UNITED STATES OF AMERICA

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DEPARTMENT OF THE TREASURY

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ADVISORY COMMITTEE ON THE AUDITING PROFESSION

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MEETING

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Monday,
December 3, 2007

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The Advisory Committee on the Auditing Profession met at 10:00 a.m. in the Cash Room of the Department of the Treasury, 1500 Pennsylvania Ave., NW, Washington, DC, Arthur Levitt, Jr. and Donald Nicolaisen, Co-Chairs, presiding.

MEMBERS PRESENT:

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

OBSERVERS PRESENT:

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

TREASURY OFFICIALS PRESENT:

ROBERT K. STEEL, UNDERSECRETARY FOR DOMESTIC FINANCE

DAVID G. NASON, ASSISTANT SECRETARY FOR FINANCIAL INSTITUTIONS

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

10:02 a.m.

CO-CHAIR NICOLAISEN: We're going to stick very tightly to that five minute limit.

We're then going to, after each of our five panelists have had an opportunity to express their introductory comments, we're going to turn to the members of the Advisory Committee, the Subcommittee that deal with each of these topics.

So the first Subcommittee is Human Capital. And we're going first to the members of that Subcommittee to ask their questions. Again, we're going to limit the exchange between any one member to five minutes. You call follow up, but let's try to stick with that five minute rule.

After we've exhausted the Subcommittee, then we're going to turn to the rest of the panel so that everyone will have an opportunity, we hope, to ask a question.

In the event the members of the Committee, if your question is not answered and you'd like follow up or you have additional questions that you'd like responses to, please submit them to us and we will forward them to the various members of the panel. We'll ask them if they'd be so kind as to respond;

both the inquiry and that response will be a matter of the public record. So everything that we look for and seek will get into the public record.

BlackBerries, cell phones, etcetera, please turn them off. Those of you who have them in the room, good idea not to have them near a microphone because it will interfere with the process.

With that, let me introduce the first member of the panel. And I'll introduce each of you separately. I'll ask for five minutes of introductory comments and then we'll proceed as I had previously discussed.

So let me begin with Joseph Carcello, Director of Research at the University of Tennessee's Governance Center.

Mr. Carcello, would you care to start?

MR. CARCELLO: Good morning.

I thank the Committee's Co-Chairs Arthur Levitt and Don Nicolaisen for giving me the opportunity to testify before this distinguished group.

In my written testimony submitted last week I identified four challenges facing the public company auditing profession. These are:

(1) The accounting profession is not

attracting the best and brightest. Salaries are low compared to competing fields, finance and law, and this gap has become wider over time;

(2) The culture of business school students and faculty is not consistent with a public interest mandate;

(3) Existing curriculums are not keeping pace with the growth and the need of knowledge and skills required to effectively audit public companies, and;

(4) There is a serious faculty shortage, and this shortage is expected to get worse and is particularly acute in auditing.

I would like to suggest a market solution for these problems, but for the reasons explained in the attached handout, which all of you have, I do not see any market solution as currently viable. Both public company audits and accounting education, especially doctoral education, are public goods. And like most public goods are prone to honored investment.

I am here today to propose a potential solution that addresses all of these challenges and that would serve the best interests of the investing public. I recognize that recommendations will be viewed as aggressive, and may be provocative, but I challenge the Advisory Committee to not ignore the challenges that I have identified. They are real; they are likely to get worse, and they will not be solved on their own. But rather to seek fundamental, long lasting improvements rather than simply incremental change.

Currently accounting programs are housed within colleges of business. A typical college of business has a strong focus on private interest. However, the focus of public company auditors should be different. I suggest that the Advisory Committee consider a different model. An education model involving professional schools of auditing and a licensure model where a separate certification for public company auditors would exist. The model I suggest is included in the flow chart that I have distributed to you this morning.

I recommend that the SEC through its rulemaking authority or the Congress expand the PCAOB's mandate to include education and licensure. Under its education umbrella, the Board, in a cooperative partnership with the AAA, would develop standards to accredit professional schools of auditing. A prime benefit of professional schools of auditing would be that the accreditation process could include developing a student culture of professional responsibility.

Another benefit of professional schools of auditing is that the curriculum can be designed to uniquely meet the needs of public company auditors. Moreover, accrediting standards can be established to break the stranglehold of three accounting research journals on the tenure and promotion process and to emphasize the importance of professional interaction between terminally qualified professors and the practicing profession.

Under the licensure umbrella, the Board would create a national license for auditors of public companies, the CPA-PCA, public company auditor. The Board would partner with the AICPA in adding a fifth and sixth section to the CPA exam. These sections would cover, in greater depth, issues particularly germane to financial accounting, auditing, and ethics for public company auditors. In addition, as part of its inspection process, the Board would specifically inspect the work of candidates for the CPA-PCA license on a random basis. If individuals knew that the PCAOB might inspect their work, and that this inspection would affect their prospects of licensure, it would have a powerful effect on individual behavior.

Upon completion of all six sections of the exam, and after completing two years of public company auditing experience an individual would be licensed as a CPA-PCA.

I believe that the above model would make the public company auditing profession more attractive to students, and that graduates so educated would be better prepared to serve the public interest. Students would clearly be entering a profession, and the demands of establishing professional schools of auditing and of passing two extra sections of the CPA exam should result in a situation where salary levels would have to rise to attract the needed supply. The combination of being educated like other professions and having higher starting salaries should result in more of the best and brightest being attracted to the public company auditing profession.

The need for graduate education for accountants has been recommended by various "blue ribbon" committees for almost 40 years. Now is the time to act.

Thank you.

CO-CHAIR NICOLAISEN: Thank you very much.

Turning next to David Leslie. Mr. Leslie is Chancellor Professor of Education of the College of William and Mary.

Mr. Leslie?

MR LESLIE: Thank you, Mr. Chairman.

I've conducted research on the faculty workforce, the American faculty workforce since the late 1970s and have served approximately since 1987 in external review panels for one of the education department's data sources, National Study of Post-Secondary Faculty.

I've used the data from the national surveys to prepare for this session. I understand you may have a copy of my fuller report in front of you.

I estimate that the total number of accounting faculty declined 13 percent over the period 1988 to 2004 while the number of all faculty and other business disciplines increased over 22 percent.

The decline in full time tenure eligible faculty between 1993 and 2004 was over 19 percent. The decline has been less, on the order of about 10 percent, among faculty who are not eligible for tenure.

Contingent and part time faculty not eligible for tenure now constitute about two-thirds of all accounting faculty, including at two year institutions. That proportion rose slightly from 59 percent to 64 percent over the period '93 to 2004. It's close to but a little higher than the 58 percent of all faculty in all fields who are either contingent or part time and not eligible for tenure.

The most serious loss of full time faculty in accounting has occurred at four year nondoctoral granting institutions, amounting to 31 percent of the 1993 total. Little change in the number of full time faculty occurred at either research and doctoral universities or at two year institutions.

The decline has been principally among male faculty, of whom there are now about 3,000 fewer than there were in 1993. The number of women accounting faculty has not increased numerically in any significant way, although they are an increasing proportion of all accounting faculty.

As the number of faculty in accounting has declined, undergraduate student enrollment has increased about 12.3 percent over the same period.

These trends have led to what appears to be a significant increase in workload for accounting faculty. The ratio of students to full time faculty members at baccalaureate and higher institutions has increased sharply from about 20:1 in 1993 to 28:1 in

2004.

The mean age of accounting faculty increased between 1993 and 2004 by three years for full time faculty and five years for part time faculty. And the number of accounting faculty over the age of 55 increased faster than the number of accounting faculty under the age of 40.

Both my study and Plumlee's 2004 study estimate the number of retirements is likely to exceed the number of qualified replacements in the immediate future. Given the stability of Ph.D. production at about 140 per year on the average and with retirements estimated at about 500 per year, the production of new Ph.Ds does not appear sufficient to fill the demand.

In addition, new data just out this week on doctoral recipients indicate that 69 of the 138 Ph.Ds in accounting in 2006 went to non-U.S. citizens.

So at the risk of oversimplifying what is a very complex scenario, I would conclude that fewer and older faculty in accounting are teaching heavier loads and are not being replaced fast enough. There is some reason to believe that programs in doctoral and research universities are holding their own against these trends, but that programs in comprehensive colleges and universities are potentially losing their critical mass.

Thank you, Mr. Chairman.

CO-CHAIR NICOLAISEN: Thank you very much.

Let's continue with our next round of comments from Ira Solomon, R.C. Evans Distinguished Professor, and head of the Department of Accountancy at the University of Illinois.

Mr. Solomon?

MR. SOLOMON: Good morning, Mr. Co-Chairmen and esteemed Advisory Committee Members, it's my pleasure to testify before you today with respect to human capital issues and their audit quality implications.

My written testimony addresses three issues:

(1) The state of the accountancy professorate;

(2) Who is choosing to study accountancy in universities and in what numbers; and

(3) The nature and quality of the university accountancy education programs.

My oral testimony this morning, however, will be on the professorate and, in particular, the auditing professorate.

It's axiomatic that the preparedness of

persons entering the accountancy profession is a function of the quality of their education and, in turn, accountancy education efficacy is critically dependent on the accountancy professorate.

Recent studies report an overall accountancy faculty shortfall, but most importantly they project an especially acute shortage of auditing Ph.Ds. Indeed, while since the 1980s the number of accountancy Ph.Ds has fallen significantly, today the number of new Ph.Ds specializing in auditing is by some accounts in single digits per year. Current demand for auditing faculty is several times that number, and future demand will be even greater.

Although I'll focus the remainder of my oral testimony on the auditing faculty shortfall, I note in passing that the average age today of the tenured accountancy faculty at Illinois that are associate and full professors is 54.1 years. Many, if not virtually all of these persons will be able to retire by age 60. Since it takes about five years on average to produce a new Ph.D., even a large doctoral program like that at Illinois will barely produce enough accountancy Ph.Ds during the next five or so years to offset its likely tenured faculty retirements.

I believe the shortage of auditing Ph.Ds is acute mainly because of the highly constrained availability of auditing data in human subjects. A generally accepted notion with universities is that it's important to conduct research in the same area in which one teaches. Otherwise, one is deprived of the natural synergies between teaching and research.

Some auditing data that's essentially for research is found in audit working paper files, including assessed risk levels, the specific audit tasks performed in response to the particular risk of misstatement, the nature and magnitude of identified audit differences.

Past researchers have used these and similar data to make important findings about audit effectiveness and efficiency. Other data must be obtained directly from audit firm personnel who participate in experiments and surveys.

All such studies can inform related public policy and help to improve audit processes and outcomes. Such improvements, in turn, help to assure the efficacy of our capital markets. All persons interested in the efficient and effective operation of our capital markets, therefore, should be supportive of auditing research.

Since the '90s both archival data and access by researchers to practicing auditors have become extremely limited. One consequence is that there has been a drastic decline in auditing research. One overarching factor here seems to be fear of potential litigation; that is if a research study were to portray auditors or audit processes in less than a positive light, legal exposure some feel may be increased.

Related, there's a concern that if data are placed into an archive, attorneys may obtain access including access to data they'd not be able to acquire in other ways.

With respect to human subjects, one issue seems to be the opportunity cost associated with research participation. And with respect to data from working paper files, client confidentiality is often raised as a constraint. The idea is that such data have been gleaned either directly from specific clients or in response to clients' specific circumstances. But many of these issues, though serious, should not be showstoppers.

For example, the auditing profession is not alone in terms of confidentiality concerns. Think of the medical field. Indeed, within that field patient confidentiality is a critical and longstanding concern. That said, when one becomes an in-hospital patient one is often asked or required to sign a release acknowledging that some of one's tissues and fluids may be provided to researchers who will use them to push the medical knowledge frontier, and ultimately improve medical processes and outcomes. Would a similar approach not work in auditing?

Specifically, could client confidentiality concerns be removed by placing an engagement letter as a disclosure about providing data to researchers with the goal of pushing the knowledge frontiers, ultimately improving audit processes and outcomes.

Now related to this I've learned from faculty members working in the Illinois National Center for Super Computing Applications that there are huge advances being made in a relatively new field of anonymization, and these advances hold considerable promise to persons who seek to balance protection of confidential and private data with the good that can come from making such data available to researchers.

Thank you.

CO-CHAIR NICOLAISEN: Thank you very much.

Let's turn next to George Willie, he's the managing partner at Bert Smith & Co. Good morning, Mr. Willie.

MR. WILLIE: Thank you, Mr. Chairman. Good morning to you, Mr. Chairman, Chairman Levitt and Chairman Nicolaisen and members of this Advisory Committee, and all the guests.

CO-CHAIR NICOLAISEN: Is your microphone on there? Thank you, again, sir.

MR. WILLIE: I thank you for the opportunity to testify today regarding the expanded need for human capital, especially the need for greater minority participation in the audit profession. No doubt you have heard and will hear from many persons with different perspectives on this challenge that we face. And I'm honored to be one of those voices on this important topic.

The Bureau of Labor Statistics projects that minorities will account for one-half the U.S. population by the year 2050. Our economy, including audit clients and audit committees, will reflect these realities. In response to these demographic shifts, the CPA profession must enhance existing strategies to continually attract and retain minorities within the profession. The face of America is changing and the face of the profession must change with it.

Twenty-two percent of the recent graduates in accounting were minorities. Twenty-three percent of new hires by CPA firms were minorities: Asian/Pacific Islanders making up 12 percent, Hispanics or Latinos 8 percent, African-Americans a mere 3 percent.

Minorities represent only 10 percent of the professional staff employed by CPA firms. Five percent Asian/Pacific Islanders, 3 percent Hispanic Latinos and 2 percent African-Americans.

What these data show is that while we're slowly attracting an increasing number of minorities in the study of accounting, we're not keeping them in the profession as CPAs and ultimately as partners and executives. Of particular concern are the African-Americans numbers: only 7 percent of the graduates, 3 percent of the hires and 1 percent of partners and CPAs. CPAs are the lowest level of African-Americans, representation in the professional workforce.

The CPA designation is the building block for all segments of the accounting profession. Certification is the gateway to successful careers. Careers that blossom in the public, corporate and governmental arenas. The profession can and must do a better job to sustain itself.

Simply put, if the profession is to grow and deliver the quality necessary in the marketplace, the attraction and retention of many more minorities are imperatives. To do this, universities must find ways to get more minorities through the critical pre-hire education path, and the firms must do more to retain and promote professional minorities.

Throughout the history of our nation, minorities have had no presence, almost no presence in the accounting profession. We cannot sit idly by, continuing to talk about representation of minorities, report on the issue without results. This is unacceptable if we are to have a vibrant and diverse profession serving the public's interest.

The competition to recruit top talent is fierce in the professional labor markets, including accounting, with many firms seeking to enhance staff diversity in order to meet both staffing needs and client expectations. Changing markets, relationships, regulatory initiatives such as Sarbanes-Oxley create the need for greater numbers of qualified auditors. To make the profession more representative of the population, the AICPA and the firms must enhance existing strategies to continually attract greater numbers and integrate minorities in this profession.

The current strategies are commendable,

but still insufficient to the task. The bottom line is that we need to do a better job of reaching into minority communities. And all the efforts must be threefold, all relating to pipeline expansion: Creating student awareness, recruiting students into accounting programs and then into the firms, and ensuring that we have sufficient faculty to meet the needs.

It is important to help prepare the next generation for the challenges tomorrow in the academic, personal and professional lives through partnership between the CPA profession and educational institutions.

I see the effort to diversify the accounting profession as a combination of initiatives. First, educators have to be an integral part of our recruiting efforts. There has to be an intensified outreach program by academia to prospective accounting majors.

Second, the families of minority students must promote commerce, accounting and finance as alternatives to the ministry, medicine and law as important professions.

Third, and equally critical, is the involvement of mature and accomplished accounting professionals whether as community leaders, guest lecturers, or participants in adopt-a-school programs, CPAs of minority ethnic background have demonstrated that with hard work, the right relationships there is much to be attained in the accounting profession.

I said in a recent interview with *Web*CPA that a critical issue, the critical mass is the key. When the faces in the hallways of the large and mid-sized firms mirror the variety of faces we see walking down the street, then we would have achieved critical mass. As long as African-Americans, the Latinos or Asian/Pacific Islanders are not exposed to accounting as a career choice, then we'll continue to experience a shortage in these groups in the field as a whole. We have a responsibility as a profession to engage one another and to make a difference towards critical mass. There are documents upon documents saying that there is a problem, but these are just words on paper. WE need to take action and make a difference. As a profession, we have the responsibility to engage one another and to invest in the future.

Again, I thank you for the opportunity to be heard this morning.

CO-CHAIR NICOLAISEN: Mr. Willie, thank you.

Our last panelist, certainly not least, is Julie Wood, Chief People Officer at Crowe Chizek and Company, LLC.

Ms. Wood, hopefully, you have some good news for us. It sounds like we have a lot to do.

MS. WOOD: We certainly have a lot of issues to tackle.

Good morning, Chairman Levitt, Chairman Nicolaisen, Members of the Advisory Committee and other guests. Thank you for the opportunity to talk with you this morning about the public company auditing profession and the critical area of people, specifically how we attract, develop and retain people in our profession for the long haul.

Crowe is one of the nation's largest public accounting firms, and I serve as the firm's Chief People Officer with tremendous pride.

To begin, the expectations for our profession are very high. We are required to provide independent attestation to support the capital markets. We are required to exercise professional skepticism to protect investors. And we must do so in a rapidly changing world in which new standards and requirements often emerge, seemingly overnight.

Public discussion about public company

auditing can at times tend to focus on such issues as reporting models, standards and regulatory oversight. But I strongly believe that our success ultimately depends on our ability to fill our profession with the right blend of people. People in the profession must possess a combination of talent, commitment and a high degree of integrity.

At the start of this decade, the profession appeared to be losing ground relatively to the pipeline of new entrants coming into the profession. Many of the brightest students were choosing other fields such as technology and finance and the number of accounting graduates fell to new lows. The talent flow from colleges to the accounting profession peaked in the 1994 to 1995 school year with some 61,000 bachelor's and master's degrees in accounting. The number of degrees then fell sharply to just under 45,000 in 2001 and 2002. Fortunately, the number has since rebounded by about 20 percent.

While the pipeline of students has rebounded, not all students who graduate from an accredited institution will have the desire, aptitude or motivation to choose a career as an auditor. Thus, the real pool of available talent for auditing is smaller than we require now and will continue to be so in the future.

As a profession, we are also looking to build a more diverse group of auditors. I believe firms in our industry, along with the academic community, have made great strides in addressing this issue. Unfortunately, as you've just heard, we still have a long way to go.

We believe creating a more diverse workforce allows us the opportunity to not only expand the pool of talent, but also to develop more innovative and engaging work environments; environments in which audit professionals are positioned to provide the highest quality service to their clients.

Persuading students to study accounting is just the first step in a continuum that aims to create a corps of professionals with the technical training, the intellectual inclination, the rounded judgment, and the personal commitment that we need.

Once a prospective CPA enters the educational pipeline, he or she must receive a top-notch undergraduate education based on up-to-date curricula and a deep reservoir of qualified faculty. As it happens, the level of academic resources, especially Ph.Ds to direct the course of study, is an area of serious concern. Mr. Solomon has already addressed this issue in his testimony.

New hires need extensive additional training once on the job. It has been said that college prepares students to “become” accountants, not “be” accountants the day after they receive their degree. Further, “become” a CPA in many ways is a life long quest in which learning never ends. If you doubt the need for continuous learning, consider how much the world has changed for an auditor just since the start of this decade with Sarbanes-Oxley and the implementation of new accounting and auditing standards.

We also need our best people to stay in the profession. That means that we must continuously reenforce their sense of personal accomplishment, ensure they have the skills necessary to do their jobs well, recognize the pressure that comes with passing judgment on the financial reporting of companies with billions of dollars in assets, account for the new challenges and career risks from enhanced public and government scrutiny, support their need for fulfilling personal and professional lives, and address some of the family relocations and travel issues that affect many auditors due to mandatory partner rotations.

Identifying talented new people at the start of their career is highly important, but we will not and cannot fully tap their potential unless we give them high caliber mentors from whom to learn.

The auditing profession, this Committee and all who understand the value of auditing must find innovative ways to attract America's brightest to the accounting profession. We also must make sure there are enough doctoral faculty to train these new entrants.

I hope policymakers will also help us retain quality people in the profession by finding ways to reduce the professional risks that may drive veteran auditors out of the profession early.

Given the growing expectations for audit quality, the demand for a great amount of forward looking information and the coming implementation of SOX Section 404 compliance for smaller public companies, just to name a few demand drivers, we're going to need more auditors.

Mr. Chairman and the Committee, I thank you again for the opportunity appear here today. And I'd be happy to respond to questions.

CO-CHAIR NICOLAISEN: Panelists, thank you very much. We're going to turn now to our Chair of the

Human Capital Subcommittee, Gary Previts to throw out the first question.

And, Gary, I have to say I can't think of anymore more important to the quality of this profession than the human capital that's employed. And it sounds like we have some issues that need to be addressed.

MR. PREVITS: Thank you, Don.

I would like to ask each of the witnesses to give me -- you've all mentioned some concerns and what is of concern to you. But I'm going to kind of put your on the griddle a little bit and ask you to perhaps respond with an identification of one particular item that you might recommend, the foremost item in your concerns and some practical considerations about how we can address that.

And I'd start out by asking Professor Carcello.

MR. CARCELLO: Thank you, Gary.

I have provided detailed specific recommendations that I believe will help achieve and sustain high quality personnel for public company auditors. I know that some may oppose my recommendations because they represent substantive change and not incremental change, and change is never easy. Others may oppose my recommendations because they may perceive that it challenges their business model, and hence challenges their self-interest. Others may oppose my recommendations because they may lose power. But such opposition ignores the human capital challenges that I have identified.

First, the best and the brightest students pursue MBA degrees and join investment banks, consulting firms, hedge and private equity funds or pursue law degrees and New York City law firms. The best and brightest generally don't join public accounting firms. And it is not even clear that the best and brightest undergraduates even choose to major in accounting. This is a fact, and it is verifiable.

Two: The culture of business school students and faculty is not consistent with the public interest mandate. In my view this too is a fact, albeit harder to prove.

Three: Existing curriculums are not keeping pace with the knowledge and skills necessary to audit public companies. If you doubt the veracity of this statement, explore how many universities currently incorporate coverage of fair value, IFRS, XPRL, the COSO framework and ERM concepts into their curriculums.

Four: There is a serious faculty shortfall, especially in auditing. This is a fact and the evidence here is overwhelming.

Finally, accounting programs are stepchildren within most colleges of businesses. Deans worship at the MBA altar every morning. And if I don't speak truth, then why have the number of accounting faculty declined approximately 20 percent over the past 15 years or so at the same time that the number of other business school faculty have increased by approximately 20 percent, particularly in light of the growth in the number of accounting students?

It is fine if others oppose my recommendations for improvement, but here is the challenge that I lay before your, Chairman Levitt, Chairman Nicolaisen and some Subcommittee Chairman Previts. I described four human capital challenges facing the public company audit profession. The Advisory Committee either needs to refute my identification of human capital challenges facing the the profession or develop solutions different from mine that have a legitimate chance of addressing these challenges.

And whatever educational recommendations you make should be responsive to the concluding recommendations of the report of the Panel on Audit Effectiveness, a group created at the request of then SEC Chairman Arthur Levitt. And now I quote: "The Panel recognizes that in the final analysis the most important determinants of audit effectiveness are the personal attributes and skills of the individual auditor. Most importantly, individual audits as members of a respected profession should assign their highest priority to protecting the public interest."

The investing public needs this Advisory Committee to recommend an educational model that is most likely to make this aspiration a reality.

Thank you.

MR LESLIE: I would just like to respond just very briefly from the point of view of someone who uses data to try to analyze problems.

I'd like to start off with a quote from the Cheshire Cat, "If you don't know where you're going, any road will take you there." If we don't know where we are in this process, we're not going to know what road to take.

I'd just like to point out the fragility of the data sources that I've relied on, which include the National Study of Post-Secondary Faculty, the Survey of Earned Doctorates, the National Post-

Secondary Student Aid Study, and AICPA's own work.

None of these data sources is perfect and all of them liable to the vagaries of funding, mostly in the education department. I'm particularly concerned about the National Survey of Post-Secondary Faculty. Imagine if we held this hearing about five years from now, I would still be reflecting on 2004 data and we would have lost the interim period.

I'm hearing impaired so I didn't even know that was off. I hope you've all been able to hear me. But the problem is with the data.

The National Post-Secondary Student Aid study, which allows us to track students at the level of discipline has already lost the capability of producing data by majors at the level of accounting. So we're stuck with data there from the year 2000, but I don't have anything beyond that other than what AICPA has produced.

The Survey of Earned Doctorates is very reliable. The two estimates, Plumlee's estimate and what we have from the survey itself are very similar, and those look very good.

I think what we need to consider really strategically, from my point of view, is the point that if we held this hearing five years from today would we have enough data to be able to generalize about the trends. And I'm not fearful that we might not, and therefore I would probably have to decline to testify.

MR. SOLOMON: My recommendation is going to deal with the need for more auditing research. If we had the ability to conduct more auditing research, not only would we help to solve the shortfall of auditing professors, but we might along the way improve audit processes and outcomes. So in that domain I've got two thoughts.

One is presently and traditionally the limited funding for auditing research generally has been provided directly or indirectly by auditing firms themselves. Given the public interest in research that improves audit processes and outcomes, I believe that consideration should be given to new sources of financial support for such research.

Now specifically again about the audit data issue, at present access to archived data and to practicing auditors necessary for conducting auditing research is simply not generally available. Members of the auditing practice, the academic and the regulatory community should work together to make such archival data and practicing auditor access much more readily available to accountancy doctoral students and faculty.

Again, I believe there's a public interest in here that goes back to the efficacy of the capital markets. I urge, therefore, the formation of a task force not just to talk about these issues, but to identify the specific barriers and then to propose ways of overcoming them.

Thank you.

MR. WILLIE: Dr. Previts, I think my position is so stated. It's my concern over the years for involvement of African-Americans and other minorities in this profession. And I think what I hear you ask, sir, is what is it that you think could make a difference?

MR. PREVITS: George, you mentioned the exposure to accounting as a career choice. That might be an example of a specific item that you could make a recommendation about?

MR. WILLIE: That's where I was headed, Mr. Chairman. But more important to me is what have we done and what are we doing. And in my earlier testimony I talked about not being collectively going at the same objective. Everyone is trying to do the same thing, but not in collaboration. I believe, Mr.

Chairman, that we need greater outreach to universities.

When I served on the AICPA Minorities Initiatives Committee one of the things we talked about is how do we get in front of young minorities to get them involved in accountancy. We have to be out there, Mr. Chairman. We need those of us who have been lucky, successful, been fortunate to be a part of this profession to be in front of young kids, encourage them to be CPAs and to be accounting majors.

As you know, Mr. Chairman, the AICPA and the other groups have spent millions of dollars on scholarships. We know that helps, but there's got to be greater involvement, collaborative efforts by the firms and an increased awareness by those of us who have made it to be out there giving back, asking the profession to join us in talking to young African-Americans, Latinos and Asian/Pacific Islanders that accounting is a worthy profession, and perhaps we would be able to make a change.

