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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THURSDAY,
MARCH 13, 2008

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

MEMBERS PRESENT:

ARTHUR LEVITT, JR., Co-Chair
DONALD T. NICOLAISEN, Co-Chair
AMY WOODS BRINKLEY
MARY K. BUSH
RODGE COHEN
TIMOTHY FLYNN
ROBERT GLAUBER
KENNETH A. GOLDMAN
GAYLEN R. HANSEN
JEFF MAHONEY
BARRY C. MELANCON

PRESENT, CONTINUED:

ANNE M. MULCAHY
RICHARD H. MURRAY
MARK W. OLSON
GARY J. PREVITS
DAMON A. SILVERS
SARAH E. SMITH (via telephone)
WILLIAM D. TRAVIS
LYNN E. TURNER
PAUL VOLCKER

OBSERVERS PRESENT:

ROBERT H. HERZ
PHIL LASKAWY (OBSERVER-DELEGATE FOR SIR DAVID TWEEDIE)
MARK OLSON
ZOE-VONNA PALMROSE
MICHEL PRADA

TREASURY OFFICIAL PRESENT:

ROBERT K. STEEL

TABLE OF CONTENTS

Introductory Remarks.........................4

Donald T. Nicolaisen, Committee Co-Chair

Presentation of Preliminary Recommendations

Subcommittee on Human Capital............8

Subcommittee on Firm Structure and Finances.................124

Subcommittee on Concentration and Competition.......................244

Closing Remarks...........................335

Arthur Levitt, Jr., Committee Co-Chair

Adjourn

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

10:10 a.m.

CO-CHAIR NICOLAISEN: Well, good morning. I'm Don Nicolaisen and I'm representing both Arthur and myself, at least for part of this morning. Arthur's on his way; should be here around 11:00 or 11:30, so we look forward to his arrival.

We'd remind everyone to take your Blackberrys and put them away from the microphones. It will help because this is being web cast and it will help other people to hear more clearly.

I want to express my appreciation to all the members of the Subcommittees, particularly the chairmen of the Sub-committees who worked very diligently to pull together recommendations, observations and will be available today to discuss those.

I also would like to welcome a couple of new faces today. Phil Laskawy is sitting in for Sir David Tweedie and we're delighted to have him here.

Michel Prada is here representing France, I guess, as well as IOSCO, the European Union, and maybe many other things, but we're absolutely delighted to have you here, and I sincerely appreciate your willingness to help us out on what we think is a very important project. So we look forward to your inquisitive nature as we discuss these issues of the day.

And then, Chairman Volcker. Chairman Volcker is someone who I have respected my entire adult life. I first met him in Milwaukee many, many years ago. He probably would not remember that; I was just a young guy. And he was there as Chairman of the Federal Reserve, and I was pretty much in awe as I listened to him speak and carry that big cigar and the big stick of Washington.

What we're going to do today is we're going to hear from the Subcommittees. As you know, we have three Subcommittees.

We're going to divide the day up about evenly with lunch in the middle, so what we will do is start out with the Human Capital Subcommittee. We'll spend a little less than two hours with that Subcommittee.

We'll then move for about an hour into the Firm Structure and Finances Subcommittee. And then we'll have lunch promptly at 1:15. Wherever we are, we're going to break at 1:15 for lunch.

We'll come back at 2:00 and then we'll complete the rest of the day with the other half of the Finance Subcommittee and then moving onto our Subcommittee on Concentration and Competition. So, it's going to be a full day. I would ask that as we go through the recommendations of the Subcommittees that you remember that these are all preliminary thoughts at this point. At the end of the day, after we have considerably more dialogue, what we'll be looking for is not recommendations of Subcommittees, but recommendations of the full Committee.

So, everyone is on one Subcommittee, which means that there are two that you're not on. The two that you're not on, you're probably going to have the most questions in those areas. And I think that's very important that you express your views, your opinions, your questions, and in particular that you also ask about what you thought might be a recommendation and is at this point not something that appears.

So, we want to have a wholesome full dialogue. We'd appreciate it if everyone would respect the time element, so the questions that have 20 sub-points to them are not preferred. What we'd prefer is a quick direct question and we can always come back to ask another one, but the focus should be on respecting each other's time. There will be deep emotion around certain issues, as you can imagine; I'd be disappointed if there wasn't.

That's okay, but you should

probably recognize that in a three-minute discussion you're not going to change the minds of the rest of the Subcommittee, but you may have that opportunity with passage of time. So once you've made the point, let's move on and we'll deal with as many things as we possibly can.

Any other things from Kristen, Bob Steel; anything that we're missing here? Great.

Well, let's get started then. We're going to start with Gary Previts, who has been the Chairman of the Human Capital Subcommittee. I think all of you have seen a note that Arthur and I circulated last night where we commented on some of the things that we think are important of what we've heard at this point, but it's now free reign to have that very open dialogue.

So, Gary, let me turn the mike over to you.

MR. PREVITS: Thank you, Don. Good

morning, everyone. I'm pleased to have the opportunity to introduce the members of our Subcommittee who have done most of the work and will be doing most of the presentation.

We have four recommendations dealing with the nature of the material that students in the education pipeline, higher education pipeline, should be given the opportunity to consider. And the recommendations about the curriculum will be given by Amy Woods Brinkley. The recommendation dealing with the nature of faculty to meet the demands for the future will be presented by Barry Melancon. And then Anne Mulcahy and possibly assisted by Sarah Smith, who is not with us, but I think may be joining us telephonically in the interim will address the issues of dealing with both the representation and retention of minorities in the human capital structure of the auditing profession. The final recommendation will be a data development recommendation and I'll present the thoughts about that.

In our tab, you'll see the one-page summary and I guess I'm a bit of a driven person about one page and I missed it by about four lines, so I guess we got some reducing to do to get the recommendations down to one page. But of course the real devil is in the details, and you'll see that the explanatory language for each of the black letter recommendations is included separately and subsequently. And of course we'll be continuing to work on forging the ideas and perfecting and winnowing out the ideas in the weeks and months ahead.

I want to thank the Subcommittee members for their patience and for the healthy attitude of exchange that we've enjoyed. It hasn't been easy for any of us because this is the first opportunity we've had to work together. We're coming from very different backgrounds, as is the case, I'm sure, in all Subcommittees.

There were some items, as we go through and think about the testimony we listened to starting in October. Professor Carcello, Professor Solomon, Barry Salzberg's testimony on the West Coast in Los Angeles last month, Professor Phil Reckers, the data that we received from Professor Leslie. In our Subcommittee hearings which were held here in January as we talked to accrediting agency representatives and demographers, as we attempted to get data to support our positions, we found that data wasn't always available; no surprise, and that informed opinions are what all informed opinions are. They contain a little bit of the subjectiveness that we find and the richness that we expect.

There were some things that were suggested to us, particularly, I think, Professor Carcello's suggestion about a professional school of auditing, which we put aside. We felt that while there were educational concerns with the pipeline, you know, be it at an adequate capacity to serve the needs of the public company auditing profession, that we did not see it as being broken. It does need attention, it does need resources and we can't anticipate that the future will be a rich and happy one without the ability to shore it up and reinforce it, and suggest and recommend improvements. So we did not follow up on that particular suggestion. That would have been what I would call a breakaway suggestion. It would be something that would be called for if we are ever to face a crisis.

