UNITED STATES OF AMERICA

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THE DEPARTMENT OF THE TREASURY

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MEETING OF THE
ADVISORY COMMITTEE ON THE
AUDITING PROFESSION

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MONDAY,
MAY 5, 2008

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The Advisory Committee convened at 1 p.m. in the Cash Room of the Department of the Treasury, 1500 Pennsylvania Avenue, N.W., Washington, D.C., Arthur Levitt, Jr., and Donald T. Nicolaisen, Co-Chairs, presiding.

PRESENT:

ARTHUR LEVITT, JR., Co-Chair
DONALD T. NICOLAISEN, Co-Chair
ALAN L. BELLER
AMY WOODS BRINKLEY
MARY K. BUSH
RODGE COHEN
TIMOTHY P. FLYNN
ROGER R. GLAUBER
KENNETH A. GOLDMAN
GAYLEN R. HANSEN
BARRY C. MELANCON (via telephone)
ANNE M. MULCAHY (via telephone)
RICHARD H. MURRAY
GARY J. PREVITS
DAMON A. SILVERS
SARAH E. SMITH (via telephone)
LYNN E. TURNER

PAUL A. VOLCKER (via telephone)
ANN YERGER

OBSERVERS:

CONRAD HEWITT
MARK W. OLSON
ZOE-VONNA PALMROSE

TREASURY OFFICIAL:

ROBERT K. STEEL

TREASURY STAFF:

KELLY AYERS
GERRY HUGHES
TIMOTHY HUNT
KRISTEN JACONI

A G E N D A

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

(1:22 p.m.)

CO-CHAIR NICOLAISEN: Good afternoon, everyone. Let's close a couple of the doors there, and make way for our remaining Commission members as they enter. We apologize for what has happened today. We apologize for the slow start, but we, I believe, have adequate time. We have about five hours scheduled for today. I'm not sure we really have five hours of content, so it may be that we'll end a little bit early in any event.

I would ask, as we always do, that you turn off your electronic devices, especially Blackberries. If you keep them in your pocket, it's probably okay, if you leave them on the table, they will interfere with the system, and that's the sound that we hear.

We're going to today try to make progress on the recommendations that have been accumulated thus far by our three subcommittees. And I think as you look at the report - welcome, Lynn - as you look at the report, you'll see that it's beginning to flesh out, and there'll be additional sections that we hope to have in before the June 3rd session. We do not yet have the background section, and the background section is a very important piece, because it lays the groundwork for why these recommendations are here. So, to some extent, we're looking at the recommendations by themselves without all of the pieces that are there.

Today, what we're looking for is with respect to the recommendations that you do see. We're looking for commentary, input, suggestions, recommendations from our Committee members and observers, particularly those of you who are not on the subcommittee that's reporting at a given point in time, if you could interject your views, I think it would be helpful, then we'd feel that we have a broader cross-section of input to all the recommendations that are being made.

The focus will be on today's draft. In addition to what you do see here, there are a number of other observations or issues, questions that have either been dealt with and haven't been written up yet, or are in the process of deliberation.

In the human capital area, some of the things that have been talked about that are not written up here include partner rotation, retention of staff, compensation of those in the audit profession, work life compression, comments on teaching accounting at the high school level as a way of increasing interest in the accounting profession, and visas.

In the governance section, the finance section, we have some pretty meaty issues that are still under deliberation. They include litigation, transparency, what kind of information should the audit firms make available to the public. There's a question of should the engagement partner sign-off on financial statement audits, the question of whether or not the auditor's report is adequate at this point in time, as well as some additional commentary on capital structure, business model, and whether outside capital is appropriate. So a lot of what is not here we've laid out in this very brief piece of paper that should be in front of you of open issues.

That doesn't mean these are the only ones that we'll consider, so if there are other things that we ought to focus on, it would be helpful if you'd raise those either today or bring them up during the course of the next week or so. But for the purposes of today's session, the primary focus will be on the items that we do have recommendations for.

So we're going to begin with Gary Previts' Subcommittee on Human Capital. We're looking forward to those observations. We will allow about 75 minutes for discussion.

If we don't need all the time, that's perfectly fine, with at least the co-chairman. So, Gary, I'll turn it over to you and your subcommittee.

MR. PREVITS: Thank you, Don. Good afternoon, everyone.

I believe all the members of our subcommittee are either here in person, myself and Amy. We have three joining us by phone. I heard Sarah, and Anne, and Barry check in, so we do have the opportunity to respond if you have particulars, or if they would care to comment.

Our chapter is marked Chapter 5, Human Capital. With regard to changes since the previous discussion of these recommendations and text which occurred at our March meeting, there's been one addition. I'll review that with you, and then, also, a reordering of the list of recommendations in the sense that there was a consensus, I believe, in the Committee that the human capital issue of making our profession and our public auditing responsibilities as attractive as possible to minority groups to become aspirants at the entry level from other areas, and other types of backgrounds to provide additional feed stream to the profession.

The ordering, therefore, of the five recommendations, and I think it's meaningful that we have, to this point, even having considered many of the items that Don previously mentioned about items that are still on the list of issues, so to speak, even though we have considered those to some length, at the moment, the five items that make up our recommendations include the content of learning. That's the first recommendation at the moment. The issue relating to inclusiveness of minorities in the profession, that's the second recommendation.

Again, these two are relatively -- they have been combed out and refined, but essentially, directionally and in content, very similar to what we recommended in the earlier drafts as we were preparing for the draft of the final report.

The third recommendation has to do with faculty, both the minority and the faculty recommendations are, if you will, specific human resource recommendations. The faculty composition is also about the importance of having a dynamic balance between academically and professionally qualified faculty.

The fourth recommendation deals with data development, the supply, and cooperation to produce those so there could be timely guidance and information, versus other forms of information which sometimes are anecdotal and is always limited by the experience of those who may share those anecdotes.

The item that is added as a recommendation really is the result of discussions that occurred in our telephone meeting of the Committee as a whole later in March, and it has to do really with the response to a document that was prepared in November 2006 by the International Audit Networks and the other firms, which was called "The Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Network."

I say it's in response to that, in addition to discussion we had, because there's an awareness that without a vision as to what we perceive education should be supporting in the future, for those firms that are involved in publicly held audits, and the registered firms that are supplying the process of the audit, without some expectation, some vision about where auditing is going to go, and where the needs of investors are going to be in the future, and where the needs of public companies are going to be in the future, all we're doing in education is attempting to modify it incrementally.

I think I may have mentioned on the telephone conference call that in 1980 there were zero, absolutely no accredited accounting programs in the United States. Today, there's over 160. That doesn't happen without a sense of vision and planning, and that vision and plan was put in place in the late 1960s with a program called "Horizons for Profession", which was partly funded, I believe, by the Rockefeller Foundation, and instituted and guided through professional societies.

It was that vision that provided an anchor, or if you will, a platform from which to prepare and provide the kinds of additional education, the quality of education, the post baccalaureate education that we have today. And it only took 40 years to accomplish, and we have to be very patient, I think, sometimes, but persistent, as well. It also happened based upon the resources and energy of a very involved academic community, and we now have, for all intents and purposes, a supply line that is capable of producing high-quality individuals with graduate education.

That vision may have served its purpose in the whole thought of studying and preparing, and undertaking a visionary effort, creating a committee or a commission to identify possible education institutional structures, including the possibility of a professional postgraduate school that will prepare registered firm auditors to meet the needs of investors and others, and intermediaries in the global operating future, is what this fifth recommendation is about.

The ordering of these recommendations is a matter of some continuing discussion. I will share with you personally, and maybe to the chagrin of my subcommittee members, but I tend to think the two human capital recommendations, the one that deals with minorities and faculty, really are priorities in one sense, because people are the prime ingredient of the profession, of

Tim's firm, of everyone's firm. And to the extent that I would argue that perhaps we should prioritize those two particular human resource recommendations, we'd be interested to see what the other members of the Committee, and what you feel about that.

Human capital recommendations such as those relating to our ability to attract and retain high quality individuals really sets the stage. If you have good people, the institutional arrangements follow, the curriculum follows, the appropriate gathering of data follows.

The process of building the curriculum and all the other matters, therefore, are driven by the quality of the people, and so the number one and two recommendations, at a certain point in time, may become those that are human capital expectations.

Now, indeed, our recommendations are few, and that's to, perhaps, the chagrin of some who have not seen something important to them included, but they are few, and they're focused, and they're in my argumentation and view fundamental. They address the vital basis of the human capital framework that we will be faced to provide to registered firms so that they can serve the public interest in an increasingly globally complex situation.

We anticipated, too, that our recommendations have to be made more readily actionable; that is to say, these have to be things that can be accomplished with reasonable effort and support. Therefore, the test of these recommendations that we'd ask you to consider is not so much their popular appeal at the moment, because I can tell you, having traveled among academics and shared with them some of the concerns, they already say hey, we're doing that. And I say well, maybe you're not listening to everything that you're being asked to do in the future. And with a recommendation that's visionary now, I think we can also challenge them to think beyond just their immediate goals.

In any event, not just the popular appeal of these items is what's given us, if you will, the attitude and the importance of making these in our list. The point is that rather than have just something that would be popular to put in front of groups, we've really tried to look down to what the subjects are that will stimulate action, that will be visionary, and most importantly, change-oriented.

I gave a speech in Chicago about 10 days ago talking about these, and I looked at the audience and I said, "We have to be ready for change in academe." Most of the folks there, depending on where they were in their careers, either welcomed or kind of frowned when I said, "We have to be ready for change." If this organization and this activity is not about a message to bring about change, I think we may have missed an opportunity to plant that message.

Amy, I believe we're supposed to be opening for questions, but would you care to comment?

MS. BRINKLEY: You've covered it well, Gary. The way I think the Committee came to look at this is, first of all, and you can draw the order in any number of ways, but first of all, what is it that the profession really needs to be equipped knowledge-wise and content-wise to do what is required for quality auditing in today's complex global world that is changing so dynamically. And so that is where we centered on curricula first, and there's a huge amount of work that needs to be undertaken there, and with a great deal of urgency.

Then it becomes who is your talent pool, who is your talent pool that you're going to recruit into this profession? And that pool is going to need to be broader, more diverse, and pulling from places we have not historically done so. Similarly, faculty is going to have to be attracted into the educational system, and we would hope over time increasingly higher caliber students and faculty as we think about talent pool.

And then we did see that there was a need for something that is even more visionary to get out there, to think is there a new educational construct that might enable all of these things to take traction and get us there sooner, rather than later, getting back to the point of urgency.

Finally, I think the data piece underscores all of it, and can help us achieve all of the objectives. But if there's another word I would emphasize that came out of our work, it was one of urgency.

CO-CHAIR NICOLAISEN: Well, great. Let's throw it open then to comments from other Committee members. Sort of the litmus test is, do these recommendations add to the quality, sustainability, and effectiveness of the audit process? Are there others? Are there some things that you want to ask questions about? Are there some areas that you think need to be covered that you're surprised aren't on the list?

And I'll make one comment about the ordering of recommendations. From my perspective, they're all important, so I don't think we want to spend a lot of our energy on which one is first. I think the key is, do we have the right set of recommendations, and that will be true, I know each of the subcommittees have wrestled with that question, but that should be true for all the subcommittees. I don't think you need to worry too much about the order. The marketplace will figure out which of these are, in their view, higher priority. So, Arthur.

CO-CHAIR LEVITT: I wonder about the elephant that's not in the room, and that is the overall public image of what it is to be an auditor. And I wish this Committee had touched on that issue more than they have.

It's not among the most popular career choices as you go through high schools and senior classes at colleges, or even business schools. It just seems to me the industry itself could do a better job of creating a better image for itself. And I wonder whether that topic came up during your --

MR. PREVITS: I know Barry is on the phone. Barry, you have, perhaps, a lot more data than I might have.

MR. MELANCON: Right. Actually, Chairman Levitt, since about 2001, the accounting enrollment issues have been skyrocketing. And, in fact, last academic year, the accounting graduations are at an all time high going back to 1971. Accounting enrollments are universally up around the country, and have been for about the last five years, and are now paying dividends to graduation level.

There is a huge program where we have more than 1 million young people in this country actively engaging in an internet-based exchange process that incorporates recruiting them into the profession and educating them on the profession that is very forward-looking on image and other activities. That program is embodied in a website that is entitled StartHereGoPlaces.com, and it actually is a very forward-looking approach. It has interactive games, it has interactive competitions. It embodies certain issues, such as fraud and fraud detection, et cetera. And it has been very, very popular.

So the enrollment numbers are actually very strong. We're getting ready to issue in the next two weeks, actually, it may have actually gone out on Friday of this past week, our bi-annual supply and demand study in the profession. And the numbers are extraordinarily positive, and continue a trend now of about four years in which that's the case. So we did discuss that at length in the subcommittee, and we shared a lot of that data.

We also had individuals from human resource functions of firms, et cetera, testify in some of the subcommittee meetings. And I think the reason why we focused on those issues that are there today in the report is that the real hurdles that we face are in issues, such as minorities, as Gary and Amy have talked about, the urgency point that I think all of us agreed with the notion of making sure that curriculum and attractiveness is commensurate with what's going on in the marketplace, in the world today. And I think that comes across in our recommendations.

And then, obviously, in the system in the U.S., the sort of the hurdle that we most have to get over is the adequate supply of Ph.D.s and others to teach individuals.

But we did not ignore the notion that making sure that we are attracting people going into the future just because we are in a good place today. We do have the recommendations in there that focus on, for instance, community colleges, career changers, and things of that nature. So we approached it, I believe, more on the notion of making sure that we leverage off of the position that we are in today.

MS. BRINKLEY: Chairman Levitt, if I may also, we believe that with, as Gary is suggesting, with the curricula changes, some of the other things we're talking about, it will create a more dynamic and exciting experience, starting with the educational process, which is key. And I think therein the possibility of an independent school could be very, very important.

Some of our anecdotal experience talking with more junior partners in accounting firms, et cetera, seem to suggest that they were very stimulated by the content of their profession, and saw it as changing so rapidly they found that stimulating, and were very motivated by the challenges of the profession today.

I do just think we have to keep staying focused on providing them, and equipping them with that content capability that's required. Also, I think the global aspects, the possibility for global assignments is very attractive, and increasingly an opportunity, whether working for auditing firms, or working for large global companies in the accounting field.

CO-CHAIR LEVITT: Up until recently, the main motivating factor in growing young people into an industry has been compensation, and hedge funds and investment banks have been the careers of choice. Do the levels of compensation for beginning accountants compare to those of lawyers, for instance?

MR. PREVITS: I'll try to take a

shot at that, because the market -- I'm not one to complain much about the market reaction here. I think what's happened is we have more than an ample supply of individuals coming in from the supply chain side. The question is whether or not the demand function is going to change, and the chances are that it won't, so we're going to continue to be, according to the data in the study that was sponsored in a situation of relative over-supply, no one likes to hear that on the buy side when you hear people talk about over-supply, because it tends to keep the price down.

Over time, if the vision is correct, and if we can professionalize the educational model further, not just merely vocationalize it so that we're turning out people who can spit out nickels without understanding what they're spitting out, but essentially professionalize the education along with the kinds of educational experiences that involve experiential learning. I think we're going to see both a rise in the quality of the individual coming into the profession, and also see an adjustment in the compensation, as well.