MS. WOOD: My response, I think, would be targeted back towards some of the challenges we face in order to do what Mr. Willie just pointed out from a pipeline issue. And I think there are two areas of focus. One is certainly broadening our talent pool from a diversity perspective, and the other goes back to where I think it all begins and that is our ability to educate individuals coming into the accounting profession.

I think the shortage of Ph.Ds is a significant issue for us as we have heard. I also would like to have us address that issue, but also consider how we can bring some practical experience into the classroom so that accounting students are getting the kind of real world experience along with the kind of textbook critical learning that takes place, but a combination of those two I think would perhaps prepare individuals. As they said, they're not ready to be accountants the day they walk in the door. And so having a combination of those experiences I think would make a significant difference.

I also agree that we need to work collectively as a profession to expand our outreach from a diversity perspective. I think that as many of us in the industry know, we have done a lot of things to try to address the issue. But I would also agree that it's probably not enough. But it is something that we continue to challenge ourselves on every day. How can we reach down younger in the formative years with individuals to start planting the seed of accounting being a profession they might consider entering into.

So I would agree that we need to, perhaps, have a combination of practical experience in the classroom, address the significant Ph.D. shortage and then expand our collective work in trying to reach out into more of a diverse pool of talent.

CO-CHAIRMAN LEVITT: I wonder if we're not talking in part about a societal issue that hasn't been mentioned. I'm curious to know as to whether the resources devoted by private universities, ivy league schools are any different than the resources devoted by state universities. I wonder, again, whether the accounting profession might not have a perceptual issue, whether accounting as contrasted to other areas of activities not viewed in part as a blue collar profession.

As I talk to groups of students and ask them about career choices, I am dismayed to see a substantial number of them opt for hedge funds and private equity and the brokerage industry, the law. Accounting takes a backseat to other business professions. And I wonder how this is related to: (a) resources devoted by the universities that I speak of, and; (b) what the industry itself is doing to make the image of accounting as prestigious as any of the other competitive careers?

You don't all have to answer that. But if any of you have some observations, I'd be interested.

MR. CARCELLO: I'll take a shot, and I'm sure Ira will jump in here after I'm finished. But I think it's a very good point, Chairman Levitt.

If you look at the elite privates: Harvard, Chicago, Stanford, Yale, the only one I can think of that's an exception is Wharton, they don't have undergraduate programs in accounting. It's not even an option. So, I mean it's a very simple discussion: It's not there.

The overwhelming majority of entrants to the public accounting profession are trained at the large state schools. There are some exceptions. There are some private schools. Not at the level of Harvard that are big players, but Illinois, Texas, Georgia, you know the type of schools -- Florida, generate a lot of the entrants to the profession.

Second point that I'd like to make: in my written comments I tried to provide data for this group on salaries. In accounting and in law, and investment banking. And what I also tried to do is to look at how those salaries had changed over time.

I don't think anybody expects that an accounting graduate, even with a 150 hour degree, is going to start at the same thing as someone in law or investment banking because they often have an MBA. But the differences over time have become even larger. So the relative financial attractiveness of the field is less appealing today than it was 20 years ago.

The third thing, you talked about status of the field. Leaving aside the issue of the public interest and feeling you're entering a respected profession, which I think I've probably said enough about, David has some data that maybe he'll talk to where he looks at the relative prestige of different disciplines within the university and accounting is near the very bottom of that list. And I recall correctly, law was up not at the top, but much closer to the top. The physical sciences, if I remember correctly, were at the top.

MR. SOLOMON: Chairman Levitt, I would agree with most of what my colleague Professor Carcello said. It's very clear that there are many deeper pockets today in the private school domain than there are in the public university domain. And things have gotten worse, not better.

There was an article that appeared in *The Wall Street Journal* over the weekend, which I think is a pick up of a piece that's going to run in the current issue of *BusinessWeek* which talks about this growing schism. And while faculty salaries are only a small piece of the puzzle, the data reported in that article were quite scary. In particular, the article points out that in the academic year 1980/81 faculty salaries at the full professor level at public institutions were 91 percent of those in private institutions. Today, '06/07 they're 78 percent. That's a growing and much more difficult schism for us to deal with.

One of the other points I want to make, though, here is that I think that our profession, in particular public company auditing, is a very exciting profession. And I think we've got lots of opportunity to sell young people on careers in that field. I would argue, however, that the dollar side, in particular starting salaries, is only a very small piece of the puzzle here. And my belief is that it's critically important for us to get access to young people when they are, in fact, rather young; 17, 18 up to 21 and 22. It's in that time period that we have the best shot to influence their value creation.

Excuse me. To influence the creation of their values. Value-based decision making is something that my university has experimented with, and I've concluded based on about a decade and a half worth of experience that you can influence significantly people's values.

They need students in accounting programs who need to understand the bedrock fundamentals: integrity, objectivity and independence. Now, I know in some sense I'm preaching to the choir here. But taking those notions and translating them from not just compliance activities but translating them more into the reasons for being and the value proposition of this profession is something we can do effectively if we get access to them as undergraduates.

CO-CHAIR NICOLAISEN: All right. Thank you.

Barry, did I see you wanting to make a comment?

MEMBER MELANCON: To ask a couple of questions, if that's okay.

CO-CHAIR NICOLAISEN: Well, in a minute. We're going to try to do this in order through our list. So we're going to start with Amy, if you would care to throw out the first question. And then we will give each of our Subcommittee members a chance to have a question. And then we'll come back and open it up.

Thank you.

MEMBER BRINKLEY: Thank you very much.

And I would open this up to any of the panelists who would care to comment. But I am interested to know how you see universities actively pursuing programs to engage practitioners, as you suggested, Julie, to help compliment the faculty situation and to potentially help fill the gaps and the value add that you suggest, Julie, I think could merit that. So to any of the panelists, please.

MR. CARCELLO: I'll take a shot at that. Because you're going to hear that a lot. So I think it's important for the group to understand a few things.

Currently accreditation standards only require that 50 percent of a faculty be AQ, academically qualified. So that allows for up to 50 percent to something other than academically qualified. As a matter of fact, accreditation standards right now have a category called PQ, professionally qualified; the exact type person , Amy, that you're talking about.

One of the challenges, though, is it's not easy once you join a faculty to maintain that PQ status. And there's a movement afoot that Gary's more familiar with than I am, to basically create a third category, which is called MQ or mission qualified which is essentially -- I mean to be blunt, faculty toward the end of their career who have stopped doing research. They might have been AQ at one point, but if you don't stay research active you lose that. Or people who were PQ at one point but who have not stayed involved with the profession and they lose the P in front of the Q. And so now what do you do with these people? And so there's some movement to move to an MQ. Okay.

So anyway, right now there is the opportunity to hire the kind of people that you're talking about. But there's also I think an important reality that this Committee needs to understand. Okay.

And here's the reality. If you're a dean, you know I kind of tongue in cheek said "worship at the MBA altar every morning," but that's not really far from the truth. The MBA program is what's supported by most of the disciplines in the college. It's what's ranked by *U.S. News* and *BusinessWeek*, it's where your money comes from for the most part. And so that's where the priority focus is.

According programs are, at best, a support area to MBA programs. So if you're a dean and you look at your accounting group and you say they're a support area to my primary mission. That's strike one.

Then you look at salaries, and with the exception of finance, accounting salaries are generally the highest in the college of business. That's strike two.

And then you look at the research productivity of the faculty, and for reasons that you haven't asked me about, but generally the research productivity of the accounting faculty is the worst in the college of business. That's strike three.

Then if you go out and you have a very high percentage of your faculty not even academically qualified because at universities like Illinois, Texas, Tennessee, Georgia, Southern Cal research is the coin the of the realm. And the more faculty you have that are not research active in the internal pecking order of the college of business, you lose.

And there are definitely deans out there, Amy, who would not think twice about killing accounting programs. They're not concerned about turning out supply for the firms that are represented in this room.

So I think these are all things that need to be thought about very carefully.

MR. SOLOMON: I'd like to jump in, if I might, here as well.

I guess one of the things that I would like to say is as I reflect on my 30 years of experience is that practicing members of the accountancy profession are in the accounting classroom today more than they ever have been during that 30 year time period. They're in a variety of modes. Joe talked about sort of full time, change your career, become a member of the academy mode. But there's many, many other modes.

Some of the people who are here have participated fairly regularly in classroom settings of one type of another.

The real problem as I see it is not that we have a shortage of practicing members of the academic community in the classroom and not, quite frankly, that we have a shortage of people who are able to relate the most recent issues from the practice world and translate them into the classroom. The real problem is the shrinking Ph.D. qualified members of the faculty. That's clearly what's in

David's data. And this is one of the issues that is going to create a negative cycle if we don't get on top of it very quickly. Because as Joe says if the number of Ph.Ds in accounting in universities shrinks to some point they are going to lose credibility on universities campuses.

MEMBER BRINKLEY: Just as a follow up on that, and Ira, perhaps you could comment on the public/private partnerships for funding along the lines of what you're just talking about. Do you see that increasing, decreasing to encourage the Ph.D. candidacies and so forth?

MR. SOLOMON: Well, there are members of this panel who have firsthand knowledge that exceeds mine with respect to some of that. I can tell you that I'm aware of some initiatives. Many of these initiatives, however, I am somewhat concerned about because they seem to be focused on money. Money is an issue. All of us like more money than less money. Universities are no different from that. But the reality is money in many situations is not the only serious constraint. And in many instances, it's not even the binding constraint.

The binding constraint in my experience, particularly if we're talking about people who are going to go into the classroom and educate the future generation of public company auditors, the binding constraint runs back to what I spoke about in my testimony. And that is the availability of data.

We have lots of people who come out of public accounting firms. They've been there five, six, seven years. They are really excited about public company auditing and they want a career in academia, they want to kind of spread the word, engage with the young people. They get to the university setting and the first thing they're told is "You know what? You got to push that interest aside. Because you will not be able to be a fully functioning scholar/educator in the auditing arena because you're not going to get access to data."

Now, I just want to highlight that the world has not always been this way. There was a time in the 1970s and in the early 1980s where there were several research programs. One of the ones that was most successful was the research opportunities in auditing program, which was established by Mr. Flynn's firm at the time, late 1970s early '80s. It generated, in essence, a blizzard of research in the auditing arena. Faculty who were not trained in auditing tooled up. Ph.D. students rushed to the area.

Now, again, we like more money rather than less money, and that program provided money. But I have told many people, including Mr. Flynn, that the real value in that program was the access to people and data.

CO-CHAIR NICOLAISEN: All right. Well, thank you very much.

Let's move along and we're going to do the rest of the Subcommittee, and let's do it in order. Barry Melancon, following by Anne Mulcahy, followed by Sarah Smith.

MEMBER MELANCON: Thank you, Don.

So basically we've had this notion of an increased pipeline of students, a big time Ph.D. issue and then we have some demographic issues, as Chairman Levitt pointed out, that are societal as well.

And so to just sort of take pieces of that, I'll hit a very quick list for a few of you.

Joe, it seems to me as you focused on more intensive public company auditing education, I'll call it, one of the things that's missing in that analysis, and since you do an awful lot of research, is the data that we show about the generational aspects of people entering college or in college today, or at the point of leaving college, is that they clearly know that their careers, 40 or 50 year careers, will be very diverse, will be what demographers tell us is that they will have, some say, nine careers, some say 15 careers depending on who you want to believe. And I'd just ask if you could, and then I'll give real quick questions and you'll be first, but sort of reconcile this sort of deep dive notion versus this flexibility of career notion that this generation is really containing.

In the Ph.D. area, I know you just said money is nice and it's not that you would dismiss it but I heard the data and the people access. But if you could focus on the money for me, particularly as it relates to the career changer, back to this point, coming back into a Ph.D. program. Because there is a standard of living issue that has to be adjusted from that standpoint.

And, George, if you could give the minority opinion, if you will, or at least your perspective of the minority opinion as it relates to additional education, the so-called 150 hour issue.

And, Julie, if you could, you mentioned in your remarks about the retention issue and some of the impediments to it. Maybe if you could just expand on some of the things that firms are trying to do in that area, I think it would be beneficial for the Committee.

And so let's start with you, Joe?

MR. CARCELLO: It's a good question, Berry. And when I developed this proposal I exposed it to some people and people raised that issue. I guess my response is in my mind what I'm really proposing is essentially a law school model. And when you look at people who go to law school, they don't all stay in law firms their whole career. I would say most of them don't view their legal education as having been a waste.

And when I look at the body of authoritative literature as well as the competencies and skills needed and, you know, think about for those of you who are in the room who are accountants, think back on your own education. I got my undergraduate degree in 1982. And there were 34 FASB standards at that time, just one set of auditing standards, there was no fair value, there was no IFRS, there was none of this. There's no ERM. There was no second set of auditing on internal control. The body of knowledge has just expanded at an increasingly rapid rate.

So essentially I think the choices are either we need to deliver it in the universities, and

I will tell you that virtually every PCAOB SAG meeting I go to this issue of fair value comes up over and over and over again. So we've either got to provide the time to do it or we've got to accept the fact that students aren't going to know about this and stop complaining about, or we have to basically say to the firms you're going to deliver the training. And I'll tell you if you go there, guys, because I'm very familiar with the firms' training, okay, a lot of people who go there view it as a week of vacation and they're out to 1:00 or 2:00 or 3:00 in the morning drinking. Okay. There needs to be accountability, there needs to be testing and there needs to be rigor when that type of training is delivered.

MEMBER MELANCON: You're not implying that the drinking doesn't occur on the college campus, are you?

CO-CHAIR NICOLAISEN: I was just going to go there, Barry.

MR. CARCELLO: No. But I can guarantee you that at the end of the day if they don't understand the material, they do not pass my classes.

MR. SOLOMON: Okay. Thanks, Barry, for asking the question about the career changers. I think there's a couple of aspects of this.

First off, while at first blush those of us in the Academy say that Ph.D. education in accountancy is free, it is in one sense but not in another. Many universities, Joe mentions this in his written testimony, provide stipends of $15,000 to $20,000 along with tuition waivers that are pretty comprehensive. Students still have to pay for their books. Many times they have to pay for their health insurance and so on.

At the University of Illinois we provide $30,000 worth of stipend. Now if you think about this, though, over the course of let's say a five year period during which one would earn a Ph.D. in accountancy, Joe estimated the opportunity loss to be at $200,000. He went to a conservative lower bound. I went to a mean of $300,000 with the idea being that I'm thinking about someone who is, let's say, maybe seven years into a public accounting firm and is going to give that up for the $30,000 stipend. Now that's part of it.

So they have a direct opportunity cost, many of these people have families. And even in a community like Urbana-Champaign, it's become increasingly difficult to live off of $30,000.

But then the rest of the story kicks in

from the financial standpoint. And that is when they're ready to leave, they get what we in universities settings think of as very, very high compensation levels. In the big ten last year the public universities were paying in the neighborhood of $200,000 starting salaries. But imagine that the person had stayed in a public accounting firm and now is a 12, 13, 14 year person. They're going to be making, at least based on the public data that are out there, a lot more than $200,000. And as a practical manner once you're in the system, particularly if it's a public institution, you're subject to the whims of the state legislature which, you know, has been granting 1, 2 percent kinds of increases for the last several years.

So clearly from a pecuniary perspective it's not a winning game.

My view is, however, that people don't go into the accountancy professorate for financial reasons. You're called to this. The trick is not for us to mimic what they would make in the business world, but to shrink the gap to the point where we can compete, where we can make it small enough that we can get the people who are called to this profession to see clear to come in.

CO-CHAIR LEVITT: I think I'd just like you to consider this issue. If you're a young student given the opportunity to join a McKinsey and Company or Goldman Sachs or an accounting firm in an audit capacity, not in an advisory capacity, you know where the choice is going to be. How do we steer some of the best and brightest to be auditors?

MR. SOLOMON: Well, Chairman Levitt, first off many of the people that are brought into these kinds of organizations, whether it be a consulting firm like McKinsey or hedge funds, many of these people are coming out of MBA programs where they already have a number of years of work experience. And so in one sense I would be remiss if I didn't point out that we've got something akin to an apples and oranges comparison. Because the people coming out of accounting programs would be more generally 21, 22, 23 year olds, not 28 to 30 year olds with several years of work experience.

That said, I have to tell you I have found, and this is based on my own personal experience, that we have a compelling story to tell.

Some of you who had a chance to read my written testimony will see that the enrollments in accounting programs at the University of Illinois are huge. Our biggest problem, what keeps me up at night, is not whether we are going to have enough students to teach, but whether we are going to have faculty to teach them.

CO-CHAIR NICOLAISEN: Okay. We're running a little bit behind in our response time. So I would ask if we could just keep responses very crisp.

MR. WILLIE: Mr. Chairman, I want to get back to Member Brinkley's question of professionals in a classroom. And I will give you my perspective.

My perspective is that there are two issues, and Chairman Levitt is correct. There's a societary issue which is very more critical, African-Americans communities. We see certain professions; the ministry, medicine and law as up here while very little knowledge about our parents or grandparents exists about accounting. That's relevant.

And so in the classroom to see an accomplished auditor, a partner in an accounting firm, standing in front of the class talking about a profession, talking about what it is is what we need.

The graduation rates are going up for African-Americans. That's not issue. It's how do they get hired and how do we keep them until they can last all the way to the top.

To your question, Mr. Melancon, regarding the 150 credit hours and education in particular, I give you my advice. Those of us who graduated in the late '60s or early '70s, all the individuals I know earned MBAs. And all became CPAs because we were told back then in early '70s that if you want to make it in this profession, you need to have an MBA. We weren't thinking of a Goldman Sachs or the hedge funds or equity, or anything like that. We were thinking of joining an accounting firm and being the best we can.

I believe the 150 credit hour, and I was a champion of it back then and I'm still a champion, I think African-Americans and other minorities need it. We have seen those who have the master's degree pass the CPA examine in extremely higher rates than those without the CPAs. We already have insignificant representation in the profession, not to have the advanced training that allow you to be a CPA in my mind would be a death knell to whatever we talk about here today, or to our strategies in moving forward.

MS. WOOD: Mr. Melancon, I believe your question to me was around retention strategies in the firm. And I guess a few things come to mind.

One is I think one of the most important ways that we focus on retaining professionals in the industry is can you continuously make sure they have the skills they need to do their jobs. Learning is a significant part of our retention effort, and certainly considering Mr. Carcello's reference to the social aspects of training in the firms, there is certainly a component around networking and socialization and such that takes place as it relates to training. But we also continuously reenforce how that knowledge is being applied on the job, performance feedback on the engagements and such.

I think from a learning perspective there's a combination of both making sure our people have the technical capability to do their jobs and also what some might call the soft skills, which I believe are actually very hard skills around just interaction, critical thinking, being able to make very difficult decisions and weigh different options and the nontechnical training that takes place is very important in complimenting the technical as well.

And you referenced the generational issue. It is a significant one for us. As we look at the individuals coming into our workplaces now, they want something different than what, I think, we provided in the past. They want to work differently. They want flexibility. They want to be very, very good at their jobs. They're coming to be an auditor. They want to do it the best that they can at that work, but they also want to be able to give back in other ways.

And so as employers we have to find ways to not only prepare them to be very good auditors, but also support the other interests that they have. They're operating within a larger system within our organizations and they are critical in helping us to continue to build our pipeline of candidates, to help coach and develop others who are coming up through the industry. And to provide that knowledge to those that are coming into the organization.

So a combination of learning, both on the technical/nontechnical, trying to find ways to provide them with that diversified experience that they're looking for, trying to recognize them everyday and that looks different for every person. So clearly we have to make sure our compensation systems, monetary awards are appropriate for the effort they're putting forward. But they also want some of the other simple things: Recognizing them, saying thanks for a job well done, keeping them motivated. Those are the day-to-day areas that we have to focus on.

The last one, which is a very common reason we see individuals leave our firm is around workload/worklife. The stress, the pressure of the profession. At some point individuals reach that, at times that point where they say this just isn't worth it. The financial rewards that I see in the future are not necessarily worth what I am going to sacrifice in the meantime.

So we work very hard to try to manage their workloads, their levels of client load and what we can do to provide them with the flexibility they need to stay in the profession over the long term.

So those are a few of the areas that we focus on.

CO-CHAIR NICOLAISEN: Thank you.

Anne?

MEMBER MULCAHY: Yes. Good morning and thank you all for both your testimony and your comments. I certainly have learned a lot since this is not my background by profession.

And I come with the context of what I view as a kind of a five alarm fire in terms of the preparation and quality of candidates for the future business.

And, Ira, you talk about this profession is exciting. I agree with you completely. I got to tell you, it's really exciting. I'm just not sure that that's the profession we're training our accountants for. And that this, you know, battleground kind of learning that's taking place in business today I think is extraordinarily rich and rewarding and we're really well served by it. But I think this gap between the way we think about preparing for it and what really is happening in business today is growing, and certainly not everywhere but in general.

So my question is if the really big needs have to do with creating a business context today that I think is very different -- and by the way there should be I would think lots of room for things like internships and apprenticeships so that people have really good kind of practical exchanges. We're a global company. Think about where business is going, the need for really great understanding of international standards. And this need for what I would call deep technical expertise, but not for everybody. This context of specialization that I think needs to be so much a part of how we get served today, that just doesn't seem to be part of the structure.

So, kind of what's getting in the way of reengineering the context so that we actually -- by the way, I think it would solve a lot of the pipeline issues because I think people would really view that kind of broader curriculum and agenda as a much more exciting place to be than perhaps more of a technically focused agenda.

So what is getting in the way of having a curriculum that's really reflective of where business is today and certainly where it's going?

MR. SOLOMON: Boy, I couldn't have said it better. In my written testimony I wrote that I believe that audit education and accounting education is partly to blame for some of what you just talked about.

Now I want to be careful. I don't want to say that there's been no innovation over the last 15/20 years. There clearly has been. But if you compare the pace and nature of change in the business world due at least largely to innovations in information, communication, transportation technology, all of which have dramatically transformed business models, business processes and yet we're still teaching in many instances intermediate accounting the same way it was taught 20 years ago.

Now, there are schools where changes have been made. It's difficult. There are a lot of frictions. There's a shortage of good educational materials. Text book publishers are very risk adverse.

Incenting faculty. In a world in which there's an extreme shortage of faculty if they don't like what's happening at your place, they can walk down the street. There's other jobs available for them. Incenting them to do the difficult thing; to innovate in the classroom is not an easy thing.

But there are universities where this has happened. You see the rise of skill based education. You see a grounding of accountancy to a much greater extent in business context. And I would argue that in many of those universities the students have flocked to the accounting curriculum, which is the proof in the pudding that you were talking about.

MEMBER MULCAHY: Thank you.

CO-CHAIR NICOLAISEN: Sarah?

MEMBER SMITH: Thank you. Good morning, everyone.

So far this morning all your comments have been solely discussing accounting graduates and accounting --

CO-CHAIR NICOLAISEN: Sarah, I think you might need to get a little closer to the mike?

MEMBER SMITH: How's that? That better?

I'll shout.

You've talked about accounting graduates and the accounting education. And I just wonder as someone with a 30 year career in accounting, including 12 years as an auditor and I don't have any accounting graduate degree, I thought that I might ask Julie, perhaps, to talk about as you look at the world today, the complexity of the capital markets, the increasing globalization, and, just following up on what Anne said, the increasing need for very specialist skills how do you as a firm think about attracting nonaccounting graduates into becoming CPAs, those with math degrees or you know, we talk about fair value, for example. Math is the single most important skill set in tackling that issue. And economic graduates and so forth. And would that help in broadening the pool of available talent?

MS. WOOD: We have had some discussions within the firm around how do we, perhaps, broaden our pipeline of students to those coming from nontraditional, perhaps, degree programs. And I actually believe some of the larger firms even than us have probably done more work in that area in terms of taking individuals, perhaps, from a finance type of program and helping them to kind of retool and build out the accounting specific knowledge that they might need in order to assume an auditor type of role.

I think it's an area of continued focus. It's something that we have talked about within the organization. And we have had some success doing that, but it may need a little bit more conversation around that.

MR. SOLOMON: Mr. Chairman, may I jump in on that just real quickly?

CO-CHAIR NICOLAISEN: Absolutely.

MR. SOLOMON: We have seen the growth in student interest in enrollment in one of our master's degree programs which is targeted at people that have undergraduate degrees outside the business school. Computer scientists, engineers and so on. So we've seen that. And it's real. And I think it's likely to continue. But the numbers are not so great that they would, in my view, are likely to become without further interventions a significant piece of the puzzle.

One of the other things that I would say here as well is that consistent with my earlier comments, I think it's critically important that we get to people when they're very young. If you want people coming into the profession who have fully internalized the public service notion, then you've got to get to them before they're already fully functioning adults.

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

We have about seven or eight minutes left. So let's do as many as we can, quick questions, quick responses, please.

Let's start with Damon and then Bob and we'll work our way.

MEMBER SILVERS: Just very quickly. I think one of the things that Arthur tried to bring out here is the way in which we are being -- you all are showing us a very unforeseen consequence of broadening income and equality at the high end. Something not talked about very much. That is what I think Joe's table really shows in terms of banking, law and accountancy.

My question to you all is, Joe, you said that you're suggesting a law school model as potentially a fix. I would like the panel to respond to the question what about a medical school model? What about a model that more deeply integrates the training with the firms and one in which potentially would I think also deal with the research data issue?

MR. CARCELLO: Damon, to be frank with you, I haven't thought about that. So, you know, I would have to think about it some to have an intelligent response. But it's something that I'll think about. Certainly worth considering.

MR. SOLOMON: I would add that traditionally you haven't seen a lot of that because a lot of the folks who came into Ph.D. programs already had a large number of years of experience, five, six, seven years or more sometimes. But as we start to see people with different backgrounds -- and I want to pick up on something that David said in passing that is very important. A very high percentage of the people coming out of U.S. Ph.D. programs today are not U.S. citizens. Now that's fine, but what you have to know is while they're coming out of elite universities and private schools and very prestigious public institutions in the U.S., before they came to the U.S. to enroll many of them were in Mainland China. And they have no experience with western business practices, western business institutions and so on.

One of the things that could be done here very productively would be for a partnership to arise between the practicing community and the universities whereby people who have just completed Ph.D. programs get an opportunity to serve time and gain firsthand knowledge of western business practices and institutions.

CO-CHAIR NICOLAISEN: Bob?

OBSERVER HERZ: Yes. As I heard a lot of this, at first I found it a little bit difficult to reconcile with there was a *BusinessWeek* cover a month or two ago. It said "The Hottest Place To Work" and it had ranked I think among the top ten or twelve places were the four major accounting firms. And then, you know, they had long interviews with happy people there, and some of them were actually in audit. I don't know whether it gets to Chairman Levitt's observation that maybe that's more around other parts of the firm, transaction, advisory or remaining part of the consulting or what. But I'm still having a little bit of a difficulty, or maybe it was just good marketing by those four firms with *BusinessWeek*, but I found that a little bit hard to reconcile. And if it's just that, you know, the sexy part of the firms are still the non-audit part of the firm, you know why is that? You know, getting to Ira's point about really having a pride in not only the competencies that you need to do to do a proper audit and be a guardian of the public interest, but just the pride in doing that.

So any thoughts on that as to whether or not -- because after reading those articles, I got pretty pumped up that maybe the corner had been turned.

MR. CARCELLO: Well, Bob, I think certainly the major accounting firms do a very good job of recruiting. They hire a lot of people. They're on campus frequently. They shower a lot of attention on 19, 20, 21 year olds. And a lot of other employers don't have the same large-scale hiring needs. So they're not as ubiquitous on campus. And I think that that has an effect.