In the history of accounting education in this country, there are many schools of accountancy; some very good ones at Southern Cal, at Florida. There's a freestanding school where the dean reports directly to the provost at Old Miss University in Mississippi. So those type of arrangements are around and they've evolved in the last 25 years, and they're worth watching and they're worth considering going forward. But at the moment, we did not see an educational structure change as something that we would recommend.

Another area that Amy reminded me that we've had discussion about, based upon a study that was done in 2005 at the University of Southern California for PricewaterhouseCoopers on retention, that the retention issue in firms remains a critical one, but we don't have particular recommendations at this point in time because we think it's being managed reasonably well. That doesn't mean that there couldn't be improvement. A snapshot in this morning's *USA Today* talks about the fact that work/life balance and flexibility are preferred over compensation as the thing that gets people to accept current, you know, changes in positions. So, the economy, we think, is tuned in on that issue. And given the need to keep our recommendations as focused toward achievement as we could, we went to the four that we are going to explain to you this morning.

And with that, I'll ask Amy to begin. She's got the first recommendation.

MS. WOODS BRINKLEY: Thank you, Gary.

As a backdrop to our discussions and recommendations on market-driven curricula and content, we see two very important benefits. The primary benefit is for the assurance of a qualified pipeline of new entrants who are prepared for the rapidly changing demands of the complex markets.

Secondarily, but very importantly, we believe that by enriching the curricula and content the field of study will become more attractive to more of the best and the brightest who are out there. The intellectual stimulation, the judgment and the rigor inherent in auditing amidst today's global markets should appeal to a wide range of the highest caliber students in our educational institutions, and high quality of curricula and high quality of students will make a big difference in terms of high quality of audits going forward.

So our first recommendation is to implement market-driven dynamic curricula and content for the accounting student that continuously evolves to meet the needs of the auditing profession and helps prepare new entrants to the profession to perform those high-quality audits.

To fulfill the first recommendation, we actually came up with three sub-recommendations. The first is to regularly update the accounting certification exams to reflect changes in the accountancy profession, its relevant standards and the skills and knowledge required to serve increasingly complex and increasingly global capital markets.

Now accounting and auditing professionals commonly complete the requirements of professional exams, including the uniform CPA exam. And we do believe that the professional exam content could serve as a very important catalyst for curricular changes to reflect the dynamism and the complexity of auditing public companies in the rapidly-evolving markets.

The AICPA already regularly analyzes and does update its exam content. We recommend that those changes remain a focus to ensure important ongoing market developments such as the increasing use of IFRS, expanded fair value measurement and reporting, new PCAOB auditing and professional standards, very important risk-based business judgment and technological innovations in financial reporting. And we think that those do need, again, the focus group that they're reflected in a timely manner.

Now specifically the Subcommittee

recommends that the market development outlined above in those categories be made as soon as practical and no later than 2011. Additionally, it's important that we continue to communicate broadly to college and university faculty and administrators so that corresponding curricular changes can begin and continue to occur in the educational institutions also in a very timely manner.

Now the second recommendation to fulfill this first broader one on curricula and content is that real world changes in the business environment are reflected more rapidly in the teaching materials. Students use a wide variety of teaching materials, textbooks, etcetera and they're a very important part of the educational process. These commercial materials are often, though, conservatively managed and follow rather than lead the developments that are happening in the markets.

So the Subcommittee believes that

accounting educational materials can actually help accelerate the necessary curricula changes and that commercial content providers should reflect this in the published materials. So specifically we recommend that organizations such as the AICPA and the American Accounting Association meet with commercial content providers and encourage them to update their materials to reflect the new developments; again like IFRS, new PCAOB standards, risk-based judgment, fair value matters and other technological developments in financial reporting and auditing such as XBRL.

Also, to insure access to such materials is a very fundamental element of education. The Subcommittee highly recommends that authoritative bodies and agencies should be encouraged to provide low-cost and accessible access to digitized searchable authoritative literature and to make these available both to students and to faculty. We believe that this access to primary materials would enhance student learning and also improve technical research.

And finally, the third sub-recommendation in the area of curricula and content is requiring that schools build into accounting curricula current market developments. Now, accrediting agencies review institutions of higher education and their programs and establish that overall resources and strategies are conformed to the mission of the institutions. For example, the Association to Advance Collegiate Schools of Business and the Association of Collegiate Business Schools and Programs accredit undergraduate and graduate business administration and accounting programs. The accreditation standards relate to, among other things, the curricula, the program and faculty resources and development.

The Subcommittee believes that accreditation standards can play a very critical role if they do in fact reflect the requirements of today's auditing world and what's out there, the dynamism and complexity that we talked about. So the Subcommittee recommends that the accrediting agencies develop standards specifically emphasizing these things that would continuously update the programs in the institutions.

So, that concludes the recommendation around content and curricula.

CO-CHAIR NICOLAISEN: Very good. Let's open it up to questions. Suggestions?

MR. HANSEN: Don, if I might; and Barry, correct me if I'm wrong, but in looking at the exam and your discussion of that, you talk about the AICPA, but NASBA was very involved in that process as well and there's a board of examiners. So I would suggest that in the detail that you cover that maybe a little bit --

MS. WOODS BRINKLEY: Fully?

MR. HANSEN: -- more broadly in

terms of who has that responsibility.

MR. PREVITS: Are you talking with regard to the examination process in particular?

MR. HANSEN: Yes, it's called a practice analysis. I don't recall exactly how many years they go through.

MR. PREVITS: Right. Right, I think they're going through a process right now, right?

MR. HANSEN: They're going through it right now.

MR. PREVITS: Yes.

CO-CHAIR NICOLAISEN: Bill and then Bob.

MR. TRAVIS: Amy, two questions. Was there discussion around whether the technical accounting schools are doing enough training in the areas of liberal arts and how to think about business? And the second question is, given the dialogue we've had about the importance of fraud, was there a discussion about the importance of pressing further on ethics training and fraud detection training?

MS. WOODS BRINKLEY: Thank you, William. I think the answer is yes on both, most definitely. With respect to the first issue, we had very robust discussion about whether we need to do things to further encourage a wider range of students from different disciplines to come into the funnel of the accounting profession, if you will. That the UK model was actually very interesting to us. We had a couple of people who were very well-versed in that model where people in fact, they say, read in many different subjects and then go on to undertake accounting study. And we think that's very important because that's an element of how you develop judgment, learning to think and reason around things. There are programs out there that encourage it. That would have been way up our list as well, if we'd had a longer list, to look for ways to further the diversity of disciplines that are likely to come into the school.

Now, when I mentioned the secondary benefit we thought of enriching the curricula, our hope would actually be that more students who would think they want to be in another field and are likely to be taking a lot of course work, would still be drawn to this field because of the intellectually stimulating nature of it. And we think there still is somewhat of an impression that it's a little bit of a green eyeshade profession, which for those of us who work in business or accounting, know it is hardly that now, and actually one of the most interesting areas out there.

So does that answer on the first piece?

MR. TRAVIS: Yes, I'd just like to put in a personal plug, that I think my experience at McGladrey, the best auditors that we had were individuals who were the most well-rounded both in terms of their thought process and in terms of their thinking and the frauds we did uncover weren't because of an understanding of the technical accounting standards, it was because they really understood business and business strategy in particular and identified something didn't smell right and had the courage of their convictions to follow through to find out why, what was the substance of the red flag that they did notice.