Right now, when I travel around the country going to regional meetings of the Association, what I hear coming back from goods schools, big schools and small schools, is a lot of our best five-year people go into the firms at a level that are competing with four-year people at work that isn't necessarily entirely responsive to what they've been trained to do in their fifth year.

If that's an issue, then including the Faculty of Texas, and the folks that I've talked to on that faculty, there might be a mismatch occurring, which simply says that the model of accepting people into the firms may have to better represent what they're prepared to do when they enter. Either that, or people are discounting very heavily the education that they've received, which is another possibility. They can simply say well, the educational function only serves one important function. Bring us bright people, and don't mess that up too badly. I think we're doing more than that in the classroom. And we're capable of doing more with the kind of curriculum suggestions that are coming about.

The other thing I would say is my brother-in-law many years ago when he came through medical school and started, and today some of the young people come through pre-med don't start at very high wages. They understand the compensation model is one that puts them into a situation that they have to expect to perform, and the compensation adjustments come after the entry level.

MS. MULCAHY: Gary.

MR. PREVITS: Yes. Go ahead, Sarah. Did I hit --

MS. MULCAHY: It's Anne.

MR. PREVITS: Anne, yes. Please go

ahead.

MS. MULCAHY: I think, Arthur, to your point, I'm not sure that the competition that's compensation driven has been between the business world and the accounting firm world, but we've all, I think, been competing for best talent against the financial services world. And it may be one of the only positive outcomes, but I think that it's starting to be a little bit of a self-correcting phenomenon right now.

And I do believe that the answer is not, necessarily, pulling up to the level of financial services, but, hopefully, a little bit more of a rationale over time. But I think in terms of business and accounting firm worlds, I do think that that's a relatively rational compensation platform, and one that actually is conducive to exchanges between business and the accounting firms. And, hopefully, it won't be quite the crazy pull for talent that financial services has drained the business world of over the last few years, as well.

MS. SMITH: It's Sarah Smith. I would just say up front, I'm not a huge fan of the downgrading of the financial services industry to achieve this.

(Laughter.)

MS. SMITH: I think also from our observations with members of the accounting profession on this topic, that while -- to your point, that starting salaries of say somebody entering into the accounting profession, versus someone entering into the law firm, or for an investment bank, may be lower. I think that's probably true.

I think most people entering into the accounting profession understand that over the long haul, those salaries can change significantly to the upside, and can take you in many different directions in your career, all of which will be likely to bring remuneration. And that it's somewhat viewed as an apprenticeship or early start, in order to get one into that type of position of moving up the firms, or out into corporate America. So I don't think we found that to be a deterrent, as you've heard here. There's a huge supply coming into the firms. And I just thought I would add that point.

MR. HERZ: Hi. This is Bob Herz. I'll reiterate a data point that I provided in our last meeting in Washington, but over the last four or five years, each year we have 10 or 12 what we call postgraduate technical assistants, who are the best and brightest graduates of five-year accounting schools. They spend a year, 15 months with us. And over that four or five years, all but one or two of them were recruited into the transaction services with the large firms, not at the audit. So I sat down with the current group and I asked why is that. And they said well, two factors; they perceive the work they would be given in transaction services as intrinsically more interesting and using their skills, than additional years of audit. And, secondly, they were being paid about 60-70 percent more.

I gather a lot of people are coming into the accounting profession, a lot of people in accounting enrollments, but I'm still not convinced the best and brightest are going into the auditing side, just from that data point.

MR. MELANCON: That's a single data point, though, or a single subset of a data point. In other words, you have several examples, but they're in one environment. And, clearly, the best and brightest go in a lot of different directions, and so we use that term pretty loosely.

The fact of the matter is, is that major universities with topnotch programs are producing a lot of graduates that are being hired into the profession today, or being assigned in various ways in the firms, including audit, tax, and other places. But you could certainly give examples. I don't doubt the examples, because I think those things do happen, but it's not everyone that's in that environment.

MR. HERZ: Well, this is over four or five years, and it's like 95 or more percent of the people. And so I agree, it's not a scientific sample and all that, but I have concerns that we're not attracting the best people. It's not the first choice, so I agree kind of with Arthur's overall point, that making the audit the first choice would be possible, rather than tax, rather than transaction services, would be a good thing.

MR. FLYNN: Well, this is Tim Flynn. I think there's a lot of discussion around this, and I think a couple of points. I think Anne's point regarding financial services in an overly heated market and coming back a little bit is a very valid point.

I think that as a profession today,

we have to define audit pretty broadly. We have transaction services specialists supporting the audits, we have valuation specialists supporting the audits. We have complex financial-driven experts supporting the audits. We have international tax experts supporting the audit process, so you can't think of this one-size fits all auditor, and say that's what the firms have today.

There's a whole series of very complex issues that specialists are dealing with that spend a great deal of time working on audits, so I think you have to look a little broader than just thinking about what one might think about 10 or 15 years ago.

The other thing I think, if you look at the firms today, there's probably no other profession, or maybe industry segment, where you have Fortune 100 best places to work, the four major firms, where you have in the 50 best places to launch a career in the top 15, all four of the firms. So I think you've got work environment, you have a lot of things being put to try and drive talent into the profession. And I think we've done a pretty good job of attracting a more diverse talent force with broader skills.

I think we also have to look at, we don't have, to Chairman Levitt's point, we don't have the major business schools with major accounting graduate programs. Our recommendation number five says let's step back and let's look at that. Should there be a broader array, a different way to look at attracting maybe we'll call it that next tier of talent more broadly in the profession. I think recommendation five does that.

I also think the other recommendation on curriculum is an important way to look at how do we develop skills, not only coming in from academia, but the training you get. One of the big attractions of the profession historically has been an apprentice model, where you come in for a couple of years, you become licensed, and you have a certain additional degree working for a major accounting firm that's marketable out in the marketplace.

So I think you have to look at this in many different ways to look at what we have here. Many people go back to graduate school after being with us. How do we get those to come back into the profession? So I think some of the recommendations here taken to the next level challenge us to think broadly about talent attraction, and about curriculum, challenge us to think how to attract a different level, maybe to compete with some of the higher learning educations and specialists.

At the same time, the models, I think, in today's environment are working pretty well. And to keep that in balance, having that future vision, as well as leveraging off the strengths we have today.

MR. TURNER: I think Arthur did

raise a very valid question about esteem. And I do think that recommendation five runs directly to the heart of that. I think that until we can create an educational system that is on par with the law schools and the medical schools, we're not going to attract the best and brightest. And when compensation is far below what you can get in those fields, it just isn't going to occur.

I couldn't agree more with Bob Herz that, in fact, we aren't, I don't think, attracting the best and brightest. Students go where there's jobs, and students go where there's jobs that pay a halfway decent wage. And since accounting is creating a lot of jobs, if you looked at the job data just last week, accounting was one of the fastest growing ones. That's, obviously, where students are going to go into college, so that they can get a good job when they get out.

I'd like to think it was the independence rules that Arthur and I passed back in 2001, but I don't think that's necessarily what brought on the high rise in enrollment after that. But, anyway, I do think that there is a key issue here on compensation, because it is much lower. There is a key question here on the educational system, because it isn't on par with the law schools or medical schools, isn't even close, in my mind. And, as a result, I don't think we're attracting the best and brightest.

While recommendation five I think is good, it's going to have to be more than just a national commission. If someone doesn't actually act on that, if all you ever have is another national commission, then we'll be in the same place in two decades with absolutely no improvement in the profession coming out of these recommendations. And I think the recommendations, in a strange way, tell you just how bad we are in the educational system in accounting, because we're recommending that people have textbooks that are current. We're recommending that they have teachers that are current, and recommending that they have curriculum that are current.

If a Committee of this stature has to recommend that to a profession, you have to say where does the profession stand, that you're actually having to have those recommendations made? It is not a resounding support for where that system is today. It needs to go a lot further. The recommendations are, in fact, almost a condemnation.

MR. MELANCON: This is Barry. I think that's, with all due respect, Lynn, a little bit of an oversell on that point.

The fact of the matter is, is that there is a lot of evidence that the change that has occurred. Clearly, education systems in the United States, broadly speaking in any area, are subject to a lot of recommendations. It is a very difficult change management process, whether we're talking about elementary and secondary schools, or institutions of higher education, and in all areas.

The fact of the matter is, is that demographically in this country, if we want -- and we spend a lot of time looking at these issues - if we want to talk about what's happening in the adult workforce issue, there are significant advantages that our profession has. We are doing a much better job in attracting people than some of the competitive professions.

I think there are certain aspects of people graduating in accounting that are attracted to other places in the sort of business reporting, and the business channel. That's a fair statement, I agree with that. And I think that will always be the case. That's the nature of a free market system.

But in many instances, for instance, Chairman Levitt asked a question about pay for lawyers. There are certainly some lawyers that enter some job situations at higher pay than some entry level accounting students. And then, as Sarah mentioned, I think if you look at career earnings in many of those cases it begins to flow. There are also many, many, many examples of lawyers that enter their jobs at less than what people enter into our profession.

I thought Tim's point about the broad nature of the opportunities in our profession is very important. We're dealing with a generation today that looks, quite frankly, and we do a lot of work with futurists that look at the job market, and regardless of what they're majoring in, something in which they will have anywhere from nine to fifteen careers before they retire. And the CPA profession is attractive to them for that very nature, because the skills that they get, the exposure that they get, the different business opportunities is actually something that is a very strong selling point to the fact that, that can be leveraged by them in different ways in their careers over the next 20 to 30 years.

And, so, while some of the points you make are legitimate, there's a whole host of forces on the other side of that, that are not being taken into consideration, that actually play very positively to where the profession is positioned.

MS. BRINKLEY: Barry, this is Amy. Excuse me, Don.

CO-CHAIR NICOLAISEN: Just a second. As we go through these issues, I think we could do point/counter-point, but the idea here, compensation is one of those things that has not yet been talked about. It's on the list of things to be discussed, and have commentary and input from the subcommittee. So to the extent that we can do something productive here in a relatively short period of time, particularly those who are not on the subcommittee, if you could offer your views as to, you think it's an important issue, or you're pretty well convinced that it's not, that would be helpful to keeping this dialogue moving. So we'll do Amy, David, and Mary.

MR. GOLDMAN: What about me?

MS. BRINKLEY: All right. I'll go quickly.

CO-CHAIR NICOLAISEN: All right. Let's do in that order. We also have Ken and Anne, so just right in that order.

MS. BRINKLEY: Clearly, I think the reality is somewhere in-between, that there's a lot of truth in what Lynn had to say. And I think it underscores -- I mean, it was striking that we had to go to such fundamentals when we talk about, is the curriculum adequate? Are we really attracting the right students, and enough of them? Is the faculty being prepared in the pipeline? These were all very fundamental things, but I think they're real. And that is why I underscore urgency. And what's going to be critical are our next steps of how we're assigning accountability for taking these things forward, and in a quick and orderly fashion, and seeing results sooner than later. The idea of a school, as we've talked about in recommendation five, that concept could be very, very critical.

Part of what we think with compensation is that if all of these things are working together, compensation will follow; that it may not have to be the lead, that these other things are going to be critical ingredients to driving compensation to where we think it should more appropriately be.

MR. SILVERS: Per Don's suggestion that we hear from other members of other committees, I think that the compensation issue is certainly important, but it needs to be integrated into a larger set of circumstances. I think this dialogue was sort of pointing in that direction. I want to be maybe a little more explicit about it.

This Committee is entitled "The Advisory Committee on the Auditing Profession." I think the word "profession" is supposed to have some meaning. And I think the meaning has something to do with the notion that this is not a pure market transaction, in a sense; that the auditing profession, like the medical profession, and the legal profession, architectural profession, is seeking to establish standards and hold its members to a standard of conduct, both in terms of professional expertise, and in terms of professional ethics that are, at some level, not actually encompassed by the compensation they receive, or don't receive.

I think that making that real, and I think that we've had a series of problems in the profession that have called that whole structure of behavior into question. Making that real is critical to being able to attract people to an economic circumstance that may not be the best they could get. It may not be profit-maximizing to be in this profession for every member.

Now, I think that, that has to be, the subcommittee looking at this may wish to think about following fact. Among the data that we have received as a Committee, is I believe the data, and I can't remember it precisely, but someone will correct me with the exact number, that the typical partnership share in an auditing firm today is around $800,000. I think that number is out there.

That seems -- I mean, this is a public meeting. I think for most members of the public, $800,000 a year as annual income seems like a big number. It's approximately -- it's a little less than 20 times the median family income in the United States today.

For people who are used to the labor markets involving financial services professionals and corporate lawyers at the senior level, that actually sounds like a somewhat low number. Certainly, it's a low number in relation, for example, to CEO and CFO compensation in the public companies that auditors are auditing.

I point out, though, to the group, that in 1964, the median -- the typical CEO compensation was approximately 20-25 times median family income. What that seems to tell us is that a variety of players at the very high levels of corporate finance have seen a great growth in their incomes relative to the rest of Americans in the last generation, but that auditors have not really participated in that. And it's an interesting conundrum why that would be, because the value of the service that the auditors provide, at least to the users of the auditor's financial statements, is quite high.

Having accurate financial statements is something of great value, perhaps even greater value than some of the services provided by investment bankers and corporate lawyers. But, yet, that value doesn't seem to flow into the chain. It's not encompassed economically. And it strikes me that this complex of issues is maybe where, at least the analysis in our report, ought to -- there ought to be some acknowledgment of it, and some sense that we need to be simultaneously looking at improving the training and the professional components of the profession, creating circumstances in which individuals can pursue a career in auditing, confident that they are pursuing a higher calling.

And, thirdly, that perhaps this is indicative of perhaps some larger issues, that when there's enormous call -- when the economics push all of our talent into a relatively small set of functions in our economy, that it becomes very difficult to fix the pressures put on those segments of the economy that aren't enjoying that. That, in certain respects, the auditing profession is in a no-win situation, and that has a lot to do with the pressures perhaps not to act professionally when there might be an economic reward to doing so.

CO-CHAIR NICOLAISEN: All right. Mary. And just a reminder to those of you who are on the conference call, if you could put your mute button on when you're not speaking.

MS. BUSH: Two comments I'd like to make, just on Chairman Levitt's point about transmitting to potential students and people who might enter this profession, that it is an attractive profession to be in, I would like to support that comment wholeheartedly.

I think despite what has been pointed out in the draft report about the numbers having increased substantially, I do think that still there needs to be sort of an image change, if you will; that people need to understand what Tim Flynn was talking about, that you need people with expertise, and who will work in several different areas of specialty, despite the fact that they are with an "auditing firm". So I think that's very important to attracting more, and better, and high-quality people to this industry.

Then, secondly, you have several, or a recommendation with several parts, on attracting minorities. And I commend you for that. I would like to commend to you a potential model to review, and it really doesn't have to apply just to minorities, it could apply to anyone, since you're trying to attract more, and highly qualified people to the profession.

This is a program that started several years ago, at least a decade ago, maybe more, by the man who is currently President of the University of Maryland-Baltimore County. His name is Freeman Hrabowski. He's an esteemed and highly regarded educator. He is African American, and he started a program called, "The

Meyerhoff Fellows", funded by the Meyerhoff family in Baltimore.