CO-CHAIR NICOLAISEN: All right. Gaylen had raised his hand. Then Mary, Lynn, Mark and Zoe-Vonna. We may not get to everybody, but let's give it a quick try.

MEMBER HANSEN: Thank you. I wanted to really direct this to you, Joe, because you were talking about specialty. And I appreciate those comments. It's something that I've thought about over the years.

But as a young accountant I do have some concerns about that approach so early in the cycle of a person's career development. And it certainly reminds me of my own kids as they're in athletics and you have a coach that only wants the kids playing soccer or basketball or baseball. But it goes to this retention idea.

And when I started my career with a big eight firm once and very large public companies, but I always balance with private companies and nonprofits and governmentals throughout the course of that. And then later evolved into more of the dedicated SEC work.

In our firm, even though it's a small firm, we only allow people to be on so many SEC engagements because of the year round pressure. With SEC engagements you have quarterly reviews, you have registrations, you have form 8Ks and so on that they're constantly involved with, middle of the night type of stuff. And so my concern there is on retention.

The other concern that I would have is with small firms. The more you dedicate individuals to one practice area, you start getting into well how much can a small firm dedicate individuals just working on SEC engagements. So it goes to the concern of concentration and whether or not we're further segmenting our profession so that only larger companies can do SEC work.

So I'd be interested in your comments.

MR. CARCELLO: Those are good points, Gaylen.

You know, with five minutes you got a limited amount of time in terms of what you can say. But in my more detailed comments one of the things I talked about is I think there would still be a role for four year accounting programs and a staffing model that might evolve is really again, a staffing model very much more like law firms where there's a cadre of para-professionals that do a lot of the more detailed lower value added work and the people who would go through a professional school would essentially be on track to ultimately be partners in the firm and would be tracked from day one into more challenging work.

So it would not necessarily eliminate the opportunity for people to get four year training in accounting, especially those people who weren't sure they wanted to be in public accounting for at least the long term.

As it relates to the big firm/small firm issue, that's a challenging issue. I think, as you well know from some of the conversations we've had in other venues, there are changes coming in our field, Gaylen, with IFRS and fair value and so forth that, you know, separate and apart from what this Committee decides and certainly separate and apart from anything to do with education. I think this is going to pose increasing challenges for small firms.

CO-CHAIR NICOLAISEN: Well, all good things must come to an end, and fortunately we're about out of time for this panel.

What I would ask is those of you who would still like to ask questions, and it's probably everyone, if we could submit those questions to Kristen. And if you could accumulate those and get them to our panelists and if you'd be so kind as to respond back, we will make them a matter of public record.

Ms. Wood, Mr. Willie, Mr. Solomon, Mr. Leslie and Mr. Carcello, thank you very much. It was a great panel. It does emphasize the importance of the work of this Committee. And I think certainly is a great start to the day.

We will take a break for ten minutes. And we'll be back with panel number two.

So thank you again very much.

(Whereupon, at 11:29 a.m. a recess until 11:41 p.m.)

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

I'd like to call the meeting back to order once again and to emphasize the importance of timeliness. We've been pretty good thus far, but I hope that all presenters will stay within the five minutes, that the Members of the Committee will ask questions in an efficient way and responses will be as efficient as the questions. And that way, as many of us can participate as possible.

I'd like to first introduce our first member of the panel, Peter S. Christie of Friemann Christie, LLC.

MR. CHRISTIE: Thank you. Good morning. Thank you for inviting me here.

My entire career has been as a broker and advisor to large professional firms, and in particular the Big 4 accounting firms advising them on insurance. And then as there was no insurance available, increasingly on self-insurance.

In the five minutes that's been allocated to me I thought I would try and recap some of the themes that I touch on in the paper I believe you have. And I'm going to take a close focus, because it's where my expertise is, in the question that I think was posed in the discussion outline, is why can't insurance solve the liability problem.

In addressing that, I made a few presumptions to give it a context. And I think some of the presumptions are quite questionable.

Firstly, I presume in dealing with the question as to why insurance can or can't aid in solving the problem, I presume that an increase in the ability to pay, increasing the profession's ability to pay its liabilities rather than reducing those liabilities is a good idea. I think the question is framed in a way that suggests that. I find that a highly questionable proposition, but I take that assumption for the analysis.

I also assumed that the definition of solving or fixing the problem is a very high test. It is not at all unusual that participants in threatened industries, industries that face high liabilities, can't buy sufficient insurance.

It is also the fact that quite often participants in those industries go out of business or are required to carry very, very large amounts of capital. However, as I understand the proposition here, it is that that normal effect should not be permitted to happen and that there is a social public interest in making sure these firms remain viable, putting a much higher test as to liability than I think we would normally find.

My third presumption is that there is a current and real risk, the one loss or aggregation of losses can destroy one of the big 4 firms. I accept that proposition. I think it is clearly true, particularly if one focuses not on what the history has been, but what the potential for the future is.

I also take as a proposition that the likelihood of that happening will increase to the degree one increases the assets available to the firms.

So, I'm looking at a high test in saying what is the solution to the issue; reality of sort of telephone number liabilities, and; then face the question of can insurance materially alleviate the problem or, indeed, will it aggravate it. And I arrive fairly quickly at the conclusion that since we have here, I think, essentially an unlimited exposure it is not realistic to expect a limited insurance market capacity to respond to an unlimited exposure.

That analysis, as I say, is based on a number of assumptions. I believe there is insurance market capacity for liability risks broadly of this nature of somewhere around $750 million to one and a half billion. In other words, people can go out and buy those sort of limits per loss for heavy liability risks. So the question then becomes, it seems to me, rejecting my previous position that creating more insurance does not assist the viability of the profession. If you reject that and say there isn't an amount of insurance that would assist, and if that amount is between 750 million and one and a half billion, then how reasonably well can we access that and why can't we now?

Again, I think it would be extremely difficult because it's proved to be impossible so far, and would prove to be extremely difficult for the Big 4 to attack that capacity. In my view if it was doable, and I'm certainly not saying it is, but if it was doable, you would have to bring that insurance market capacity in well over current expected loss levels. And there's a whole complication here about whether we're talking about aggregate or each loss, but in broad terms I'm positive in the paper that might be $2 billion a year, say.

So is there a possibility of market interest at a higher level of attachment than we have historically seen? A level of which the insurance market believes that loss is realistically quite unlikely. That has its own problems, of course. At that level you have much less predictability than we do now, which is a major problem anyway, the lack of predictability.

The buyer of the insurance has to essentially pay for access to capital rather than pay for his projected losses. He's just paying for the right to call upon capital in the future, which is expensive.

And thirdly, any solution we have has to have sustainability. And it’s not very clear to me that that sort of insurance can be that sustainable if it's used with any frequency at all. But, maybe that's worth further study.

Clearly it's not a silver bullet. Any silver bullet there is I think has to be a protection that outstrips the amount of expected liability. And I think that is unrealistic.

So in summary, I think there's not enough insurance in the world to fix the problem.

I think the Big 4 have serious inherent problems in accessing market capacity.

And I think at the end of the day perhaps the real issue is one of capital.

Insurance can be an efficient source of operational risk capital. But if an industry can't sustain capital to meet its obligations that are created by being in that industry, I suggest industry cannot solve what is a basic business model problem.

Thank you.

CO-CHAIRMAN LEVITT: David A. Costello, President and Chief Executive Officer at the National Association of State Boards of Accountancy.

Sir.

MR. COSTELLO: Thank you, Co-Chairs Levitt and Nicolaisen and distinguished Committee Members.

The National Association of State Boards of Accountancy, NASBA, is the membership organization for 55 Boards of Accountancy, that includes the 50 states plus the jurisdictions of Washington, D.C., Puerto Rico, Virgin Islands, Guam and the Northern Mariana Islands.

NASBA serves as a forum for state boards and seeks to enhance the effectiveness of state boards by providing high quality programs and services, issuing research, and communication opportunities and developing collaborative relationships with organizations that impact the regulation and practice of accounting.

State boards have been established and maintained to protect the citizens of the individual states and jurisdictions as evidenced by the 10th Amendment to the Constitution, the U.S. Constitution. Individuals should be protected from those who have superior privilege through the licensing process. One hundred plus years of history is a testament to state-based accounting regulation as an effective and trusted methodology to accomplish the public protection mandate.

This mandate has been carried out in a relatively efficient manner in regulating 658,000 individual licensees and 48,000 CPA firms through the use of 55 field offices, over 400 volunteer Board members, almost 400 full time staff and expenditures of about $53 million all derived from fees, not taxes.

Licensing, practice privileges and enforcement of regulations and rules are the principal roles of state boards.

The AICPA NASBA Uniform Accountancy Act, the UAA, is model legislation. I stress that word "model legislation" which guides state boards, professional societies and legislatures in supporting the adoption of regulations. While no one state has enacted the UAA verbatim, a vast majority of the states has substantively enacted the key provisions relating to: Education, the 150 semester hours; the examination, the uniform CPA examination, and; experience. Those areas are national and even international in scope.

NASBA has been and is currently working with its boards, the AICPA, professional CPA societies in each state and jurisdiction, and others to accomplish effective mobility of CPAs without administrative and cost encumbrances. We believe that about half of our states will have adopted mobility provisions in their laws by the end of 2008, and that this number will swell to 45 to 50 states and jurisdictions by the end of 2009.

We are unaware of any other approach that so effectively balances consumer choice and access, the accounting profession's access to markets and clients and the statutory mandate for public protection.

State boards actively investigate and discipline CPAs who have violated federal and state laws and rules and professional standards. State board enforcement differs from federal enforcement, not only in scope but also in direct and immediate results. State boards are the only bodies which can take away a CPA's license to practice and, of course, this discipline is the harshest of all short of criminal prosecution.

Although there is room for improvement in the complaint referral system, states cooperate with SEC and other federal agencies to enforce state law and rules against noncompliant CPAs. State-based accounting regulation is, in several respects, the largest accountancy regulatory system in the world. And I believe for the resources expended it is the most effective. State boards' history of success derives from evaluation of competence, education and experience of its licensees, continued monitoring of ongoing education requirements and assessment of the quality of firm practice and the enforcement of state rules and regulations.

Thank you.

CO-CHAIR LEVITT: Thank you very much.

I hope in the continuing dialogue with the Committee we can help address the issue of redundancy, if possible, and how we can eliminate that burden on the industry.

The next speaker will be Mr. Lawrence A. Cunningham, Professor of Law at George Washington University Law School.

MR. CUNNINGHAM: Thank you for inviting me to provide some views and for your important work on these important problems to highlight ideas from my written statements, which looks like liability system design and ways to address some of the problems that were identified.

The experience of the past 15 years suggests reasons to maintain or strengthen the existing liability system. Its deterrence level was reduced by a series of legal changes made during the 1990s. Following these, lawsuits against auditors dropped and remain at historically low levels. But these steps were also followed by some of the largest financial frauds and liability cases ever, like Enron and a dozen others, plus the destruction of Arthur Andersen. Other factors may have contributed to these costly events.

CO-CHAIR LEVITT: You know, I'm having difficulty hearing you. Is your microphone on?

MR. CUNNINGHAM: How's that? I'll move in a little closer.

CO-CHAIR LEVITT: Okay.

MR. CUNNINGHAM: Is that better?

CO-CHAIR LEVITT: Yes.

MR. CUNNINGHAM: I was just recounting the experience of the past 15 years, including the sizeable frauds at Enron and other places and the destruction of Arthur Andersen. I said that reduction in liability risk probably contributed to these, along with cross selling of non-audit services, industry concentration, limited liability forms of audit firm structures and limited industry oversight. Some of these problems have been altered to reduce the need for legal deterrents, but many of them endure.

The serious current liability concern, as Peter Christie just said, is the risk that a large case could destroy an auditing firm with calamitous systemic consequences. Claims as low as 500 million could bring that about, although as Peter also said, it might be up to two billion. And trying to avoid that by limiting liability, as by capping the damages, is a tempting solution but also perilous. Caps easily can backfire because they reduce legal deterrents. Setting damages levels or formulas ex ante is likely to appear arbitrary and unlikely to prove optimal.

Caps can also benefit larger firms while hurting smaller ones. Consider then a less risky approach: Auditor liability bonds. This approach adapts catastrophe bonds, nicknamed "cat bonds," used to handle insurance capacity problems covering natural disasters. Developed in response to insurance market contraction after Hurricane Andrew and the Northridge earthquake, cat bonds have relatively short maturities, high interest rates and are repaid if no triggering event occurs before maturity, but principal is released to cover losses if one does.

Since 1995 several hundred cat bond deals have closed, including a recent one covering liability losses in the oil industry. The bonds are sold in private placement, generally to qualified institutional investors, along with some mutual funds.

To illustrate how they would work for auditing, the firms use non-U.S. special purpose entities to issue the bonds. Bond maturities are one to three years, principal is a few hundred million dollars. Principal is repaid at maturity if no triggering event occurs, that is if no big claims arise, but is released to cover those otherwise.

Triggering events are negotiated. As one alternative, an event could be if the firm settles or is judged liable in securities litigation for an amount exceeding $500 million, or it could be 1 billion or 2 billion. This is referred to as an indemnity-based approach. Under it, self existing self-insurance and reinsurance covers the first 500 million or so of losses and the cat bonds provide an extra layer above that.

Using an indemnity-based approach can increase moral hazard, however, especially in the claims settlement process. Alternative approaches called non-indemnity-based are designed to address that. Instead of tying coverage to actual claims, it is tied to indexes outside the firm's direct control.

For example, an event could be if the largest firms as a group so settled or judged liable for some amount, say 2 billion or 4 billion.

However triggering events are defined, the interest rate is set accordingly. This is influenced by the comparative cost to firms of the bonds versus self-insurance or reinsurance and the ability of investors to price them at a fair risk adjusted rate of return.

Auditing firms and their insurance brokers have all necessary information to evaluate risk and price these bonds. Investment banks, risk modeling firms and rating agencies would participate to analyze the information for investors.

All parties should find this approach appealing. Share owners are protected against massive audit failure. Firms get additional coverage.

Insurers keep their existing business rating policies as bonds to only cover losses that current coverage does not, and no government intervention is needed.

Numerous systemic benefits appear. First, it expands resources to address the catastrophic cases, it enables managing moral hazard, existing self-insurance and reinsurance are functional retentions and the extra layer can be designed as indemnity-based or nonidemnity-based or a combination. The bonds do not attract lawsuits against investors because they fund only catastrophic layers of loss, upwards of 500 million.

Second, the new resources tap capital markets. This should increase capital market monitoring of auditors and even lead investors to see auditors less as guarantors of financial statements and more as partners in promoting financial statement reliability.

Third, at present, proponents of reducing auditor liability risks have incentives when in doubt to interpret information in ways that overstate risk. In contrast, selling cat bonds would create opposite incentives to understate risks. Together, a more accurate picture would emerge.

Finally, it is much easier and less risky to structure and sell a cat bond deal to address risk affirmed destruction than attempt to the notoriously difficult task of tinkering with the liability system.

Again, I thank you for your work and for the opportunity to be here. I look forward to questions.

CO-CHAIR LEVITT: Jim Doty, who wrestled with these issues under Richard Breeden as general counsel for the SEC, we're honored to have your testimony this morning.

MR. DOTY: Thank you, Chairman Levitt, Mr. Nicolaisen, distinguished panel.

We have in our testimony gone to what we think are the jurisprudential issues. I have never managed an accounting firm, I am not an accountant. I have some familiarity with how hard it is to deal at an executive level with lawyers, but not accountants. And I think the substance of the testimony that I have submitted to you has suggested that any assessment of the current civil liability, civil litigation regime for the audit profession and for public confidence has to take account of substantial changes wrought by Sarbanes-Oxley, and these are specifically the statutory codification of the SEC's disciplinary power under 102(3) and the creation of the Public Company Accounting Oversight Board.

And I suggested in approaching the legal reforms in my testimony, in which are a number of interesting ideas that the profession has, and others have at time suggested, that to the extent that any of these limit mega-litigation the significant regulatory developments of the powers, the expanded powers of the SEC and the Oversight Board may properly limit compensatory policies.

I think that one of the issues that Professor Cunningham and I may have is I question whether under the current regulatory regime and with the merit regulation system we have put in place with the Oversight Board, whether there is any meaningful expansion role at all for private civil litigation. I am arguing to you that we do not need the plaintiff's bar to assist us to assure professionalism, confidence and oversight of accountants.

Now, I have talked about a number of responses that I think are useful. Permitting interlocutory appeal by the defendant of a denial of a motion to dismiss effectively limits discovery that is just intended to harass the firm or to establish the basis of a settled claim.

We could revise the appeal bond process so that unreasonable appeals or appeals could be taken from bonds which if they are not adjusted by a court or by an administrative agency, could constitute an unreasonable bond that would effectively deny due process. This came up in the Pennzoil case.

We could create exclusive jurisdiction in federal courts so that the standards that are being adjudicated, which is the departure from federally mandated standards of practice, would be part of a federal litigation system and you would not have opt-out plaintiffs going to state courts with a view to fragmenting litigation in class action contests.

Finally, the agency and the Congress, I think, could control the admissability of consensual administrative orders which haven't been tested by litigation into private securities litigation.

And I point out that none of these really change the applicable conduct standards. They do recognize the significance of the federal regulation of a profession in terms of adjusting the rules of the litigation game. In fact, they're intended to reduce the gaming of the regulation of the accounting profession.

An important notion that deserves in my view more explanation is bankruptcy reform. We need to start thinking about extending protection of the Bankruptcy Act to firm partners by statute so that that cannot be a wager in litigation as to whether a court will allow it. You could authorize greater SEC and PCAOB activism to intervene in the interests of stabilizing a distressed firm. These are suggestions that are discussed more in the testimony, but both of these involved more intrusion of the bankruptcy regime and the regulatory regime into the litigation phase of a case in which there is a firm that is actually threatened with extinction or destruction by litigation.

Contact limitations are being considered broad. I personally think that rather than limiting reliance totally, that instead more attention should be given to authorizing limitation or authorization of arbitration provisions, mandatory arbitration provisions which have worked in the brokerage industry. The analogy is not perfect, but you can imagine a regime in which more attention is given to arbitrating meritorious claims, scaling those claims so that they become compensable over a time in a ratio of the capital that doesn't destroy the firm.

Arbitration has generally not appealed to the firms, but I think it is an idea whose time has come, especially in the international regime that we're looking at.

Finally, I do think it's time for reconsideration of the structure of firms. I am aware of the cultural difference that a change would make in moving from a partnership in an international network of linked partnerships to a more corporate type of structure. And it holds real issues of adapting for the firm, but it does provide I think a way out of some of the litigation problems under Tellabs.

I look forward to discussing any of these with this panel.

CO-CHAIR LEVITT: Thank you, Jim. I think as you work with us again we'll have to consider how these recommendations would impact investors, what would the effect be.

MR. DOTY: Yes.

CO-CHAIR LEVITT: Our next panelist will be Dennis M. Nally, who is the Chairman and Senior Partner at PriceWaterhouseCopppers, LLP.

Dennis.

MR. NALLY: Thank you.

Chairman Levitt, Nicolaisen, Members of the Committee, Treasury staff, good afternoon.

Thank you for the opportunity to present

PriceWaterhouseCoopers' perspective on the important topics before this Committee.

Over the next several years, I believe we will see a further and a dramatic acceleration in the pace of change impacting our profession, as well as the capital markets. The growth rates of emerging economies, the use of technology to instantaneously draw populations and information closer together, and an increasingly mobile international workforce will combine with profound consequences for our auditing profession.

One can imagine a scenario where continued innovation when combined with geopolitical trends will challenge what we think of as auditing. Technology-driven enhancements in data quality as well as accessibility, coupled with the imposition of global standards will most likely require a broad focus beyond audits of financial statements to include a much more comprehensive review of the underlying data, controls, processes as well as non-financial data.

I believe that we'll have a dramatic impact on how we audit, such as requiring audit procedures be performed where the most appropriately skilled workforce resides, rather than where the client is today.

Globalization, as well as the move towards one set of global accounting standards provides an important platform for reducing complexity and increasing global consistency. To be truly effective, however, a number of considerations must be addressed to ensure that the goals of these changes are as positive for the future of the capital markets as they could be.

First, the current legal and regulatory framework must be aligned with the markets of the future. Increased recognition and acceptance of well-reasoned, documented, professional judgment are critical to the successful implementation and long term viability of a single set of principle-based global accounting standards. Whether it's the current disciplinary model of negligence-based professional standards or the protocol for inspection teams, both should be reviewed with an eye toward the need for greater collaboration and the respect for professional judgment.

Another part of the solution requires a good hard look at the standard applied to determine materiality in financial reporting, which not only must move towards increased recognition of the use of professional judgment, but also towards a better definition of what is relevant and is necessary for capital market stakeholders.

Taking the challenges of the legal and regulatory framework one step further, I believe that the U.S. litigation system continues to be a root problem here. And it is correctly at the center of the debate around our capital markets competitiveness.

We urge the Committee to consider opportunities for broad-based litigation reform which can further support the use of much more principle-based professional judgment and will benefit both the broad capital markets and the profession as we embrace an increasingly competitive global economy.

Another fundamental concern, which is critical to the firm's ability to serve the capital markets more effectively given the future challenges in these new environments, centers around our ability to attract and retain talented professionals from diverse backgrounds who can be deployed efficiently to meet the increasingly complex and globalized needs that I just referred to.

Firms like PWC serving large multinational companies must be able to recruit and retain individuals with specialized knowledge and expertise who can compliment and enhance our audit work. This is especially important as audits become more complex.

A significant component of the human talent challenge involves the need to modernize university accounting curriculums to ensure knowledge of increased specialized topics like IFRS, finance, economics as well as process controls. It will also require that we work even more closely with academia to address faculty retention and enhance faculty education programs.

In closing, it's time to focus on the future. And we applaud the Committee for its thoughtful consideration of these issue.

Again, thank you for the opportunity to appear here this afternoon. And I'd be happy to address any of your questions.

CO-CHAIR LEVITT: Tim, would you open up with any questions you may have.

MEMBER FLYNN: Maybe we can just step back for a second and have a discussion around the reasoned judgment issues talked about and the requirement or the need as we move toward a fair value accounting model, as we move toward IFRS which is principle-based in terms of discussion, as the profession looks at that and looks at the overall business structure of the firms themselves today and the environment, where do you see some of the changes that we should consider as part of this Committee?

MR. NALLY: Yes. I think, Tim, the issue around the use of professional judgment I think is one of the core issues that we need to address as a profession. And what I mean by that is I think over the years our profession has become so focused on dealing with the complexity of the rules that are out there, getting the technical answers right at the expense of exercising good professional judgment and coming with a balanced reasoned approach to deal with the challenges that are facing the companies that we audit.

I think as you move towards one set of global accounting standards, which would be a much more principle-based approach to deal with standard setting and away from a rules-based approach, it's going to require the use of much more judgment to be successful there. And I think in that regard one of the challenges that we have is to ensure that the regulatory environment supports a balanced approach to deal with the exercise of that professional judgment. And I think that's one of the real challenges this profession has today, and will only increasingly be an issue as changes take place in the future.

MEMBER FLYNN: Mr. Doty, when you look at the discussion Dennis has had around professional judgment and you look at the legal framework we have today and the process in which claims are reviewed in the current environment, do you have some observations about that?

MR. DOTY: Well, I think first it's clear that claims in the court don't fair as well, I think, as they should if protection of investors in the goal. To go back to Chairman Levitt's remarks, the SEC-administered funds have probably done a better job of getting money in the hands of investors than have some of the private judgments that are recorded against firms.

Also, I think the gaming of the system of litigation involves threatening the existence of the firm or creating demands in negotiating which are now not really subject to anything more than the clash of parties in litigation. I think one of the things that these types of more regulatory interventionist approaches in audit failures offer is the chance to subject the whole process to some kind of review in terms of both the scale of the harm, the proper result in accessing the harm.

Audit failures are very public. They are very public matters, generally. And we now have an agency in the PCAOB, with a shotgun behind the door at the SEC, who really have the expertise and the capability over time to go in and assess whether or not an audit failure was the result of concealment by management or whether it was the result of judgment which should be permitted but perhaps needs to be reviewed, or whether it was the result of out-and-out professional negligence.

That's what the SEC and the PCAOB are for now. And I want to see a more expanded role for them in addressing what happened in the audit failure, just as they do in what happened in other corporate crises of the kind we have reviewed. And I simply fail to see that the private litigation adds much to that.

MEMBER FLYNN: Mr. Costello, there's been some discussion about the licensing requirement at the state level and the PCAOB that is not here today that if you will, regulates firms on a federal level in looking at public company audits. How do you see those two things working together: The state level boards as well as the PCAOB? And to follow on to that, I think Mr. Levitt talked about it briefly in the beginning, kind of the redundancy possibility and the enforcement actions today at the state level and the federal level?

MR. COSTELLO: Thank you.

We've been working with the PCAOB very closely coordinating efforts, trying to diminish as much as possible the redundancy in enforcement. They have clear rules and guidelines as to what they can do on investigations and inspections and what they can do in the ensuing process.

State boards, of course, I would say they are guided by state law in all enforcement activities. They have a very clear set of rules and regulations to follow when one of their licensees, whether operating with a nonpublic organization or a publicly registered corporation, they have to address those with the state law.

All I can say about that is that states try to do whatever they can to make sure that state law and regulations and rules are being followed and then work with whether it's the PCAOB, the SEC or any other federal agency as well as we can.

Now there are limitations. We all have to follow due process; we want to do that. And due process at the federal level, at times, creates the issue and the challenge that state boards often do not get referrals back from federal agencies on a very timely basis. But that's part of the due process challenge we have. But when state boards do get those complaints, get those referrals, not in a redundant fashion do they investigate, but they pick up on whatever investigation has been done, whatever enforcement results have been achieved, and then go from there.

As in the Andersen case in Texas, criminal conviction is tantamount to a state board's revoking the license. It's prima facie evidence for that.

So we do strive, all state boards strive to work very closely with the federal agencies and to minimize any redundancy.

CO-CHAIR LEVITT: Thank you.

Gaylen?

MEMBER HANSEN: I do have a question or two that I'd like to pose a few of you.

Just a follow up, Mr. Costello. There was some discussion in an earlier panel, and I don't want to go back to the earlier panel's subject, but it touches on this specialty and whether or not state board and NASBA as opposed to sort of specializing auditors in terms of what they do, and why in some form of licensing or accrediting them so that they could take that on. So that's a question for you.

And I have a couple of other quick ones. For Mr. Cunningham, I read your written materials with great interest on the subject of IFRS, and also your comment letter to the SEC on that, for that matter. And I guess my question, and you had phrased it in your written materials, that there's a vagueness related to those. And I think you attributed that to -- and then you discussed that in light of liabilities and heightened liabilities. I think the same thing might be said about fair value. So I thought maybe you might comment on that?

And also the SEC's position and where they seem to be going on that?

And then, Mr. Nally, I wanted to ask you about use of experts. Because in your written materials, if I can find them real quick here, you talked about the need for engagement partners to be able to draw upon process improvement experts to design audits that are both effective and efficient. And as audits grow and we have these larger companies, the concern that I have is at what point, and we've had the same discussion over at the PCAOB SAG, at what point do audit partners become general contractors when they are drawing on valuation experts and all sorts of specialty types of people, does their responsibility get shifted elsewhere? So maybe if you'd just comment on that.