MS. WOODS BRINKLEY: I think it's an excellent point. Anne, you want to mention something?

MS. MULCAHY: Yes, I was just going to add that we're going to deal with it from a little bit different perspective, and that's, you know, how do you increase the recruitment of minorities into the profession? And the part of it is, is literally widening the recruiting pool, and I think it has two benefits. Obviously, you increase the pool, but you start going after some of the non-traditional disciplines and there is a little bit of a burden that says then you have to insure that you've got then the ability for the firms to kind of catch up on some of the technical training. But we think that it is going to be key to getting a more diverse recruitment pool in terms of looking at non-traditional places, whether it's disciplines or community colleges or a whole set of opportunities that probably aren't fully exploited yet.

MS. WOODS BRINKLEY: Your second question around fraud and related ethics training, I actually would concede that we just should add that, because we had discussion about it. It should probably be in our list and was perhaps an omission. We should certainly do that and I think it ties in so much too to risk-based judgment, that not everything is black and white. Sometimes it becomes an ethical issue, sometimes it's a different type of issue. But I think that's a good add.

CO-CHAIR NICOLAISEN: Bob Herz.

MR. HERZ: Yes, thank you. I think these are very good recommendations and we'll certainly do the ones that touch upon us; we'll do whatever we can.

In that regard, on making the technical materials available in a searchable on-line fashion, in January we launched what we call our codification. That is an on-line database with all sorts of nifty bells and whistles, and that is available to anybody, free of charge now. So, it's in kind of a pilot phase for a year to make sure we get the bugs out of it, but I would hope that after we sprinkle the holy water on it, because it will actually become US GAAP and the relevant SEC stuff will be in there as well, that you know, we would continue to make it available, at least all the content and all the search facilities to people, you know, as a public good.

As far as accounting fellowships, we do have a program. We have two of them right now and we also have a thing we launched last year called the Financial Accounting Standards Research Initiative with a bunch of researchers to try and beef that area up. And I think the PCAOB is doing something similar now as well.

One thought I had, and I think there's been something going on; Gary would probably know a lot better than I do, but I know we've had some contact with folks at the AAA about actually getting more proactive with them in actual curriculum development. Because that seems to be one of the stumbling blocks people would cite is that, you know, is I don't have the time to redo curricula. If other people could help with that, or if it could be made institutionally available, that would help. And one source of that might be, you know, the AAA actually getting into that.

MR. PREVITS: Yes, I can comment that on both the IFRS and the value measurement area there's a couple of committees that have been newly formed. And of course, in that space, in that educational space, there's a lot of on-line activity going on now with the firms, specifically one of your board members, Tom Linsmeier. The former academic is actively working with this subcommittee. And on-line things, I think Tim's firm has got an IFRS educational effort for the faculty going on this week. And our annual meeting in Anaheim, we have almost 30 sessions out of the 375 that will be occurring at that meeting. A lot that deal with international standards and Paul Packter is coming in, to give an example, to talk about the small and medium-sized firm implications.

So, the kettle is starting to boil. That's the great thing about this system; it takes a while to get it to boil, but when it starts boiling, a lot starts happening.

CO-CHAIR NICOLAISEN: That's great. And, Bob, thank you very much on behalf of a lot of people in the accounting profession. I think that's a tremendous development, the things you're doing, and in particular, the codification. That's an extremely valuable contribution.

I think today market value is the thing that people are most concerned with.

Tim Flynn?

MR. FLYNN: Thanks, Don. I think the recommendation is a great one and I was wondering from the standpoint of the deliberations in the Subcommittee about how we're going to engage the profession more in curriculum development and execution. And I know that all the firms are doing a number of things to engage faculty and what's happening in real time, but if we could explore some way to bring more structure to that and pull it across the firms. And if we can take our learning and update faculty on current events and what's happening, then that gets into the classroom a lot faster, so case studies are the thing. So I would welcome the chance to have our people to help talk about that, bring the profession together as a way to broaden that out and do more in that area, and I know the profession would love to do that and I think we could both benefit from that process.

MR. MELANCON: Tim, there's actually a recommendation in the next recommendation that tries to get exactly at that, with cross-sabbaticals that really tries to imbed that sort of frame of reference in the standpoint.

MR. FLYNN: And I think that's great. And I think the cross-sabbaticals are -- it's hard to get much mass and volume. And I'm thinking, well you could really bring the main educators and the profession together, almost like a continuing education-type process that we would help run as the profession. Bring that information out to what's happening in current events, and bring that into the classroom, and even co-instructing some of that with the professors as you move forward. There's got to be ways that we can do more of that and I think could accelerate the current -- to your point on bringing real market developments, we could really accelerate that if we built time in the class for that type of interchange in case work.

CO-CHAIR NICOLAISEN: Great.

MS. WOODS BRINKLEY: I think it's a great idea.

CO-CHAIR NICOLAISEN: Well, it sounds like there's a lot of support here for this recommendation with some additional bells and whistles. And I think the way to move that forward is some of you will leave here and you'll have other thoughts about, you know, what a particular recommendation might say or do, how to make it more forceful, how to make it more effective. But I think if you continue to communicate with the members of the Subcommittee, or at least the chair of the Subcommittee where that recommendation had its genesis, that would be very helpful and we'll continue to work on these. We'll continue to go back. Subcommittees will continue to work on their particular recommendations and eventually we'll all own all of them and that's a goal.

It sounds like we're starting to move into recommendation 2. So, Amy, I'll say thank you very much for that, recommendation 2. Gary is going to be addressed by Barry Melancon. Thank you.

MR. MELANCON: Thank you, Don. Really, the second recommendation sort of takes off where Amy's point stopped, which was the issue of the dynamic curriculum, etcetera, and really focuses on the people that deliver that dynamic curriculum, and that is the people in front of the classroom.

There was a lot of testimony that the Committee heard at both of the public hearings, and also in our Subcommittee about the concern about the so-called Ph.D. shortage. And I think we looked at it from not just the Ph.D. perspective, but in a broader footprint of professionally-qualified, as well as academically-qualified individuals who would be in front of the classroom. And obviously having quality people to educate classrooms full of people, regardless of their background or how they initially get into the pipeline, is a very important concept. And the demographics of society are affecting all parts of the adult work force and it's probably more acute in the academic community, given certain economic issues and things that are out there, and the way the academic community is structured.

So, what we did is we actually had a recommendation to insure sufficient robust supply of qualified financial accounting, audit and tax faculty to meet the demand of the future. The data actually supports the fact that the problem is more acute in accounting, auditing and tax than it is in systems and management accounting by a statistically significant difference, those two areas; not to say that there is no problem in those areas, but it's even more acute in the accounting and auditing area.

And so we thought that that was a very important aspect to address this particular issue, and we have three as we did in Amy's area. We have three parts of the recommendation that focuses on that.

And one theme in the first part is really a better public and private partnership to create the Ph.D. slots that are necessary to fill the classroom at the Ph.D. side of things. The auditing side of the profession is in the midst of a fairly major fund raising activity to increase, over the next seven years, the number of Ph.D.'s created in accounting by 120. I think Amy and Anne and Sarah coming from the corporate side, as we started to focus on this, were very clear in pointing out that the corporate side of the world has some obligation, or at least a greater awareness, might produce some better results in that particular area as well. And we thought that there were some opportunities from that and we made some recommendations that really we need to look at it holistically, not just from the auditing part of it, but from the broader business community. And with that also is the funding from predominantly state, but the university side because we know that funding for those slots have been impacted as well.