The reason that he started this particular program was that he had observed that young black men were no longer entering, or majoring in math and science. It was a very, very, very small number. And so he started this program to really get young black or African American men interested in math and science.

He later expanded it to black girls, as well, and then to everybody. And what has happened as a result of that is that now his university, which takes in a lot of the Meyerhoff scholars, produce more African American math and science Ph.D. candidates than any other school in the country. So it's been a very successful program. I can't tell you all of the things that are involved in it, but it seems to me that in conjunction with the recruiting at historically black colleges and universities, and the other kinds of suggestions that you've made, that this might be a very good model to study. And if you'd like, I could put you in contact with Dr. Hrabowski.

CO-CHAIR NICOLAISEN: Okay, Mary. Thank you very much. Ken Goldman.

MR. GOLDMAN: Yes, I thought it wasn't right. Thank you. That more rigorous curriculums that would be helpful, I think would go a long way here. To that point, I was sort of thinking about the training for partners. And again, I wonder how much of that is pure on-the-job training, and seminars, and so forth, versus what would be helpful in terms of business school training, whatever, so you have a better big picture view of that.

And then that got me thinking, I was actually talking to someone I got to know a little bit over the weekend, of all things, and I don't want to go too far into it, but is an individual that is a very senior individual, and was involved in some of the backdating stuff. In some respects, he should have known, but he didn't know, or whatever, he says he didn't know. But, I guess, the point is, I just wonder over and over about the financial literacy of everyone involved, not just the auditing profession, not just the CFO and accountants. I know it's not the province, per se, of this Committee or subcommittees, but I do think we have a real issue in terms of increasing the financial literacy of everyone involved. And I think that would make the work of the auditing profession, and the financial people in the company a lot easier going forward. So I keep on thinking through that, and I think that we need to do that from high school all the way on.

Third point is compensation. Again, my sense, and I don't know this, but my sense is a very steep curve. What I see pretty frequently are people coming to me that want to leave the profession two, three years in because the salary is quite low, and they don't want to go through the laborious work, I guess, to get up to a partner. So I just wonder whether that curve is too steep in firms. And I'm not saying that partners shouldn't be paid what they want, but I wonder whether the incoming salaries have gone up high enough, sort of like the legal profession did a few years back.

Fourth point, and I was sort of thinking about recognition, a point Arthur Levitt was saying, and I started thinking about when you see investment banks or commercial banks, whatever, when you get recognized as a partner, you see these big articles, mention in the *Wall Street Journal*, whatever, here's a list of new partners, whatever. I wonder how often the auditing profession recognizes their partners, their new partners. And if they do, I have never seen it, per se. And it would be nice to see a nice page, here's our new partners, a list, and local papers, *Wall Street Journal*, whatever, as a recognition. I think more recognition for partners, I think would be a good idea.

CO-CHAIR NICOLAISEN: Yes, I think they do that.

MR. GOLDMAN: Do they? I don't see it then, if they do. Okay. Anyway, those are my thoughts.

MS. YERGER: Just very quickly, one comment, and one question. I wanted to second -- I'm sorry. Can you all hear me? Okay. Thank you.

I wanted to second Mary's comments about commending the subcommittee for its recommendation about expanding minority representation in the profession. It's obvious from the statistics that it's needed, and I wanted to point you to another model, which is the Tweedle Foundation, which has worked hard over the years to expand minority representation on Wall Street, providing fellowships to college students and networking opportunities. And that might be something to add to the mix of the recommendations.

And I actually just had a question. We're all wrestling with this convergence, international convergence of our accounting standards, likely, and I was just wondering whether the Committee had considered models outside of the U.S. This is a sort of U.S. centric set of recommendations, and I don't know if there's any models outside of the U.S. that could be imported or overlaid into these recommendations. And, possibly, that's part of the number five that's sort of the vision recommendation.

MR. PREVITS: Well, let me respond directly by saying that there is an agency that is in the private sector called International Accounting Education Standards Board, and they've been deliberating two models. One model, which traces back to, if you will, the apprenticeship system. And, of course, the higher education model; both of which have completely different origins, and if you will, social backgrounds. So those two models are the ones that are being discussed in terms of the process of looking at international education standards.

To the extent that recommendation five really envisions a model for the environment of the United States, it is looking at the possibility of a postgraduate education model.

Yes, we're aware of the fact that there are many different approaches to educating, and depending on where you are, whether you're in Australia, or Canada, or the UK, or France, or Germany, which has its own model, you'll get different - or Turkey - you'll get different views as to which one is stronger and better. And that's about as far as the information goes. I hope that's responsive.

CO-CHAIR NICOLAISEN: Great. Gaylen Hansen.

MR. HANSEN: Anecdotally, I will add that I have, between my wife and myself, eight children. The last one is now 18 years old, and has been accepted to go off to college. Not a single one of them have become CPAs, and that includes a lawyer in there, certified financial planners, some systems analysts. And I have to tell you, I'm a little bit discouraged with the results of all that, but I think that there is an aspect of image that really does need to be addressed. And I think professional schools of accounting certainly need to be considered. And I know your committee has discussed that a great deal.

And I'm glad that Anne brought up the subject of international standards. I wanted to, at least, make a comment about that. It runs through a number of these Committee reports, and I do know that it's being argued, discussed, debated, however you want to put it. The SEC is doing a great deal of work on this right now.

I believe that is appropriate. It's probably the direction we're headed. But I think that the report should stop short of endorsing international standards, unless that's openly debated. I've been reading Lawrence Cunningham's paper; he was an earlier, as you know, witness here, and he has an excellent paper out on the subject. But I think that there's a lot of other implications, especially in the HR area. And I was going to hold off for Damon's subcommittee, because I think that there's also a huge impact of these standards on small firms.

Since I'm the small firm represented on the Committee, I feel particularly sensitive to that. I think that it could have an enormous impact on competition, as well as concentration. And I have not heard words to that effect yet.

CO-CHAIR NICOLAISEN: Rodge Cohen.

MR. COHEN: Thank you. The one aspect which strikes me of the recommendations is that it is focused almost entirely on the pipeline, as opposed to the career when you're there. I don't think this is an omission, but I'd like to make sure that my observation is accurate.

What we did not hear, I think, in any of the panels was an undertone of job dissatisfaction. To the contrary, I think there was job satisfaction. But if that is wrong, then there is a second part of the issue which needs to be addressed.

CO-CHAIR NICOLAISEN: Very good. I wanted to raise something that's a little bit similar to that, and that's this issue of this is the first major study of the profession post-Sarbanes-Oxley. And we heard, at least we've heard over the years that the profession has changed dramatically post-Sarbanes-Oxley.

There's more compliance work, there's more work on controls, there's more documentations, and there's more of a direct edict to the auditor to really challenge the work that management does, challenge the conclusions that management has reached, challenge the judgments that management has undertaken in preparing their financial statements.

Some of that might imply that the skill sets that would be critical or would be the attributes of a really outstanding professional auditor perhaps also has changed. We haven't talked about that.

I'm sure you've talked about it in the subcommittee. We don't have a lot of time right now to get into that, but I would appreciate, as you craft the final language of the extent of dialogue in other areas, that you touch on this, as well, because I do think that there is a perception out there. And I certainly have heard it amongst the more mature auditors, that the world is different than it was when they entered the profession, or when they had their training. And sometimes that's not described in an absolutely positive fashion. It comes across as “I'm now the documentor of everything. I'm the chief compliance person. I don't have -- I'm not using the intellect that I could use, a challenging accounting principle standards application, and some of the other things.” So I'd just appreciate it if you'd talk about that.

MR. HERZ: Hey, Don. This is Bob Herz. I had a point which I think may be a subset of the point you're making, and it really starts with the point, the hypothesis, which I hope we would all agree with, that financial reporting is for the benefit of investors and other users; and, therefore, the audit being a very important aspect of financial reporting, is also aimed at that, that objective in the consumer population. And, therefore, I think this gets to the content of the curricula.

I think it's probably implicit in the write-up, but maybe it ought to be made explicit that, it seems to me that to be an effective auditor, it becomes important, therefore, that the auditors be trained either at the university level, and/or in the firms in things like financial analysis, things like security valuation, business valuation. In other words, to look at things through the eyes of an investor.

That doesn't mean that's the exclusive part of the curriculum, but I think if they're serving the customer, they ought to know how the customer looks at things.

CO-CHAIR NICOLAISEN: All right. We have about five to ten minutes remaining in this section, and so whatever input we can get in that time, I'd appreciate. So perhaps relatively short comments. Zoe-Vonna.

MS. PALMROSE: I'll be brief. I just wanted to reinforce, Don, what you had said. It's very difficult for me to think about education in the narrow sense of university, college and university. To me, it's really a lifetime education process, or lifetime learning process. And so, if we could think in terms of that lifetime learning process, and what happens at what stage in that process in this post-SOX environment, I think that would be very helpful.

CO-CHAIR NICOLAISEN: All right. Others? Yes, Gary.

MR. PREVITS: Just one final comment about the context. When we look in the short run, particularly with the rampant rise of international standards, and the attention to XBRL, which is pretty much a product being proposed within the most recent years of the current administration, and when we think about the analogies to law school, these are all helpful. They sort of drive a sense that we ought to be doing more.

The law school is still an applesto-oranges type of analogy, however, because there is a three-year post-baccalaureate education required for law. There's an additional two years deferral of income for people who are pursuing legal education, and I'm not so sure that everyone who leaves law school is being hired at multiples of what people are being paid when they go into accounting. So I think that's still a little bit of an unclear argument to me, that you can compare adequate compensation between those two professional entry points.

And as far as where the auditing and accounting education model is today, I would agree. It's not at the point it should be. It needs to be visionary, it needs to be thinking out into the future. However, I would absolutely reject any assertion that it hasn't been very effective for the generation that's now about to depart the scene.

I would suggest that if you go to any other field, and you find where they have essentially upgraded the faculty requirements from being a service faculty with a Master's and a CPA for the most part, to a doctoral degree being a terminal degree, at least to the accreditation standards, that you brought an entire cohort of 160 schools into accreditation standards, where the requirements are that the faculty be professionally qualified, be research active, where the proportions of resources be appropriate. All that's occurred in one generation.

The accreditation standards changed in 1969, and Horizons for Professionals was 1967, so it's time to take stock. And if we're a little impatient with the educational community, recognize that across campus, your tax dollars are subsidizing the COMPETES Bill, which passed on August 9th, and signed by the President in 2007, which outlines a $33.6 billion package for science education.

Now, at the last meeting, Damon and

I said, you said the line would get long in that area if you start looking for resources for that area. We've already been beaten to the punch. And every year, this country spends $29 billion on health education.

I said to Bill Gradison at a recent meeting, wouldn't it be nice if we'd get one-half of one percent of that for education of auditors. That would be $145 million. I'd take that for ten years, because the entire investment in this structure in 40 years has been the Accounting Education Change Commission of $5 million over six years.

Now you cannot get blood out of a turnip. You can get progress. You can get a changed education level, but when we start thinking about placing demands on the system, recognize science and engineering have already been there, and medicine is there. And you're not going to get all these grand structures of increased education without investment at some level. And, hopefully, a professional school can bring out that mix of the skills that are needed from practice, and the skills that are needed from general education, higher education, produce a higher quality auditor.

We have to be patient, but we have to be persistent.

CO-CHAIR NICOLAISEN: Great. Thank you. I would also say, those who ask, have a better chance of getting than those who don't, so it's probably part of our role here.

Any other burning comments? If not, we're going to move into the next subcommittee.

Great. We'll take a break after we finish discussing the Firm Structure and Finances Subcommittee, led by Bob Glauber. Other members are Tim Flynn, Gaylen Hansen, Ann Yerger, Rick Murray, Bill Travis, and Lynn Turner. So I believe you have your full crew here today, and I yield the floor to you, Bob.

MR. GLAUBER: Thank you, Mr. Chairman. Realizing that I'm the only thing that stands between all of you and a break, I will try and be brief in my summary of what we've said. And, indeed, what we've said here is mostly unchanged from what we said before, with the exception of some cosmetic refinements.

To remind you, on Recommendation One, which is about fraud detection, we are proposing a national center that would act as a clearinghouse for practices, data on fraud detection. I should point out, it is now a national, not an international center, reflecting our judgment that it's more likely to get something done if it starts at the national level. But we do note in the text that we believe and recognize that a national center in best practices will have greater impact if these concepts are ultimately extended and embraced internationally.

The second part of that recommendation is to invite the PCAOB and SEC to clarify what exactly is the -- what is the auditor's role in detecting fraud, to clarify that in the auditor's report, because we think there is an expectations gap between what the public expects the auditor's responsibility to be, and what auditors are actually both capable of, and responsible for doing.

Our second recommendation really is -- and I note back to what Don said a minute ago. We are now in a post-SOX environment, and the second recommendation, I think, can be seen in that setting; that we really believe there is need for greater regulatory cooperation and oversight now that we have markedly federalized the process of regulation of audits of, at least, publicly traded companies. And to that end, we call upon the states to embrace the mobility provisions of the UAA.

We still set the date of December 2010. We have discussed, and noted, some people have pointed out that that may be too pressing a time table. It may be. We think it is worth putting that time table before the states. It would give states even with bi-annual meetings an opportunity to confront this issue, and it would perhaps encourage them to put it at the top of their agenda.

The second part of that is, again in the spirit of trying to urge better cooperation, roundtable meetings of regulators and other governmental enforcement bodies aimed at improving effectiveness, and reducing duplication.

And then, finally, we take note in the third part of that recommendation of the financial position of the state boards of accountancy, and urge that they be given greater operational and financial independence.

The third recommendation deals with governance, and we urge that there be appointed to both advisory boards, and to the actual boards of audit firms independent members, which would have full powers of any member of those boards, and particularly of the governing boards, whose duties would mirror the duties of a Director in a public company; that is, duties to the firm and its partners/owners. We analogized it, as you could see in the text, to the duties and responsibilities of directors in public companies. That is non-executive directors of public companies.

Our recommendation four deals with disclosure in the 8-K. Essentially, that when there is an auditor change, that the firm explain in the 8-K why, and the auditor respond to that explanation.

Those are the current state of our recommendations. We note at the end that we have not made a particular recommendation. There are many recommendations that we have not made. You may ask why do we note this one, in particular. This is one that we did, in fact, discuss; that is, we are not likely to make a recommendation regarding mechanisms for accessing outside capital. We believe that that just is going to be too complicated to get a meaningful and acceptable recommendation.

We are, as you understand, discussing a number of other issues, some of which are, indeed, on this list of issues and observations for further deliberation. We are working hard on those. We hope to come back to the Full Committee with some productive recommendations in those areas.

I think that's really all I need to say, Mr. Co-Chair, Mr. Chairman. Arthur?

CO-CHAIR LEVITT: I think the recommendation for independent directors is probably long overdue. The question that that raises, of course, is where are they going to get them from? Did the Committee consider some sort of recommendation for protection?

MR. GLAUBER: The Committee discussed it, and the Committee is well aware. I think there's actually a sentence or two in the text suggesting that this may be operationally difficult.