MR. COSTELLO: Start with me.

Okay. As relates to licensing, we believe with all our fervor that licensing is reserved to the states. So we would oppose and challenge any kind of national licensing scheme. However, I believe as there currently are many credentials and even some national credentials out there as certifications, we would not be opposed to that. We would like to look at those. I think there is an appropriate place for certifications and credentialing on a national basis. And if it would help to maintain the public trust and what the accounting profession does and what regulators do, we would certainly support that.

So we're certainly not against credentialing certifications of a sort. We're very much opposed to national licensing.

Does that address your question?

MR. CUNNINGHAM: The idea of a principle as it's always used on contract to a rule, and to try to give meaning to those phrases I've spent a lot of time unpacking them. And what it ultimately hinges on is the relative vagueness of the proposition, the relative specificity and directiveness.

So when people talk about principles-based systems, what they mean is that the apparatus contains vaguer propositions. And that certainly means that people are expected to exercise greater judgment when applying those propositions. And certainly fair value accounting will call for a level of judgment that differs from historical cost accounting and so on. And I think this could be a considerable shift when one moves from U.S. GAAP to IFRS.

I think one of the reasons the IASB has tended to use a more principles-oriented approach is precisely because these standards need to command the consensus among dozens or hundreds of countries in the world, and it's just not possible to articulate detailed specific rules when you're trying to get agreement among that large a group of people.

In addition, I think one reason they're emerging as vaguer and more principles-oriented is precisely because they're relatively new. I think as people work with them over time they will develop a more definite character and resemble more like rules. But in the beginning judgment will be broader. And I think that the Big 4 firms and a lot of other people appreciate that that means auditors will have to exercise judgment in a way that they haven't before.

And there is a serious risk of liability as a result of that from second guessing. And so many of the firms take the position that as we move into that world, we need to also look at our negligent standards or the performance standards.

I think that's reasonable. At the same time that sort of vagueness, that need for judgment will also create opportunities for aggressive accounting or worse, or irregular accounting. And so I think the movement to this world can cut both ways in terms of liability risk. That's what I was trying to get at.

And my own sense, I mean people in this room probably have a better sense than I do, but the SEC seems very strongly committed to moving in this direction. We'll have to see how the next few months in the public meetings that the Chairman has called in December work out. But I think there's strong momentum institutionally in favor of this.

MR. NALLY: Let me pick up the question around specialization. And I think it's here today, but more importantly as you do look forward, I think it's only going to be increasingly clear that the role of the lead engagement partner will be one who really has the ability to integrate a whole set of different types of skills and competencies that deal with the complexity of the engagement that he or she is leading.

You know, when you think about 10 or 15 years ago, one individual probably had the ability to comprehend the volume of whether its accounting, auditing, literature or even taxes, for that matter. But as times have become more challenging, more complex and that environment continues to change at a pretty accelerating pace, the ability of that one individual to have a command of all of that in a very technical sense I just don't think is realistic. I don't think it make sense.

So that lead partner, the model of the future I think, is going to be one of an integrator of different skills and competencies. It doesn't mean that he or she doesn't have responsibility for the judgments that are being rendered in connection with the audit effort. But that ability will have to bring teams of people together that have much different skill sets, different kinds of skill sets than what we have today.

IFRS, you know, fair value, process controls. When you think about all the offshoring of work that's being done, how that gets done together, how it will get done five to ten years from now. So I think the role is only going to become much more increasingly complex. And it will pay a huge premium for individuals that have the ability to bring those types of teams and skill sets together.

CO-CHAIR LEVITT: Thank you very much.

Rick Murray from Swiss Re.

MEMBER MURRAY: Thank you, Chairman Levitt.

The inquiry of this Committee is intended to be both broad and fundamental. I have a few questions I would offer to anyone on the panel who can help enlighten us on your perspectives on those fundamental issues.

Seventy-five years ago Congress and the SEC assigned the responsibility for auditing public companies to private sector audit firms. And I think our scope is as basic as recognizing that there may be jeopardy faced today in the further reliance on that form of validating capital market information. And the question we are looking at specifically is whether or not current liability conditions should be changed or modified in respect to that jeopardy.

I think it should be noted that when the assignment to the private sector auditing firms was made 75 years ago, the civil liabilities conditions we know today did not exist and were not contemplated by Congress or the SEC to evolve.

The issues that arise for today's discussion tend to fall into the categories of are we in the right position because of the deterrent value of liabilities or because of the compensatory value of liabilities as public policy issues. And the questions that I would pose for your reflection with respect to deterrence there is an assumption underlying much of today's debate that the problem is a problem that is largely self-induced by the audit profession. Yet that seems a bit curious given that it is not a problem that exists for those audit firms who do not specialize in auditing public companies. Is it in your view a problem that may have key elements to be addressed in the way in which public company characteristics of business and regulatory oversight effect this? Deterrence as a theory also assumes that auditors are the only component of financial system oversight processes that need liability motivators to behave well. And that seems curious considering that the other oversight facilities of the three branches of government, the directors of companies, attorneys as well as auditors among that community no other component of the oversight functions is either lacking immunity from liability or lacking the protection of a broad business judgment like entitlement to be honorably wrong without being liable. Is that a sound assumption?

And very briefly in the compensation aspect: Because our current liability system is the most uneconomic in the world consuming more than 50 percent of its intake rather than compensating victims contrasted with worker's compensation for example where the overhead is 3 percent, what proportion of the relevant losses to the capital markets are compensated by the auditing profession? And given that it's a very small proportion, is it in your view any influence on capital market decision making that they might be relying upon the audit profession as recourse for the risks they're taking?

CO-CHAIR LEVITT: Anybody. It was a long question and we have limited time for an answer. So short answers.

MR. DOTY: I note that there's a difference between the standards of conduct of directors, which you have just noted, a raincoat provision under state charters. That has helped to get us here. There is no doubt that auditors have a more hair trigger standard of liability.

It does seem to me, and without knowing statistics, there is a lot of anecdotal evidence here, but it does appear that the principle deterrent and the principle protection of investors that arises from deterrent is the fear of law enforcement by the SEC and the PCAOB. I think that that is a much stronger deterrent now than the risks of private civil litigation regarding the conduct of an auditor.

The compensatory system is now focused on whether or not a firm can afford to fight. And I am simply respectfully suggesting that's the wrong emphasis

CO-CHAIR LEVITT: Okay. Again, I would ask the panel to keep their questions short and the answers. And the panel to keep their answers also so we can all get a chance to participate.

Lynn Turner, former Chief Accountant of the SEC?

MEMBER TURNER: Mr. Christie, a year ago I met with three of the four largest insurers of professional services around. And those three all told me that the instances of claims against the profession and the magnitude of those instances have all dramatically fallen as we've gotten out of Enron, and they also cited the Dura Pharmaceuticals case as another reason why those instances, not only the number of instances but the magnitude of those have fallen dramatically. Some of that's also come out in the Cornerstone/Stanford Securities laws data. Is your understanding the same with respect to that data or did you have any other data in that regards?

MR. CHRISTIE: No. I have no other data. I mean clearly --

MEMBER TURNER: Okay. Mr. Costello -- I'm keeping these short.

Mr. Costello, Chairman Levitt noted I think appropriately so the efforts to reduce redundancies here. Anything in particular that the SEC or the PCAOB could undertake to do that would assist state boards and, therefore, perhaps reduce redundancies?

MR. COSTELLO: Yes. Thank you. Very shortly what they could do is to study their processes and try to shorten the time from the time they begin an investigation to the time they complete them and let state boards in on what's going on so that state boards either through a prosecution or litigation monitoring kind of process or some other way where state boards can get in on the process earlier so that the redundancy can be minimized.

MEMBER TURNER: Mr. Cunningham, I recall in reading your testimony you talked about civil cases. Do you think that the civil litigation cases do provide meaningful deterrence and what is your experience in terms of some of the large cases like the Enrons, WorldComs, Tycos, if you will. Was it the civil cases that resulted in the greatest return to shareholders or were the SEC settlements larger?

MR. CUNNINGHAM: I have to look into the exact data. I think that there were some compensatory contributions from both. But there can be no doubt that the SEC, the Department of Justice and any other public enforcement apparatus will face competing policy demands. They need to look out for a wide variety of activities, whether it's internet trading, mutual funds, globalization or something else. And the private securities bar does play an important role. It would be hard to get along without them.

MEMBER TURNER: Okay. Jim, I was surprised by your comment that having been a partner in one of these firms, certainly SEC litigation always caught my attention and certainly was something you never wanted to go through. But neither was it the plaintiff litigation. In fact, when you and I were both together at the SEC we prosecuted my firm on the MiniScribe case and, in fact the SEC ended up totally dropping the case and there was a multi-hundred million dollar judgment against the firm from the plaintiff's side in that particular case. So the SEC action seemed not to be the one that caught people's attention, but rather the plaintiffs'.

Do you think in some of these cases that civil litigation does provide a meaningful deterrent?

MR. DOTY: It was a long time go, much longer than you or I would like to admit that this happened. I think the world has changed utterly since Sarbanes-Oxley. Absolutely a transforming change in that we have an entire profession now that is regulated.

And bankruptcy courts and the SEC can actually probably do more to be sure that investors get some money back from a firm as opposed to having a firm fold its doors as Laventhol did, for example.

MEMBER TURNER: You mentioned, though, you bring up the bankruptcy case and you also mentioned earlier compensatory damages. The firms have been pushing in their engagement letters to get limits on compensatory damages. And I'm not a big fan of punitive damages and all that, but compensatory damages that would just put the company back in the position as if they'd been in as if the work had been done appropriately. And they also pushed to limit the ability of a bankruptcy trustee to take action against the firms as well. Are you in favor of limiting compensatory damages or the ability of the bankruptcy trustee to go against the firms?

MR. DOTY: I think that if you view this as a whole, what this Committee can do is start a holistic review of how the pieces of the puzzles can fit together. And it is exactly this kind of discussion as to whether or not you get A, B and C or whether you modify A if you do something in C; that's what led to the Litigation Reform Act, it led to the Remedies Act. It's the same kind of discussion.

So it may well be that the ability of the firm to limit by contract any compensatory damages to the registrant will be effected by how much it gives up in the area of bankruptcy trustees being able to say "Well, you have to pay back a stipulated amount over a certain number of years because you can afford that."

CO-CHAIR LEVITT: And --

MEMBER TURNER: One last question.

Dennis--

CO-CHAIR LEVITT: Lynn, your time's up.

Ann, Council of Institutional Investors.

MEMBER YERGER: This is actually a question for the legal eagles on the panel. And that is could you just give me a brief summary, pros and cons, of your recommendations from the investor's perspective? Because that's the angle that I'm coming from here on the panel.

MR. CUNNINGHAM: Well, I'll share that angle, although I'm not sure if I'm a legal eagle. Thanks for that.

As I explained in my written testimony and as Jim just suggested, there are many components to this apparatus in trying to design an optimal system, whether we focus on deterrence or compensation or the auditors as gatekeepers or some other group. And it's very hard to dial it up exactly right.

And in my view, and if I were wearing my investor hat, I recognize that we're going to probably err on one side or the other. And in my view I would prefer to err on the side of slightly tighter regulation and auditor activity and auditor pressure, frankly. I think that spending money in that context is going to be more cost effective than the costs of audit failure and the resulting misallocation of capital and noncompensatory payments and audit failures.

So that's a very broad framework, but I do think that error risk is real and we have to decide which is more tolerable over or under deterrence.

MR. DOTY: The best thing for investors is a good audit. The best thing for the public is to know that the audit firm has located a problem, if it has a problem, and has done something about it. And that means that I think that the regime of private civil litigation has less to contribute to that than the regulatory regime we now have.

CO-CHAIR LEVITT: Anything else, Ann?

All right. The next member of the Committee, former McGladrey & Pullen managing partner, Bill Travis.

MEMBER TRAVIS: As companies become increasingly global in scope and global in the markets that they serve, I'm interested in your perspectives on two areas. One is are there other alternative structures that can be put in place that would allow firms to more consistently be able to deliver audit quality across the globe? And when I talk in the context of "audit quality," it's not just the delivery on that engagement but it starts with recruiting and training the right people and all the systems and supporting IT systems that it takes for that process.

The second question I have has to do with not enforcement, but proactive collaboration of regulators. Is there something that can be done where regulators collaborate better across the globe to ensure that requirements, rules, enforcement are more consistent?

And specifically my third question for Mr. Costello is, given the complexity and global magnitude of U.S. companies, do state boards have the experience and expertise necessary to participate in this process? And if not, what are they doing to improve their capabilities?

MR. NALLY: Bill, let me start with the first one, which is structure. I guess the way I think about that is I'm not sure that there really is a structural solution here, given the nature of these practices and given the local laws that really govern, you know, how we would practice in over a 100 countries around the world. I think it really gets back to maybe a more fundamental point, which is how do these global networks really manage and control the quality of the work that's being done regardless of the location around the world. And I think the more each of the firms do to have clearly defined sets of minimum standards that are expected for each of the firms to utilize, and how those standards are actually monitored in a much more effective way, I think that can do a lot more towards driving and enhancing overall audit quality, notwithstanding the fact that the structural issues are something we all have to deal with.

MR. CUNNINGHAM: Can I just add to that? I think on the question of coordination of global enforcement authorities, I think as we move into the IFRS world that's going to be vital, that is to assure comparability in application of those standards throughout the world is going to require some enforcement coordination. I mean, the SEC is not going to be able to do it by itself. It might not even be able to do much at all. Proponents of IFRS are encouraging all of the national securities regulators to keep their hands off and let just the IASB or some other mechanism promote comparability. And the SEC is working closely with CESR to try to develop a system that will promote that. But I think at present that's something that's missing.

MR. COSTELLO: Yes. Earlier in my opening remarks I stated that there are about 400 volunteer board members on state boards in the 55 different boards. And that 400 is comprised of people such as yourself, people who are professionals, who are CPAs, highly regarded in their own field. They come from the Big 4, they come from smaller firms, some come from industry, there are other public members.

So do they have expertise? Yes, they bring that expertise with them. They have a different hat. They represent the public at that time with a different public perspective. But, yes, they have the expertise.

They also, through NASBA, we cooperate with national and international regulators. In fact, we're planning an international regulator conference within the next year to even learn more about what we should be doing together. We've been doing that for some time with the SEC, even the PCAOB and other federal agencies.

But I think through a process of cooperation, collaboration and also continuing to have appointments from governors of people coming out of the Big 4 firms and others, we will have the necessary expertise, as we have had in the past.

CO-CHAIR LEVITT: Thank you.

Lynn, you -- we're running ahead of schedule slightly. If you could briefly pose the question I terminated?

MEMBER TURNER: Thank you, Mr. Chairman.

Dennis, as you know, I'm a fan of trying to find some way to provide some litigation relief to the firms, especially when they've done a high quality job because of the point that Jim Doty made, which I think is absolutely the key point here. But I also have a belief that when you make that decision, you ought to make it based upon facts and good information. And one of the key components of that is being able to access and get the financial data of the firms which heretofore have been very oblique and private.

Is your firm willing to provide to this Committee a set of GAAP -- I understand they aren't audited, I fully understand, but a set of GAAP financials for the last three, four, five years, a full set of those financials to the Committee so it has the ability to take a look at that, make an informed decision?

MR. NALLY: Yes, I think it's a really good issue, Lynn. I guess the way I've thought about that is there probably are areas that we collectively as a profession can have much more transparency of information around to the investing public. I think it would be an interesting discussion around what that is. You know, is it financial information, is it more information around how we manage our risks, client selectivity, our quality, retention, how we train our people? I think there's a number of those types of areas that it makes a lot of sense to try to evaluate.

I think, you know, when you get to the specific question around financial information, I think the question is what are we trying to accomplish. You know, there's one important aspect of that that I think has changed post-Sarbanes-Oxley, and that is we have the PCAOB. The PCAOB does have complete access to the financial records of the firm. They are providing and looking at that type of information.

So I would like us to understand exactly what it is we're trying to get accomplished. And if it's in the interest of providing more transparent information for a purpose, I think that's certainly something that PriceWaterhouseCoopers would be willing to obtain.

CO-CHAIR LEVITT: I was going to tell him no you wouldn't do it.

I think that's a reasonable response. I think this is an issue whenever requests of this nature are made, it involves issues of competitiveness. And I think we've got to work together to try to be focused in terms of what we're trying to accomplish. It's a tough issue.

The floor is now open. Mr. Cohen?

MEMBER COHEN: During the presentations and questions to this point there's been an understandable focus on civil liability. But, of course, it was criminal charges that brought Arthur Andersen down. And my question is whether there is a need for reform in this area, specifically a requirement that the Department of Justice consult with the PCAOB and the Commission before threatening criminal action and/or there be a standard such as pervasive conduct, senior management direct involvement or failure of prior lesser regulatory or other sanctions to succeed?

MR. DOTY: It's very important that the Justice Department not continue to marginalize the SEC by seeking to jump into areas where the Commission has not only expertise, but jurisdiction. It's very important that some accord be worked out of the kind you're talking about, Rodge. And I think at some point the firms would have to face the difficult aspects of entering into a deferred prosecution agreement.

I don't believe any of the firms are prepared for the allocution of a deferred prosecution agreement which has become a kind of standard operating procedure at the Department. I do not believe it has had serious thought given to it. And there needs to be a stepping back of the rule of the criminal process in all of this and some rigor imposed on the way in which the decision to investigate criminally, intent, and what the SEC proceeds.

MR. CUNNINGHAM: I support that as well. And just observe, too -- I mean I support in particular that coordination requirement. I think it's very important and that there has to be some judgment made at the Department or in the consultation about whether it's a firm or person that is culpable. And I think we learned a lesson from that in the KPMG tax cases, which in the end I guess were handled prudently.

CO-CHAIR LEVITT: Mary, you had a question?

MEMBER BUSH: Yes. Thank you.

One of the panelists, I believe it was

you, Dennis, but I'm not absolutely certain. But one of you made reference to a potential model for the future where an engagement partner or senior partner would, for instance, be more of an integrator of different skills and competencies. And that struck me as something that should be looked at further because of the complexity of auditing nowadays, the complexity of companies, types of companies, the things that we were hearing about earlier on our earlier panel about the kinds of things that we see commonly, but that are not covered in the accounting school.

So I'm wondering if you could elaborate on that.

And the second part of the question is we also talked in the earlier panel about the attractiveness, if you will, if apprenticeships and real world experience for people who are planning to become accountants, auditors. That, I think, is also a very interesting model for exposing people to what they will be exposed to if they do indeed become auditors. And all of this to me also ties into the increased need for the use of judgment, particularly as we move to a principles-based system.

So I wonder if you could comment on those things?

MR. NALLY: Sure. Be glad to.

Maybe I could pick up on the *BusinessWeek* comment as well, because I don't think that was an accident that the major firms were all cited by *BusinessWeek*. I continue to believe that this profession is just a tremendous place for individuals to start their career. And I think that's one of the reasons why the firms did so well. And I think the experience you get early on in your career allows individuals to figure out from a longer term standpoint what they want to do. And I think it's a great training ground. So the more we can do to support that I think makes a lot of sense.

The notion of internships or the ability for individuals to get some firsthand experience in these firms is a great way to expose individuals to what these firms can really offer, what this profession can really offer. And I know I speak on behalf of all the firms. Internships are the way that we attract talent into our profession today. Hires in anywhere 2,000 to 4,000 individuals a year at some of the largest firm. So it's a great way to expose them to the profession.

The final comment I would make is really just the beginning of a shift of what I think the role of the engagement partner will be over the next five to 10 years. It's happening today, but I think as we start to deal with increasing complexity with all the issues that we've talked about, it's going to place a real premium for that lead partner to be able to navigate through a lot of complex areas, many of which he or she won't have the technical skill sets to be able to deal with. And so being able to manage large teams of people, lead large teams of people that have very different and diverse skills sets I think is going to be a critical component for the successful lead engagement partner in the future.

CO-CHAIR LEVITT: Mark?

OBSERVER OLSON: This is a variation of the question that Mary asked and I think, Dennis, probably primarily to you although others may have opinions.

The accounting profession is still a private sector business and it's still a business. And even with the new rules, the appropriate rules regarding conflict of interest and independence in a dynamic economy as the world changes private sector businesses find that they have certain core competencies that develop into skills that develop into revenue streams. And consistent with the new regime that we have now, does the business model today still allow for you to build on those core competencies and to go into directions, perhaps independent from the other of the Big 4, the other of the accounting profession, that allows for you to continue to have a viable business prospectively?

MR. NALLY: Yes. I think it's a good question, Mark. I think it does. I think the business model does work. You know, I know there's a lot of discussion around, for example, should these firms which are private partnerships, as we all know, should we be thinking about different types of structures, outside capital, for example, outside investors? I think that's certainly an area that we ought to look at.

I think as I begin to sort of get my mind around that, I think it raises a lot of interesting questions. For example, you know in today's environment where these firms are there to serve the public, once you introduce organizations with outside capital, they may have different objectives that may not necessarily be totally aligned with the investing public. The private partnership has the ability to stay with that focus, that core mission.

So I think there's some really interesting issues that we ought to make sure works as we go down that thought process.

CO-CHAIR LEVITT: Zoe-Vonna?

OBSERVER PALMROSE: Thank you, Arthur.

It seems like when we talk about litigation and legal liability, one of the real challenges for the firms is managing catastrophic risk. And so Professor Cunningham, I was intrigued by your discussion of cat bonds as a potential solution. And, in fact, it almost made it sound like it's a silver bullet in an area where I didn't think there were silver bullets to be found. So I'd like to have a little bit more understanding of what are the impediments. Why don't we see cat bonds being used in this market? And also perhaps Peter and Jim and Dennis could weigh in here on sort of your thoughts on whether cat bonds are a viable solution to managing catastrophic risk.

Thanks.

MR. CUNNINGHAM: Well, thank you very much.

My own diagnoses for the absence of this device is probably that the firms would need in negotiating with investors to disclose potentially sensitive priority information about loss histories.

And at least in the conversations I've had with people on the ground, if you like, that is a serious concern or legitimate concern, however you want to classify it. But they would have to do that. That is, Ernst & Young or whomever sitting down with Goldman Sachs, would have to provide some information that they might rather not provide.

I think there are ways around that. The firms now share that kind of information with their insurance brokers and it's protected by confidentiality and so on. I think it should be possible to do that.

The next step, and this is a little bit beyond my core competency, but is to precisely calibrate the risk and then price it in a capital market environment. And my understanding from talking to people who know more about that dimension of it than I do, is that it should be possible to price these bonds and to sell them. But that's a laboratory experiment that hasn't occurred yet.

MR. DOTY: It seems to me they could be issued without registration under the supervision of the court of an administrative agency, and that would reduce friction and cost and enable more to go straight to investors and a smaller percentage into the pockets of plaintiff's lawyers.

CO-CHAIR LEVITT: Barry?

MR. CHRISTIE: The catastrophe bond market is pretty small, still in its infancy. And the number of catastrophe bonds that have been done to cover liability risk is very small indeed. Those that have been done have been where the liability risk arises out of a random physical act, such as an oil rig falling over.

I believe there would be very little capital market appetite for catastrophe bonds at this point in time for this type of liability insurance. And, indeed, a lot of people are trying to place that for other classes, other industries and have had no success.

CO-CHAIR LEVITT: Barry.

MEMBER MELANCON: Thank you, Chairman Levitt.

Two quick questions. First, Peter, there was an exchange that implied maybe some reduction in claims that are existing in today's environment. I would just wonder if you could pull on your experience and do you think that is something that would be an indicator of the future or do you think that there are other elements such as the economy, et cetera, that might revert that to a different area?

And, David, to you. You talked about the mobility provisions. I thought maybe you could just comment on maybe some other things that were considered and why you believe that that's the best answer: Things such as compacts and all of those.

And to the question that was made earlier on the double jeopardy. Both Lawrence and Jim talked about the dialing of the civil litigation and the Department of Justice on the criminal side. Is there not a way that state boards still in protecting their mission from a state constitutional perspective could defer when it is a matter related to a public company audit to an outcome of an investigation that the SEC or the PCAOB has conducted so as to not create this double jeopardy environment that people are concerned about.

MR. CHRISTIE: The first question, I was going to say to Mr. Turner that when he had three insurers in his room who thought that the experience was improving, he probably had a 150 percent of the market that is available to ensure large accounting firms at this point in time. And I think the reason for that is that that focus is going to be, the market's focus is going to be on future potential liabilities. Has the possibility of this happening to me dramatically changed? It's comforting that you have a short period, maybe a long period, but a period of time where the losses have apparently alleviated. But they're going to want to see real permanent change in the environment that makes it unlikely. And unlikely is quite a high test as well. It's like saying you know, I've now got one bullet in my resolver with my Russian roulette than two. It's half the amount, but it's still very worrying indeed. And that's their concern, it can happen.

MR. COSTELLO: Barry, we've made a number of efforts to come up with a way that we can effectively have national permission and international permissions and at the same time not diminish the state board sovereign rights to protect its citizens.

One idea was the compact. We've looked at it over several years.

Interestingly enough, about ten years ago we became involved in the Uniform Accountancy Act process, the revising of that to come up with a concept called substantial equivalency. And here ten years later we have 48 states that are substantially equivalent to the Uniform Accountancy Act under those grand themes of education, examination and experience.

And we have now initiated the mobility efforts based on that. And as I've told you earlier, we expect by the year 2009 to have 45/50 states where CPAs can truly be mobile, much like our driver's license approach.

Contrast that with the compact where the best example probably is the nurses and here ten years later they have less -- well, they have 21 states effectively under that compact. It does not have the strength that we have through mobility. For instance, the compact only covers individual nurses, it does not cover their employer. That would be a significant weakness under our mobility provisions. So we have firms and individual licensees covered by that.

So it's almost like -- and we've had states that actually have compacted together in the past ten or 12 years. And we had North Carolina/South Carolina, perhaps Georgia. We had some in the midwest, we had some in the northeast. And quite frankly, they broke down. They didn't work very well.

So we believe that mobility is the best way to do that.

Deferring prosecution: States do that, have done that, I think they should continue to do it. And not be redundant in the prosecution efforts. We believe that.

CO-CHAIR LEVITT: Damon?

MEMBER SILVERS: Thank you, Arthur.

Dennis asked a few minutes ago what purpose is served by financial information in relation to this Committee's efforts. And you know, outside this room all kinds of people would love not to be subject to civil liability for the risks of what they do, including me when I drive my car.

There are also, I think, anyone who has ever had any dealings with the criminal justice system on the receiving end is aware of how unpleasant an experience that is. And we'd all love to be free from that; not have to worry about it in any respect.

The auditing industry and its friends and advisors are seeking really extraordinary exemptions from the standards of responsibility that both businesses and individuals live in in our society. The conversation, in my opinion, simply cannot begin without a detailed factual justification for why that question should even be taken up. And, frankly, if you compare the testimony of this panel with the last one, it's obvious that it has a sort of oracular quality in comparison with the previous panel, which is full of very pertinent data. Without the data, I just don't see the point in the conversation.

Now I have two questions. One is, Jim, you talked about the public utility model. And you know, that has a great deal of appeal here. Because clearly we're dealing with a kind of public good problem with sort of structurally limited competition, not unlike what a public utility is.