One of the parts of the first recommendation is to encourage college administrators, people who make the decisions about who's in the classroom, to look more broadly about exactly what the backgrounds of those individuals are. The accreditation standards allow a fair amount of flexibility for a good mix of academically-qualified, as well as professionally-qualified individuals to be in the front of the classroom and still meet the accreditation standards. The fact of the matter is, is that not every university embraces that, or not every person who makes those decisions in the university setting really embraces that. And the first part of the recommendation is focusing on the issue of having a greater awareness and a willingness at the administrator level to not just be focused in the traditional mindset of how to fill the classroom slots, but to look at that flexibility and bringing the professionally-qualified and professionally-qualified who are experienced in the delivering of the services in the marketplace, which could be from the corporate side or the auditing side as well.

And then the second part of it really goes to the question that Tim asked, which is how do we make sure that the people who are in front of the classroom really are bringing the real world experiences into the classroom. And that what we focused on, and we actually set a marker, that for every accredited accounting program we would like to see one per year, what we called cross-sabbaticals, or where the university would support the accounting faculty member to be placed inside of a firm for a year. And our theory on that, and Tim's points about sort of the mass aspects of this is very relevant, but also the fact that if you've got one a year in an accredited program, the sort of cross-pollenization of that when they came back into the academic institution would spread pretty rapidly from that standpoint.

Now there are certain hurdles to that occurring. There are economic hurdles to that occurring, because the typical arrangement for a sabbatical in a university might entail some reduction in pay of the Ph.D. or might even be zero pay, depending on the arrangements in the particular university. And so, obviously those who are accepting, whether it's a corporation or a whether it's a firm accepting that person into a sabbatical arrangement, should in fact be part of the solution for fixing the economic reality of that particular element. And so we thought if we got into every accredited program one a year, over a fairly short period of time we would start to have a fairly significant effect across the faculty as a whole in those particular environments.

And then to add to that, we thought that the incentives to do that needed to also come from the accrediting process. One of the things that the accrediting process looks at is how much publishing an individual does, particularly publishing in what's called top referee journals, and that's certainly part of the Ph.D. expectation and research is a very critical part of that. And we felt that what we should encourage should happen is that the accrediting process should look at a person spending a year in a sabbatical in either a corporate or an auditing environment to be viewed, as far as a score card is concerned, on equivalent terms with a major research project that would be published in a top refereed journal. And that takes a little bit of a mindset shift there, but we thought that that type of practical experience being brought in the classroom can really drive the education process and really produce young people who graduate in accounting and enter the profession with a head start really focused on the quality from that standpoint.

The final recommendation is that in order to do these things it obviously takes resources and so one element is awareness, which was sort of tied in the first part, but the second is that to the extent that tax incentives over time could be created to really focus on the creation of this, particularly the Ph.D. track and the access to information that they need to do the research in order to become Ph.D.s, both of those wouldn't be big price tags, but that outside incentive would help create an awareness and a willingness for institutions, whether it be corporate institutions or CPA firms, to really be focused on trying to fund those faculty slots or universities to find the resources to fund those Ph.D. slots.

So, it's sort of a three-part process in which we -- more Ph.D.s from a public and private segment standpoint having an environment or a mind share at the university level that it's okay for the professionally-qualified to be a significant part of the faculty mix. and then looking at this cross-pollenization through cross-sabbaticals where possible, but at least sabbaticals going from the university into the firm with a target of one per year.

The reason why we said, by the way, cross-sabbaticals is because of the shortage of Ph.D.s. When a Ph.D. leaves to go into, let's say, a firm for a year, if the firm could supplant that person with a person teaching in that environment for a year, again you get cross-relationships that get built. But more importantly, because of the shortage of Ph.D.s, the university probably needs that teaching slot filled for that year's time frame as well.

And then finally, the tax incentives and tools to help create the Ph.D.s, the money and the incentives to access data to do the research that's necessary to grant the Ph.D.

CO-CHAIR NICOLAISEN: Barry, thank you very much. We'll open it for questions, but just one technical question on tax incentives. I'm not sure I quite understand what that would be, what kind of tax --

MR. MELANCON: We didn't spend a lot of time coming up with specific recommendations in that area, Don. We just felt that maybe some enhanced deductions, or whatever, for support on that, again focusing on the efficiency of the capital markets would be a small price tag, but would really encourage let's say corporations from making that investment in the overall quality of people who are going to impact financial reporting.

CO-CHAIR NICOLAISEN: I'd ask that you flesh that out a little bit more so that it could in fact be actionable.

MS. WOODS BRINKLEY: Yes, we got briefly into that, whether it could, you know, be seen under some of the philanthropic things that are done and that it's supporting in educational institutions. So will flesh that out.

CO-CHAIR NICOLAISEN: Excellent.

Questions? Chairman Volcker.

CHAIRMAN VOLCKER: I haven't got a question, but I've got an observation.

I am probably the least

technically-qualified in this group, but I've got opinions. And I think I want to be broadly in support with all this emphasis that's put on education and the students and the professional faculty, but let me just put it in a little broader background, if I might, from my observations about accounting in recent years. I've got more involved in my old age than I ever was.

But it does seem to me that accounting as a profession through the decades actually has been downgraded in terms of respect. From those old days when Scotland’s Chartered Accountants were the king of the world, accountants are underpaid, under-respected, undereducated, whatever you want to say. It reminds me of the status of public administration too. It's not considered -- you know our most fashionable schools don't teach accounting. Business schools don't teach accounting. And we've got huge accounting problems, or they teach it as, you know, two sessions in a semester of financial engineering.

And it kind of shows. I happened to be at a meeting yesterday where a civil engineering professor, a distinguished civil engineering professor was bemoaning the fact that our best universities no longer teach simple engineering, except they still have a few old faculty members from 40 years ago. And you consider all the effort that these same universities put into financial engineering, and what's the result? Deteriorating infrastructure, bridges that break down; they look ugly and a beautifully theoretical financial system that produces ugly and fragile markets. Too much theory and too little practice. And I think that is what has happened a good deal in the accounting profession.

And when you look at it, what's become so apparent to me, which all you people know, it is an enormously challenging intellectual problem to know how to get proper accounting in modern economy, and particularly amid all the financial engineers. And I don't think this enormously difficult intellectual challenge has been fully recognized and it involves just not theoretical thinking, but it involves some blend of theoretical thinking with practical, which is why I think the emphasis that you put on getting some businessmen in there and accounting people into these faculties is terribly important. So I feel very strongly about what you're saying. We can't leave this, I think, to a few Ph.D. theorists.

It's known to some people around this room, and I have a certain amount of problems with fair value accounting, seems to me this has been seized upon as a summum bonum of accounting, of general field theory that was going to solve all problems. I think it's evident it doesn't solve all problems; in fact, it may create a few in practical applications, some along the lines of some of our financial engineers to keep running into 100-year possibilities every two years. There is a real question of how to blend the real insights of mark to market accounting in markets where there's not a market, or in fact the accounting practice may lead to exaggerated movements in markets, which is the opposite of what we want to happen. And I don't say there's any easy solution to this. All I'm saying is this is kind of a creative core for me that these efforts that you make at education, I think, are terribly important and the more that you can blend the theory with the practice, the better off we're going to be.