We discussed it. We could not come up with any effective recommendation for dealing with that; while, nevertheless, realizing that that exposure could intimidate some otherwise interested people. But perhaps there are other -- I should invite other members of the subcommittee to speak.

May I just for the record point out that despite the fact that Ann Yerger is sitting on the side of the table with the Subcommittee on Competition and Concentration, we have not traded her, nor do we intend to trade her.

CO-CHAIR NICOLAISEN: Great. Well, let's open it up to commentary or questions. This is somewhat surprising.

CO-CHAIR LEVITT: Why didn't you C-

MR. GLAUBER: Excuse me?

CO-CHAIR LEVITT: Why didn't you

come up with a recommendation about insulation?

MR. GLAUBER: Well, it is related to a broader issue of liability, and it is an issue that we are discussing at some length. It is an issue of complexity, I would say, and our hope is to bring before the Committee at some time, some kind of recommendation in that area. Whether it will reach, Arthur, the specifics of insulating particular directors, I'm not certain. That, as you could imagine, is very complicated, as well.

CO-CHAIR NICOLAISEN: Your thought process here, though, this would be the firm itself, and the partners of the firm would recommend outside members.

MR. GLAUBER: Absolutely.

CO-CHAIR NICOLAISEN: They'd have a vote on it, that those members of that board would or would not have some fiduciary responsibility to the investing public.

MR. GLAUBER: Well, our view,

first, on the first part of your question, it would, indeed, be the members of the firm. This would be an exercise that we would view as voluntary. They would invite members, people to join the board.

In terms of their responsibilities, we say specifically that we think that they have responsibilities as public directors, non-executive directors of public companies, to the entity, and to its owners. In this case, the owners would be the firm owners, unless we, again, did something we're not recommending, which is to have public shareholders.

CO-CHAIR NICOLAISEN: So you're really looking for fresh ideas. The objective is fresh ideas, some input from those who are not part of the profession.

MR. GLAUBER: I think that's right.

CO-CHAIR NICOLAISEN: Some challenge to things that are proposed, or thought about. Is that --

MR. GLAUBER: Don, I think that's said very well. I think it is the view of the members of the subcommittee, that if you put people of standing and breadth of vision on those boards, that they would introduce ideas and dialogue into those board discussions, and governance discussions, that could be both very useful to the firms, but also very useful to the public interest, as well.

CO-CHAIR LEVITT: I guess I'm concerned that just floating that topic by itself is going to raise more questions than responses, in that you have to deal with the issue of conflict. You have to deal with this issue of liability for those directors.

I'm not taking a position one way or the other, but I think to be silent on this, I'm uncomfortable with it.

MS. BRINKLEY: But did you attempt a definition at independence?

MR. GLAUBER: Well, conflict exists in many settings on boards of directors.

There are full definitions of independence that come down from the exchanges in the SEC for board members. Here, the independence, I suppose, could be defined in some similar way, but that doesn't eliminate conflict. So I think it's always going to be with us.

I think it would be possible to have rules of blatant conflict that you could deal with, but you're never going to deal with all of them, any more than the stock exchange rules deal with all the conflicts of directors.

CO-CHAIR NICOLAISEN: Lynn. Tim, did you have your hand up, too? Tim. All right. Lynn, and then Tim, and then Damon.

MR. TURNER: I think that we have received very little data that would tell us from a legal perspective exactly what you'd have to know to deal with some of the issues that you're raising. And I think it would behoove us, especially since the two of you control that list of testifiers on June 3rd to some degree, that we hear from people, and that's one reason we do exposure drafts, to get their input and thought on that.

You're talking six firms, so you're probably talking 60 or fewer board members, and if a majority of those have got to be independent, which they should be, in my mind, then you're talking somewhere in the neighborhood of 30 to 40 people. And I suspect that we can probably find 30 to 40 people in the United States to be independent directors on these organizations, and do a good job.

To your point, Don, about the obligation to the investing public, I personally believe that with the franchise these firms have, and their direction from Congress to serve the investing public, I think a director would be serving not only the partners in the firm, but because what's good for that firm from a public perspective is good for everyone in that firm - we certainly saw what happened when you didn't meet the needs of investing public, and that turned out. I think that boards' fiduciary obligations to the partners, as well as to the investing public kind of go hand-in-hand. I don't know that you can really separate out the two, but I certainly would encourage you to insure that we get more testimony on this, and some of the other issues that we're dealing with, so we can make a very good, informed decision.

CO-CHAIR NICOLAISEN: Great. Tim Flynn.

MR. FLYNN: I think the issue is, I think, if you look at this particular issue, Don, we did talk about a number of different analogies, and we did believe that the responsibility to the board should be to the owners of the business, just like a public company. The responsibility of the public company board is to the shareholders.

Part of that responsibility is to

make sure that the institution operates in a manner consistent with its authority, be it a regulated, FDA, whatever you might be in. So, clearly, this governing board, just like the boards of the firms today, have an accountability to their partners to make sure the firm is operating with quality control procedures, all things that you'd want to make sure in the regulatory environment we have today, and that we are conducting ourselves in the interest of the public, as well as our owners. So I think those items are interlinked. I don't think you can separate those two, but we did stay away from a recommendation where the board would make some kind of -- the independent board members to make some kind of report to the public independent from the owners. That, to me, is the difference in terms of where you cross the line in terms of what we're trying to drive here, is an independent board that can add value and insight from a governance, independence, and oversight component for the owners of that business, in the environment they operate in, to be successful in their carrying out their responsibilities as an entity.

CO-CHAIR NICOLAISEN: Thank you, Tim. Damon.

MR. SILVERS: Two points, one about this, and one about something else. I think Lynn's point is well-taken, that there are legal issues here that are not straightforward. But they're not insoluble either, and I'm not sure that it is the task of the Committee in its recommendations to attempt to solve them all, but rather to be kind of directional.

I think that the idea of having a real board of directors for the firms that includes substantial numbers of independent individuals supervising a firm that continues to be really, in its essence, a partnership of professionals, is the right thing to do.

The legal issues that it seems to me this raises that you might want to sort of mention, but not try to resolve, are one, the difference between an advisory board and a fiduciary board, a real board. And I think we're talking about a real board, I think.

MR. GLAUBER: Actually, we suggested that they be members of both.

MR. SILVERS: Right. But the point being that there is -- that you have outsiders to the firm participating as fiduciaries is important. I think that that may create certain problems in terms of the current structures of the firms, soluble ones, but still needs to be raised.

The second question, which Lynn raises, which is duties to the public, to the investing public, I think raise another level of concern. There's no question that the duties on the part of auditors and of audit firms to the investing public are very important.

Trying to figure out how you would embody that legally is quite complicated, because although it's true today that in corporate law, for example, a director is not solely responsible to the shareholders, but to the corporation, as well. That question of partnerships is somewhat different, and in neither case is there under current fiduciary law a notion of a general duty to the public.

There is embodied in fiduciary law a notion that you have some obligation as part of your obligation to the firm, an obligation to insure that the firm is obeying the law. And in this instance, that you might be able to relatively easily extend the idea of the duty to the firm, to the idea of a duty to the firm as a partnership of professionals to maintain professional standards; and, thus, to meet its duty to the public. Again, these are the issues, I think. I don't think you need to answer them all.

The question I had for the

subcommittee is actually on a different matter. The draft report envisions asking a -- and I forgot the phrase now -- but a national center on auditing to look at the fraud detection issue. And I wondered if any members of the subcommittee could talk about the question of whether -- what the pluses and minuses are of tasking that to, essentially, an association of the auditing firms. Would there be a more public body that could be looked to? How were those questions thought about, and if you could flesh out a little more the thinking that went into that.

MR. TURNER: I think there's probably different views on the subcommittee on this particular issue, even as we go to a draft thing. In the past, the firms themselves have had responsibility for setting and establishing the fraud standard, and the current one we have, it did arise out of that process. So, on one hand, people might turn around and say why would you recommend that you send it back to the same people who have gotten you to where you are today? On the other hand, there are some people within the firms that are very, very good forensic accountants, some of the best I've ever seen. And if you put the right group of people together, I think you could come up with some significant improvements over where we are today.

My own personal preference is that eventually this gets to the point of where it's done under the auspices of the standard-setter, who is a private, independent group, the PCAOB. And since they're setting the standard, I think eventually this has got to get to where they, and a task force of really knowledgeable people that really know this stuff well, are pulled together to do it. Because, ultimately, without that occurring, I don't think you're going to see much in the way of an improvement here. And it couples with the thinking of the recommendation that says let's make sure we tell the public what our obligation is.

Right now, that's in a mode of going out and saying we're responsible for setting up an audit, getting it designed to do a good job, but we're not necessarily, responsible for finding the fraud; whereas, the public still today expects you to find a fraud, especially if it's a large fraud. Not small frauds, they don't expect that, but large frauds of the magnitude we've seen this decade, they certainly expect you to find. And so, while we're going to go out and tell the public what the obligation is, it probably still doesn't narrow the gap between what the public actually expects you to do, and what you're doing. In a way, it still results in a product that isn't meeting what the customer's expectation is, but at least they're going to be on notice of that now.

MR. GOLDMAN: A couple of things. One is, I was looking at the preface here, and we talk about the firms' financial strength. And I know that we're going to talk about it a little bit in the next committee, but did your committee give any consideration to the thought of the firms having to report auditors' financial statements? And then the question is, if they do, do they do that to the SEC, do they do that publicly? So I'd like to ask a question.

And then I'd like to understand, back to recommendation four, take a little bit more discussion on that relative to auditor change. And, really, I'm still concerned about the last item, premature engagement partner change, and how that would really be applied in practice. I don't know. I just worry about -- again, I worry about what would be said relative to partner changes. And, also, whether you gave any consideration to whether you stay to five years, or go back to seven years. So those are, I guess, questions.

MR. GLAUBER: Okay. To your first question, Ken, we have, indeed, discussed audited financial statements, and continue to discuss them. And we hope to come back to the Full Committee with a recommendation dealing with the disclosure, the preparation first, and then disclosure at some point in some way of audited financial statements.

MR. GOLDMAN: Yes. The reason I bring that up, I actually think that will help create the competitiveness, because you'll get to see -- first of all, you'll see a stability, also sort of like the same thing. If a firm is making "too much money", that sort of creates a better market, and back and forth. So I just think having that public can afford a lot of benefits. I know some of the negatives, too, but I still think it's positive overall.

MR. GLAUBER: We do think, and we've encouraged that there be some testimony on just how audited financial statements would encourage better audit quality, and, as you pointed out, perhaps better competition. So I think we need to understand that, as well.

As regards recommendation four, the best I can tell you is we think that this is entirely operational. This can be done, and we think that it would be useful for disclosure. Clearly, that the firm explain the changes, but also that the audit company, audit firm have the opportunity to respond to whatever the firm says, so I don't think there's any lack of clarity. I mean, perhaps there's some concern you have about it, which we'd be very anxious to hear.

MR. GOLDMAN: Well, let me -- I'm just curious, Tim, are you comfortable, that if you had an audit, an engagement partner that for whatever reason, that three years rotated because maybe there's a personality conflict, maybe whatever. Are you comfortable that that could be disclosed in a way that it wouldn't affect the --

MR. FLYNN: Ken, I think it's a fair question. I think we wrestled with that. I think the recommendation that we came down to is that the firms are to notify the PCAOB of any premature changes in the five-year rotation rule. And the PCAOB may or may not choose to look at that.

I mean, one of the concerns there would be, would there be a client putting pressure on a partner, or a partner raising tough issues, was asked to come off early. So there would at least be a roster of changes made at a firm that was outside the bounds of the five-year rotation, and the PCAOB may or may not choose to look at that as part of the inspection process, but that would be a data element for them to have. That was the context of it, not to make that particular item a public disclosure.

MR. GOLDMAN: Not that. I'm sorry.

MR. FLYNN: So that's what I thought from that standpoint.

MR. GLAUBER: We should be clear, and if I, in introducing the recommendation was unclear, it says very clearly that what would be reported in the 8-K would be an auditor change, not a premature partner change. That would be reported to the PCAOB.

CO-CHAIR NICOLAISEN: Mark.

MR. OLSON: Let me come back to the point on the audit center for the audit prevention and detection experiences, and the development of the best practices. There's a significant difference between establishing a standard of inspecting for the extent to which the standard is being adhered to, and the development of best practices. And that's why we have some concern about having the PCAOB being the repository of the group that develops the best practices. We think it ought to be best done outside of the regulatory construct.

Now, many -- we're like a lot of regulators these days, we're not looking for new territory. And this is one where it seems that the important role of the PCAOB would be one that would, or any of the regulators, including the SEC, the important role would be as an advisor, as a consultant, but the repository probably ought to be outside. It's our judgment that it ought to be outside of the regulatory agencies. But we support the concept, and we would look forward to be an active participant.

CO-CHAIR NICOLAISEN: Okay. Conrad.

MR. HEWITT: Thank you. Concerning the reporting of auditor's changes, in the late `70s a commission that tried to do this, and that was met with so much opposition that they abandoned the idea.

The other item I'd like to bring out on the change is the change that we had on executive compensation disclosures this past year. In doing that change, and having those additional disclosures to help everybody, we found that doing it created a lot of boilerplate, information that was not useful, and it was the same information. So we'll look at this again, if that's what the Committee decides on, but I would like to point out those two items.

CO-CHAIR NICOLAISEN: Great. Let me ask a follow-up on the fraud recommendation, as well. And I do think there is potential for confusion in everybody's mind as to exactly what the auditor should do, can do, and is required to do.

One might think about, as the auditor, looking for fraud after discovering or being led to believe, or having indicators available that say the financial statements do not seem to be appropriately prepared. Others I think might think the auditor would look for fraud as part of a normal thing that they do, that they would look -- that they would run credit reports, that they would search emails, that they would do things that real fraud auditors would do if they were actually - or the federal government would do, if you're searching for discovery of who's involved, and whether or not there's intent, and all the other things that are typically involved in even trying to define what fraud is, versus an error in financial statements that may have arisen from other sources.

In the best practice area, maybe just help my thinking, if you would, put a little context as to exactly what it is you're thinking that best practice group of fraud institute would do, because I could imagine this being the new sounding board, listening in to cell phone calls, and everything else.

MR. HANSEN: If I might, I appreciate that. I think we need to be more specific in terms of actually what this center is supposed to do. I think we should be talking about continuous auditing, for example, algorithms, those sorts of forward-looking things, math models that is more predictive in nature that would identify hey, these are your high-risk clients, and those are the ones that you need to put your best people on, your best auditors, and the scope needs to be the tightest, and you should be covering more ground with those. So I think the point is very well taken, and I think we need to flesh that out a little bit more.

CO-CHAIR NICOLAISEN: Related to that, and I think it will come up later in this question of the auditor's report, whether or not it would be expanded. What you've just said is the auditor has on file a risk assessment of that client, and its likelihood that the financial statements would be adequately prepared.

When you think through the auditor's report, I think that's one of those things that you ought to think about, whether that is the type of information that would be useful to an investor to have an understanding as to how the audit firm risk rates that particular client. I'm not trying to enter into a dialogue here, because I realize we're not going to go very far with that.

I see Bob wants to --

MR. GLAUBER: I wanted to ask for a clarification.

CO-CHAIR NICOLAISEN: Let's just go right around the room. Lynn, Damon, Zoe-Vonna, and Mark.