I am curious as to whether you and Dennis might be able to respond to your view about really a full public utility model which would include: Full disclosure of all firm financials on an ongoing basis; substantive fee regulation by the regulator; substantive regulation by the regulator of capital requirements for the firms; substantive oversight of capital spending by the firms by the regulator; a role on the part of consumers, the investor constituency, in the governance of the firms not unlike like that in many public utilities.

And finally in light of your point about the relative effectiveness of public and private enforcement agents, your attitude toward providing the PCAOB or the SEC, whichever you think best, with both the added resources and the authority and mission of obtaining compensatory damages for investors from audit firms where that's necessary and warranted.

Now for Larry and for Mr. Christie.

CO-CHAIR LEVITT: Damon, try to phrase this in terms of a question.

MEMBER SILVERS: Not easy. What I just asked was for those folks to respond to that list. I would like to know what your view is of a full public utility model?

For Larry and for Mr. Christie I'm curious. It seems to me as though the legal framework for auditor liability, unlike other forms of liability in the securities regulation area, in the post-Central Bank of Denver context, is actually sort of extraordinarily unclear what the liability standards really are. And I wondered if you might comment on that lack of clarity as an issue in terms of the ability of both insurance and capital markets to assess it.

MR. DOTY: The audit firms are a national asset. They're not a public utility, but they are totally regulated as public utilities have in the past been. So the argument, Damon, is to suggest that they simply are different from an oil and gas company, an exploration company; they are different. There are very few of them. The monopoly has evolved historically. It has not been achieved by predatory practices. We have a national responsibility to try to sort out how far we go with regulation, but we have sipped out of the cup of regulation. And therefore, we should not simply roll along with a system of civil litigation that is not subjected to the same kind of analysis of whether it fits with the regulatory model that we now have.

You've heard things today that sound a little bit like Federal Deposit Insurance, but they're not really Federal Deposit Insurance.

You've heard suggestions that resemble insurance models, regulations, state and federal being combined but they're not really the same.

So we're not talking about an industry which fits neatly within any known model, and there's a reason for that, but it does have a very important responsibility.

I don't want it to be, to fit the old story of the Department of Agriculture when the new Secretary comes in he finds a man, a veteran at his desk, crying. And he says "Why are you crying?" And the man says "My farmer just died."

The risk is that one day we'll have a public accounting board and no accounting firm.

MR. NALLY: Yes, Damon. I think you

raised some really good issues, and I guess the way I look at this is what we're trying to address here, what you're trying to look at is what's really necessary to ensure the long term viability, sustainability of this profession. And is this whole question of catastrophic loss, which I think is the issue that we're trying to wrestle with, are there things that we can do, should do in order to preserve the long term viability of this profession? And I think it goes without saying that to the extent that there is a solution that is put on the table that really deals with that issue, if it requires more transparency from these firms, I for one from a PWC standpoint, I think my peers would say as well, we would support that. There is a quid pro quo for that benefit.

CO-CHAIR LEVITT: Last question.

OBSERVER HERZ: In terms of promoting very sound and strong professional judgment that would be aligned with investor interests and a general public interest, what would be needed? How would we bound it? How would -- to get to Professor Cunningham's point of view, how would we integrate it into the rest of the system? Can it be done through just regulation? Does it require more than that? You know, who would have to be involved in defining some kind of framework in order to do that, but do that in a way that actually promoted investor confidence?

MR. NALLY: From my perspective, Bob, I think coming up with that type of framework that has the input, insights from all of the various constituent groups I think is absolutely critical. And I think you need that kind of framework if, in fact, that's going to move forward.

I think we need many ways for where we're trying to move reporting and standard setting et cetera. And I think it does require a fair amount of work to get the various groups aligned on what we're trying to get accomplished here.

MR. CUNNINGHAM: If I could take a quick stab, too. I mean as far as the framework is concerned, we have a fairly elaborate framework. And the question is how much tinkering you want to do with it by regulatory devices, governmental intervention and how much do you want to try to rely on markets where judgments are likely to be more robust and reliable over time. And that's the motivation for my proposal and contribution on catastrophe bonds.

And Peter's right that they haven't been done for professional services firms, but we haven't designed a package or gone out to the market to see if they're saleable. And this really comes under Damon's point, too. That, sure, it may be changing legal environments like the Central Bank of Denver case and other things that happen over time will influence the probability of these things and their magnitude, and that would influence the insurance capacity and the pricing of these things in public markets, but that's the kind of thing public markets do all the time -- private markets do all the time.

So my basic pitch is that this device ought to at least be pursued to some extent before the governmental and regulatory apparatus swings in.

CO-CHAIR LEVITT: Thank you very much. And I know there were other questions. I'm sorry we haven't been able to get to them in the interest of staying absolutely on target time wise.

The panel gave very good, concise answers on issues that certainly bear a lot of dialogue.

Thank you very much.

We will reconvene promptly at 2:30 in this room.

Thank you.

(Whereupon, at 1:11 p.m. the meeting was adjourned, to reconvene this same day at 2:34 p.m.)

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

2:34 p.m.

CO-CHAIR NICOLAISEN: It is the appointed hour. We're going to commence with panel III. We have two panels this afternoon, the first of which will deal with concentration and competition and the second will deal with general sustainability of the audit profession.

I think we're falling into a pattern that seems to be working out very nicely where our panelists understand we're looking for an introductory comment of roughly five minutes. And we will then shift over, after we've gone through all five panelists, and begin our questioning of the panelists.

Probably awarded for traveling the furthest is Paul Boyle. And thank you very much, Paul, for coming here. He's the Chief Executive at the Financial Reporting Council. And he came in from London.

So, Paul, if you'd like to start, I'd appreciate it.

MR. BOYLE: Thank you very much, Don. And good afternoon, ladies and gentlemen of the Committee.

Thank you for the opportunity to participate in your deliberations today.

As Don mentioned, I am Chief Executive of the FRC. The FRC is the independent regulator in the U.K. responsible for promoting confidence in corporate reporting and governance. We have a wide range of responsibilities, including responsibility for regulation of the audit profession. And so if you like, we are the PCAOB equivalent in the United Kingdom.

I also have the privilege for this year to be the Chairman of the International Forum of Independent Audit Regulators, which brings together 22 audit regulator authorities from across the world and is promoting cooperation amongst the authorities. However, I have to give the usual regulatory disclaimer that my remarks today are personal and do not represent necessarily the views of the FRC or any of its members.

And I'd like to supplement the written testimony which I submitted to the Committee in order to persuade you on two points. Firstly, that the seriousness of the risks to economic prosperity posed by the current level of concentration in the audit market is a serious problem. And secondly, that whilst there is no silver bullet to solve the problem, there are a number of things which could be done to reduce the risks.

Now firstly, it is really no exaggeration to say that the current state of the audit market poses significant risks to economic prosperity. In fact, it's almost unnecessary for me to make this point to you because of the very existence of the Committee suggests that the point is already well recognized. However, it is worthwhile making the analysis explicit and I'd like to talk briefly about the three dimensions of the risk: Namely the impact, the probability and the duration of the risk.

And relative to the U.S. economy, and indeed all major developed economies, is that they have evolved to operate on the assumption that high quality independent auditing would be available wherever and whenever it is required and, therefore, the availability of high quality independent audit is taken for granted in the economy just as much as the availability of electricity or clean water. And this is important not just for the securities markets, but for other sectors of the economy, too.

Now it would be possible to contemplate an economic model in which high quality independent auditing was not available. But it would be significantly less efficient than the current model.

And an interruption to supply of audit would be as damaging as the interruption to the supply of electricity or clean water.

Now there are a large number of events which could trigger a disruption in the supply, however in my judgment the most serious risk is the possible withdrawal, either voluntarily or involuntarily of one of the major firms from the market. And my assessment of the severity of the risk is in fact supported by those people who are presently in the best position, arguably the only position to assess the level of risk, namely the senior management of the audit firms. And you only have to listen to the passion with which they argue for liability reform to understand that they believe the risks are harmful.

Now, as regards to the probability of this reocurring, I think it would be pretty close to negligent for public policymakers to dismiss the probability as low. There have been a number of well documented actual withdrawals from the market in recent years both in this country, in other countries, and a number of other near misses. And no doubt, behind the scenes, there are a number of other potential risks which are not yet in the public domain.

And the demise of Andersen illustrates the fact that audit firms have some similar characteristics to banks. A loss of confidence can trigger a run, not a run of deposits but a run of clients which may be impossible to stop or could only be stopped at extraordinary cost. And, again, the arguments here are reinforced by the firms.

And remember for policymakers the key risk is not whether a particular firm might withdraw from the market, it's whether any one of the firms might withdraw. So the cumulative risk is much greater than the risk that applies to anyone individual firm.

Then there is the question of the capacity of the market to absorb without disruption the loss of a firm. Some people might say, well the market coped with the loss of Andersen. However, the issues that we will face in absorbing one into three, or one might argue one into five, are wholly different than the situation that was faced when Andersen fell over.

And in the absence of significant changes in policy, the mostly likely scenario is that the current level of concentration of the major firms will persist for many years. In other words, on current policies the duration of the risk is very long.

So in summary, we have a serious risk to deal with. And at the risk of upsetting what I know is intended to be bipartisan or possibly even a nonpartisan Committee, we are faced with what might be called an inconvenient truth.

Now I suspect that a number of policymakers have been aware of this inconvenient truth for a number of years, but have not acted because they have been unable to identify acceptable solutions. Well, this no longer need be the case.

And speaking for the FRC here, we have not sought to reduce the risks to zero, but rather to move from a high risk position to a lower risk position, not even necessarily a low risk position but a lower risk position. And in this context, I would commend to you the work of the FRC's Market Participants Group. The MPG consists of equal numbers of corporate representatives, auditors and users of financial statements and its report was unanimous.

Now when you come to consider the FRC's recommendation -- the MPG's recommendations, it may be worth bearing in mind three points.

Firstly, throughout the two year debate that has taken place in the United Kingdom on this issue, no one has identified a silver bullet, i.e., a single policy proposal which will on its own solve the problem. And for that reason, the MPG recommended a package of proposals, some of them modest, but which have the potential cumulative to reduce the risks.

Secondly, it is possible to criticize the MPG's recommendations for having this or that imperfection. However, given the risks presented by the status quo, perfection is maybe a luxury that we cannot afford.

And thirdly, the extent to which the 15 recommendations of the MPG are internationally transferable varies considerably, some of the recommendations are very much placed in the context of the U.K.'s corporate law and governance arrangements, and those are rather different than those that you face here in the United States. However, some of the recommendations I think are transferrable internationally.

And the one which in my view offers the greatest possibility in the medium to long term for reducing the risks is reform of the rules relating to the ownership and funding of firms. The present position in many jurisdictions is that only qualified auditors are permitted to control and be the source of equity capital for audit firms. The origins of this requirement go back many years and the idea was to protect audit quality and auditor independence.

Now to take an analogy, everyone would agree that air passenger safety is an important public policy objective, but no one agrees that only qualified pilots should be entitled to own airlines. And the same argument can be made in relation to other important public policy issues like food safety or drug safety, or indeed the fairness of financial advice to retail investors. And the time really has come to reform the position in relation to audit.

Why is this? Well, simply because if we are to reduce the risks associated with the withdrawal of one of the major audit firms, we need to have more firms capable and willing to audit the largest public companies. And one of the issues which the MPG recognized and emphasized was the need to avoid damaging audit quality. If these firms are going to have the capability to audit the largest clients, then they need to have people and systems and global capabilities which are comparable. And this requires investment. And if the only source of investment is from the partners of the firms, then the rate of investment will be slower than is necessary. In other words, we will be extending the duration of the risk that we are exposed to.

And there's no reason why a change in the ownership rules need damage either audit quality or auditor independence. The existing registry arrangement for auditing standards and independence and independent inspection can remain in place, but focused on the operations of the firm, not on its owners.

Now the possibility of making a change in the ownership rules is now a serious public policy matter out for debate in the United Kingdom, and in the European Union. The European Commission has recently published an important study on this issue and there will be further papers published by the FRC and the European Union in 2008.

Finally, just a word on audit liability reform on which the firms place much weight. I accept the firms' arguments that it's not appropriate for them to act as the insurers to the world's capital markets. And that's why some sort of reform would, in my judgment, be desirable. However, it is neither possible nor desirable to reduce to zero the risk that a firm would leave the market. And, of course, firms are not just exposed to auditor liability risks, but to a whole range of other financial and operating risks. And I'm not confident that we can prevent or even should attempt to prevent the withdrawal of one of the major firms. What we need is a position where the market is more resilient in the unfortunate event that a firm were to withdrawal.

Thank you very much.

CO-CHAIR NICOLAISEN: Well, thank you very much.

Next we'll turn to Lew Ferguson. Lew is a partner at Gibson, Dunn & Crutcher. And I perhaps know him best in his former role as the first general counsel as the PCAOB.

Lew?

MR. FERGUSON: Thank you for having me here today. And I'd like to emphasize at the outset that I am speaking in my personal capacity and not as the former General Counsel of the Public Company Accounting Oversight Board or on behalf of my law firm, Gibson, Dunn & Crutcher or its clients.

While there are 985 U.S. public accounting firms registered with the PCAOB, all you have to do is --

CO-CHAIR NICOLAISEN: Lew, I think we need your mike on or you need to get a little closer.

MR. FERGUSON: -- Ninety-eight percent of the sales of public companies in the United States.

And in the limited time I have I'm not going to discuss how we got to this state, but merely point out that in today's global economy significant structural barriers exist to entry into the ranks of the very large firms.

In addition, many smaller firms have made the conscious decision that they don't want to incur the infrastructure costs and litigation and other risks perceived accompanying membership in the ranks of the largest accounting firms.

In 2003, the GAO in its report on concentration in the accounting profession concluded that despite concentration, vigorous competition existed among the large accounting firms. So should we be concerned about the existing level of concentration? I believe we should be concerned because there are several features of the U.S. legal system that increase the risk that at some point in the future one or more of the large accounting firms may face circumstances that could lead to its failure, further increasing concentration at the top end of the profession and creating a host of problems.

And I'm not here in any way to say that any firm should be too big to fail, but I think there are reforms that could be done that could make it much more likely that a firm that gets in trouble, would at least have the full panoply of procedural rights that I think we would want it to have.

And for example, in 2002 when the Department of Justice indicted Arthur Andersen and Company for obstruction of justice, we learned just how fragile a major professional firm can be to the mere pendency of a criminal charge. Within a matter of weeks after the indictment most of the firm's major clients had moved to other auditing firms. The firm had begun to experience a lethal number of defections of its most skilled professionals, and the Andersen international network fell apart.

The risk of large judgments in civil litigation also pose unique risks to accounting firms, particularly because the standard of liability can in some cases make the auditor the effective guarantor of the balance sheet of the client, or at least the last deep pocket. There are a number of pending cases where accounting firms face damages sought in the billions of dollars. And when punitive damages are added, a judgment can be a multiple of the plaintiff's proved loss.

In these situations the size of the trial court's judgment may not only be beyond the firm's ability to survive, but may cripple an audit firm's ability to obtain an appeal bond, and that's not fair or appropriate. That's why the largest accounting firms may be well capitalized; even they cannot survive excessive civil judgments.

In addition, today large accounting firms find themselves unable to obtain insurance to protect themselves against such catastrophic judgments. And while I'm not an insurance expert, I know that insurance for these types of civil judgments is simply not available. Insurers perceive the risk as too great. Such risks help explain why many smaller firms decide not to try to enter the ranks of the largest accounting firms. And this also helps to keep concentration levels high.

If the factors I've discussed do indeed raise questions as to whether even the present degree of accounting industry concentration is sustainable, what can be done about it?

There are several areas where I think public policy could be helpful without radically changing the structure of our legal liability system. One step would be to assure that judgments at the trial level would be subject to affordable appeal bonds so that access to the appellant process would be assured and judgments, particularly punitive damage judgments, could be reviewed.

Another suggestion which I touched on previously would be to reform the law or to create other mechanisms to permit accounting firms to acquire or afford insurance against catastrophic claims.

A somewhat more radical suggestion would be to have the SEC issue a standard as to how auditors should exercise and document their professional judgment. Such judgments are an inevitable part of the auditor's work. And then provide some protective coverage for audits that meet those standards so that an auditor's judgment exercised in good faith with due care and properly documented could withstand second-guessing by regulators and litigators. In many ways, such a rule would be an analog of the business judgment rule that protects corporate officers and directors for judgments made with the care and loyalty required by the rule.

Also, in criminal matters the Department of Justice's apparent willingness to consider using deferred prosecution agreements in appropriate circumstances is a very welcomed development. It reduces the risk posed by criminal indictment that an entire firm will be brought down by the acts of a few people.

And while these steps wouldn't eliminate the structural barriers to entry I referred to earlier or that Paul Boyle talked about, they would decrease the risk that concentration in the profession will be further increased by the failure of one or more of the larger firms brought about by a criminal indictment or a very large civil judgment that cannot be taken to appeal.

Thank you.

CO-CHAIR NICOLAISEN: Thank you very much.

Let's shift next to Louis Grumet, who is the Executive Director at the New York State Society of Certified Public Accountants.

MR. GRUMET: Thank you very much, Mr. Co-Chairman.

Can you hear me?

CO-CHAIR NICOLAISEN: Yes, I can. Well, I can hear you. I'm not sure about the rest of the group.

MR. GRUMET: Can everybody hear me now?

Thank you for letting me be here. And I, like everyone else, don't want to hold my society for what I'm about to say.

The major issues are being discussed

today, and particularly the competition here, I'd like to tie it back to the earlier two panels if I may.

When I was young legal researcher I was a staffer for a group just like this looking at local government in New York State. And, indeed, the first person that I got to interview was Chairman Levitt's father, the State Comptroller of New York State. And I spent a great deal of time asking him questions about how many local governments we had and whether there were too many or too few, too big or too small. And he said to me it doesn't really make any difference. It makes a difference how many qualified professionals we have and who is watching them. If the professionals are doing their job and the regulators are doing their job, he said, it's all going to work out.

And it took many years and many decades to understand the truth of what he had to say, and I would like to suggest as well to you that some of the real questions, so many of which were addressed this morning and I won't repeat them, particularly by Joe Carcello, I believe that in terms of the supply of how many auditors, qualified auditors we have in an increasingly complicated world requires graduate level work.

I think that we have to deal with the fact that 150 hours, which was a compromise agreed to, is a number and it's 150, which is different I guess than 120 and different than any numbers you can come up with. It really doesn't have very much to do with the quality of what type of critical level thinking we're requiring in pre-service training for auditing. And we rely too heavily on the very large firms we're talking about in this session to do the training, and they do most of the training and most of the education for people who wind up doing the type of auditing which we're talking about in a multinational, multi-jurisdictional setting.

Without repeating much of your morning session, I would urge you to call for graduate level training or pre-service to get into auditors. And I put into my written document, and I won't take a lot of time talking about it, I would call, because of the urgency of the situation, I would call for federal funding and possibly through the PCAOB to put together a national academy or one or more academies that could get some of these critical skills on a very, very fast pace, the way we did after Sputnik 50 years ago caused us to look at science and caused us to look at math.

The fact is that I have to respectfully

disagree with David Costello who was here earlier about whether the state boards are doing an evenhanded regulation of the rest of the economy, the bulk of the economy which we call small business, which we call nonprofit, which we call local government, which we call state government.

I'm very, very concerned that as life has become more complex we are not using our higher ed system to get auditors ready to do the complex issues, to look at the complex issues underlying auditing. And I call on you to give some serious thought to that.

I'd like to spend most of my time this morning, the several minutes I have left -- this afternoon, rather, talking about the interstate compact. Mr. Costello indicated that they had looked at the interstate compact and he thought it didn't work. I don't really think anyone has seriously looked at it, and I want to explain to you why I would like you to look at an interstate compact.

Right now we have 50 states and of course the other five jurisdictions, including the Marianas, looking at auditing, looking at standards, looking at accounting standards, looking at tax standards across the nation. There is no uniformity.

You could have a national license, and I assume that's one of the things you're looking at. Though as an attorney, I think there are serious constitutional problems as to whether you could do a national license, except for the publicly traded corporations.

And I do believe that when you have a state like the state I'm from, the State of New York which was the first in the Union to have the CPA profession and is still existing with the same law that it had in 1897, last updated in 1947 when Jackie Robinson was breaking into the Majors, you're not dealing with the type of serious regulation, you're not asking the serious type of questions that need to be asked across the country.

And I think what we need to do, Mr. Costello talked, and I'm only dealing with David because he dealt with this issue, about the fact that we have to have more mobility. I know Barry feels very strongly about that, and I think mobility is good. But I don't think the stress needs to be put on whether or not auditors can cross state lines. The stress has to be on whether the people of the country are protected across state lines.

And I think what we need to do is have the type of inter-relationship and the enforcement of the sovereignty of the states that you can only get through an interstate compact.

It's able to have been worked as something like the Advisory Commission and their governmental relations. A number of you talked about data this morning. And I'm suggesting that if data were transferred across state lines and it constituted across state lines through the force of law and the force of sovereignty through an interstate compact. And if the Congress joined the interstate compact the way they did with the ACIR, you would then have the federal agencies and the states being able to share their power in a sovereignty basis.

It's a very simple concept. Mr. Costello said the nurse's compact wasn't ideal. It doesn't have to look like the nurse's compact. A compact is merely a contractual idea which our founding fathers were smart enough to stick into the Constitution when they weren't sure how to deal with two or more states' dealing.

It can say whatever you want it to say. And I believe what you should want it to say is a uniform standard of protection of the public across these states so that you get away from what I'm afraid you're moving towards now, which is more and more coalition and concentration on an international basis of common standards with absolutely no connection to the states who are looking at the licenses. And I would urge you as part of your studies to look at, let's say, 12 issues that the SEC did on some sort of compliance discipline problem and go backwards to the states who issued the licenses to the firms that were looked at and see if there's any connection. And I would suggest there is not.

Thank you.

CO-CHAIR NICOLAISEN: Very good. Thank you very much.

Our next panelist is Wayne Kolins. He's the National Director of Assurance and Chairman of BDO Seidman.

Wayne?

MR. KOLINS: Chairman Levitt, Chairman Nicolaisen and Members of the Advisory Committee, thank you for the opportunity to present my views and those of my firm on important issues about the future of the auditing profession.

BDO Seidman is a national accounting firm providing services to a wide range of publicly traded and privately held companies. We serve clients through 35 offices and more than 150 independent accounting alliance firms nationwide. As a member firm of BDO International, we serve multinational clients by leveraging a global network of resources comprised of member firms in 107 countries.

We currently audit well over 300 U.S. publicly traded companies, including four in the Fortune 500. Over the last three years we've gained a substantial number of large publicly traded audit clients.

In framing my comments I thought it would be useful to mention a recent conversation I had with the CEO of one our largest clients. He told me that he looks to us to have a deep understanding of his business, be promptly responsive in dealing with issues and, most importantly, to make sure the company gets things right. Similar priorities were echoed by the client's audit committee. I believe these views demonstrate the attributes most highly valued by management and audit committees in the Sarbanes-Oxley environment.

Because of the brief time allotted to my testimony, I focused my comments on audit firm capabilities and competition. I'll also offer suggestions regarding both of these areas. First, I'll cover audit firm capabilities.

Investors in public companies and other stakeholders want and deserve to have high quality audits to protect their interests. But audit firms are not fungible or homogeneous. Accordingly, there is no one size fits all concept. To ensure high quality audits, audit committees may review an array of factors in choosing an auditor that provides the best match.

First, accounting expertise and experience. Companies that frequently engage in complex transactions want to ensure that their auditor has the resources to analyze them. In addition, audit committees want to deal with a firm that has a deep understanding of the industry in question.

Other factors include the PCAOB's inspection results, whether the firm has sufficient resources located in multi-jurisdictions, the nature of partner involvement in the audit process and partner interaction with the company. And last, but not least, firm culture and tone at the top.

While size of the accounting firm is one of the factors that may be considered by an audit committee, it should never be a prima facie bar to selection, except perhaps for the very largest of companies.

The BDO Seidman service model is well suited to handle large multinational companies, as we've demonstrated by our client base.

Turning to competition, over the past several years my firm has participated in a number of significant proposals competing against other large firms. Based on this experience I view the market for audit services to be highly competitive with the retention decisions predominately triggered by the qualitative factors I previously mentioned and fees determined by frank and open discussions between the company and the firm through a balanced consideration of the cost and benefits of the services provided.

Finally, I elected to discuss possible courses of action to consider to enhance audit capabilities and competition. I suggest you consider the following, which I view as market-based initiatives rather than regulatory mandates.

First, issuance of guidance by regulators and exchanges that would strongly encourage audit committees and other participants in the financial markets to consider suitable qualitative factors in evaluating audit firms. The active focus on this objective by these regulatory bodies should emphasize their concern for the enhancement of audit quality and communicate their belief that there are many firms with the requisite qualifications to serve large public companies.

Next, having regulators and exchanges encourage small to medium size firms to join a domestic alliance of independent firms to obtain support services similar to that of the firm's national office.

Other suggestions include:

Enhancing the availability of industry and specialized accounting and auditing training to audit professionals in small to medium sized firms;

Renewal by the SEC Division of Corporation Finance of its practice fellow program. This program, as well as the existing program of the Office of the Chief Accountant, should provide opportunities for professionals from small to medium size firms, and finally;

Creation of a PCAOB practice fellow program, reaching out to professionals from firms of all sizes.

Again, thank you for the opportunity to present these views. And I'll look forward to discussing them and other issues during the balance of the session.

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

Lastly, we'll turn to our final panelist, Jeffrey Steinhoff. He's the Managing Director of Financial Management and Assurance at the U.S. Government Accountability Office. And you can be certain that the data he'll provide us with is accurate.

MR. STEINHOFF: It is. It is.

I'm speaking for GAO, not only for myself but GAO does stand behind its work 100 percent. The effectiveness and efficiency of the audit market for public companies are critical to the functioning of our capital markets. Therefore, I commend the Secretary of the Treasury for establishing this Advisory Committee to proactively evaluate the auditing profession.

We are currently completing an update to the 2003 study that Mr. Ferguson mentioned earlier, and I'll summarize some of the key observations from that current study.

First, if you glance over at the first chart, the audit market remains the same for the largest companies, those over $1 billion. Ninety-eight percent are audited by the Big 4.

A slight shift when you get to $500 million to $1 billion. You've gone from 95 percent to 92 percent.

The big shift is really when you get to companies below $100 million, and I'm talking about revenue here, where it is much more competitive. You have a large number of the third tier firms. By a third tier firm we mean a firm that's 100 registrants or less. And that's gone from 45 to 69 percent. And you see the domination of the Big 4 not being in that tier, and also dropping from 44 to 22 percent. So there has been a market change. Reduction in all firms less than $500 million of revenue. You still have 94 percent of all audit fees are paid to the Big 4, and that's down from 95 percent.

Now if you look at the second chart, and this gets down to market concentration. By any measure this is a highly concentrated market, but where it's most highly concentrated is from 500 million on up, that's where the biggest issue is. It has stayed the same for those firms that are the largest. They're still as concentrated. And, again, for the purposes of this it is considered to be highly concentrated if what's called the Hirschman-Herfindahl rate is above 1800. So the overall rate is 2230, but the rate for the first two quadrants there, for the largest and the second largest tranche of firms, are both above the 1800 mark. But what's important here is for those with revenues between 100 million and 500 million, they have dropped from being highly concentrated to being moderately concentrated. And those below $100 million in revenue are now considered to be unconcentrated.