It reminds me a little bit of, you know, my great former profession anyway of economics, but it makes these beautiful theoretical models which impress accountants, I think, because they got Nobel Prizes and stuff; we ought to get Nobel Prizes in accounting, but applied to the real world don't work very well. And that is, I think, the big challenge that you're struggling with here in this whole effort. So I wish you well, but I guess I want you to lift your sights even above what's reflected here. You're not just -- why aren't the most prestigious universities introducing this, maybe even into the undergraduate curriculum as an option, but certainly into the graduate curriculums, and do it in a way that combines the theory with the practice.

And with that little sermon, I will sit up, but wish you well.

CO-CHAIR NICOLAISEN: We appreciate that. Thank you. Gaylen?

MR. HANSEN: Yes, if I might follow up and just to tag onto what Chairman Volcker just said, too much theory and too little practice.

There was some testimony about adjunct professors, and I'm really talking about 2(b) here, effectiveness of cross-sabbaticals, and that suggests bi-directional. This talks about taking faculty and putting them into practice units. Some of my best professors that I had when I went to school were practitioners that came in and taught the practical aspect of the real world. And I understand the balance part of that and I wonder to what extent the Committee was focused on what is that appropriate balance and does it need to be there? Should we have practitioners that are more engaged and more involved in teaching our students?

MR. MELANCON: Well, the standards actually allow, in most universities, up to 50 percent of what's called professionally-qualified to be part of the faculty and still become an accredited university. There are some incidences where it's slightly less than that, but based on the standards. And there's not a lot of specifics, but from an anecdotal standpoint, there's not a lot of universities that are at the 50 percent. At some point that standard may have to be addressed. We don't think that's the hindrance at this particular point. And actually AAA and the AICPA do have a program that we're piloting on getting people later in their careers; it's a bridge program, it's called, "Into the Classrooms." Obviously you do have to teach people how to teach a little bit, because just because you're a good practitioner doesn't mean you know how to teach. And so, there are programs that are being developed from that standpoint as well.

So we did talk a little bit about the standard, but I don't think that there was a lot of evidence that showed that getting the professionally qualified in the classroom was being hindered by the standard that exists at this point. Instead, it's more of the mind share of the people who make the decision as to the mix of the people as to how willing they are to have people in that classroom.

And that's why we sort of focused the recommendation on that point. That is not to say that if we were sitting here three years, or five years from now and we were successful in that, that we might say that the standard might need to change. But at this point we didn't think it needed to be.

MR. PREVITS: I guess as a card-carrying academic, and sitting around the table I'm aware of at least one other of those; Zoe-Vonna's at the SEC currently, I think the best schools -- remember that there are, according to the supplemental filing from the Center for Audit Quality, we've identified approximately 200 schools that supply the public company auditing profession. I think it's 241 in the original listing.

That list is very helpful in identifying, you know, the broad coverage of schools that are involved. And as I travel around the country in my concurrent role this year as president of the American Accounting

Association, we have a very rich community of practice-based academics. The difficulty is, that if you're scheduled in a class at 1:00 in the afternoon or 10:00 in the morning, you've got to allow for that, particularly on your residential campuses. Having been a department chair and an associate dean, I wrestle with those practical issues. Hearing Chairman Volcker's comments, hearing your comments, Gaylen, I want to assure you that most campuses that are in the heart of this 200 group have a very good mixture of it.

If you decide you're going to offer a master's degree or a Ph.D., that's where the challenge comes in, because the expectation is that you have a higher degree of academically-qualified faculty. Let me suggest to you that while dean is a four-letter word in our business, deans have a lot of challenges and resources among the most of them. I think Phil Reckers commented about that. And without belaboring the point, the resource question for us in the future is going to be the critical one. You notice we didn't use the word crisis around the Ph.D. shortfall, because we think there are actions in place that began to address that. But it's the closest thing we've got to a crisis, is that pipeline, because it not only affects primarily the hiring in the public auditing firms, but secondarily all the placements that occur when people leave public auditing and go to work in industry. So we're going to pay very close attention to it.

And yet, thinking about my own campus, we have two retired partners who have been teaching now for seven years on our campus full time. They're an integral part of our faculty; they have faculty rank. They're not tenured, but they have faculty rank. We haven't used the tenure word before either, so I think the sensitivity is very high, it's increasing and it will be a focus for many years to come because of the general demographics.

CO-CHAIR NICOLAISEN: Damon.

MR. SILVERS: Thank you. I have two observations and a question.

First, I'd like to thank Chairman Volcker for his comments and I hope that the broad thinking reflected in them can be operationalized in further drafts.

Apropos of that, I want to make an observation about the tax recommendation. When you seek funding from an additional tax subsidy, obviously today if taxable entities give money to educational institutions, they get a tax break. If you seek a further tax break, I think inevitably kinds of questions like, well, shouldn't we be giving tax breaks to accountant training versus say civil engineer training in a time when we have very serious human capital issues more broadly in terms of whether we're getting the talent we need generally as a society.

I might suggest that the

Subcommittee consider thinking rather than about a tax break out of general revenue, thinking about the various funding mechanisms that already exist surrounding the auditing and accounting professions and their regulation as perhaps a channel for moving additional monies. We're already funding the PCAOB, the FASB and so forth out of the institutions that would most directly benefit from this. And that doesn't raise directly the sorts of questions of if accountants, why not civil engineers, why not people working on alternative energy, and so on and so forth.

The question I have for you all is, Gary, in your introductory remarks, you commented that the Committee did not really take up the notion of a more sort of apprenticeship-based model for the initial training of auditors, if I heard that correctly, in the view that that would represent a more fundamental structural shift in auditor training, which the Committee didn't feel was necessary; it wasn't broken. You have, I think, pushed somewhat further down the road in that direction in terms of the teaching model, right, the idea of moving people in and out from teaching to practice and back again. And I wondered if you all might comment on what the thinking is in believing that that is the appropriate sort of career model for the instructors, but in not pushing down that road in terms of what the training experience is like. And I don't mean to criticize your decision; I want to understand it better.

MR. PREVITS: Let me try to reach that with particulars. If we deal with an undergraduate model, for example, there are 120 hours, four years at 30 hours roughly a semester basis. Less than 30 hours of that program is dedicated to accounting. So you have a limitation at that point in time as to, you know, what you're going to be covering. You're asking about, you know, whether or not we ought to discard that model, change that model, increase an apprenticeship approach to it.

Right now internships are becoming very, very, very common in terms of students between their sophomore and junior year, either in industry or in practice. So there's an evolution going on. A lot of what we call upstream hiring is occurring. If you wait to recruit someone who's in the fall of their senior year, you're going to find probably that there's very few desirable people left. So it's occurring. If you wanted a revolutionary outside-the-bounds approach, you would look at engineering schools, medical schools and law schools, speaking as an educator, and attempt to create that model on a more vital pace.

The cost of that, the profession backed away from in the 1970s. The professional school model and the separate accounting accreditation were proposed and they weren't successful and, frankly, the cost of education is very high. And so that model just did not have the economic, you know, substance to justify the resources, given the quality and quantity that's currently coming out. We have no evidence today to suggest that the kind of investment that would have to be involved in changing the entire format when you could lose half of your faculty in five to seven years is a model worth risking the undertaking of.