MR. GLAUBER: Thank you very much. I just wanted to clarify whether you're talking about the agenda, as I think Gaylen was, of this national center that we proposed, and the research agenda of that, or are you talking about what should appear in the auditor's report?

CO-CHAIR NICOLAISEN: Yes, I was asking the second question.

MR. GLAUBER: The second. And, of course, we haven't gotten to that yet.

CO-CHAIR NICOLAISEN: Exactly. And we're not going to get into much detail today.

Lynn.

MR. TURNER: I think that, Don, you raise a really good point, an important point. There's also another point that goes with it, though, and that is in many of these frauds, as we heard some testimony out in L.A. on, it wasn't a failure of detection of the fraud that was a problem, it was the failure to report the problem to the public then when the auditor did find it. So in a number of these cases, it's not a detection problem. And that's an issue that we probably haven't dealt with that well in this report, either, I might note.

In terms of best practices, though, my experience has been this is not necessarily something that's a best practice area. All the firms have their own practices in this area, and do it, and you can say let’s put together best practices, but all that's doing is codifying what people, for the most part, are already doing. And if I go and talk to any one of the four firms, they all indicate to me they've got the best practices, so I don't know that we're really going to change much by saying let's pull together a group of people and do best practices.

I think it has to be a fundamental, let's take a look at what the auditors are doing, and then see if they're doing the right stuff. And I know from time and time again, at Glass, Lewis, as well as at the Commission, we went and visited with three of the four firms' national office at Glass, Lewis and looked at what they had in terms of tools to use to detect problems in the financial statements, and we found their tools were just way out of date. I mean, they just didn't have the tools, and weren't looking at the type of things. It was almost like they had blinders on in the way they're approaching the audit. And I think the notion of pulling together in a task force some very knowledgeable forensic people, some people off

Wall Street, some out of the hedge funds, some of the people that carry out these investigations that really have seen it and know what you've missed.

It's not about going in, necessary and doing a fraud audit, per se. It's just that in the day-to-day operation of an audit, and what you see, they're not using the tools, they're not getting the blinders off to see the bigger things. And it was always amazing to me that we could run models using tools that we in Wall Street had to detect things, and we could find things, once financial statements were published and put out to the public, that the auditors had never identified. And I think that's what has to get done and codified, quite frankly, into a standard. So, to Mark's point, I don't think this is about best practices. I think this is about changing some basic fundamental practices, either when you see it, you've got to tell the public. You've got to have the right level of skepticism, as we've talked about. And then you've got to have the right tools and the right mindset when you start to look for this stuff, and you're not just ticking, and tying, and going through a process. And I think that's where we've got to have fundamental changes. That's only going to come in the way of a standard, not a best practice.

CO-CHAIR NICOLAISEN: Thank you. Damon.

MR. SILVERS: Yes. This comes back to the, I guess what I was, in part, trying to get at in my initial question, which is that, as I understand the draft, there's an A and a B. And A is a recommendation that best practices be drafted. And it appears to me, pursuant to Mark's concern, that it looks to a private -- a collection of private folks to do the drafting, perhaps with some consultation with the regulators.

And then B is a standard, seems to

be related to the standard; although, B, I would say, is written in a kind of on the one hand, on the other hand kind of language, so it's a little unclear exactly what is being said about the standard. I understand why that might, as opinions about this subject vary a fair amount within the Committee, let alone within the wider world.

That seems, to me, not a bad setup, as long as it's clear that's what we're talking about. But the standard-setting goes to the regulators, and the best practices goes to the -- and the best practices, and the kind of collection of talent that Lynn was talking about goes to the firms. That strikes me as not a bad way to handle it, I think.

I would just point out, though, that because there's kind of this on the one hand, and on the other hand tone to this, that two things. One is that I think there is a longstanding concern on the part of investors going back to the immediate aftermath of

Enron, that the current standard, the current auditing standard around fraud, is both weak and misleading. And that there needs to be some clear obligation to look for fraud to a degree, and the to a degree part, though, is important.

There is also, I think, an understanding on the part of anyone who has looked at this with any degree of thought, that you can't audit ad infinitum, that there has to be a reasonable sort of stopping point. But where that stopping point is, is probably -- should be influenced by what one sees, that there are certain -- that there were warning signs, and that sort of thing, that would indicate a greater degree of diligence.

I think some people refer to this as risk-based auditing. That may be a red herring phrase. I don't want to be associated with all that might come with that. But the point is, is that sorting this out in a standard that would not only -- that would be one that (a) would be clear, and (b) would be appropriate and sufficient, and those two things are different, is a very important goal with investors. It's been a goal for some time, and I think the Committee appropriately, I believe, in Section B, is putting the burden of doing this where it belongs, with PCAOB. But in A, you're suggesting this kind of informal process.

If I got it wrong, I hope someone from the committee will enlighten me.

MR. GLAUBER: You have it, if I may say, absolutely correct. We invite in B, PCAOB to do two things. One is to clarify for the public what exactly is the role and the expectations, but second, to reconsider its standards. So I think you have exactly right.

CO-CHAIR NICOLAISEN: Good. Rodge Cohen.

MR. COHEN: Two comments, if I may, please. The first is on the independent directors, which of all the recommendations, I think would be perceived as one of, if not the most significant. But I want to express agreement with Chairman Levitt, that unless there is something more other than just the exhortatory aspect of this, that it will not get done, because there are significant issues. And I think we've identified at least four, how many independent standards, to whom are the duties owed, and liability, both standards and insulation.

I also fully agree with Bob, that it's not going to be possible to resolve those issues. But I do think it would be very helpful, either directionally, or a process to resolve those so it could be implemented.

The second relates to fraud, and this is going to be provocative; and, therefore, probably ultimately futile. But there are two aspects of fraud, one is methodology, and one is people. And this, of course, is geared appropriately to methodology. But if one really wanted to make a dent in fraud, we need to have some form of process by where reports can be made, and then the person making, the corporation, the person making the report is insulated, just like financial institutions have a suspicious activity reporting requirement, which then has the full protection of law. Unless we get there, fraud detection is going to be very difficult.

CO-CHAIR NICOLAISEN: Great observation. Mark Olson.

MR. OLSON: Staying within the process of the two of Rodge's recommendations, I think there is -- I think the report hits on it, but there's -- it seems to me there's an important distinction between the value of best practices, and adherence to, or the appropriateness of the audit standard, itself. And I think that's exactly what the Committee has identified and has recommended.

But as I have seen best practices used, where there's an independent entity, where there is a sharing going on, it is, by definition, iterative, and that the participants who are participating in the collecting and the sharing of that data then have access immediately to the best of what is available, and have a chance to talk that through, which is quite different from the identification of a standard, which is much more broadly defined, and much more slowly, and I think appropriately, developed.

The existing says, 99, I think, is relatively new, and that was in 2003, but a lot has happened, of course, during that time. Now, what we have done at the PCAOB, we have, in the process of our inspections, we're looking at the extent to which the appropriate auditor responsibilities are being followed, and are baked into the audit methodology. And, recently, we put out a statement giving some indication, what we call a 4010 report, which describes some of what we have seen as relative adherence to that. But I think it's appropriate to keep those separate, and I think it's appropriate to keep the regulators' role appropriate in that context.

CO-CHAIR NICOLAISEN: Mark, thank you. Zoe-Vonna, I'm going to come back to you in a minute. I think Rick Murray was next.

MR. MURRAY: Thank you, Don. I don't intend to address any of the specific issues we've been discussing, which I think this has been a good discussion, and a careful one. But I would like to make an observation about the context of this discussion, and the context, as well, of the issues that we have yet to resolve and report on. And I may equal or exceed Rodge in stirring a sense of controversy.

The discussions we're having in the subcommittee and around this table have most of the time of dialogue, been occupied by the presumptions that the large audit firms responsible for public company auditing are not sufficiently motivated to do their jobs as well as they can, and that there is something of a disdain for the consequences of a lack of proper motivation. That results in discussions that focus on the necessity to continue to use tools of risk and external control for assistance to somehow bring the profession up to the standards it ought on its own to achieve.

Those kinds of presumptions are difficult to discuss. They operate at an instinctive and emotional level. They depend on one's experiential background a great deal. My own perspective is that -- and I think this is reflected in Damon's subcommittee report -- that there is strong evidence that the accounting profession has significantly enhanced its achievement of sound goals of serving the public well in recent years, and that it is a profession that bears the burden of being expected to be the guarantor of public company integrity.

If you start with the perspective

that I'm suggesting, that the firms are as committed to and as competent at achieving their public service objectives, as any other segment of the profession or society, you will still have room to discuss how can that be improved, what procedures, and what people, and what systems can provide support for those fundamental goals. That's a different kind of dialogue than we tend to drift into in terms of how do we have to properly motivate and control a profession, which is so often seen as failing to, on its own, achieve those goals. And I personally, both working inside and observing outside the profession, think that is a limited, flawed, certainly not a complete or fair view. And the difficulty of presenting the alternate view of what the profession succeeds at, and how often it succeeds, and at what cost it succeeds is very difficult, because those are not public topics. They cannot be public topics. They require a sense of the daily experience of being inside the profession, and I do think that generally, which end of the telescope is one looking in, is a burden on all of the issues in front of us, and a challenge to the Committee to work through issues toward a concentric sense of how to assist, rather than punish the profession as the means of improving audit quality.

CO-CHAIR NICOLAISEN: All right. Thank you, Rick. I think we're all interested in strong audit quality, and I think you heard a lot of comments earlier on that the profession ought to be rewarded for the work that it does do. And I think there was a lot of conversation around compensation and other areas, so I suspect that, like most things, we tend to look at those things that haven't worked perfectly, or where there's not the evidence of independence and oversight, maybe independence that exists, but the oversight aspects that probably add to the value, and probably drive some of your perspective.

I do think on what we have heard is a fairly balanced view of the profession. I think we've heard a lot of good things that have happened, as well, so I don't want to -- I'm not sure that we're going to be issuing a report card, in any event, but those things that make this a more attractive, viable, sustainable profession for people who are attracted to it, is really what we're working on. Zoe-Vonna.

MS. PALMROSE: I didn't want to change directions, but I did want to make a couple of more points about the fraud center. Is that okay?

CO-CHAIR NICOLAISEN: Absolutely.

MS. PALMROSE: Okay. Well, thank you. What this thing is all about in my mind is kind of a multiple choice question, and the answer is all of the above. And there's a couple of points in that that I would like to make, that I think haven't been discussed.

One, to me, it would be about what

went wrong; in other words, lessons learned from the failure to detect fraud. We've seen research on that primarily using SEC enforcement actions, because that tends to be the data that -- those tend to be the data that are available, but that's not necessarily optimal, essentially. So one of the roles would be research, I think, in lessons learned from the failure to detect fraud.

But, also, it's one area of research that we have very limited evidence on, is what went right; in other words, evidence from auditors detecting fraud that then was corrected before the financial statements were published. And, frankly, the study on that is almost 20, 30 years old now, and hasn't been updated, so it's an area for research that I would think would be part of this fraud center.

In addition, it's what auditors are doing day-to-day, both in terms of best practices, as well as fulfilling their requirements under the standards, would be one element. But then the fourth element I think is an innovation element, which is really a nice recommendation -- component of a recommendation, because it's where innovation can occur here that's simply win-win for everybody, win for the auditors, win for investors, win for all market participants.

And final point is that one of the advantages of having this as a private, what Mark calls a private sector activity, is that it can also encompass more than the auditors. In other words, there's sort of a broad set of participants that probably should be at the table here for fraud research, not just auditors, and maybe there would be possibilities for that within the fraud center.

CO-CHAIR NICOLAISEN: Strong endorsement. Tim Flynn.

MR. FLYNN: Just to follow-up on Zoe-Vonna and Mark's comments, because I do think we have to think broadly about this fraud center. I almost like to think of it as a center for fraud detection and prevention, have both components to that. And I think it's much broader than just the auditors.

Registrants ought to be involved. What are internal auditors doing? What are regulators doing? What is the whole body --to the point of the market supply chain, from investors all the way through the supply chain. And how do we not just share best practice? How do we create best practices? How do we create innovation? How do we create tools in an open architecture that could be shared among all the participants? Let's not compete on fraud detection and prevention, let's figure out some way to broaden that whole array and lay it out for everybody to use, and build off of, from the largest to smallest firms, from registrants to investors, and regulators.

I think that's the spirit of what

this has been thought about. And the word "best practice" we debated a lot. I think you've got to pull that out of this whole context, because that seems to be well, let's get together and talk about what works, and it's a lot broader, a lot deeper, and I think can have a much more lasting impact if we think about it across the entire chain from innovation to prevention, not only detection.

CO-CHAIR NICOLAISEN: Great. Bob.

MR. GLAUBER: First, indeed, I think I agree with what Tim said, and we do say fraud prevention and detection methodologies and technologies, and those are a very important part of it.

I wanted to respond to Rodge Cohen's not surprisingly very useful comments on the non-executive director. On the issues you raise, I think we could say something explicitly about how many. I think we have in mind, obviously, a minority, but we should say something.

I think, as we discussed earlier, we ought to say something more definitive on independence. I think one can reach for pretty good guides of what independence is. We do speak to the issue of to whom they're responsible. We speak to it in the text here, and I think that's what we mean.

And on liability, I'd like to say something. I think it is very complicated, and I think it is a major impediment. We could call on Congress to do something about insulating them, although that would get wrapped up in some other liability concerns that we have yet to fully address.

CO-CHAIR NICOLAISEN: Thank you. Alan Beller.

MR. BELLER: Thanks, Don. Just a couple of observations, one on the center that a number of us have been focusing on. And maybe picking up on one thing that Lynn Turner said, and that is that the demands on the profession are growing more complicated day by day. We've talked about them in private sessions, in public sessions, globalization, fair value, just to name a couple, and there are lots more.

One of the, I think, major values of this effort of trying to develop best practices, I think they would be targeted at fraud prevention and detection, but I think they would have broader beneficial applicability, frankly, is just to make sure that the toolkit is up-to-date.

I think those of us who work with financial statements every day, I know I do, blanch at the degree to which the issues one has to confront change quarter-by-quarter, if not month-by-month. And this kind of a collective effort could, I think, help the profession stay on top of what used to take five years to develop, now takes two quarters, or one quarter, or something.

The second observation goes back to the directors. And I'd like to -- again, this goes a little bit beyond what Rodge had said in his remarks. I think this recommendation is fraught with practical difficulties. I'll throw one more on the table. Not only do you have the liability difficulty, but you have the liability difficulty for a director in an industry which certainly if you're talking about the Big Four, the companies are uninsurable, and there is no reason to believe that the directors are going to be any more insurable than the companies are. And that's a very big difference from the rest of public corporate America, and I think has to be confronted specifically.

The other thing where I think the Committee maybe needs to do some more thinking about this, we say, and I've said it, and it's easy to say, but it's a little glib. These will be directors. There'll be fiduciary directors. The owners of the enterprise are the partners. There's no doubt in my mind that good outside directors with a fiduciary duty to the partners in the enterprise will improve the governance and performance of the enterprise. I'm good on that. But we then also talk about the public interest, and how these directors will, in some sense, do that.