So this is a pretty big change from our previous study. This is 2006. Our previous study was 2002, issued in 2003.

I will add that if one of the remaining Big 4 failed, that rate would go up to 3,030. So it would go from 2330 to 3,030 for the HHI score, which is astronomically high. So it would raise that score by roughly 30 percent.

Second, although we found there were highly concentrated markets, we did not find that in those markets where they were especially highly concentrated that audit fees were higher. There were some segments where the scores were as high as 3500, but we did not find a significant or hardly any variance in the audit fees.

We found that the loss of another firm, as I mentioned, would be very difficult. Therefore, it is very important that audit market concentration continue to be monitored and any significant future concentration be evaluated for both price, quality and innovation and do we have sufficient choice. But, again, we did not find any major effect on price or quality.

I would submit that the big issue here is one of quality and not of one of concentration. And it is ensuring that everything that is done is focused on ensuring quality. And I'm kind of going off my prepared script here. It might be over my time already. But if you look at the big audit failures, they weren't close calls. They were bad, bad audits. There was no quality in those audits. So if a firm wants to help ensure it will not fail, it will do high quality audits and it will have a great incentive to do high quality audits. And that is probably the key to both protecting the investor and in ensuring the concentration problem does not get worse and, perhaps, improves in time. What becomes difficult is finding that balance between audit quality and price. And that's the difficult issue.

Third, the growth in capacity of a second and third tier firms is not really likely to enable them to make a serious dent into that first sector where it was 98 percent. As the third chart shows for the four second tier firms if they were consolidated together, they would have 2600 fewer staff than KPMG, which is the smallest of the Big 4.

So you aren't going to grow. You have the fact that they can grow in some of those quadrants like the third and fourth ones I showed on the initial chart, but you're not going to see significant changes for those companies today over $1 billion. You might drop it down a couple of percentage points, but you're not going to see a tremendous change.

Third, and go to the following chart, here is really why folks said what's important here is we found that the second and third tier firms were not highly desirous of entering the marketplace for the largest companies. Seventy percent said they'd like to take a pass on that. At the same time 90 percent of the corporations said they'd like to take a pass on the second and third tier firms. So that kind of works out fairly well to the marketplace; they don't want to do it and they don't want them to do it.

Here are the reasons cited, and I think these are things that this group can look at: Are there things here that you can address?

Standards are many times cited. The fact that there is something like 2000 sets of rules or regulations; somebody counted them up one day that really governed this process. The complexity of both accounting rules as well as auditing standards. And you have the real needs of these multi-national corporations that do not think that the second and third tier can always meet their needs.

You can certainly build these firms to be more responsive, to be more able but it's going to be very, very tough to crack that 98 percent to any tremendous extent. Even if you dropped it down to 90, it would take a Herculean effort and, you know, it's not something that's going to occur very, very quickly.

Fourth, we did look at a wide range of proposals that have been made by a wide range of folks. Some of those you all are addressing earlier today. We didn't find any consensus or support for anything. We found a lot of ideas, a lot of people very sincere in their views about their ideas, but there was no proverbial silver bullet. There wasn't, perhaps, even a full agreement what was broken or that something was in fact broken. I thought a lot of people believed that there was competition today, that there was improved quality today and that, you know, they weren't really sure that these were solutions that would really improve the profession going further.

I'd like to make one final observation. While we did not relook at audit quality, the market participants felt that quality had improved. I think this is a byproduct of the audit profession's realization in the face of major audit failures that the audit quality had to be center stage, together with Sarbanes-Oxley and the establishment of PCAOB. They've all had an important effect. The issue is can you sustain that?

We've had these perfect storms before. At the time of the S&L crises there were a lot of substandard audits. GAO had the privilege of looking at those. And the real issue becomes will we be in a position where we face the perfect storm again where we have business owners combined with bad auditing, and will the focus on quality remain.

In closing, as I said at the outset of my remarks, I applaud the Secretary of the Treasury for convening this Committee and would be pleased to respond to any questions you all may have at this time.

Thank you very much.

CO-CHAIR NICOLAISEN: Thank you very much.

We're going to turn at this time to Damon Silvers, who is Chairing the Subcommittee on Concentration and Competition. And I'm confident in Damon and Subcommittee that if there are some silver bullets here, that he'll find them.

MEMBER SILVERS: I don't do silver bullets.

Well first, let me add my thanks to the panel for the very thoughtful presentation, for joining us today.

I've got a question for each of you, and I'll go through each question and then hopefully you can take them in turn. And then hopefully my co-panelist will come forward with theirs -- my co-Committee members.

First, Mr. Boyle, you focused in your description of risk reduction proposals on changing the ownership and control restrictions on audit firms. We heard this morning from several panelists who were very insistent on the need to sort of redouble the question of professionalization in the audit function. And in a way one could infer that they were urging a further sort of decommercialization; quite the opposite direction I think from where you're going. I wondered if you might talk in a bit more detail about why you think that's maybe unnecessary and not a problem. And secondly, what would there be about opening -- we also heard about real problems in the insurance markets this morning that would suggest that there's kind of a problem with financing risk here. And I hope you could explain how going through the public markets would change any of that, that public investors would see any differently in the current structure really a risk adjusted return that would make any sense in these firms?

Mr. Ferguson, you talked about, among other things, your suggestion that the SEC define a clear standard of care in public company audits. I'm curious what your reaction would be to the idea that in exchange for that, the SEC also define a clear standard of standing for investors in relation to litigation so that it would be clear that any investor who sustained a harm in relation to a violation of that clear standard of care would have a cause of action?

Then Mr. Kolins, I'm curious as to whether or not you agree with Mr. Steinhoff's characterization of your business goals and concerns. And in particular I think our entire Subcommittee is extremely interested in your views, whether on behalf of your firm or other firms that are quote "second tier or third tier" to the extent you're aware of they're thinking, as to what are the obstacles in being able to compete for these high concentration segments of the market?

And finally, Mr. Steinhoff. I really appreciate your description of quality as the major issue. And I wonder how you might talk about what I see as just a fundamental issue in relation to this full Committee's work, which is in a world of our major audit firms there are enormous temptations, both well meaning and political, to essentially say we can't afford a failure, therefore there will be no accountability around quality? And isn't that a real problem in terms of concentration? Not a conventional problem in the anti-trust type of scheme, but isn't it a real problem, in fact the fundamental problem that we're dealing with here?

CO-CHAIR NICOLAISEN: Okay. I think there were at least five questions in there. We're going to have to move fairly quickly on the responses. You can go beyond yes/no, but let's keep them brief.

MR. BOYLE: Thank you.

On the first of the two questions aimed at me, I think it's absolutely important that there should be professionalization, but there is no necessary conflict with commercialization as well. In the United Kingdom the major firms have been publishing full financial statements for a number of years so we can see the profit per partner and guess what the U.K profession hasn't followed over. But if you want to know what's the key performance indicator inside the major firms in the U.K, it's profit per partner. And so anyone who says that the current owners of audit firms are not motivated by profit, I think is making a mistake. These are already profit-driven firms and the fact that they might have outside investors who are also interested in making a profit is not necessarily a bad thing.

It's possible to run a safe airline with profit-seeking investors. So it would be equally possible to run a high quality audit firm with profit-seeking investors.

The second question was about the risk adjusted rate of return. This, there's either a fundamental problem with the risk reward in this market or there isn't. Okay. And if there's a fundamental problem, then maybe we need to change the overall equation, which is in part why there's a good case for some sort of liability reform. But if you say there's a fundamental problem, then that means there won't be investment by anyone in the market, whether private partnerships or public markets. And the very interesting part of the European Union's recent research study is that on average they estimate the cost of capital for investment in audit firms publicly funded would be ten points lower than the existing model. And why is that? Because of the liquidity and the diversification of risk opportunity which public investors would have compared to partners on private capital.

MR. FERGUSON: The question you asked me was whether in return for some kind of a rule that might protect auditors for the good faith exercise of their judgment there should be a clarification of the standing requirements for investors. And I think clarifying the standards for investors to be able to sue under the federal securities law might be a good thing in general, quite apart from the other standard. But I think if that were coupled with a pretty clear sense of causation, that the investor had to establish that there was a causation here, that that might be a useful thing to do and that that would be a useful trade-off.

MR. KOLINS: Okay. You have two questions for me. On the first one whether I agree with Jeff Steinhoff's characterizations about our willingness and perhaps to the extent I know other firms' (in the second largest four firms) willingness to compete in the large firm arena, I think certainly my firm and I would probably imagine the other three firms of the four probably on the reciprocal end of that 90 plus percent, we are very willing to complete in that arena. As I mentioned before, we've got four of the Fortune 500. Over the last three years we took on about close to a 100 publicly held engagements, the substantial majority of which have revenues over 100 million, about half a dozen had over a billion dollars. So we are very much in that marketplace and are willing to compete in it.

And on the other part, which part of it is dealing with the characterization of the 90 plus percent of companies that are only willing to take the largest four firms and what are the obstacles? You know, what are the barriers to entry?

Certainly for some firms litigation causes a barrier to entry, not only the cost of cases but the actual cost of handling litigation, the insurance costs.

Industry expertise, it's a real barrier. If you don't have the industry expertise, you can't compete.

Lack of resources. Just the numbers of people and where they are around the world. So geographical coverage is very significant.

And you still have in some quarters biases among investment bankers and others in the financial markets that go against the smaller firms, the non-Big 4 firms. I think the more they work with firms of our size, the more they understand the capabilities. And for them you've actually to convince them of the capabilities. But that word doesn't necessarily get around so easily. So I think one of the recommendations I had is to what extent the SEC and the market's exchanges can strongly encourage audit committees to fully vet the auditors in terms of their capabilities, and not just relying on reputation and word-of-mouth would be a significant benefit to the profession.

MR. STEINHOFF: You asked about the issue of ensuring audit quality and the importance of that. First, the audit must be seen as something of value. And I think the issues today are the financial statements and is the audit seen as something of value. And then is it properly priced in terms of what a corporation's willing to pay for it.

While we haven't studied this, the common view was that this particular commodity had been during certain periods seen somewhat as a loss leader for other work. I think we've seen a big change since Sarbanes-Oxley. I think all the market participants we spoke to felt there was increased quality. You see an increase in audit fees, in part because of the 404 work, but it's much broader than that. I think people recognize that quality is number one. I think that protects the investor because the investors did lose massive sums of money as a result of some of the major audit failures. I think it properly protects the audit firm.

I just wanted to make one comment about that first segment there. When Wayne mentioned, you know, taking a half dozen, you've got about 30 roughly. They've got two percent of 1500 that are audited by really these second four. So it's going to be really a difficult road to hoe to make any big change there. But I think we can agree on audit quality issues.

I will say, though, that there is probably no set of definitive guidance that can be issued. I think somebody mentioned more guidance. There's a ton of guidance out there today; each firm has its own methodologies for doing this. We have a lot of talk these days of principle-based standards, which means you don't have a lot of guidance. But the real, real key is to focus on audit quality.

I know in the organization that I'm in that audit quality is by far number one. If I were to come in and say it took me more hours to finish it, that would not be a tremendous problem as compared to going in and saying I rendered an opinion on these financial statements, let's say of the Internal Revenue Service and, opps, they're wrong. I'm going to have to go back and rescind this. So to the extent you can promote audit quality and keep that as the most important thing and to have a meaningful inspection process and then a meaningful process within each firm, because it's in their interest not to get into the litigative posture. There should probably, though, be some mechanism if they have done the job right that they're not held responsible for unfortunate market conditions. But where they haven't done the job right, I think that's where they get themselves in an extremely precarious position.

CO-CHAIR NICOLAISEN: Great. Thank you.

MEMBER SILVERS: I insulted Mr. Grumet by not asking him a question. Do you mind if I just put it out there and he answers it at some point in the discussion?

CO-CHAIR NICOLAISEN: We'll come back to you. We'll come back to you. Let's try to get as many people in as we can. I don't think he's insulted.

MEMBER SILVERS: Okay.

CO-CHAIR NICOLAISEN: Mary Bush?

MEMBER BUSH: Yes. Thank you, Don.

We can all say that quality is extremely important, and it is. It’s particularly appropriate that we focus on audit quality in an industry where there is such a high level of concentration. But what I'm interested in getting at is what are some of the practical steps that one can take to assure audit quality. Who should be involved in that? Should it be the accounting firms themselves, PCAOB, SEC? What are some of the criteria for judging audit quality and for the quality of the individuals and the team, and the skills that are doing an audit for a particular company? That's one part of a question.

And the second part is will transparency about audit quality help the smaller firms? Because, you know, we're so concerned about concentration. Will that be helpful in terms of the smaller firms being chosen or selected for a broader range of audits?

And I'll address that to anybody, but I'd also be particularly interested in hearing if in the U.K. that was considered?

CO-CHAIR NICOLAISEN: Wayne, maybe you should start.

MR. KOLINS: Yes, I'll take the first shot.

In terms of who should be involved in overseeing that audit quality is maintained and monitored, well you've got a confluence of overseers these days. Of course, you've got the PCAOB, which for anyone who has been through a PCAOB inspection understands the depth at which the inspection teams approach their work. I believe when I tell you that the audit teams that are inspected by PCAOB take it very, very seriously and learn from it. Quite often the teams are -- or the partner is inspected again the next year, not because he did a bad job in the first year but because he just's subject to the luck of the draw. It's a risk approach. So the partners know that their jobs are subject, it may not happen all the time, but are subject to oversight by the PCAOB inspection process, which has proven to be an extremely effective tool.

You've also got internal inspections by the firms that in some cases could be even tougher than an external inspection because they know what all the firm policies are. Although large firms have internal inspection programs that are very strenuous and, again, putting their people through the paces.

You've also got, and I believe all of the large firms have it, I'm sure the smaller firms have it, too, partner evaluation processes which largely have evolved over the last few years that place a significant focus on technical competence, as like the number one criterion. And that is also focused on by the PCAOB because the PCAOB inspection does look at how the partner evaluation process is handled and is it placing the emphasis on the right attributes of the partner versus, for example, selling skills.

So I think you've had a change in the marketplace. You have a very effective overseer to ensure that quality is included in the audit process.

MEMBER BUSH: What about continuing education?

MR. KOLINS: There's been a significant

increase. I can only speak to my firm. But we've had a significant increase in the amount and nature of continuing education that we provided over the last few years due in large part because the rules have gotten -- we call them rules versus principles -- have gotten more complex over the last few years. So that need has increased, I wouldn't say geometrically, but certainly has increased significantly over the last few years. And we have that as one of the prime qualifications in our partner evaluation process to the extent to which people participate in the CPE programs.

MR. BOYLE: If I may come in from the U.K. perspective, three quick points.

One. Audit quality is absolutely critical here, and that's why in paragraph 1 of the terms of reference for MPG.

Secondly, there was a lot of comment in the U.K. Everyone thought audit quality was important, but no one could agree on what it was. So in addition to publishing this document, we at the FRC have also published a whole paper on audit quality, which I'm very happy to send to you, which sets out not a wordy definition of what it means but five or six key drivers the presence of which is likely to be consistent with audit quality and the absence of which would be indication that there was a risk of a loss of quality.

And we've consulted widely on this. The drivers now agreed, the consensus in the U.K. on this, and it's intended this framework will perform, first of all, the basis for our inspection work because now we've understood these drivers in theory where they're testing in our audit inspections to see whether they're found in practice.

Secondly, we're encouraging firms indeed to be transparent about the measures they are taking to promote audit quality, again following the drivers of quality framework.

And thirdly, as a basis for dialogue, for example, between audit committees and auditors or investors and audits, there you have an agenda for that discussion.

If I may make one final point, I don't agree with my colleague from the GAO that audit quality is the main issue here. It's absolutely important, but the risks that the firms are exposed to go well beyond audit quality. The biggest near miss that we had recently was KPMG, well documented, had nothing to do with audit quality. But that firm nearly fell over because of a tax related issue.

And so even if we solve the audit quality problem, we still won't eliminate the serious risks that one of these firms might run into difficulties. So it's an important point, but it doesn't solve the issue.

CO-CHAIR LEVITT: What you said is consistent with one of the observations that the FRC made, I think it's recommendation 11, that authorities with responsibility for ethical standards should consider whether any rules could have an adverse impact on auditor choice when compared to the benefits to auditor objectivity. You're not suggesting that the FRC is charged with promoting confidence in corporate reporting or governance, are you?

MR. BOYLE: I'm sorry. It is the FRC's role to promote confidence in corporate reporting and governance. That's --

CO-CHAIR LEVITT: Is it really?

MR. BOYLE: Yes. That's our mission statement. It's on the back of our business cards.

But the way in which we do that is through, we are the publishers of the U.K. combined code on corporate governance, we are responsible for U.K. GAAP, we're responsible for enforcement of accounting standards, both IFRS and U.K. GAAP, we're responsible for auditing standards.

So there is a package of things which when put together should lead to overall confidence in corporate reporting and governance.

CO-CHAIR LEVITT: It's an awfully ambitious agenda.

MR. BOYLE: On the other hand it makes sense because the issues are all linked. And we think it makes sense not to look at audit in isolation from financial reporting or financial reporting from the professionalism of accountants. And, of course, the proper governance provides the umbrella which holds it altogether. That's at least our view in the U.K.

CO-CHAIR NICOLAISEN: Well, great.

Let's turn questioning over to Rodge Cohen.

MEMBER COHEN: Thank you, Don.

One specific question and then one much broader one. The specific is that Mr. Ferguson touched on an issue raised by an earlier panelist, and that would be the ability of the defendant to get an immediate right to appeal a denial of a motion to dismiss. It seems to me that that prevents legal gaming, promotes judicial efficiency and it doesn't really detract from investor protection. So what are we missing and why isn't that -- maybe it's not a bullet but at least a pretty foolproof approach.

A more general one we've assumed, I think, inherently but maybe not correctly that concentration is a problem. The question is why? I think Damon correctly identified moral hazard is an issue. A second one Mr. Boyle identified was the inability to absorb a failure which would inevitably occur in December at the very worst time.

So, are these the problems? Are there others? And if ability to absorb is a real problem, should we be proactive dealing with that risk whether or not there are four or five or six major firms?

CO-CHAIR NICOLAISEN: Lew, it sounds like--

MR. FERGUSON: Oh, I'm sorry. Was it addressed to me?

CO-CHAIR NICOLAISEN: I think you got the first one. I think Paul, perhaps, can --

MR. FERGUSON: I mean, I think an immediate -- the ability to get an immediate appeal from a motion to dismiss that was denied would be a good thing. I don't know if that's necessarily a bullet, but it strikes me that's also a quite large change in our legal system. Because it would involve, potentially state courts as well as federal courts.

And basically, I try to kind of stay away from what I thought would be just major systemic changes and deal with more incremental problems like an appeal one. But I mean I think that could be very useful if firms could actually get the core of the case, whether there's a claim at all, heard by an appellate court. I think that that would go a long way.

MR. BOYLE: The ability to deal with the withdrawal of one of the major firms is, in my view, absolutely the top issue you should deal with. Now other issues are important. For example, the quality of young people coming into the profession. That will absolutely be an important issue for the next 25 years. But we've got a more urgent issue to deal with, I would subject.

And the three subjects which we set for the FRC's work were:

1. To increase the choice available in the market, which is intended to promote greater resilience of the market in the event of one of the firms falling into difficulty.

2. Given that it will take some years to

achieve this, what can we do to prevent the unnecessary withdrawal of a firm? I've in other places described this as how do we prevent a toothache turning into a brain tumor. In other words, if there's a problem in a limited area, let's yank the tooth out, let's not shoot the patient in the head.

3. It will never be possible to reduce to zero the risk that a firm might leave the market. So in those circumstances we need to have some measures in place to reduce the costs of uncertainty and disruption which would inevitably follow from the loss of a major firm. It would be a serious problem for all market participants.

And one of the questions we've sought to engage corporate directors on is you have a legal obligation to appoint auditors, what would you do if your present firm was unavailable to you? Have you got an answer to that? Because you have a legal obligation to appoint auditors and we know that in some cases corporate directors have chosen to appoint firm A to do their audit, firm B provides them with tax due diligence services, firm C does their internal auditing for them and firm D does their due diligence work on acquisitions. So if their audit firm fell over, by their own choices they've got nowhere to go.

And this is a question which we think corporate directors and CFOs should give serious consideration to.

CO-CHAIR NICOLAISEN: Great.

Ken Goldman?

MEMBER GOLDMAN: I finally got a chance to talk here.

Basically, our Subcommittee is really going back to the focus of what is the problem and how to solve it. And I really think about really back to the concentration. And I'd like to first start with a question, really for two folks. First off, Mr. Steinhoff, I keep on looking at the chart in front of me and we've seen some other data which really shows that the concentration hasn't changed very much over the last several years. And then if you sort of look at -- and I was sort of focusing on the small companies. The question I have really, first of all, is if you see that a number of companies that are in a non -- I had to use the second tier -- but non-Big 4, nothing seems to be moving to the right. And then if you sort of think about why a little bit has changed, one of my thoughts -- reality is that some of the reason you've even seen a little bit of movement is because the Big 4, so to speak, haven't really had the capacity to serve as many companies as they would have, particularly with Sarbanes-Oxley and 404. So that's one thing, and really just in terms of the whole concentration and why is it not moving?

And, honestly, another aspect of concentration that's even more dramatic if we looked at it by industry. I mean, there are certain industries where we really don't have four, you may really only have one or two.

My next question, and this is really two questions, relates to Mr. Kolins. And it really comes back to are we comfortable with the sort of Big 4, the next four, the next four? Do you really think there's a desire to have a big five or big six? Would you like to be involved in that big 5 or big 6? Do you think the investing public or underwriters or company managements really don't want -- really like to see it, but are not comfortable with using a firm that's not in the "Big 4" or a larger company?

And the last thing, which is sort of my crazy idea. I was sort of thinking about you got the NFL. When they have to go expand, they have this expansion team and they get the draft from the other teams. And so do we really need to have a draft from the Big 4 to create a 5 or 6 so we really do have a six or seven or eight major firms here?

It's really a two part question.

MR. KOLINS: Do we get first draft pick?

First, and just responding to Paul's comment before about firms A, B, C and D. Perhaps they can go to firm E in that case.

To answer your question directly, we have no primary objective to be the fifth of the big five. We're quite happy in the marketplace where we are now. We do feel that realistically there are companies out there that will only pick the Big 4, for whatever reason. It's a reputational thing. It may not be looking at the specific attributes from a technical and coverage standpoint for the firm. And that's why we wanted to get that information out there in the marketplace.

And I can't speak for the others in the second level of firms in terms of the size as to what their objectives are. I know it's very difficult to even on an aggregate basis as was shown there, to come up close to a big five. It would create all kinds of logistical issues, I'm sure, from an organizational standpoint. So I'm not sure that's really in the offing as far as I'm concerned.

MEMBER GOLDMAN: If I can evolve the

question. You don't even see the desire for M&A transactions that would allow some of the non-Big 4 including yourself to increase your size via a major acquisition route? That's hypothetical.

MR. KOLINS: Yes, of course. And I think all the firms look for strategic acquisitions to either shore up a geographical area that they don't currently practice or an industry where they don't currently practice. And I think that will happen.

But just to merge for size sake, I'm not sure is the best strategic move because of the limitations that you already have in the marketplace.

MR. STEINHOFF: I wanted to comment on your expansion team proposal. Typically expansion teams once they have been formed have lost for years and years and years because they might get the first pick of the expansion team, but it's not the first pick of the losing team.

We didn't really see any easy way to --

MEMBER GOLDMAN: A lot of them are bidding my 49ers, so I don't know about that actually.

MR. STEINHOFF: Yes. We didn't really see the same point that Wayne Kolins is making. We didn't see that the second four were pressing to merge or combine or even to compete always for the same clients. They're looking for niche, they're looking for those larger companies where it makes sense. But there's a huge capacity issue. And there's a lot of audit risk. I mean, these are extremely complex entities with worldwide reaches. And people are looking for a certain comfort zone.

So we did find that there was a great deal of desire there.

CO-CHAIR NICOLAISEN: All right. Great. We're now to the free for all sessions. So if anyone else has questions for the panelists, please do it.

MEMBER HANSEN: Yes. And I'd like to follow up several of the questions to you, Wayne. And it has to do with market bias. You've mentioned several times, and it was a couple of different places in the written materials that were submitted. I don't recall if it was by you or not. But I'm always sort of concerned when I hear that word "bias."

And I was wondering if you might comment on how widespread that might be? It infers that there might be some artificial dislocation of resources within our profession. And what, if anything, do you think can be done about that?

And then I wanted to direct just very quickly to Mr. Steinhoff. If you look at that chart, it would imply -- and I think it's pretty clear that there's a lot of concentration at the upper end of the Big 4. But it sort of implies that within the smaller firms that there's less concentration. I agree with that, but when I look around, and I'm from a small firm, I'm seeing about half or fewer of the number of small firms that are doing SEC work these days.

So I don't know if that is implying that there's not a lot of concentration. I think there's that trickle down from the big firms into the second tier, but I think there's a whole lot of concentration within even the small firms these days. I'd like you to comment on that if you would, please?

MR. KOLINS: I guess I was the first that that was directed.

In terms of how widespread the bias is, I can only recount based on my own experience that my firm has had over the years. And I think whatever bias there was has been reduced over the last few years. Certainly the companies that we've gotten involved with as auditors have overcome an initial bias that they might have had because they found out about qualities of the partner on the engagement -- of the engagement team, of the industry expertise, of the national office resources that the firm had. But, frankly, in some cases it was a selling job. It was to get them to understand it. It wasn't a given. And once they understood it, then we became able to operate on an equal playing field with everyone else.

I think it's a question in large part of the knowledge being communicated in the marketplace about the abilities of individual firms to enable the audit committees to make the appropriate decisions. To the extent those things happen in the investment banking community, in many cases it's an individual decision, it's an individual banker's decision based on that banker's knowledge of the accounting firm that he or she happens to be working with.

MR. STEINHOFF: What we found was the term "bias" didn't really come up, but what we found mainly were issues such as reach. The largest, the Big 4 firms had offices around the world. They had a broader reach. They had a broader ability to really address the needs for the largest firms, the largest companies.

Also the fact that for the larger audits you're talking about putting hundreds of auditors on those audits. And that really stretches the second four as to how many of those engagements they can in fact take on. So it greatly limits that.

With respect to the concentration, we didn't look at how many firms are performing the work. However, our survey clearly showed that the percentage of audits being done by the firms below the top eight have grown appreciably by over half from 45 percent to 69 percent in just four years. And then they have over doubled the amount of work they're doing in that grouping between 100 million and 500 million.

So you have seen an appreciable shift in that particular arena. And I would expect that those would present their greatest opportunity for reduced concentration going forward. You still are highly concentrated in the 100 million to 500 million, but you're less concentrated and you're unconcentrated in those audits for those companies with revenues below 100 million dollars. But you do not see a whole lot in the upper end. I think it's because of the capacity issues.

And, again as I said before, I'm not saying that the second four or the firms below it wouldn't seek a larger company, but they're not seeking them in large quantities. So you're not going to have a big shift there.

MEMBER HANSEN: Would you say that's capacity issues or perceived capacity issues, or were you able to address that perception?