So, the high-quality ideas, we need to be able to apply them, getting that mix together in an academic community that has just survived its first generation of Ph.D.-dom, remember the accounting Ph.D. requirement was a factor of 1969. This is the first generation this discipline has had an academic base. Prior to that, for the last 75 years before that, it was mostly MBA, CPA types. Those may be the ones that you related to in your classroom. So we're evolving into a higher education discipline, at the same time trying to understand, you know, are we like medicine, are we like law? Where do we get the application, the experience in so that it isn't just all high ideas that can't be, you know, tested in the laboratory of practice.

MR. MELANCON: If I could just add, I think it's a misnomer to say that we don't have that model. In fact, the basic business model of a CPA firm is hiring graduates and they work through an experiential advancement process. The person who graduates and takes the CPA exam and becomes a licensed CPA isn't the person signing off on the audit report of a major company. There's a misnomer that CPAs do audits. Firms do audits as part of their system of quality control in the total human resource component that they bring to the platform.

To shift to a pure apprenticeship model like, let's say the UK model, which has attributes of education and attributes of apprenticeship in it, you have to look at the actual volume and the differences in the U.S. economy versus these other countries. And the countries that have apprenticeship models around the world; and there are some very much like the U.S. model and there are some not like the U.S. model, there's basically two around the world. And they tend to be in smaller geographic footprints where the volume can be managed in a different way through that.

And also I think you have to look at the generational aspect of the students that are coming out and the attributes of the generation that's coming out, particularly the generational attributes in the U.S., which may or may not be the same as are in the other places in the world. And, you know, the degree of patience, whether they're majoring in engineering, as Chairman Volcker said, or they're majoring in accounting, the degree of patience to a 19, or 20, or 21-year-old is totally different than the degree of patience that a 19, 20 or 21-year-old had 20 years ago. And there is all kind of studies that we have done, and work in that particular area, and you have to be sensitive to a shift in that area, not only the resources that Gary pointed out, not in the Ph.D. issue, but the demographic realities of a young generation and what they expect from a work perspective, and the volume differences in the U.S. market to others.

Because remember, the education system in the U.S. doesn't just support a niche that just audits public companies. I mean, there's 44,000 CPA firms in this country, so there's a much broader footprint there than a shift to that would probably be able to be effectively managed.

CO-CHAIR NICOLAISEN: Lynn?

MR. TURNER: I'd just like to echo what Paul said, for the most part, all the way down to where he started talking about fair value.

But, I think Paul's point about observing accountants who are undereducated and under-skilled, I think is right on, as well as the need to take it to a higher level. And I think that's what is missing. These recommendations are all good. I mean, they essentially say let's have a current curricula that's up to date. Let's have professors who know what they're doing and up to date including what's going on in practice and let's have textbooks that they can use that are up to date as well. I mean, that's not a bad recommendation. Tough to argue with those recommendations, you know? Maybe it's a sadder commentary on the fact that these recommendations even need to be made, but I think that directly supports what Paul was turning around and saying.

But I'm not sure that that's still going to get us the best and brightest in the profession. Having taught in the universities with these curricula, other professors and these textbooks, one of the problems that faced us that I don't think that we've taken on head on here is if you look at the material that needs to be taught to take that undereducated person up to the level they need to be, you just don't have enough time in the classroom today, within the current curricula and the current 150 hours, which is why, you know, three decades ago, former SEC Chairman Cohen recommended taking it up to the professional school level. And there are costs associated with that, as Gary mentioned, and God knows, we have enough trouble now funding our state schools where many of these students come from as it is. But I think unless you take that bold step and say we got to get there sooner or later and figure out a way to do it, you aren't going to get the people educated at the intermediate accounting textbooks before you add on this information that needs to be brought up.

Right now, there are a few schools that have gone to three semesters, because you can't teach it in two semesters. And yet the vast majority of the universities, including some of the very good ones, are still teaching it in two semesters. They do it by skipping chapters in the book, including things like on-risk management derivatives. That's a chapter, because it's kind of a black hole, everyone skips and, voilá, we know what happens with that then in practice. They kind of follow that model too.

So, I really think that until you take on and grapple with that issue, you can have the best textbooks, you can have the best curricula, you can have the best professors, but until you give them enough time to teach the material in the classroom and fund that, you aren't going to solve it and you're still going to lose the best and brightest to the other two professional schools, which is law and medicine. Kids realize that; they observe it. It's part of what was mentioned again in the Cohen materials that's in all of our books, about the need to really strengthen and identify this as a real professional. And which I think runs back to some of Paul's comments, so I'd echo those.

I'd also echo what Bill said, something about fraud detection. It was good that the report mentioned need to educate more on fair value. That's certainly important in coming with what's gone with the markets and the type of things we're doing, risk management and that area. So fraud, I'd throw in there along with fair value.

And on the funding, at the end of the day the funding for these universities really comes from two sources; it either comes from their endowments, which means we've got to get the firms and the corporations. Often corporations look at this as the firms to fund, and then they lose their people to the corporations during natural attrition. And so there's the real apprenticeship thing, I think, for the most part. And I do think apprenticeship can be built into a professional school-type program and would be very beneficial. I know some of the firms have pushed that and I agree with them on that.

But ultimately, the funding is going to have to be either the states or private enterprise is going to step up. And right now the states aren't stepping up and I think part of the recommendation is the states have got to step up. The taxpayers have got to be willing to pay for this, or we're going to have the problem that you do a very good job of laying out with the shortage of Ph.D.s.

CO-CHAIR NICOLAISEN: Well, we are a federal commission, so we have an opportunity to ask. Zoe-Vonna and then Mark, Rodge. We'll keep going right down. Let's just go right down the row then.

MS. PALMROSE: Thank you, Don.

Maybe I've been inspired by Chairman Volcker's eloquent remarks as to what not only is, but really what should be or could be here.

So, it seems to me in listening to the conversation that there's a wonderful opportunity for the Advisory Committee to not just this conversation, but also when you look at the recommendations of other Subcommittees that do touch on issues related to education and training, there's a wonderful opportunity here for the Committee to develop what I think of as a framework for lifetime learning here within the profession.

And, some of the elements or threads of it here are part of the discussion. For example, it's enormously important to bring real world business examples, experience, into the classroom. But frankly, teaching undergraduates who have no reference points because they have no business experience is a very difficult challenge. And on the other hand, once you've been out in the profession and have that experience, there's no time for reflective thinking. And so what you have here in a recommendation with a cross-sabbatical is not just a substitution of educators into the practice, but you also have an opportunity for practice to substitute into education, not just teaching classes to meet the classroom demand, but really give an opportunity for reflective thinking that you just never have time for. So, I wonder if there isn't development there that could occur.

Also to expand on the apprenticeship opportunities that have been discussed, one of my concerns is that so far those internships, while they're again enormously important, students have changed by the -- you know, if you take them and teach auditing pre-internship, post-internship, they're in a totally different place. But there's also a major recruiting element to internships in the current environment. And so it kind of undermines the educational experience and I wonder if there isn't more that could be developed there in the internship way, again thinking about this lifetime learning process.

