that.

I think that has been dealt with in rules, but I just -- what I really wanted to get was sort of constant vigilance about not letting these things -- particularly in the mutual fund area where an audit can't have much impact on the price of the shares, because it is really the underlying securities that cause that, that we not go overboard on independence.

CO-CHAIR LEVITT: I want to thank the panel and the members of the Committees and the -- I can't break this up without thanking Treasury and its staff, particularly Kristen Jaconi, for orchestrating a difficult, complex, but I think hugely effective, informative, open, and fair-minded hearing. So thank you all.

(Applause.)

(Whereupon, at 6:40 p.m., the proceedings in the foregoing matter were concluded.)