MR. STEINHOFF: What we heard from the market participants that we spoke to was that there is a lot of complexity in a number of these sectors. And that they believe there are limits to how many audit firms are in a position to really address the specific nature of the business that they have. In short, 60 percent of the large companies felt they didn't have adequate choice, whereas that number drops to 25 percent when you get to the left side.

So you have the biggest opportunity to reduce concentration over the left. And on the right it's going to be very small movement.

CO-CHAIR NICOLAISEN: Okay. We have roughly ten minutes and we're going to try to squeeze in four more questions. Lynn Turner first and then Tim, then Bob and Barry.

So Lynn?

MEMBER TURNER: Jeff, I am somewhat puzzled here, but I'll just try to do it succinctly.

Peter, you said the reason that we should look at different firms of alternative forms of organization for the firms is to allow them to raise capital so to create another firm. But in reality, that's going to give the current firms the ability to raise capital, not another one because Jeff has indicated from his survey people aren't interested in going to another one of these firms anyway. So it doesn't sound like it's going to create an opening for another firm to deal with.

And in light of that, though, you said the liability thing is still the biggest issue rather than quality while Jeff turned around and said our problem was we had a lot of bad, bad audits.

I guess the question is if we had a lot of bad, bad, bad audits as Jeff indicated, shouldn't quality come first and make sure we got the bad audits fixed so that the firms don't have the problems to start with that give rise to litigation? And was the problem, both you and I think maybe Lew brought up the issue of second-guessing, was the issue with these bad, bad audits that exposed these firms to litigation second-guessing on those where it shouldn't have been?

CO-CHAIR NICOLAISEN: I assume that's to Paul?

MR. BOYLE: Chairman, I second-guess that Peter meant Paul.

We absolutely agree that audit quality is important. But even if you solve the audit quality problem, you would still be left with an exposure to the risk of a firm leaving the market. And, you know, the primary reason why I thought about changing the ownership rules was we had some conversations with mid-tier firms in the U.K. who demonstrated a sort of appetite for growth similar to that which Wayne has mentioned. And specifically one of them said to me, "Mr. Regulator, if one of the Big 4 falls over, don't come to us to solve your problem." That was an extremely informative remark. That made me realize that if the mid-tier aren't going to be the solution, we need to at least create the possibility of new entrants. And there are other markets. You can look at the airline market here in the U.S. where new entrants have successfully broken in to an otherwise unpromising market. And they've practically transformed the market, not overnight but over a period of time.

And the reason they've been able to do that is the reason that all business works: You take a guy with a good business idea, you hook him up with some investors looking for return on capital and you give it a go. And sometime the business ventures succeed, and sometimes they fail. That's capitalism. But unfortunately, the current rules prevent capitalism working properly in the audit market. And that's our contention.

MR. FERGUSON: I would not in any way, shape, or form want to stop second-guessing of bad audits. Second-guessing of audits in general. I would simply propose a rule that would say that if certain standards are met, if there's adequate documentation, if alternate accounting approaches are considered, if there's a clear record of this that there should be some protection there.

We second-guess directors all the time in terms of what they do. But if they meet certain procedural requirements, the fact that they made a bad business judgment is protected. That's all I say. I wouldn't stop -- I wouldn't provide any protection audits.

CO-CHAIR NICOLAISEN: Tim?

MEMBER FLYNN: Mr. Boyle, there's been a lot of discussion this morning and again this afternoon about the European market and more principles-based than rules-based. Can you just give me your views in terms of how important is a standard setting as being principle-based compared to the regulatory environment, litigation environment in the capital markets in terms of getting that proper balance?

MR. BOYLE: Well, I think the current translation of this as principles versus rules is a mischaracterization. I mean there is the joke that, you know, that even we in the U.K. have some rules and we understand that you in the U.S. have some principles, too. So it's a mischaracterization.

In fact, specifically in relation to audit if you were to make a comparison between the U.S. auditing standards and the standards that apply in Europe, you would not see great differences.

So I happen to think that the main reason why the two markets differ to the extent they do is primarily because of the litigation environment here in the U.S. genuinely is different than we have in the U.K. But as far as auditing standards and even in their fundamentals, the accounting standards, they're not that different.

CO-CHAIR NICOLAISEN: Bob?

OBSERVER HERZ: I'm actually going to try and relate something that Paul Boyle just said with the concentration issue, and maybe you did, and with the audit quality issue. And I'll broaden it to just say product quality to the ultimate consumer who is the investor and public of an audit.

And, you know, if we hypothesize a totally unregulated market, which is just doing this for sake of hypothesis not for sake of proposing it. One way to cure concentration issues, that might cure concentration issues is what Paul said. Somebody comes up, innovates, provides a better product to the market.

So I just kind of wondered, you know, whether or not the issue might be around when we define audit quality as to whether or not the ultimate consumer can observe that or not? They're doing it through all sorts of proxies and very indirect indicators. And what they observe is when it fails completely, obviously there wasn't audit quality. But distinguishing whether there was quality or not to the consumer is ultimately the consumer, the investor seems not very transparent. And, you know, some people have advocated for example that there be the ability to do actually more long form reports directly to investors, not just the communication to directors. But that again has other connotations in our system.

But I'm just kind of wondering around that whole issue of kind of the visibility of the quality of the product to the actual consumer.

CO-CHAIR NICOLAISEN: Somewhere in that statement there is a question, and if we can respond to it quickly, it would be helpful.

I think we got the gist of what you're communicating, Bob. And let's move on to Barry and this will be the last question for this panel.

MEMBER MELANCON: Thank you.

I have a real quick question for Paul. You indicated that as part of the contingency plan and you talked to directors and said in the worst case if there was a sort of reduction in the market what is your contingency plan.

I'm just curious. How did you do that and what was the reaction?

MR. BOYLE: We did it by speaking to a number of them. Also by raising in our draft MPG report, we put the issue out on the table, recommendation 15 was issued in draft format. And we got a range of answers.

Some people said well we haven't really thought about that because if our audit fell over, that would be catastrophic and you, the regulator, would step in and change the rules. Guess what? We won't.

Some people said well we thought about it, but we thought it was so unlikely we didn't bother.

And a few companies said actually we do

have a contingency plan and we absolutely know who we would go to, and we have already one particular firm to be our contingency firm. And we know who they are, and that firm knows who they are. And I think that's a pretty interesting strategy.

CO-CHAIR NICOLAISEN: Well, thank you very much, panelist. I appreciate your inputs. And Committee members and Subcommittee, we thank you for your good questions.

A ten minute break and we're back with our concluding panel.

(Whereupon, at 4:00 p.m. a recess until 4:11 p.m.)

CO-CHAIRMAN LEVITT: Okay. We are about to begin the -- I would ask the panel and the Committee to consider our deadline. We are going to end at 5:40 sharp. I would like all questions to be as brief as possible and all responses as pointed and responsive as possible.

The first panelist is Michael O. Cangemi, President and Chief Executive Officer of FEI, Financial Executive International.

MR. CANGEMI: Good afternoon, Chairman Levitt, Chairman Nicolaisen, distinguished Members of the Committee and observers. I thank you for inviting us here today to provide recommendations on the general sustainability issues impacting the audit profession.

I am the President and CEO of Financial Executives International. Some of you know us as FEI. My views are influenced, therefore, by our 15,000 members who hold senior positions in finance, typically CFO, Controller, Treasurer, Tax Director and other senior positions.

Additionally, my views have been influenced by my 35 years of experience in accounting, finance and in senior management positions prior to taking this position at FEI. And, therefore, my recommendations represent somewhat of a balanced view from the perspective of being on both sides of the audit engagement -- as a partner in an accounting firm, a senior executive with a Fortune 500 company and then as a CFO and then CEO of a medium sized company. So I served in the Big 8, which is now the Big 4, and maybe part of the reason why we're here, as a Regional Director of IT auditing as well as in management at BDO Seidman running internal audit services and IT auditing.

And during this 35 years, I've witnessed more than one accounting supply cycle. So I'd like to start off with that.

Not so long ago the introduction of computers and automated accounting systems reduced the demand for accountants. And I remember writing an editorial about the first decrease in the registrations for the CPA exam. Well, that decrease has been replaced by an increase in demand as a result of the global economic expansion as well as the expanded scopes related to the recent financial scandals and the Sarbanes-Oxley law.

It was very interesting for me to hear the first panel today. And I have to say they expanded my understanding of the issues related to staffing and the human resource issues. And one point I will add to my written comments is that adding Sarbanes-Oxley work or documentation of internal controls might be feeding part of that problem in that that is not the most exciting part of a college graduate future CPA's plans for what he would like to be doing.

So what follows are some recommendations for your consideration in this area.

First is in the area of the structure and ownership of the firms. As has been pointed out, there's a large gap between the Big 4 and the next tier. And this impacts to a large degree the choice that my members, the CFOs have, of which auditing firms they could use especially in the multinational sector.

Recently efforts that have been underway to consider ways to expand the number of firms are important to us. And these discussions, including considerations of different structures for the firms as well as ways to reduce the litigation risks are very important. They may continue to relieve the pressure and provide additional opportunities for resources available to our member companies.

Separately, though, coming from the small company side the potential for smaller companies to be over audited by larger audit firms exists. And it would be helpful to expand the choice of audit firms for high quality audits at a reasonable cost for smaller companies.

In terms of specific recommendations, we support exploring the alternatives mentioned today including ownership of audit firms and corporate structure and potential public ownership of accounting firms or some type of a blend approach.

We would also advise you to consider the expansion of the types of audit firms to add value at lower fees. And I won't take any time to document the significant cost increases for audits in the past five years, and we're also very cognizant of the fact that the quality of audits has gone up and the capital markets have been stabilized. What our members want basically is good quality audits, properly scoped at a reasonable cost.

So what we're recommending you consider that may address the expansion of competition and reduced concentration by providing certain services in support of an audit by lower fee firms doing specialized work that the opinion signing firm could rely on. For example, audits of internal control under Sarbanes-Oxley, audits of XBRL payment or sites in the past year with the current deliberations of utilization of XBRL and the audit work that may be required for audits of the tagging.

There certainly will be a requirement to rely on valuation firms. And we point out that we're anxiously awaiting some types of standards for this kind of work.

The hourly fee rate charged in the sign-off of an opinion may be relatively high, an all in one rate which is applied to both complex work and less complex work.

From my experience running a middle market company I ran into this for the first time during some asset-based lending audit work. We put pressure on the banks to reduce the cost of auditing inventory and accounts receivable. And one year they switched from using traditional accounting firms to using a specialized firm. That came in with auditors trained specifically to review accounts receivable aging and specifically to review inventory coverage.

I might also add in terms of physical inventories, one of my lessons in 35 years as a CPA both in and out of public practices that when I got into the fashion industry with a very high concentration of SKUs in our inventory, we found we actually introduced more errors by doing a physical inventory than we accomplished by counting the inventory to make sure it was all there. So we went to cycle counting. And there is some specific skills that are very difficult to obtain when you get your college degree and go out and work. So these specialized firms could be a good alternative.

We'd also recommend an expansion of different types of professionals working for firms to potentially reduce the current load and maybe reduce turnover.

An impediment, as has been mentioned

today, to attracting qualified talent to the accounting profession is quality of life issues. So we suggest creating additional lower level tracks of accountants who are trained to perform lower level work, and thereby relieve the burden somewhat across the board.

An example could be the greater use of paraprofessionals such as in the legal area or nurse practitioners in the medical field.

We're also in favor of reviewing and studying tort reform. We in our written testimony supported comments made earlier today that litigation fails to direct recoveries to those who are the most harmed. And this effort, we think, would be good for you to address somehow.

And then lastly, there has to be a change in the auditor's inspection behavior. Treasury Secretary Paulson asked in one of his speeches "Do auditors seek detailed rules in order to focus on technical compliance rather than using professional judgment that could be second-guessed by the PCAOB or private litigants?" And based on our experience our answer to that question would be yes, we do believe the auditors seek detailed ruled because they feel pressured and are more hesitant to apply professional judgment. And this does result in over-auditing.

CO-CHAIR LEVITT: I am now pleased to introduce Panelist James D. Cox, the Brainerd Currie Professor of Law at Duke University.

MR. COX: Well, I hope to do more than document the wisdom of 36 years of teaching never to teach in a late afternoon class.

I have a prepared statement which I want to just amplify a few points, and supplement a few points. But some things that aren't in the statement came about in the testimony today. And the last few years I and my co-author Randall Thomas and then I've become an empiricist. And have done a lot of studies of securities class actions, which obviously accountants play a role in. And I just want to share some of those insights with you.

With respect to the fact that the SEC is an organization that I have a great deal of admiration and, indeed, delight in it being one of the most successful government organizations around, but let me just point out one of our first studies looked at the parallel cases where you had an SEC involvement and private litigation and then also cases where you didn't have an SEC involvement. And we looked at cases at settlement from 1990 to 2001. And we found that systematically during that period of time the SEC prosecuted cases, the variables that came out and they're all statistically significant came out. They prosecuted cases that were of smaller asset size, lower approvable losses and were companies that were in financial distress vis-à-vis the private litigants.

We did do another study, a follow on study of that looking at cases in the 2002/2004 period which were coming about in the market meltdown of 2001 and 2002. And there we saw some hopeful signs of the SEC cases in there were no longer significantly different in asset size, in approval losses and private litigants. But at the same time a variable did come out about companies that were in financial distress.

We're now working on a follow up study of post-2004. I think the markets for private securities litigation has returned back to where it was. We don't have that data yet. We can all speculate about whether it's going to look like at 1990 to 2001 or did we have a new shooter that came on 2002 and thereafter. But did cause some disquiet.

Along the way of doing those studies we found that, as you would expect, SEC as we know imposed very large fines and after Sarbanes-Oxley the Fair Funds provision came in. And at the same time private litigants, private cases systematically and consistently always recover more money, because I think that's what you would expect.

So while there's a lot of things that need to be reformed in securities class actions, I think we're far away from the time of thinking that we can handle this merely through government intervention.

And let me just say something else. If we're going to talk about arbitration and have meaningful sort of agreements reached between shareholders of public companies and management or shareholders of public companies and the representatives of the accounting profession we're going to have to make a lot of changes in corporate governance that aren't there right now before we ever have any faith that these come about by free and open bargaining.

So the suggestion made earlier about resorting to arbitration, to me, is something of a nonstarter in today's political environment of the American corporation.

Now let me just in the few moments I have left here talk about a few other points here. I should genuinely be concerned about liability. In the paper I lay out a lot of concerns about the impact that liability can have, not just by reducing the number from the final 4 down to 3, but also have gigantic concerns for the acquisition and combination behavior of second tier firms or smaller firms coming together. Because there's always liability concerns that come in and can deter acquisitions. And if you're spending 14 plus percent of your revenues on insurance, it's preventing you from allocating those resources to, perhaps, more productive areas.

Of the mechanisms that are available one would be caps. And what I suggest there is that we think about this not in terms of giving something, but having something that's earned. So the suggestion I make is that caps are something that if they are ever going to be extended, that one qualifies for, through satisfying a series of metrics or devices that are designed by the PCAOB, the AICPA, the SEC in combination who could agree that every three or five years if you've satisfied these internally in your organization, then you would be a firm that would be worthy of caps. That's using the carrot rather than the stick kind of liability.

The SEC, you know, has a long time-- I'm about to run out of time here -- a long history and I think a wise history of prohibiting indemnity agreements for auditors of public companies, and for the obvious reasons. It just gives you a financial interest in your client and it robs you of your independence. And I think that's a wise position.

To the extent that the accounting profession is able to do this outside of public reporting companies that's their client, then I think we have to ask whether they're able to do that merely because of the concentration and the lack of competition that exists among the Big 4, and that makes it possible for everybody to do something, which I'm not sure clients would otherwise find it would be an open bargain for them.

And the final point I want to talk about is equitization. Roscoe Pound has a famous statement that said "being a professional is not to be a member of an association of grocery merchants." Being a professional is not an airline pilot. Being a professional means that you have professional obligations, which means you have public obligations, obligations that extend beyond your client. And nobody has those obligations more than the auditors of public companies. And before we start giving public accounting firms private owners who are driven by profit motives control of the profession, we need to stand back and ask ourselves do we really want to have our profession.

Thank you very much.

CO-CHAIR LEVITT: Thank you.

Our next panelist is Tony Sondhi, President of A.C. Sondhi & Associates and member of the CFA Institute

MR. SONDHI: Thank you.

Thank you to the Chairs and to the Committee for allowing me to speak here today.

My comments are based on a little more than 30 years of experience as an educator, as a management consultant and for the last several years as a standard setter as well.

The common theme in everything I've done and will continue to do is the use of financial statements and so I'm actually one of those people who actually reads financial statements. I actually even read the footnotes. And as you'll see on my comments on disclosures in just a few moments.

I think probably one of the most important things to keep in mind today in the light of your charge is really the fact that there is a difference between what auditors and prepares do with respect to financial statements and what we, the ultimate consumer, the users of financial statements are interested in.

It seems to me in my work and in my conversations, discussions with auditors and preparers, I think they're focusing on auditing and accounting issues as compliance. It's a series of checklists rather than as a means of communication. Until we change that, we're going to have these problems that you're dealing with today.

Unfortunately, this extends even more significantly to disclosures. The way disclosures are developed, the way disclosure requirements are developed, the way they're audited I think everyone gives short shrift to them. It's very important that we start looking at this differently.

Training, for example, today works the same way. At the universities, at the companies and in terms of the preparation of the financial statements the emphasis is on compliance, it's on checklists. It is not on what the objective of financial reporting fundamentally is to begin with.

Recent decisions by the SEC and proposals tell us that U.S. companies may soon be able to use IFRS. It's quite likely that the IFRS will eventually replace U.S. GAAP. I submit to you that today IFRS are not well understood in the U.S. either by the auditors or by the preparers.

And by the way, I don't mean to single out those two. I suspect that many of us users don't necessarily understand them as well as we should either.

The question that, of course, comes to my mind is that if IFRS are not well understood, are we sure that we can enforce the IFRS in this pell-mell rush that we have towards adopting and using IFRS?

Accounting education, certain issues that you've raised and that you've been talking about here, I think again the marketplace has become far, far more complex in the last few years. If I look, for example, simply at a small number of transactions or accounting issues: stock options; derivatives for example; consolidation policy, something that we've been struggling with for more than 25 years. If you think about what we've done as standard setters, for example, with respect to variable interest entities and the consolidation requirements there, it's seems to me again we have not been able to do a very good job with that.

The complexity demands that we use financial statements as a communications device.

Again, accounting education, training and the preparation of financial statements remain an attempt at compliance rather than at communication.

What about those who teach us accounting in academia? I think over the last 30 years what has happened in academia is that there is even less emphasis on growing and increasing a decline in the emphasis on research that actually looks at practical issues, compares accounting alternatives. And this is a direct consequence of the way academics are actually rewarded. We're not. I spent more than 14 years at New York University, I've taught at Columbia, at Georgetown and at several schools in several European countries. The emphasis is on something completely different. We do not reward an understanding of practice the way we ought to. So I think that will have to change as well.

There has been a discussion here, and certainly I think all of you are aware of the well publicized problems at companies like Enron, Waste Management, Tyco, et cetera or you can think about the problems we have today with securitizations or with the accounting for structured investment vehicles. All of these demand that we think about the quality of audits, we think about the work that goes into those.

And it's important that we start developing an ability to ask questions rather than focusing on compliance.

I don't believe as a result of that that a limitation on auditor liability or an acceptance of the inability to detect fraud is the appropriate response to these problems. We need a radical rethink of how we deal with these.

Thank you.

CO-CHAIR LEVITT: Thank you very much.

Our final panelist is James S. Turley, the Chairman and Chief Executive Officer of Ernst & Young.

MR. TURLEY: Well, thank you for the chance to be here, the last panelist of the last panel.

A disclaimer first. Although I serve as the Chair of the Center for Audit Quality, which is a professional effort, I'm speaking today as the Chairman and CEO of Ernst & Young, both globally and in the U.S.

This Committee has a very broad mandate. There's been a lot of good, I think, constructive dialogue today. I've been here throughout. Some of the ideas that have been put forward I think are low hanging fruit and pledge my firm's commitment to help this body sort these through. But I think there's other ideas that would require you all to reach real high, and that's a challenge I hope you accept.

Because the Committee's efforts are so critically important, not due to their impact on any accountant or any accounting firm, but because of the importance of quality audits to the markets and to the investors. I think that's probably the best place for me to start.

I recognize very clearly that Ernst & Young's brand in the marketplace is driven by really two things: Who we audit and the quality of the audits that we deliver. And it's that belief that has guided me forever. It's guided me in the decisions that I've made over the past and currently. And I think that is very important and we all keep that in front of us.

And I think there are a couple of big issues that do go to the heart of the professional's ability to deliver high quality audits and the investor's ability over the long term to continue to receive high quality audits. And since the topic of this panel is sustainability, these are the issues that I will focus on today.

Now, to frame these issues I'd like to really summarize in my words what I heard at the March sixth Treasury SEC Round Table on U.S. Capital Markets Competitiveness. I heard three clear messages, and I have to say they're the same things I hear day in and day out from audit committees and from management at our clients all around the world.

The three issues deal with the complexity of financial reporting, with the regulatory mindset here at the SEC and with the U.S. litigation system. And only very closer to home on how this impacts my profession and our sustained ability to deliver high quality audits around the world.

The first issue, complexity, I think is being very well addressed by the SEC CiFIR Committee, the drive to the acceptance of IFRS has been talked about. I won't say much about that today, other than I am supportive of the direction that is being taken.

Now relative to the second issue, the mindset at the SEC. I believe a lot could be achieved by embracing of a professional judgment rule, which I will talk about today.

And on the third issue, the issue of uninsured, unlimited catastrophic risk I'll also say a word or two. It's been a topic over the last few panels.

So first, what is a professional judgment rule? Why is there a need for it? How would it improve quality over the long term?

The way I see a professional judgment rule would provide a framework or a process under which good faith accounting and audit judgment, they are very thoughtfully considered, you know rational, very rational decisions and very well documented, whether those judgments are made by registrants or whether they're made independently by auditors would be afforded respect by the regulators and in legal proceedings.

And as I interact with audit committee leaders around the world, we had a number of them here in Washington last week it's safe to say that the regulatory and legal second-guessing of good faith judgments here in the U.S. not only creates risk, I think it's preventing companies from coming to the U.S. And it certainly challenges the relevance and value of my profession.

Now, such a rule which I think could be built based on the model of a pretty well accepted business judgment rule becomes even more critical as we contemplate moving from a more rules-based environment to a more principles-based world.

Now today we live in a world where there is 1500 some odd U.S. companies that restated their accounts last year. One in 10 companies. And it's led to the point where investors really can't tell which restatements are indications of significant problems and which are not. I think a professional judgment rule would help this substantially because restatements in the U.S. would become more meaningful, and that's a very good thing for investors. But vital to me and vital to our firm's ability to deliver strong audit quality, such a rule would also: Underscore the importance and relevance of private sector auditing; would encourage more people to join the profession, to stay in it; would reinforce the need for well thought out, well documented rational independent judgment as really being central to the audit process.

And to be clear, a big percentage of information in financial statements is driven by estimates and is driven by expectations of the future. That makes auditor's professional judgment essential. And I think also, in turn, respecting that good faith judgment is very critical.

Now as auditors we have to be willing to stand on behalf of investors when we believe that a client is not applying the appropriate accounting standards or when we disagree with their estimates or judgments. And we have to have a personal sense of duty that goes well beyond our firm, well beyond our client. I think Jim Cox, you said this as well. And that's a culture that I'm trying to create and have tried to create at Ernst & Young. And without a doubt, that culture has to be backed up by systems, by processes, by independent oversight, by governance, by accountability, by discipline.

Let me turn for a quick second to the uninsurable catastrophic liability. Because I think that my profession often doesn't talk about this real clearly.

For me this is really a discussion about who is going to be providing audits for the investors in the future: The private sector or a variety of governments around the world? Because, frankly, in my opinion absent some reforms there's an unacceptably high risk that a Katrina-style category 5 hurricane might come along. And I think we could prudently right now build some stronger levees.

I think it is the unlimited nature of the liabilities exposure that's the risk. It's not about immunity from litigation. It's not about year-to-year cost of litigation. It's not about the number of cases. None of those things is important. It's a combination of our client's size and the volatility of their share price that exposes us to mega claims that just can't be insured, as has been talked about before.

You know, I made in my written testimony a number of suggestions around litigation exposure and litigation experience. Some of those are incremental. But more than that I think if this Committee can conclude that something must be done to address the risk of catastrophic liability exposure and initiate a process for doing so, I think it would go a long way.

And with that, let me thank you. I'd be delighted to help in any way and respond to any questions.

CO-CHAIR LEVITT: Thank you very much.

How do you get around the issue of defining catastrophe? What is catastrophe and how do we come to agreement on that?

MR. TURLEY: Well, I think that's a tough issue, Arthur. You know, to me I'm very mindful of Damon's question earlier around transparency and openness. As I think about things, I see Ernst & Young as a private partnership, but I see us having enormous public accountability and responsibility. And

I think we've got to do a great job, a better job as a profession of sharing with you the exposures we have.

Do some people want to just look inside the professions for voyeurism? Possibly. But you all have a very real need for data, we've got to figure out how to get data to you. And we, as a profession, are committed to working together, perhaps in aggregate at this point to get you the information you need.

I think at the end of the day we've got to figure out a way forward. Because a catastrophe that can't be insured today and puts a firm out, there's been a lot of discussion today of moving from four firms to three. My big fear is that that would never happen. That the people in the other three firms would say this is not a profession that I want to stay in, and would actually see an unwind from four to a government audit sector.

CO-CHAIR LEVITT: I've heard you mention today and several other witnesses the expression "second-guessing." And I've been hearing more about that recently. And I'm not sure exactly what that means. Are you suggesting that the number of restatements has become excessive, they're not justifiable? What does "second-guessing" mean?

MR. TURLEY: Well, what I'm suggesting is someone needs to really help figure out why there are one in ten restatements here. And that doesn't seem to be the experience anywhere else in the world.

Foreign private issuers who are registered here also restate one in ten. But I think that we have environments where complex financial instruments and transactions are in place are all around the world. Complex rules or principles. And I think part of it is how or whether good faith judgments should be respected.

Someone said earlier today is there a right to be honorably wrong when you make a judgment and the future plays out in a different fashion. I think these are issues that need to be figured out.

CO-CHAIR LEVITT: I guess I'm not persuaded by what I'm hearing so much of these days that other markets have somewhat easier standards. I'm not sure we're at the point of convergence where we can accept those markets as being determinative in terms of what's best for investors. So that argument by itself is not persuasive to me. Only if you could say that these restatements, for whatever reason, are overstated or incorrect or wrong headed in and of themselves, that's one issue. But the argument in terms of where we are with respect to Asian markets or European markets, I am not persuaded that that --

MR. TURLEY: And, Arthur, I'm not trying to persuade, but we have a fundamentally different regulatory mindset around the world. I hear it everywhere I go.

I'm not saying one's right and one's wrong. But I think we need to acknowledge at this table that they are fundamentally different.

CO-CHAIR LEVITT: And they have been fundamentally different for generations.