The history we have of public interest directors is not a terribly successful one. We have had it with the NASDAQ morphing into the NASD, and the SEC mandating a certain number of public interest directors, and those entities had members, but they were non-profit entities. You have the same thing with NYSE regulation, where the NYSE became a profit-making enterprise, but had this separate board halved off to deal with regulation, which was supposed to look like a non-profit board. I think the merger of NYSE and NASD, NYSE regulation and NASD into FINRA relieved us of I think the insoluble problem of having to try to deal with that structure.

Here we have, and these are

overtly, we all hope, profit-making enterprises, limited partnerships; and yet, we are trying to graft maybe this kind of a director structure. And I think we have to be clear as a Committee if we're not doing that, that that's the case. And if we think we are doing it, I think we have to do a better job than we've done so far.

MR. GLAUBER: Mr. Chairman, could I just comment?

CO-CHAIR NICOLAISEN: Bob, let me just -

MR. GLAUBER: I apologize.

CO-CHAIR NICOLAISEN: -- quickly ask if there's anyone on the conference call that wants to weigh-in on this, or any of the other issues.

MR. GLAUBER: Well, I just want to clarify something in the text.

CO-CHAIR NICOLAISEN: Go ahead.

MR. GLAUBER: I think what Alan raises is absolutely spot-on, and I participated in some of the governance issues on NASDAQ and NASD that he made reference to.

We explicitly say in this text that we expect them to have the duty of loyalty to the owners and to the enterprise, and try to be very clear that we don't expect them to be public interest directors, I think for all the reasons that Alan states. That is what this says.

Now, if the Committee disagrees with that, we ought to debate it. But this document, as we presented it, tries to make very clear that we believe that these should be directors that are not said to be public interest directors.

CO-CHAIR NICOLAISEN: All right. Anyone on the conference call care to weigh-in? And, Lynn, I will get to you.

MS. SMITH: Mr. Chairman, it's Sarah Smith. It just strikes me in this conversation, particularly with respect to honing in on an auditor's responsibility to detect fraud, that as we do narrow that, and perhaps make it more pointed, we ought to, as a Committee, think about doubling back to the human capital section to think about what that might do for people in this profession, retention and so forth, for a group of people that are already extremely concerned about their own liability, and so forth. And just try and link those two together.

CO-CHAIR NICOLAISEN: Thank you. Anyone else? Lynn Turner.

MR. TURNER: Thanks, Don.

I, for one, do think that there is a public interest role along with the role to the partners in the firms, so I don't think you can have one without the other. And I think both play a very important role, so I do think they're a public interest role there on behalf of the directors.

But what I really wanted to touch on was to come back to something that Rodge had mentioned, that piqued my interest. And he talked about the detection of fraud and the people aspect of it. Rodge, you mentioned that there has to be some system, if I understood you right, and correct me if I'm wrong, for getting fraud reported up and out. And under SOX, we've got the section that deals with the whistle blower provisions.

What, in your mind, do you think that we should be considering there that would be helpful, because my sense is the whistle blower programs to-date, people haven't paid enough attention to them. They aren't independent enough. They aren't yet working, people don't feel like they're protected, and so on the people side of it, I think we're falling short. But since you raised that issue, I'd certainly like to know what your thoughts are.

MR. COHEN: I was actually, and I agree, there's some work which needs to be done from the bottom up. I was actually thinking more from the top down.

When you dismiss an individual, you are frightened to say anything. Is it the U-5, Alan? What is it you file, the broker/dealer, when you dismiss someone? I can't even remember the number. But the minute you file it, if you say anything negative, you know you're going to be sued. Because they just wait, and they sue. Corporations dismiss people. They can't go to a U.S. Attorney, or to someone else and say this person is guilty, but they have substantial suspicions. You'll never say that because of the litigation risk.

What I'm thinking of is some form of protection where there could be a reporting mechanism so that these individuals are seen. You see -- U-4, is that what it is? Yes. You see these bad actors who, in the financial services, who go to institution, after institution, after institution, and then the regulators try and backtrack, and they say yes, we had suspicions but we were really worried about making any sort of report to anyone.

CO-CHAIR NICOLAISEN: All right. Very good. We have another couple of minutes if there are any other inputs, or suggestions, comments. Now is the time. Conrad Hewitt.

MR. HEWITT: Thank you, Don. Two items, one on the independent boards. I think it's a great concept. I had served on ten corporate boards, four of those were public. I think a lot of good things can come out of board governance. However, the liability issue is just insurmountable.

I mean, why would any individual knowing the litigation history of the public accounting profession, want to serve on a board without any liability coverage? It just doesn't make sense.

The SEC did do a good thing with the designated financial expert. I was the designated financial expert on four audit committees, and the liability for a designated financial expert is no greater than that of any other board member. If you could do something like that, that would make a lot of sense.

I would never have been a designated financial expert if my liability would have been higher than any of the board members. Just as I would never do it, so I think that's a real problem that needs to be resolved to make this thing workable.

The second point on the whistle blower thing that Lynn mentioned, so forth. Of the four public boards I served on, two of the whistle blower concepts worked very well. We had anonymous inputs on some weakness in internal controls, and those types of things that we were able to resolve at the audit committee level through management. Everything came right into the audit committee, so there is some good to the whistle blower in the provision of 404, the SOX. Thank you.

CO-CHAIR NICOLAISEN: Well, great. Thank you very much. We'll take a break until 3:45. I would ask that you be back here promptly at 3:45, and we'll convene the Subcommittee on Concentration and Competition. This is a subcommittee that has no open issue, so at least they don't think they do. So thank you very much.

(Whereupon, the proceedings went off the record at 3:35 p.m. and resumed at 3:53 p.m.)

CO-CHAIR LEVITT: I know a number of you have asked, those of you coming from the east coast have asked if it's possible you could make a 6:00 shuttle, so in the interest of that, we're starting a little bit early.

MR. SILVERS: I know exactly what the timing of that implies. Any questions?

CO-CHAIR LEVITT: Once again, caution about the Blackberries. Damon, I think your committee is doing an outstanding job, and that's why you are last on the schedule. There are so few issues to deal with, but having said that, I give us Damon Silvers.

MR. SILVERS: Thank you, Arthur and Don.

It is true that we don't have any of the items on this list, but part of that is because we're very skillful at offloading those that might have turned up there.

I'll make a couple of observations, and keep my eye on the watch here. Our committee is on competition in the audit markets. We benefitted from the GAO issuing a report on that subject just as we were convening.

The GAO report essentially found that while there has been obviously increased concentration in the market for public company auditing, but at the present time, the GAO did not see that concentration as either producing essentially uncompetitive pricing, or any of the other various pathologies associated with a true monopoly or oligopoly.

Nonetheless, I think that it was -- nonetheless, it was the view of the subcommittee that there is a sub-optimal level of competition in the market for audit services, but that this is a complicated subject, because there isn't a single market for public company audit services. They are distinctly different markets for small cap, mid cap, and large cap audit services, and the data shows that it's really in the large cap area that you see the least competition, where the four largest firms have the greatest market share.

And there are a series of issues about given principal agent problems in this area about really the benefits of competition and what the drivers of competition actually are in these markets. So against that background, we made a set of recommendations designed to sort of meet these issues as they stand today.

I would point out that I think, as Rick Murray indicated, we do state in our report that we believe that public company auditing has improved since the passage of Sarbanes-Oxley, and the Enron and WorldCom events. I don't think that we are taking a view as to whether audit firms are good or bad, whether audit partners are good or bad. Rather, we take the view that we ought to try to improve the regulatory structures and market environment so that whatever their current state is, they get better. That is, I think, kind of the approach that we've taken as a committee.

Our recommendations are as follows. Our first recommendation is that, in general, all other things being equal and subordinate to the goal of maintaining and improving audit quality, that the regulatory process and regulatory agencies encourage the growth of smaller firms. We recognize that there are a number of obstacles to that growth in the short to medium term. We have two specific suggestions, which we don't intend to be limiting; meaning, that we assume that there'll be many other circumstances where regulators will have opportunities to make decisions that would increase competition and decrease concentration. But the two specific recommendations we have are, first, that when public companies enter into contracts limiting their choice of auditor, that those contracts be disclosed to the public. And that, secondly, that there be an effort by government at all levels to include representatives of smaller firms in government programs, activities, committees, that sort of thing.

Our second recommendation goes really to our view, and I think borne out by the GAO report, that while it might not be the end of the world should there be further concentration in the audit market, that, again, all other things being equal, it's probably not a good thing. And that there ought to be ways of insuring that there's accountability in public company auditing, short of catastrophe. So our second recommendation is, first, for monitoring of issues of catastrophic risk by the PCAOB that would tend to threaten audit quality.

We've worked very closely with the PCAOB to insure that this recommendation is crafted in such a way as not to step outside the PCAOB's appropriately tailored mission of focusing on the maintenance and preservation of audit quality.

Secondly, we recommend that both the firms themselves, and then the public policy process create a rehabilitation scheme for audit firms that face a catastrophic situation. We envision this as a two-step process, the first step being, essentially, the adoption by the firms of an ability to move toward a streamlined governance process for decision making in the face of a potential catastrophe. And then, secondly, should that fail, a process by which the Securities and Exchange Commission could ask a court to appoint essentially a trustee over a firm, if that was viewed to be in the public interest. Such a trustee would be then in a position to act in the firm's shoes, resolve issues, potentially civil or criminal issues with governmental authorities, potentially private litigation issues, potentially other issues. The idea would be to facilitate avoiding a situation where clients, partners, and global network participants would flee a firm for fear that that firm was irrevocably tainted, and put the firm clearly in the hands of reputable people, whose mission was to preserve it.

This is not, by the way, a recommendation that this should be done in all circumstances, but simply an option that would be available to the SEC acting in the public interest.

It is also, and I think important to me personally, it is not a recommendation for how to preserve the capital of partners who have made terrible decisions. The idea is to preserve the firm value here, not unlike the structures that we currently have for other businesses in Chapter XI.

Our third major recommendation is that the PCAOB look at defining and disclosing metrics of audit quality. This has been discussed, I think, in a number of contexts. We, again -- the committee recognizes that there may be obstacles around doing this, and leaves sorting out the details in the classic form of these types of committees, leaving sorting out the details to the PCAOB.

But we view this as extremely important because of this issue of what drives audit competition in the market for public company audit services; that in the absence of well-understood and disclosed metrics of audit quality, there's a question as to whether one could have a variety of other things drive the market for audit services, many of which might not be in the public interest, and the interest of investors.

Fourth, we recommend that -- there has been -- one of the areas and reasons for what we believe to be the improvement in audit quality is the strengthening of independent standards, first by the SEC under Chairman Levitt's leadership, then through the Sarbanes-Oxley Act. This has given -- this now means that there are several different independence regimes, one regime for audit firms working with private clients, another regime for audit firms working with public clients.

The Committee was presented with some evidence that, particularly in smaller companies, there's confusion about this. The Committee urges that the AICPA produce a clear compendium of all the independence rules, noting at those points at which firms not used to doing public company auditing, those points at which they need to look at the public company rules, rather than the more generic rules that would apply in the audit of a private company, or other non-public business.

Secondly, I think there was a concern expressed by a number of members of the Committee, and our liaisons from the regulators, that there's a problem in relation to independence of firms kind of taking a kind of, I don't know, check the box approach to independence, and not being focused on the sorts of issues that tend to really be the ones that undermine a quality audit.

In this respect, the Committee recommends the development of mid-career training programs which would draw upon the experience of the regulators in the kind of clean-up of failed audits to inform those programs.

Fifth recommendation is that - and, again, this is a sort of a funny one, in that many members of the committee weren't aware that this wasn't already so - that currently it is not, although the majority of public companies do have an annual shareholder ratification of their auditor, some do not. The recommendation is that this be clearly identified as a best practice, and that the NYSE and the NASD adopt it as a listing standard, annual shareholder ratification. We also recommend that as part of the ratification there should be a disclosure by name of whom the lead audit partner is.

Now, finally, the last recommendation is to encourage the -- is to note and encourage the continued collaboration between the PCAOB and its international counterparts in monitoring audit quality, and in addressing some of the issues that were covered in our section.

Here, I would just note that the report takes note of a variety of things that the PCAOB has already done. The report is, there are many issues about how globalization in auditing and accounting will be managed. Those issues are controversial. There are many sides to them, probably many sides represented within our committee, and within our full Committee.

This recommendation says certain things about that, and is silent on others. Silence means silence. It is not a statement about anything, it doesn't appear to be a statement about, and I think that's important for people to note who may feel some coded message is included there. There isn't.

With that, I will say that because of the schedule involved in producing this document, not all of the thoughts of all the committee members got in on time, which is not their fault, but sort of inherent in the process.

I believe that all of our committee members are satisfied with what we have, but have some additions that they may wish to add.

I've assured them that we will be working that through in the process to come, but invite Mary, and Rodge, and Ken to not only comment, in general, on the matter, but if there are specific comments that weren't reflected in the draft, which you wish to share with the Full Committee, to do so.

CO-CHAIR NICOLAISEN: Thank you very much, Damon. Mary?

MS. BUSH: I will not add comments, but I would like to -- not add different comments, but just like to emphasize a couple of things. And one is that these governance mechanisms that we recommended were based on our very, very strong views, certainly my strong views, and I think all of the other, most or all of the other subcommittee members, that our market simply cannot afford to lose another major firm. I think Damon used the term "sub-optimal" in referring to the number of major audit firms that we have now, and that view is just very, very strongly held, that we cannot afford to lose another.

Secondly, on that mechanism, I think it is extremely important that we have a pre-established mechanism that can be used, a pre-established process of mechanism in case there is a threat to another firm. As we all know, sometimes these situations move so fast that everybody, the firm, the regulators, whatever we're talking about, the banking industry, the investment banking industry, the audit industry, or whatever, that they're scrambling to try to figure things out without some kind of structure. So this pre-established mechanism, both the internal governance one, and the external one, I think are extremely important to try to help avoid losing another major firm.

And even though we refer in here to the firms and the SEC, possibly the PCAOB, I think what is clear is that this mechanism can also be useful in discussing with, negotiating with the body that is really not a party to this, and that's the Justice Department. And that we might as well put that on the table, that this kind of mechanism, I think, would be very, very useful in a threatened situation.

MR. COHEN: I have very little to add. I think Damon has done a superb job of accommodating all our views.

This idea of what to do with one of the Big Four if it were to get into serious difficulty is, obviously, one which involves a variety of competing claims. And as is written, we aren't proposing that no matter what happens, what goes wrong, that there's got to be an absolute lifeline to keep that firm alive. But what we do want to emphasize, not only is the importance of trying to keep four firms, and ideally even more, although that is, again, as our report indicates, our draft report, a very long-term, and maybe never achievable goal. But also to deal with the very serious problem, which would occur in the immediate term if one of the Big Four were to reach a very serious problem, a la Andersen.

CO-CHAIR LEVITT: Any other comments? I'm sorry. Ken.

MR. GOLDMAN: Yes. Let me just add to some of the thoughts I sent out I guess on Thursday or Friday last week.

First of all, I didn't make the comment, that the switching costs are quite hard or high. I don't know how to address this, amongst the Big Four and from one to another. And so I agree with some of the comments made, that it would be very unfortunate if we lost another firm.