And the third is, rather than rule out this professional school as a model or as a possibility, it doesn't have to be the norm for the market place. It could perhaps be a creative alternative and I can't believe that there aren't deans and even university presidents out there that couldn't see that as a marketing opportunity for their institutions. And we could have multiple ways of delivering education, but it could give some strength to innovation perhaps if the Advisory Committee came up with a recommendation in that regard. So just some thoughts. Thank you.

CO-CHAIR NICOLAISEN: All right. Rodge, Mark, Ken and then Michel, and then, Mary, you're going to be last. And then we're going to cut it off after you, Mary.

MR. COHEN: I'll try and be brief. I'd like to pick up with Gaylen's comment, which I thought was very important. And this is an observation/question as to whether there is room for more use of adjunct professors, guest lecturers. We're talking about a resource problem. That's the constant theme we've heard. And can they be used, and not just those who are in the twilight of their careers, but in their 30s and their 40s.

And I was very much struck by the last point about the mixture of reflective thinking and practical business experience. If you are a practicing accountant or a practicing lawyer, and you have to go into that classroom, that does give you the opportunity to do the reflective thinking which you really need to do.

CO-CHAIR NICOLAISEN: All right. Mark?

MR. OLSON: At the PCAOB, in our

standing advisory group, the SAG, many of the people around this table and in this room are either involved or familiar with it, we had an applied look at this question, and I too have an observation and a question, and essentially it's this. The subject was IFRS, but that immediately then raises the question of what is the appropriate training to get ready for IFRS? And what both interested me and concerned me was the symbiotic response of the accounting profession, the educators and the public companies, the issuers. And what was clear from that discussion was that there was a three-part, three different interpretations or observations about what the appropriate level of preparedness was coming out of the schools.

So we can look at funding, for example, or we can look at the admiration, or lack of it, of the profession. But I'm wondering if just internally among the groups represented here if there is a consensus as to what that relationship should be. And I'm wondering if the committee had a chance to think through or address that issue. There should be, the educators should have a different perspective than the firms and the firms should have a different perspective than the issuers. But is that a barrier? Is that a barrier to having a consistent approach to education?

CO-CHAIR NICOLAISEN: Let's leave that as a rhetorical question that you all can consider in your subcommittees over lunch.

Ken?

MR. GOLDMAN: Thanks. Just really a couple of comments relative to the overall perspective of the Committee.

I tend to like to let the free market work, so I wonder if any thoughts were brought about as to bring more people in whether you have a salary or compensation issue; and whether generally salaries by the firms for incoming folks should be raised to attract more people because, you know, you follow the legal profession and when they had problems finding people, they just raised all the salaries in New York and all of a sudden a lot of people came about. So that's point one.

The other point, I wonder on the outside is I know a lot of the major firms have retirement age limits, around 60 I believe, but I wonder if there's any consideration being done relative to moving that higher so that a lot of the real experience we have, instead of, “forcing them out,” we would encourage them to stay and frankly continue to be engagement partners, to mentor other folks and so forth, instead of 60 and you're out.

So, I just wonder, again, to attract more people into the industry by (1)raising salaries for the, you know, the associates, if you will; not so much for the partners, and then (2) raising the age limit.

And then maybe partly with the idea that a couple of people said, I mean, the more you create a positive reputation, if you will, for this profession, the more you'll find more people wanting to go into the profession.

Last point, I just can't help it, I really prefer not to use tax incentives. Again, I come back to the free market every time I see tax incentives, and I think Damon said the same thing, then what do you try to encourage or discourage and I don't think we should be doing that actually.

CO-CHAIR NICOLAISEN: Great. Any quick reaction to the retirement issue.

MS. WOODS BRINKLEY: Or the compensation question?

CO-CHAIR NICOLAISEN: Either one.

MS. WOODS BRINKLEY: Okay. I was going to hit the compensation. We did touch on that, but our conclusion was that the pipeline issue, it's actually a much more critical issue with the Ph.D.s and the qualified faculty, that actually what we were getting from the schools and the firms recruiting from the schools is that the pipeline was all right. However, we absolutely agree that the quality of the candidates, and we want to be very bold in thinking about how do you get more of the best and the brightest there. We do agree that there is an image question. And we came at it more from enriching the curricula and helping people understand this is one of the most exciting spaces out there you can think of, if you really understand what is done here because we did not get a lot of information that suggested that compensation was the key issue. Is that clear?

MR. MELANCON: Yes. And I was just going to go on, on the retirement point, it is true that some firms have mandatory retirement for partners, some don't; some are reconsidering it. And when I say some don't, it's particularly at different-sized firms and

I sort of think some are reconsidering it.

And I guess to your free market point, I think the free market is handling that particular point.

CO-CHAIR NICOLAISEN: All right. Michel?

MR. PRADA: Thank you, Chairman. First of all, let me express my thanks for inviting me in this Committee. I'm very honored to be an observer here.

Obviously I cannot comment on the U.S. organization and education system. I just wanted to share a couple of thoughts following what Chairman Volcker said. I wouldn't be pessimistic about the situation of the accounting and auditing professions. On the contrary, I have the feeling that, at least in Europe and certainly in Continental Europe, we've never had so fierce discussions on accounting. And I guess 20 years ago people would consider accountants as very special kinds of people, doing an understandable kind of job. They would certainly not criticize what they did. They would rely on them for the formal part of the presentation of the accounts. And therefore, it was a group of technicians which was well respected and people didn't understand what they do. And they will take their conclusions as granted.

Now, fair value came. And of course all the businessmen throughout Europe, and hopefully in the world, realized that accounting was not merely this kind of obscure technique, but that it was really dealing with philosophy, if not religion. And then of course the war started and we got involved in discussions which are never ending. So that to my view, accounting has gained in visibility as an intellectual discipline which is at the very basis of the functioning of the system.

But having said that, it's clear that the situation is not well stabilized for the time being and we are in a process of adaptation of the profession and of the role of accountants and auditors. And what strikes me is that in fact what we see today is more of an interaction between traditional disciplines which are getting merged in a very complex way so that it's more difficult to understand what's going on and to be clear and clever on these issues. We see accounting being mixed with finance, with law and therefore the profession is not as clear cut as it was. And the others, by the way, are not either.

And one issue which for me is interesting is to see how the IASB has developed in the past years approaches where they say that their standards should not take stock of the legal aspects of things, which, when you come to think of it, is interesting. If the law is not the criteria, how do you decide what is wrong or right? By the way, I don't say that trying to analyze the reality beyond law is not relevant. That's not my point. The point is that clearly there is either a combination or an opposition between law and accounting which creates some of the difficulties.

Now to come back to the educational aspects of this, I guess the way we teach accounting, auditing and other disciplines has probably to be reconsidered along these views. Obviously, it is very difficult to teach auditing to a young person of 22, 23, 24 years old. And I have always thought that auditing really was something you learned in the field. And by the way, that's what you said, that firms are usually organized to send the new ones in the field, do the basic work and then try to understand what happens and become more skilled.

So, I think we have to make a clear difference between accounting and auditing, and I'm not sure that we have an easy solution to the training of auditors when they are very young. I wonder whether we should not consider that accounting can be taught and that auditing is more of the kind of practical integrated approach of very complex systems, which probably raises difficult questions for those who have the duty to teach the young ones. Thank you.

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

MS. BUSH: Yes. No, just four quick comments.