MR. TURLEY: They have been, and the markets around the world in my experience are getting more liquid, more robust, embracing better governance and actually are being viewed very positively by companies around the world. That was not the case ten years ago. So I do think we see different environments. I'm not suggesting we ought to just change what we're doing around here. But I think a professional judgment rule built off a business judgment rule is something the Committee ought to consider.

CO-CHAIR NICOLAISEN: If I can follow up on that just a little bit, too, Jim. If the number of restatements is substantial, and it has been, and the market reaction to it other than in those circumstances where it really looks like somebody cooked the books has been rather sanguine, what is the impact on your firm or on your professionals and why is there a need for a rule? What is it that may not be evident and doesn't surface?

MR. TURLEY: What is it more?

CO-CHAIR NICOLAISEN: And litigation costs?

MR. TURLEY: I don't see this as a litigation issue. Let me be very clear. I see this as a relevance issue to the profession. And we've talked in the first panel about the human capital.

I think it is when young men and women are entering a profession, when so much of the rules or principles which our clients are adopting and we're auditing have a great big amount of judgment in them, when we are absolutely having to encourage our partners and staff to exercise professional judgment, I think it goes to the relevance of the profession.

I think one of the participants in the March 6th session, Jeff Immelt, said it pretty clearly. He said if one in ten times accounts get restated, you know what good is my audit. And so I think it just goes to that issue, Don.

CO-CHAIR NICOLAISEN: Let me ask you one more question, and then we'll be fair to the rest of our Subcommittee here.

MR. TURLEY: I don't like you feeling bad about this.

CO-CHAIR NICOLAISEN: On this issue of catastrophic occurrences, are you talking about those things that have already happened or are you talking about something that could happen to the profession?

MR. TURLEY: I think we're absolutely talking about something that could happen, not anything that has happened. And that's one of the difficulties. Because often times when catastrophic risk is discussed; you mentioned, Jim, 14 percent of revenue is being spent on practice protection. From my perspective, you know, that's not an issue. The markets and the firms have absorbed the routine litigation that is present. What I'm talking about is what is uninsurable and, thank God, hasn't happened yet but that could happen.

I was talking to the CEO of a big property and casualty insurer, and I asked him about how their business was. He said it's been great because the wind did not blow this year. And you know, guess what? The wind could blow sometime in the future because there are big market cap cases that each of the firms is confronted with, and there will be more of those in the future.

CO-CHAIR LEVITT: Ken?

MEMBER GOLDMAN: Yes. A couple of comments. I think in my opinion, because I was on another Committee we talked about, but I think the restatements one in ten, I mean really to me it's two things. One, is comes back to your points but also it comes back to materiality and small numbers become material and you have to restate. And it honestly comes back to complexity.

I mean in some of the testimony I saw here, we went from APB 25, which was I think 12 pages, to 123 pages, which is 170 roughly. No? How many pages with all the attachments and appendices. Okay. You have 133.

The reality is there's a lot of complexity if we went on to debate it, but there's a lot of complexity in accounting today. Much more so I think than in the past. And then you have the materiality. So I think those things.

The only other point I want to make is you may pooh-pooh 14 percent, but I don't know if the total size of the audit industry is 40 or 50 billion and take 14 percent, that's a fair amount of change that goes back into the preparer's pockets. Because all it does it gets re-upped in terms of your fees back to us. So it's not a small number.

MR. TURLEY: Yes. And I don't mean to pooh-pooh it, but I am very troubled by too frequently, when the issue of sustainability and catastrophe is discussed, it is perceived as being about reducing that number and about profitability. And the two are totally -- these are costs, onto your question, that are not being spent because they're uninsurable and they haven't happened yet.

MEMBER MURRAY: Mr. Turley, on precisely that point. Your firm fairly recently faced a very large potential liability in the U.K which you successfully defended before the U.K. high court. Two questions. Do you feel that you would have been willing and able to defend that same obviously defensible audit in the U.S. under our jury trial system? And by the way, had you not successfully defended it, what would have been the financial consequences to your firm of loss?

MR. TURLEY: You know, the quick answer is no, we would not have probably taken the decision to defend that here. Because the risk would be -- you know, those are the kind of cases that are bet the firm cases and in my judgment ultimately bet the profession.

In the same fashion, I think it's somewhat irresponsible for us not to thoughtfully the consider the catastrophic risk. It might be responsible for one firm to actually take that risk.

I think the differences in the litigation systems were an important ingredient in that. And I think also the difference in impact would be important. And I don't know if Paul's still here. I don't mean to imply the U.K is not a fundamentally important part of our global organization, because it is. But in each of the organizations, having a threat to the U.S. practice imperils the entire global network, and we saw that in Andersen in spades. That would probably not have been the case -- probably any of the large firms could find a way with great difficulty to rebuild and repair in U.K. or most other countries.

CO-CHAIR LEVITT: Mark?

OBSERVER OLSON: This is a question for the first two panelists regarding the capital issue. Mr. Cox made a point, a very interesting, perhaps valid point that there may be a societal incompatibility with a professional firm of auditors appealing or attracting or investing -- accepting investors from external capital sources. And that may or may not be the case.

But the other question I have is that if you have a -- well, you have a business model where the revenue stream is essentially the numbers of workers times the hourly rate they charge times the numbers of hours and priced at a level that will allow that team and that team's overseers with a certain amount set aside for administrative expenses can perhaps provide for that group or the total numbers of groups very comfortable financial circumstances. If you put side-by-side another entity that has that same, that has to price competitively to meet that standard but this time you're trying to return to it, external corporate investors, a market return on that investment, how do you model that so that that could be perceived as being an attractive investment alternative?

MR. CANGEMI: I don't have all the answers on capitalization, but the thoughts that go through my mind are potentially utilizing technology for efficiencies and building a whole different model for the audit. We're still basically operating under a model that comes in at the end of the year or quarterly, but primarily a great deal of work done at the end of the year. Maybe there's been a lack of investment in technological solutions surrounding continuous auditing and ongoing monitoring. Perhaps a firm comes in with a different work model that takes advantage of different types of approaches that may require more capital.

During my time in IT audit I've often wondered where was the capital going to come from for breaking the model, breaking the audit model down and using technology. It seems now to be coming from private equity sources into specialized firms.

So that's not a complete answer, but it's just a thought.

CO-CHAIR LEVITT: Mr. Cox, did you have a follow to that?

MR. COX: Well, I guess my concern was a little bit different than that. My concern would be that a firm thinking that it could perform better audits in the long term may choose not to make those investments so as they could throw off more cash to its owners. And so that was a concern I had. And perhaps that's whimsical, but that's a concern I have.

The other concern I would have is when you take on public owners, and I think you also confound your possible conflicts of interest going forward when you're doing audits. Think about the kind of joint ownership issues. And I think that's unsettling to the investor confidence, which I think is the bedrock of that investor confidence is the independent standard of the accounting profession.

CO-CHAIR LEVITT: Damon?

MEMBER SILVERS: Thank you. I will ask two of the many questions that this panel has provoked in my mind.

First, several people on this panel and several prior panels have described the set of relationships that we as a Committee ought to be looking at in terms of the interaction between the auditor and the preparer, the company, the issuer of the financial statements. I think, Michael, you referred to that dynamic in your oral testimony.

I would ask each of you to respond to the question of to what extent is that description completely inadequate in the sense that it misses the tension that exists between both the parties and the users.

Now the second question I would pose is a much more technical one to Jim. You spent most of your testimony talking about your interest in the standard of professional conduct that would provide a safe harbor and you analogized it to the business judgment rule. And I thought you very interestingly distinguished between the issues associated with restatements and the issues associated with catastrophic loss.

I think there's a fair amount of interest in the investor community potentially in sort of reducing uncertainty in this area. On the other hand, and don't take this personally, but we kind of like you to be awake at night thinking about the possibility of catastrophic loss. We think it's good for everybody that you do that.

My question is when you described that idea of a standard, you make reference to the business judgment rule. And now you're going to provoke a lawyer kind of question here, which is that that business judgment rule is intentionally nonexpert, right? The corporate business judgment rule is a sort of ordinary person standard. But it seems inevitable that if you were going to do this for auditors, it would be an expert standard and then you'd be right into the realm of defining what necessary expertise means. That that simple solution that's involved in the business judgment rule in the corporate side isn't really available.

So I wanted you to react to what kind of standard are you really looking to have the profession be answerable to in your view?

So those are my two questions, one broad and one technical.

MR. TURLEY: I'll start with the technical one first. Because I'm not a lawyer, so I don't know the details, Damon, of your answer -- your question. What I'd like to do is get people thinking about. Because what I hear everyday from our committee members and from management and from our people is all around professional judgment. What I hear the world wanting more of from our auditors is professional judgment. When I see the move in the world, whether IFRS driven, whether it's driven by other things, whether it's the complexity of the financial instruments, whether it's complexity of the rules or principles, it all screams for judgment.

And so I don't have an answer to it, but I think it's got to be on the table for discussion.

To your point on you wanting me awake at night, I thank you. But I think you want me awake because you believe that the risk of failure of the firm and/or profession of a catastrophic risk will drive enhanced quality in the audit. In my opinion there are a whole array of things that I stay up at night thinking about that actually do drive the performance and behavior of our partners and staff on the ground. And we've talked about them in some of the other panels. Whether that's Mark's team and his inspection processes, our own inspection processes, methodology and processes that we invest hundreds of millions in to Jim's comments, or a whole array of other things that professionally our partners and staff worry about. They don't worry about what is, in my opinion, a public policy issue about if a firm fails, you know do we end up having someone else do audits. They worry about how to deliver great quality so that we don't criticize them or our regulators don't criticize them.

There's a lot of different drivers of quality. I think the potential failure of a firm is not one of them.

MR. SONDHI: I'll just make a quick comment on the first question. In a sense, that's what I was driving at and my first comment was simply intended to say that I think we need to ask what is it that users are looking for because they are the ultimate consumer. They're the ones who effectively want these audits. So the model ought to start there. We ought to ask that.

But let me just make one other comment with respect to some of the points that Mr. Turley has made, particularly with this issue with respect to demand for judgment. I have been a member of the standard setting bodies, the AcSEC Committee of the AICPA for about 22 years. And a little more than four years on the EITF. And I must say that I observed a demand for rules rather than a push towards judgment. I do not see that in my meetings, in my discussions with the fellow members of my Committee. I do not see that demand for judgment. I see instead a push for rules.

And I think that until we figure that out, we are going to have these issues.

Thanks.

MEMBER TURNER: A couple of years ago the FEI submitted a comment letter to the SEC regarding the transparency and governance of the firms and indicated that the FEI supported the firms having to measure up to the same rules that apply to the public companies in those areas. Is the FEI still of that viewpoint?

MR. CANGEMI: Yes. We, I guess just under the principles of good governance believe that more transparency from the accounting firms would lead to just a better overall environment of governance.

MEMBER TURNER: Tony, on communication you talked about better communication out to the investors. Are there any particular thoughts in terms of the type of communications you would like to see from the auditing firms that you aren't currently getting?

MR. SONDHI: I forget exactly --maybe it was Mr. Goldman who was talking about complexity earlier. You mentioned a particular accounting standard that had a few pages some years back and a comparable standard today is --

CO-CHAIR NICOLAISEN: Bob left.

MR. SONDHI: At that point I was thinking about the issue of communication. A fair amount of the work that I do these days is analyzing contracts for my clients to help them understand financial reporting risk. The contracts these days are in the neighborhood of 750 pages long. Ten years ago when I was doing this work they were not. I think there's a lot of complexity.

I'd like to see the business and the

underlying operations explained to me in the financial statements. So I'd like that communication through what the auditors and what the preparers, the management is telling me. I don't see that.

I see, for example, everyone tells me that they have these critical accounting policies. But then I come back and read them five years later, the company's told me we've made enormous strides and we're now doing something completely different. Critical accounting policies, however, are the same. And we're going to use the same words we had six years ago to explain them as well.

That sense of the change and explaining that change in a fairly straightforward transparent manner does not exist. That's the kind of communication I'd like.

I'd like disclosures, for example, that don't read the same if I read the five large companies that are in that same industry. I'd like to see somebody tell me that there's a difference and not exactly what five other people said. And what they, the company themselves, said ten years or five years ago. I'd like people to pay attention to what it is that they're conveying in those financial statements. Because I do read them and I sometimes am annoyed at myself because I think I'm reading the same annual report again. But it's not, because I'm looking at others.

MEMBER TURNER: Okay.

Jim, back to the question of second-guessing. The profession does have a rule out there that says here is what an auditor is supposed to be doing with respect to making estimates and judgments. And it seems to be a pretty good rule. But quite often in the cases that I've seen the auditor has never followed that guidance in the rule. It wasn't an issue of the rule, but the performance with the rule and certainly in many of the large bad, bad audits we heard the GAO mention about that was certainly the case. And then at Glass Lewis, time and time again including as recently as in the last year, we would pick up filings and look through what was just publicly available information and then find errors in the financial statements. And it was not unusual that we would share our report then with the regulators and including some of the national office. And it was not unusual then we'd see restatements come out of those.

And while I was at the SEC the restatement on Rite Aid was detected by a person at the SEC just reading the filing at her desk, and that's well documented even in the footnotes of that particular company.

How do we differentiate between those type of issues and restatements or those arising from even the leasing where the leasing -- it was very well known all the firms knew what the rules were and didn't hold their feet to the fire and then quite frankly, asked Don to put out a letter to help them out with it; how do we differentiate from those where there are just flat out errors and should have been caught by the audit from those where perhaps they're honest to goodness second-guessing and something should come into play in that? How would you craft that? I don't know how you would craft it. And clearly in these errors there's some real problems.

MR. TURLEY: And I agree with you clearly in the errors there are real problem. And we've in the past had, and still today have execution challenges in the risk in the profession. No one is trying to back away from that.

I think many have said that the execution of the profession has been enhanced over the last five years and we're always trying to enhance it even further.

I think trying to differentiate between

what are -- I'll call them errors and, as you said, pure errors, failure to follow the appropriate guidance and what are actually, you know, well thought out analyses of complex circumstance -- you know, I was talking to a head of a professional practice today. And often times you can get into a dialogue after the fact on whether something was persuasive evidence, whether collectability of something was reasonably assured. You know, there's a lot of judgments that are made by our clients that need to be made. Things as simple as the collectability of receivables or forecasts of what the marketplace could be in the future, and whether they're going to get paid.

I think we really need to try to figure out how to separate one from the other. Because something is causing the world outside the United States and the world inside the United States to talk about the respective judgment. This is not something that the profession invents. This is something that we hear about from the marketplace.

So I don't have the answer today to tell you how we're going to separate them, but I think we need to work together to separate them. And errors should be just fixed, restated, wrong, assuming the materiality thresholds. You talked about materiality earlier and it ought to be very clear that way.

CO-CHAIR LEVITT: Alan.

MEMBER BELLER: Yes. I guess for any of you, but perhaps for Jim mostly.

Another way of looking at that issue would be that a reasonable judgment that turns out to be a wrong judgment shouldn't be corrected at all as opposed to being updated. But it seems to me that one of the problems we have is that both preparers and auditors have not done a very good job in conveying the judgmental aspects of so much accounting. What a former Chairman used to refer to as the thaumaturgic number has taken on importance. And, you know, the number isn't a buck 88, it's somewhere between a buck 83 and a buck 93.

Is that part of the exercise that we should be thinking about that you also ought to be trying to do a better job of?

MR. TURLEY: Yes. Very definitely there is an expectation of the level of precision that is not based on reality. And one of the things that the profession, you know which is working very well together on public policy matters, one of the things we did about a year ago right now was put together on a global basis a white paper, a vision paper if you will, for things that need to be talked about.

One of the issues was what financial reporting would look like in the future, whether there would be ranges of outcomes that were put out to investors to better inform, better educate whether there would be enhanced nonfinancial information disclosed to investors so that all the footnotes don't look alike anymore; a whole array of issues that are not the accounting profession's to deal with and to solve but need the registrant community, you know it might need -- we need the analyst community, we need the underwriting community, we need the investors for sure and we need the regulators. And so it has to be thought through. So I do think that's a piece of what's driving this.

MR. COX: I think Jim actually made a good point about the concern about restatements really being more of an internal concern and not an external concern. Let me just say a couple of things here.

There's now a fairly robust literature of studying the market impact of restatements. And the answer to that is there's restatements and there's restatements. And it deals a lot with the profile of the firm, the management, the governance structure, et cetera. You know, confirming a lot of your priorities. The firms that have good corporate governance structures as perceived by the marketplace or by some set of metrics, et cetera like that tend to have less of an impact if no impact at all to restatement versus firms that have had a checkered history, for example, have more market impact.

The other data point I'll just add here is that restatements have been singularly unsuccessful in withstanding motions to dismiss in the plaintiff's side. That the mere fact you have a restatement is not something that courts have been given deference, and that was before the Tellabs case, and I can imagine what's it going to be like after Tellabs.

So I think that the concerns are legitimate about restatements because it says something about what we are expecting and holding accountants to and it does something about the morale, et cetera. But in terms of sustainability, it has an impact on the personnel issues, but I don't think it has an impact upon the liability issues and crushing cataclysmic liability.

MR. TURLEY: Alan, if I could add one thing to this financial reporting model. What was sort of surprising to me was the level of criticism, for lack of a better word, that I and my counterparts received when putting the discussion of the financial reporting model on the table. Because in that discussion was also what do investors want and when and how do they want to get it. Because, you know, we're living in the model that was built for a time that was less global, less complex, and less technology enabled than we live in today.

And I remember being on a conference, this one was in the U.K. I think, where someone said, “Do you really think if you get to more periodic reporting, wouldn't that be a good thing?” And I said, “Look, I'm not sitting here trying to tell you the answers. But what I will tell you is that if you would have asked me ten years ago if I could get every email that I received anywhere in the world, including Tokyo and Seoul, I'd have said, no, it's never going to happen. Well, guess what? It happened.”

And so I just think that this is an issue that we ought to look at.

CO-CHAIR NICOLAISEN: Let me follow up a little bit on the role of the auditor as to whether there are other things the auditor could convey in a report. I think Lynn started to go down that path, and I think I heard you, Tony, say that you'd like to see a report that wasn't the same, just the basic pass/fail report that's issued today.

And if you had companies, Jim -- let me start with you -- in the same industry, one was at the extreme end of they got it all right, they had the best people, they did everything you'd expect them to do and beyond and another that there was a lot of manual intervention, you worked with them, it was a real test to be able to issue that passing grade on that set of financial statements. Is that information that you think you'd like to communicate to investors? And maybe you could talk a little bit about would there be potential impacts from litigation if you were as candid as perhaps some people like you to be with that?

MR. TURLEY: I think all these issues do intersect. I think that, you know, in the way you articulated your question I think the way I heard the second company would be, you know, very close to a 404 mention that would be commented on. And so --

CO-CHAIR NICOLAISEN: It passed. They passed.

MR. TURLEY: Okay.

CO-CHAIR NICOLAISEN: They just got by.

MR. TURLEY: But I do think that thinking through an issue like should we change the accountant's report and doing so in a piecemeal fashion without thinking about all the rest of the issues that have been put on the table today, would be something I would be concerned about personally. Because I do think there's is an interrelationship between all of these issues and I think we need to recognize that.

MEMBER TURNER: A follow up question triggered by what Alan said about the disclosure about this information.

I remember when Arthur and I were at the Commission. We actually did a rule proposal about requiring more disclosure and range the disclosure around --

MEMBER BELLER: So did we.

MEMBER TURNER: Yes. Maybe that says how good a job we did.

Tony, if you could get disclosure about the key estimates and changes in those estimates because the one thing we know is anytime you do an estimate it's wrong, it's just a matter of how wrong is it going to be. I don't think there's any good number to an estimate. Well, there probably is. But if we could get you disclosure around those estimates and the key assumptions that go into them so that people could see when numbers change, assumptions change with them and ranges and that type of stuff, is that something that you think would help out here?

And, Jim, do you think that would help out, especially if we could get some auditing around, assurance around that?

And then, Michael, what's your reaction to that from the preparer's side?

MR. SONDHI: Lynn, I would find it useful. I think it would be very helpful to get it.

I would like to point out two things. One, in 1992 and then I believe last year or earlier this year the CFA Institute has actually published a booklet talking about the future of financial reporting from the perspective of the user. And we had made many of these arguments therein. And I think that would be a good document to take a look at.

But the second point I want to make is the ranges and that type of information is extremely useful because that's how we as analysts think. Because we're trying to understand what's going on and what might happen. What I unfortunately find, however, is that the few cases where the standard setters and the profession has made that effort, that has been a failure. The example I'm thinking about, and I'm sure you're aware of it as well, is with respect to securitizations.

For example, in response to the accounting standard on securitizations we said in the standards please tell us about these three critical assumptions and what would happen in the event your assumption regarding the discount rate was wrong or your assumption about the rate of delinquencies was wrong and so on. There are three assumptions that make up that number that goes into that.

And the firms that responded and provided that information started with the comment that this is useless because three things don't work this way.

Well, the spirit of that disclosure requirement was not the way the companies responded to it. If they had given us the information the way they managed their securitizations, I think we'd all be wiser.

So the point is that it appears we've tried it a couple of times, and we've tried of course also with derivatives and some other more complex standards, but it needs to be applied far more carefully.

If they did that, if the preparers and the auditors did that, then I would certainly find it far more useful.

And if you'll allow me just to make one other comment about restatements. I can't resist this because a few years ago, more than 20 years ago, I studied over a six year period all of the announcements of write-offs of long lived assets. And I wanted to mention, Professor Cox, that the one thing I found there was the best predictor of a write off was a company that had taken a write off the year before. I could give you have higher than 78 percent probability that there would be a write off the next year.

And with respect to your comment about the market reaction to restatements, et cetera, the first write up you have the market may have looked at it positively. But it almost never looked at the second one positively. And it was vicious if you announced a third one.

And remember, your ability to announce or predict the third one was pretty good because now you had two observations.

CO-CHAIR LEVITT: Zoe-Vonna?

MR. CANGEMI: You want me to answer? From the preparer's standpoint, just briefly, it's a very logical suggestion the range of audit reporting. And I might note, it has become more widespread in internal auditing. So it's utilized inside companies.

But to Jim's point, it is somewhat complex. I don't think the market or the users of the financial statements beyond the real sophisticated ones would understand it. There would be education requirements. And from the standpoint of preparers, I'd have three cautions.

One is that we're attempting to add precision again to an estimate. So even though, you know, delineated it's still an estimate.

And secondly, the issue of competitive information might be cropping up in the more detailed disclosures.

And third, just another increase in cost for us.

CO-CHAIR LEVITT: Zoe-Vonna?

OBSERVER PALMROSE: Thank you.

I'd like to change directions a little bit and explore with Professor Cox an area that he discussed in his paper and that you also -- your comments touched on this afternoon. And that's the mechanisms that you talk about for managing catastrophic risk and you discuss three-indemnification liability caps and then outside capital or outside ownership.

It seems to me in reading your comments in the paper I would characterize them as unenthusiastic or skeptical about all three of those. And if that's the correct characterization -- if that's an incorrect characterization, could you talk about which ones you're more enthusiastic about?

And if it's a correct characterization, do you have anything else to put on the table here in terms of suggestions?

MR. COX: (Off-microphone) -- what do we mean by catastrophic. Because I think that's part of the metrics that go into this whole process. And I know there's a delicate amount of information there. And I'm curious about caps for a number of reasons, and some of them were developed in the paper and let me just emphasize those a little bit here.

There are really two things going on in the liability regime that's going on. One is catastrophic liability because you have huge clients and melt down, et cetera. And what's going to happen in those cases is that no one would ever take those to trial. And so once you accept that, then the other thing steps in and that is as long as you have proportionate liability of a large cap firm, it's always going to have catastrophic proportions to you and you'll always settle. And you'll never be able to have your "day in court" defending on those rights.

And so to some extent caps would be a way of trying to even the playing field a little bit. You know once the complaint has withstood the motion to dismiss, there really isn't when you have a large cap issue or much choice for the defendants other than to settle the case. And the only question is trying to get to some level where the amount is there. And I don't think that that dynamic ever introduces any catastrophic loss. I mean, so I think the intrigue to me for caps is probably just a somewhat academic endeavor to wonder if you would change the dynamics and the litigation process, so maybe we would have a better sense about who the right winners are and who the right losers are than what happens right now through the sort of mercurial process of just withstanding a motion for summary judgment and then people start sitting around a table and talking big numbers for a settlement.

So the other two I think -- I don't think you want to have indemnity arrangements for the independence issues. And I don't really think we want to have public ownership of professional firms.

CO-CHAIR LEVITT: Yes?

MEMBER MURRAY: A quick follow up, Professor Cox, on the settlement dynamics that you suggest may avoid the needs for caps, that is once the motion for dismissal has been denied the rule of reason will lead the parties to an affordable solution. Another way to describe that is that we have transferred out of anyone else's hands the survival of the defendant accounting firm into the hands of a particular set of plaintiff's attorneys. Is it unfair of me to think that that is not sound public policy and that the predictions that plaintiff's attorneys will behave reasonable and will not get enthused about hanging the scalp of a Big 4 accounting firm on their belt, am I unreasonable in being concerned about that?

MR. COX: I think you're not unreasonable. But I think I can salve your unease with the following: That the kind of firm that's going to produce this sort of possibility of catastrophic loss is going to attract an institutional plaintiff as the lead plaintiff. And my history, I'm studying lead plaintiffs and then talking to the lawyers who represent them, are that these are not the slash and burn type plaintiffs. And I've had a number of these conversations. This is not very systematic, but I'll just pass it on for what it's worth. That all of them think that what they're trying to do by being a lead plaintiff is to moderate the ill-effects of the past conduct, but also to try and leave the firm in good shape.

Remember that a lot of these firms may be held because they're in an index. So you're going to own them before the suit, you're going to own during the suit, and you're going to own them after the suit, you know, to the extent that we had the big meltdowns in 2001 and 2002.

So I think that by giving the plaintiff lawyers a real client, we did two things. One, we gave them a client. We made the litigation more responsible. And two, you change the profession of the plaintiff law firms so that now you have four or five boutique firms that don't bill themselves on the slash and burn. And I think that that's responsible plaintiffs. And for that reason, the final mark I would want to add to my paper would be I don't think anybody really believes that the private litigation system is driven out of compensation. Because they're never going to be able to recover the amount of money that's in a burn down. And so that's why the element of judgment and responsible lead plaintiffs, that's where I think a good focus is.

So, hopefully, that's salved some of your unease.

CO-CHAIR LEVITT: Last question. Barry?

MEMBER MELANCON: Professor Cox, just real quick, you were opposed to indemnification clauses primarily on the independence matter I think that is what you said. Do you have a difference of opinion if those indemnification clauses are divided between actual damages and punitive damages and therefore would be limiting from a punitive damage standpoint?

MR. COX: Well, my response is clouded by the fact that I really don't think much of punitive damages. I don't have to. I teach mainly in the securities law, federal securities law where you can't have punitive damages in federal litigation. So that would be state-based litigation, nonclass action litigation, under CAFA by the way. And--

MEMBER MELANCON: That's real.

MR. COX: Pardon me?

MEMBER MELANCON: But that's real.

MR. COX: Yes, exactly. And it is real. And I think some moderation of that through private contracting, and we see that already happening in the medical area a little bit I know about.

CO-CHAIR LEVITT: Thank you very much, panelists and Committee. It's been a very productive day.

Meeting is adjourned.

(Whereupon, at 5:29 p.m. the meeting was adjourned.