Certainly, in a more positive way, we did hear some testimony. I do think we need to keep on driving this, the idea of encouraging other firms to grow big faster so that we would have more than a "Big Four", whatever term you want to use, that would be much more viable in terms of auditing major, large public companies.

My second point, and it has to do with, as I thought more about it, relative to the point, disclosing in the agreements auditor choice, and this came about relative to some testimony relative to companies going public. Unfortunately, I have to say, I think most companies don't even realize they're "blackballed" if they use a certain auditor, and so I think really this ought to be in the underwriting agreement if there are limitations, because that's where you would have to -- to the extent it's an underwriting issue, you would disclose it there front and center, and put the responsibility where it should be.

I did -- this had to do with the structure and so forth. I, again, repeat the comment that I do think it will create a more viable competitive industry in terms of having disclosure relative to public financial statements, so I again put it relative to this one, as well as the last comment we made.

The last comment I'd make is, I guess Rodge sort of talked about it, really relates to the whole issue of catastrophic issue. And I commented on that in some of what I wrote up in terms of it could be private litigation, it could be other scenarios, and so forth. But, again, there I think we need to make sure we have captured correctly here so that somebody, be it the SEC, be it PCAOB, or be it whoever, proactively addresses it with the firm, and it does not become an after-the-fact, too late, too little, too late. So those are my comments, and I do think we're close. And I think, again, I would commend the Committee, because I do -- we do have, I think, a pretty good consensus as to what we believe as how to address some of the issues here.

CO-CHAIR LEVITT: Other questions? Rick.

MR. MURRAY: I certainly join Chairman Levitt in expressing admiration for the work that this Committee had done, and it is an admirable piece.

I have three questions that would be helpful to me in understanding how you arrived at these conclusions. Starting with a strong agreement with you that we cannot afford to lose another firm, that this is a too few to fail in the public interest condition, and agreeing with the observation that failure is possible to an uncomfortable degree in today's circumstances, the first question is whether, and to what extent you had considered alternatives in the nature of failure prevention, as opposed to failure amelioration, and remediation.

Secondly, with that second alternative of ameliorating, it is understandable how a representative of the firm, either under the first or the second phase procedures, could be effective in dealing with the Justice Department, more effective than the traditional leadership mechanisms of the firm. But I don't understand why the same would occur in dealing with private companies and bankruptcy trustees who are pursuing aggressively civil damage claims, of which there are something in the neighborhood of 50 today capable of individually killing off any of the top six firms if they were allowed to run their course. Why it is that the episode being played out in the Florida courts involving Banco Espirito Santo would somehow respond better to what I think you put, Damon, as putting the firm in the hands of reputable people committed to preserving it.

Obviously, from my earlier remarks, I think those reputable people are already in position. I do accept that the perception is important at this point, and it's not clear to me how in this mechanism in dealing with not government agencies, but particularly independent and foreign institutions who don't seem to have any reason to be responsive to anything but their own objectives, how you would see the remediation process working. I'll withhold it for a moment, to preserve the federal prospect.

MR. SILVERS: Can I respond? Other members of the -- this is a consensus sort of process, so other members of the subcommittee may have a different view on these questions than I do. I think the recommendations of the Committee represent a consensus of people with, in some cases, quite different views of these issues.

In respect to your first question about failure prevention, I think we view this mechanism as failure prevention, not failure amelioration; meaning that what we -- it depends on what you mean by failure. Meaning that the sequence of events that might bring certainly Part II into play, and even Part I, might be circumstances that would be economically significant to the firm, and to its partners.

What the goal is here is to make sure that the sort of the firm value, the collection of human capital, relationships, resources, and so forth, that is not destroyed in the process. And that's the kind of failure that I think, at least, has public policy and public interest implications.

With all respect to the many fine people whose personal finances are involved in accounting firms, I don't think that's the public interest issue. So then the question of what alternatives are there might the Committee have considered.

We had wide-ranging discussions about I think all the issues in front of us, including some issues that are in front of other subcommittees. This approach is one that had a consensus behind it. For myself I would say that as long as audit firms remain for-profit entities, and not government agencies, that it's not clear to me that as a general matter, it is in the public interest, or should be, to save them, to preserve them, to keep four rather than five, and so and so forth. That failure prevention is sort of not within our power, nor maybe should it be. But that just as we have a Chapter XI process to prevent all businesses that fail from liquidating and destroying firm value, in the context of the unique -- of what we learned about what keeps audit firms alive, and keeps that firm value going, that this mechanism is designed to do that.

Now, in relation to private litigation, again, others may have other views, but it's my view that this mechanism has the prospect of shifting a number of dynamics around private litigation in a way that could be in the public interest. And, again, I think as a similar kind of dynamic to my answer to the first question, if the goal here is to insure that private litigation against audit firms is not successful, investors don't recover, the attorneys don't get paid, if that's the goal, this doesn't do it. But if the goal is to prevent a dynamic in which private litigation drives the insolvency of an audit firm in which a private litigant, or more than one private litigants comes forward with demands, they're going to blow up a firm, and sticks to them, and finds a court willing to do that, and the public interest is implicated, and I'm not sure that that's always going to be the case. But if the Securities and Exchange Commission determines that the public interest is implicated in such a matter, this mechanism would provide a method for a trustee representing the public, as well as the interests of the firm, to be the party that would be on the other side of that litigation.

The upshot of this would be that the other side of the table in the eyes of the private litigants, in the eyes of the court, would now be a trustee clearly empowered by another court with the backing of the

Securities and Exchange Commission, the federal government, with the mission of seeing to it that the public interest is protected, and that firm value is not destroyed in a way that's contrary to the public interest.

I believe that that dynamic, while not leading to immunity for the audit firm, would be a substantial -- would substantially slow whatever destructive processes were at work, and so I think it would be quite effective in that circumstance. Others may have other views, and other approaches.

MR. COHEN: Just one other comment. As Damon said, there are differing views on the desirability of litigation reform, but I think there was a full consensus, or full agreement, that it would be very difficult to carve out a special litigation regime just for the accounting firms. That's the rock where we couldn't pass. As I say, there are those of us who -- well, I'll say I believe we have a very serious need for litigation reform, but it should be broader.

CO-CHAIR LEVITT: Gaylen.

MR. HANSEN: Thank you. On Item 1A, this is the disclosure of agreements limiting choice. It is not clear to me as to, at least in this version of the draft, who that disclosure would be to. I thought an earlier iteration was in proxy statement, and I think that is something that you need to either discuss further, or clarify in your draft.

I'm glad that you're talking about audit metrics. I think that's very important. We've heard about the Europeans, and some of the things that they're doing there. I think that it does need to be linked with a specific objective, as a number of people have said. I do tend to disagree with the laundry list of things that the GAO enumerates as reasons for bigness, or what I would refer to alternatively as market bias. They talk about lack of staffing, reputation, greater technical capability, limited access to capital, I don't think that has a whole lot to do with anything, and global networks. Of the entire laundry list, I think the most significant is name recognition, but I think that there's a lot of smaller firms that would really jump at the opportunity to lay out their metrics versus the larger.

And then I had mentioned earlier, and I'll mention it again, I do think that international standards are going to have a significant impact on smaller audit firms. There haven't been any witnesses to-date to step forward at this Committee and really discuss the ins and outs of international standards, what the impact is. And I'll say this, that that is one of the major things looming on the horizon for our profession. And I think we would really be negligent if we don't spend some time talking about international accounting standards.

CO-CHAIR LEVITT: Gaylen, I missed

something there. What did you mean by what smaller firms could do? I didn't get your point.

MR. HANSEN: I think the argument that you would hear from a lot of smaller firms is that yes, it's true that they can't serve the largest clients, and by that I mean maybe the Fortune 1000 or 1500, whatever it might be. But there's a lot of big engagements that smaller firms can service. They're never really given the opportunity to, because of name recognition more than anything.

CO-CHAIR LEVITT: Well, isn't this largely because they simply don't have the international reach that those firms would require?

MR. HANSEN: Frankly, a lot of the smaller firms belong to networks of firms, and do have contacts, relationships with firms in other countries. I know, for instance, my firm has that. We do a fair amount of international work, Russia, England, other parts of the world, and it hasn't been a big issue for us.

Now, again, these are -- I'm not talking about the Fortune 1000. I'm talking about smaller companies, where maybe you would have 10, 15, 20 auditors on the engagement. Well, you don't need a firm of 80,000 auditors to do those size of engagements.

CO-CHAIR LEVITT: Lynn.

MR. TURNER: A number of questions for you. From what you've said, I take it that on Recommendation Six, then, it's not a position one way or the other on mutual recognition of international standards. That's the first question.

Second question is on Recommendation Two on the trustee, and in part back to what Rick was saying earlier, I'm not sure I totally understand this recommendation, because everyone I've talked to who has said if you ever had to put a trustee in place, you'd never save the firm. The fact that you were having to put a trustee in place would guarantee the firm would go out of business. It would be the only major accounting firm with a trustee, and it would be such a damage on its reputation that you'd guarantee that the firm wouldn't survive.

And in light of that notion, Rick talked about failure and prevention, if you will. Why is it silent on the regulators, because it seems like we've got two regulators here who have been empowered to oversee the firms hopefully to prevent that type of action, and yet you're coming back and almost setting up a mechanism that if it ever had to go in place, would not save the firm. I don't see it saving the firm.

And, finally, on the notion of competition with the small firms, I certainly hope you guys would consider making a recommendation back to investors, and the investor community, including institutional investors, that as they take a look at ratifying auditors or making auditor decisions, that rather than just focus on the name or the size of the firm, that they would consider those audit quality factors that you're talking about, and quit looking at an auditor just because they thought it had a well-known name, or deep pockets.

I see nothing like that here in the way of that type of recommendation for investors, and I think that would be good for the investor community to hear from you, as well.

MR. SILVERS: First, to Gaylen's point. Gaylen raised this with me at the break, or before we came together, whether the subcommittee had looked at the impact of globalization, both in auditing and accounting on competitiveness and the ability of small firms to grow and compete. And we haven't in any detail, and we should. And I hope that we can figure out a way to do that in the time that remains to us, and hopefully incorporate whatever learning we have in our report.

The brand name issue, the branding issue that you allude to, I think the subcommittee recognizes that. I think that our recommendation around the public policy process, including representatives from smaller firms is an effort, in part, to address that issue. I think there are limits to what -- but maybe we haven't been creative enough, and I'd welcome suggestions. The Committee, I think, would welcome suggestions as to the level at which the public policy process can address the brand issue. All right.

Although, I think the notion of sort of negative branding is what we're trying to address by requiring the disclosure of some anti-competitive agreements. I think it's not just the disclosure itself, but the signal that that recommendation sends, that we think is important in that regard. But, again, we'd welcome thoughts and ideas about how to address those issues. We recognize them, and have tried to do so.

Lynn, with respect to your questions, yes, I mean, that's what I was trying to say in introductory remarks. There are a number of specific public policy issues that are being disputed and debated right now around the question of the extent to which the U.S. accounting and U.S. auditing systems ought to be integrated with global systems, or global arrangements of various kinds, on what terms, how, and so forth, including among them is the debate about mutual recognition, the debate about the reliance on foreign regulators and foreign audit firms in relation to the audits of U.S. companies, U.S. listed companies globally.

(Off microphone comment.)

MR. SILVERS: Right. As distinct from mutual recognition. I want to make sure I got -- I mean, there's a variety of these issues before the PCAOB, some are before the SEC. The subcommittee is not taking a position on those issues, and that's what I was trying to indicate about what we say is what we say, what we don't say is what we don't say.

Now, the question of whether or not our Recommendation Two will save a firm. I'm not -- there are a number of things that I think wise people don't do. One of them is predict what Congress is going to do on anything, and another is predict whether a given idea will work optimally in the way that one would hope it would work. I'm not going to do that. I'm not going to guarantee that this will achieve what it sets out to achieve.

I think that the existence of this two-step process gives both the leaders of firms, and regulators a variety of options. Not all of them are -- there are options that are not stated. There are implications, and ways of acting that we believe these mechanisms create, which increase the likelihood that a firm that has been implicated for -- where individuals, or the firm itself, a piece of the firm has been implicated in some serious misconduct. It increases the likelihood that such a firm could be preserved compared with the current state of affairs.

If the SEC's goal was to save a particular firm, and the SEC waited until the absolute last minute to do so, it might not work. But I think people are smarter than that. I think that's not how this would be used. And I think my confidence, at least, in this matter was personally increased a great deal when Chairman Volcker indicated that he felt that this would have made the difference in the Andersen matter, as he did at our last meeting.

And then I think the recommendation -- the question of the role of the regulators, and I'm not sure, Lynn, exactly what you were asking, but it -- should the regulators do a better job? Was that sort of the question?

MR. TURNER: No. You've got no recommendations to the regulators in this area in terms of insuring that you don't ever get into one of these situations in the first place, in terms of, is there anything that you considered, and maybe nothing is necessary, but you never ever want to have to get to an Andersen situation.

MR. SILVERS: Yes, I understand. What Lynn is saying is that -- he observes that maybe we haven't made recommendations to regulators as to how to prevent anything like this from coming up in the first place.

Now, there is a recommendation to the PCAOB to look at issues involving systemic risk that would relate to audit -- catastrophic risk that would relate to audit quality. I think that is an effort to get at what Lynn is talking about. It may not be sufficient. It may be that -- I mean, the question of what insures that we won't have a catastrophic event with a major audit firm. Opinions may differ greatly as to how we do that. Some people may feel that we need to have much stronger regulatory oversight, some people may feel that we need immunity from civil liability or criminal prosecution. There may be a wide range of opinions about how we get there.

We have recommendations from this Committee that we think will address in pretty significant ways these issues that people with widespread differences of opinion can agree upon. Not perfect, but we think helpful.

And then, finally, the recommendation about saying something to investors about looking at smaller firms, I think that's a very good idea, and we'll take it up.

CO-CHAIR LEVITT: Rodge.

MR. COHEN: Just a very brief comment. Obviously, I share Damon's concern about predicting the future. I also must say I share Lynn's skepticism as to whether a firm with a trustee will survive.

But from my perspective, let me go back. Damon started off saying this four was sub-optimal, three would clearly be a negative, but we could probably live with three. I think what we cannot live with is the process which exists today of getting from four to three, and that's what I think this recommendation is designed to deal with.

CO-CHAIR LEVITT: Would you amplify that, please?

MR. COHEN: If there were an indictment of one of the Big Four firms, and we saw the unraveling occur which occurred with Andersen, it would be very quick. Everyone would start to flee. On a Murphy's Law basis, this would happen in December, and we would have a very sizeable portion of American corporations unable to complete their audits.

The idea, in my view, of this -- again, with some hope that it could permit that firm to survive, that this would give a period of time in which the firm could stay together, complete the audit work, and get us through for the four or five months which are necessary.

Same event, back to Rick's point on the civil litigation. Let's say that there's a final judgment somewhere after everybody said we'll win this on appeal, and then it comes down, and there's the one in a hundred chance to appeal to some higher court, or one in ten. Again, you would have a mechanism to resolve the issue.

CO-CHAIR LEVITT: Thank you.

MR. COHEN: A soft landing.

CO-CHAIR LEVITT: Anybody -- yes, I'm sorry.

MS. BRINKLEY: To echo some of what Rodge has said, just a couple of things. First of all, one aside, I would say that we need to be careful to think that only the Fortune 1000 are probably in need of some of the capabilities of the Big Four accounting firms. And I do know there are smaller ones that are. I think the measure is going to go more from just size, but to complexity of products that are offered, and clearly global involvement. And, so, I think the demands are going to be greater on some of the larger firms until we can accelerate the development in the smaller firms.

But back to Rodge's point, I was trying to remember how long it was from the Enron news to the collapse of Andersen, and my memory is that it's three months. I would expect in a similar situation today, that would be accelerated by some measure, and so the preparedness is very critical.

I think the mechanisms you've laid out make tremendous sense, but because an industry like the auditing industry is built on trust, it is imperative that even backup plans from that are available. And I do think that involves more regulatory thought as to what that might look like.

I think your recommendation around standards for audit quality that are more transparent could be very helpful there, in that you think about other industries that are considered very fundamental to the stability of the financial system, or to the public well-being, whether it's financial services, or healthcare, or others.

There are well-described metrics that regulators are watching to see can we deliver. And having contingency plans, as they're seeing weakening in certain players, is their capacity to take on more from others, so just another thought there.

CO-CHAIR LEVITT: Alan.

MR. BELLER: Yes. Just briefly also on the rehabilitation preservation mechanism. There's a natural desire to make it more secure and more certain, but there's also, and the subcommittee heard from a number of sources on this, the nature of the threat could be from any of a variety of directions and types. The proximate cause of the unraveling or threatened unraveling could come from any variety of sources. It could be partners, it could be clients, it could be the global network.

And in the face of the really profound uncertainties that the subcommittee and the Committee are looking at in thinking about how to construct this mechanism, I think the generality that is currently there is the appropriate way to go. You'd like more specificity, but I wonder whether it is feasible.

CO-CHAIR LEVITT: Anybody on the phone have queries?

MR. VOLCKER: Yes, I'm on the phone. This is Paul Volcker. I've been listening carefully to this. I haven't been on the phone all that long, but I see that I'm quoted here, so I better say something.

Nobody could pretend this procedure that's recommended is anything but awkward, and not exactly in itself confidence inspiring, but it deals with a situation that isn't very confidence inspiring. And I do think it has a chance of -- I'll stand by the statement that is quoted. I think we could have saved, frankly, Arthur Andersen hadn't been indicted. This kind of approach that anything else, other than keep the Department of Justice from indicting a firm, it will have improved the chances of saving the firm. You've got better chances the fewer the firms are. The people are not going to have much of an interest, as clear in this conversation, reducing further the number of major accounting firms, so you've got a certain hope or momentum going in that direction. But I don't think it's a failsafe thing, but I think you could hold some firms together, probably reduced in size, somewhat crippled, but in a position to make some recovery in some cases. Therefore, it's probably worth doing.

CO-CHAIR LEVITT: Well, your experience certainly gives great weight to your words. Thank you, Mr. Chairman.

MR. VOLCKER: Of course, not everybody might agree with my conclusion, and I was in the middle of it, so I happen to think there was some chance of saving it, or I wouldn't have gotten involved in the first place.

MR. MELANCON: Arthur, this is Barry Melancon. I have a couple of comments for Damon and his subcommittee, not specifically on Chairman Volcker's point, but really I have a question, Damon, and a couple of observations. And one is, obviously, there's a lot in here to deal with the fragile situation, the need for rehabilitation or a chance to save the firm, as Chairman Volcker just said. But I hope that, and this is an observation, I hope that as some of the open items are wrestled with in the other subcommittees, that what is clearly being defined here as a risk of loss of a firm is understood and considered by the other subcommittee as they wrestle with some tough issues that we've already talked about earlier, or at least alluded to in Don's opening remarks.

And I do think that it does point to some underlying liability issues that need to be addressed in some form or fashion. And I acknowledge, as Damon said, that you can come at that through a lot of different directions. But I would also add that to the point that Gaylen made, in that smaller firm stepping up, that's not so easy to do, and I think most people acknowledge, it's not so easy for a smaller firm to grow up into this space. And I do think name recognition and brand, and all of those types of things play a part in it. And, certainly, there is a lot of firms below the Big Four that have capacity up to a certain size, as Gaylen suggested.

I do think that liability does play into that point, as well. There are firms that choose not to do that, because of the uncertain liability issue, and the greater risk that they would face in that particular environment. And to sort of ignore that isn't fair to the process, either. It is a true statement. And, in fact, as we talk about global networks that smaller firms access that are structured much differently than the global networks that the largest firms have, and it's not just four when I say the largest firms, but that are structured much differently, firms outside of the U.S. are very skeptical about associating with U.S. firms. And increasingly so, based on some recent court rulings and otherwise, because of the fear of the exportation of the liability system in the U.S. And while I understand that that's a big macro issue, it is, nonetheless, a real issue.

The next observation would simply be - and I thought you said this well, Damon, in talking about the firms, and some people believe that from an independence perspective, that maybe not everybody is focusing on the same thing, et cetera. And I'm not trying to recant your every word, but you captured that well.

I would only ask in the final wording that we not write it in a way that would imply that firms haven't made significant strides in these areas. I go back to Rick's comments earlier on a different subject, when he talked about everything is always subject to improvement. And I would certainly welcome that, but I don't think we want to imply in the issuance of a final report something that would indicate that the firms haven't invested heavily through tone at the top, and through programs and procedures, not invested heavily in this. And, so, I would just caution that, ask the subcommittee to think about that wording as they finalize it.

And the final thing is really a question, and it's in light of some of the human capital issues that we talked about earlier. You have a recommendation, and we certainly haven't spent a whole lot of time talking about it. It's sort of a one-sentence notion of disclosing in the proxy materials the name of the individual auditor, in addition to the lead partner, if you will, in addition to the firm. And my experience is, and based on having done a lot of presentations on where the Committee is in the last several months with firms of different sizes who do some degree of public company work, there is also concern about that recommendation from an individual perspective.

I understand some of the thought behind the recommendation, and that CEOs and CFOs, for instance, sign individually. I think that was built into Sarbanes-Oxley as a way to change culture inside of an organization. I think that in the delivery of the audit, we have to think through that issue a little bit, and I know the PCAOB has wrestled with it a little bit on the audit report side, as well. We have to think through that issue a little bit as to what does it do from a human resource perspective? What does it do from an individual exposure and liability perspective? And what does it do from the standpoint of people's willingness to really be in those particular situations? And I think that's an unknown. There is certain evidence that indicates that people might react. It's not a scientific answer.

I do believe that audits are not delivered by an individual, they're delivered by a firm, particularly when we're talking about public company audits. And the system that the firm employs, and all of the resources that it brings, depending on the size of the engagement, so again, I guess my question is really, have we really thought through the ramifications of that? And it's sort of -- and given all of the recommendations, it's just a one-sentence, but I would just ask you if we haven't, to maybe give some additional thought to that one.

MR. SILVERS: I am mindful of the mission of getting people to airplanes, so I will try to answer these briefly.

The subcommittee certainly got the sense that among the firms that are smaller than the Big Four, but not so small that one couldn't imagine them growing significantly in relation to public company audits, that there's a variety of attitudes about growth among those firms, and even within each firm among different partners. And there are a variety of different motives, and purposes, and reasons in play for their attitudes toward growth.

There's no question that one issue involved in thinking about growth is the question of increased liability. That's not, by the way, not unique to audit firms. All sorts of human activities, the more complex they are, the larger scale they are, the greater the liability.

Beyond that, I would say that, again, this becomes -- we then get into a series of questions that it may be rather more difficult to build any sort of consensus on, and where, at least in my opinion, there's not a great deal of terribly persuasive data, even this stage of the game. Others may feel otherwise. I think that, as I said in my introductory remarks, this Committee has benefitted from not having been asked to resolve, say, the liability issue in total. I'm not sure we would come out with the same kind of goodwill and unanimity that we have today.

MR. COHEN: Maybe goodwill, but certainly not unanimity.

MR. SILVERS: Right. So I don't

know if that's responsive to that issue, but it's about as responsive as I can be in relation to the airplane issue.

CO-CHAIR LEVITT: Excuse me.

MR. SILVERS: Independence. I think that the -- I believe the subcommittee, and probably the whole Committee agrees that there's been great improvements in audit firm attention to independence issues since the passage of Sarbanes-Oxley. If there's a feeling that the language in the current draft doesn't capture that adequately, I'm sure we can work on that.

However, I think that there is a hidden issue in doing so, and I want to make clear that it's not that -- wherever the words get to, it is not my view, at least, that any level of internal attention to independence would justify weakening the independence rules.

Thirdly, the question of the individual auditor. As was noted, a number of individuals are identified in relationship to the accuracy of financial statements, the CEO, the CFO, the law firm partner that makes the filing is identified on the cover of the 10-K, so the question of individual anonymity, that's not the guiding principle of our disclosure system today.

Secondly, I think there's a tension here, and the tension is this. If really we are talking about a completely collective effort, and it's not meaningful to identify individuals, then it's going to be rather hard to explain why, for example, in any given context of wrongdoing, the criminal authority shouldn't be sent to the firm, as opposed to the individuals.

I think we all acknowledge that there are circumstances in which misconduct is really an issue of individual misconduct, and that there are also institutional issues.

I should also finally note that this subcommittee's recommendation does not address who should sign the audit letter. That's not the recommendation. It's a recommendation about identifying who the lead partner is in the context of the information provided to shareholders to decide whether to vote to approve the auditor or not.

This issue of who signs the audit letter is one of these things that was thankfully handed to somebody else to address. And that, I think that's -- leave it at that.

CO-CHAIR LEVITT: Rick.

MR. MURRAY: Thank you, Mr. Chairman. And to summarize where I think we are at the moment, is that the subcommittee has articulated basically three positions, that the loss of a firm is possible today, and it's not a tolerable condition to allow to proceed into the future. Second, that while prevention through pervasive litigation reform might be an attractive alternative, it's not a viable alternative. And, thirdly, that rehabilitation, therefore, while it's not a failsafe, is a valuable tool. I think that creates for us, at this point as a Committee, an attractive platform from which to combine what is achievable through preventative steps that are less than comprehensive, and do not go beyond the possibly achievable. The fall-back value of the rehabilitation program is another source of comfort. And, thirdly, a continuing apprehension that this is a problem not yet fully solved.

CO-CHAIR LEVITT: I'm not sure Damon agrees with that formulation.

MR. SILVERS: I think that's what Rick would like us to have said. That's not what we said. We said that (A) there are issues raised by the potential collapse of another firm. It might not be in the public interest to allow it. It might be in the public interest to allow it, but we need a more efficient and effective way of addressing those questions when they arise.

Secondly, in relation to litigation

issues, I mean, there is a fundamental disagreement among many people in this Committee about a principle involving litigation, both civil and criminal. Some people feel that, for a variety of reasons, there ought to be real limits on the exposure of audit firms to the civil and criminal liability that all other businesses and individuals have to live with in this country from day-to-day. There are others who think that audit firms ought to live by the same standards as the rest of us.

The way in which we arrived at these recommendations was by recognizing that those questions actually aren't the critical questions. All right? The critical question is do we have mechanisms in place to safeguard the public interest should there be another episode of serious audit firm misconduct in the context of the market structure we have today. And I think the Committee's view, among people whose views on the litigation issues are quite disparate, the Committee's view was that we didn't have those instruments, and that these instruments do address that.

I think it would be most unwise to infer answers to some of these more contentious issues from these proposals, or the narrative associated with them.

CO-CHAIR LEVITT: Thank you. Lynn.

MR. TURNER: I think if we could let Damon and Rodge come up with a way to cap the auditor's liability, and cap the investor's losses, everyone would probably be happy. But I want to go back on another issue, because I think we could talk about liability for an eon, and I would note that on the -- when I sign a report as an audit partner, whether I sign with the firm's name or my name, I had liability. Just signing my own name wouldn't have increased liability one iota. But on another point, to a point Damon and Former Chairman Volcker raised about saving the firm, if you will.

Back when Andersen went under, one of the things that Paul recommended at the time, along with his fellow committee members back then, was the issue or notion of some type of variation of audit-only firm. In light of that recommendation that was put forward by Former Chairman Volcker at that point in time, did you, or have either of the Co-Chairs considered bringing up and discussing the issue of an audit-only firm?

CO-CHAIR NICOLAISEN: That answer is yes, and I think that it was raised in the context of there could be a better argument made to put safeguards around that type of firm that is truly committed to, with the vast majority of its work, to serving the capital markets, and the public interest that are related to that. There are a number of things you could do, there are a number of things you could think about doing. I think the reaction of the profession was not enthusiasm, but driven in a context that their belief is the quality of the audit and the degree of competency that can be brought to an audit engagement is more robust, is fuller, if they have a full complement of people with a lot of different skills, and they're less dependent then upon that audit, i.e., more independent than they would be otherwise. So there had been a lively discussion, but I don't think it has risen to a point where there's a recommendation to be made from that.

CO-CHAIR LEVITT: I would call for a motion now to put our work out for public comment for the next 30 days.

(Moved and seconded.)

MR. STEEL: And you'll record, Kristen. Mr. Beller.

MR. BELLER: Yes.

MR. STEEL: Ms. Brinkley.

MS. BRINKLEY: Yes.

MR. STEEL: Ms. Bush.

MS. BUSH: Yes.

MR. STEEL: Mr. Cohen.

MR. COHEN: Yes.

MR. STEEL: Mr. Flynn.

MR. TURNER: Yes.

MR. STEEL: Mr. Glauber. He just left, I think. Mr. Goldman.

MR. GOLDMAN: Yes.

MR. STEEL: Mr. Hansen.

MR. HANSEN: Yes.

MR. STEEL: Mr. Levitt.

CO-CHAIR LEVITT: Yes.

MR. STEEL: Mr. Melancon.

MR. MELANCON: Yes.

MR. STEEL: Ms. Mulcahy. Mr. Murray.

MR. MURRAY: Yes.

MR. STEEL: Mr. Nicolaisen.

CO-CHAIR NICOLAISEN: Yes.

MR. STEEL: Mr. Previts.

MR. PREVITS: Yes.

MR. STEEL: Mr. Silvers.

MR. SILVERS: Yes.

MR. STEEL: Mr. Simonson. Ms. Smith.

MS. SMITH: Yes.

MR. STEEL: Mr. Travis. Mr. Turner.

MR. TURNER: I'll abstain.

MR. STEEL: So noted. Mr. Volcker.

MR. VOLCKER: Yes.

MR. STEEL: Ms. Yerger.

MS. YERGER: Yes.

MR. STEEL: The vote tally is 16-0 with one abstention in favor of making the draft report available to the public for a 30-day comment period.

CO-CHAIR LEVITT: The next meeting of the Committee will be Tuesday, June 3rd at the Treasury Department. At that meeting, we will hear additional recommendations of the subcommittees, Firm Structure and Finance's recommendations, and we will also hear from three panels of witnesses on the draft report.

I appreciate everybody's attention

to our timing requirement, and I hereby call this meeting adjourned. Thank you.

(Whereupon, the proceedings went off the record at 5:01:39 p.m.)