The first one is on the apprenticeships versus education. I'm not sure I understood the comment correctly about small markets versus large markets, but if I did understand it, it was to say that more apprenticeships might not be as applicable in the United States because we are a large market. But I would just simply say that large markets can very easily learn from small markets as well.

The second is on tax incentives. I

agree with Damon and with Ken. I would not go in that direction because I do agree that there are other fields of work that also are suffering in the United States, so I would not be necessarily in support of that.

The third comment is that with regard to attracting more students to study accounting/auditing, I think we need to help young people understand that this can be a very exciting profession because it's not just about pushing numbers around. You have to understand businesses, you have to understand transactions, you have to understand markets, you have to understand product risk, you have to understand all of these kinds of things. And I think that the universities, the auditing profession, you know, the regulators, whoever, as we talk about auditing, we have to help people understand that it really is very, very exciting in the modern world.

And that also argues, in my view, for some cross-fertilization in the educational arena. I was on the board of the University of Maryland School of Public Policy and they had various, you know, disciplines within the School of Public Policy. And when we started doing the cross-fertilization there, that's when we got much more excitement from the students. We produced better students who were more in demand by both the government, as well as the private sector.

And then the last comment also picks up on Chairman Volcker's comment about real world business experience in the classroom. I also think that is hugely important. I have an MBA from the University of Chicago, as most of you know. It is a highly quantitative and highly theoretical school. It's a great school. I got a fabulous education. I didn't have the foggiest notion what I was learning those things for until I got into the business world. And it would have served me a lot better had I, you know, known before going there what I was going to use it for. That's it.

CO-CHAIR NICOLAISEN: Well, great. This discussion was, I think, representative of the sentiments that are out here, that education, the input with the students, the faculty, the way in which this all comes together is extremely important.

And just listening to Mary, I was thinking back. I was of good fortune to attend an executive education program; it was actually the Aspen Institute. And one day I slipped out and sat in on the medical profession piece of it and they were talking about ethics and that's life and death and survival in these decisions that you might. And, you know, I really walked away from that thinking this stuff matters to what I do too. And so you think about it in a different context, with a different set of constraints around it and all of this cross-pollenization, all of this ability to bring to those who serve in our capital markets the ability to think rationally and to be able to make ethical and moral decisions is pretty important. So, I think we've heard a lot of that.

I guess if I've heard anything, they like the recommendation, but aspirationally maybe we can elevate it a notch.

So, let's move onto to Recommendation 3. Is it you? Anne, all right. Anne, thank you very much.

MS. MULCAHY: Okay. Thank you, and great comments. I think it certainly enhances, I think, the discussion we've had.

It would be tough competition for having the least amount of technical expertise in the room, but I do live in the real world and Recommendation 3 deals with a real world problem that's certainly not unique to this profession, but is pronounced in the profession. And that is, the really dire need to improve the representation and retention of minorities, which obviously also is synergistic with actually increasing the pool of human capital in the profession.

I think this Committee believes that it really is, you know, a big dilemma because it has both societal consequences and business consequences as well. And anybody who understands demographics today and understands them in the future, realizes that if you're not expanding ethnic diversity, you will have a much narrower pool of talent to choose from today and in the near future as well. So we've made the following four recommendations, and they're very consistent in many ways with what you've heard.

But the first is, is that we need to broaden the pipeline, recruit minorities into the auditing profession from other disciplines and careers. And it actually, I think, is somewhat synergistic with the discussion we've had about the need for business relevance, that broad-based education is really the best foundation for functional expertise. And in this case, it truly does mean that you would expand recruiting initiatives to a whole set of different sources, clearly recruiting minorities from non-accounting graduate populations, and that's both at the entry level as well as the experienced hire level. and then that has implications for some of the kind of practical life-long education experiences that are required that will need to kind of fill the gap, whether that comes from the firms themselves or whether it comes from proprietary schools, there are sources of creative alternatives that will allow you to source from broad-based places that literally can then educate and recruit a wider set of professionals in.

The second point would be one of really focusing on community colleges and the role that they play as it relates to sources of talent, and in this case, recruitment of minorities into the auditing profession.

The statistics are pretty compelling. There's 11.6 million students that are enrolled in 1,200 community colleges. I would set forth the premise that based upon today's economic implications that community colleges are going to become more important in terms of the amount of students that are going to be looking to them. And it just so happens that the demographics clearly provide a solution to a more representative type of sourcing. African-Americans account for 13 percent of the students, Hispanics 14 percent and Asian-Pacific Islanders for six percent. Clearly, a great source for changing the representation in the industry if you look towards those areas to source from. You go where there's critical mass.

And that says that to enable that, that there's going to have to be some focus on the accreditation of two-year college accounting programs and that that has to be explored and proposed so that we're not sacrificing quality and technical expertise for the quantitative aspects of it. And, there's going to have to be both, I think, auditing firms and academic institution collaboration to make sure we have strong fundamental academic accounting programs at community colleges, which include apprenticeships, internships and financial support so that we build the bridges from the community colleges for the students that actually need the support when they look to continue and look to go to four-year universities to enter the auditing profession.

The next piece of it really builds on this context of cross-sabbaticals, and in this case, really focusing on cross-sabbaticals with historically black college and universities. There's 100 educational institutions that are now designated as HBCUs. There is some sporadic recruiting going on from the profession at those universities, but the fact is, is that there are opportunities to engage with those universities, both in more aggressive and systemic recruiting, and also as it relates to cross-sabbaticals. And, this is really a big deal because, you know, two really important aspects here are role modeling, so you're basically, you know, taking faculty from these universities and inserting them into the firms. And the other piece is networking, which is creating the links and the bridges for future recruiting. Those relationships, and I can tell you at Xerox that that is one of the reasons we get a disproportionate amount of minority engineers to Xerox, because we actually work with them and have relationships and we can recruit more than our fair share of minority engineering candidates to Xerox.

You know, I think that this is one where focus really does drive different results. If we keep doing what we're doing, we will continue to have the kind of numbers we have in the profession and we need to really think about this as a different kind of approach.

Next, is really the topic of minority accounting doctorates. And we bring it up simply because it's a great example of how focus does drive results. And just mentioning the Ph.D. project, which is an effort with the KPMG Foundation, when that was established in 1994, the number of minority professionals at U.S. business schools has increased from that point in time from 294 to 812. Focus drives results, and clearly that has had an impact.

So, I think we would use it an as example of something we need to continue to fund. This is where very focused funding does drive results and also to look at alternative programs that could have similar results.

So, that's kind of the net of those recommendations and something we think, although not terribly theoretical, there are specific actions that can drive different results.

CO-CHAIR NICOLAISEN: Great. Thank you very much. This is one of the most exciting, I think, of the recommendations that we're going to talk about too. And the question is, how do we do it?

MS. MULCAHY: Right.

CO-CHAIR NICOLAISEN: How do we make it happen faster? Damon, we'll start with you.

MR. SILVERS: Let me echo what Don just said. I think this is an extraordinarily thoughtful set, and specific and practical. I particularly think, based on some experiences I've had in addressing similar problems in other contexts that the focus on building relationships and networks with historically black colleges and universities is a very important piece of this puzzle.

I would ask that you consider,

perhaps you did, and you could tell me why it's not relevant, in light of the fact that unlike some of the other professions in which the key career decision is a post-graduate decision, that in accounting and auditing the key kind of training, the key decision is made at some point right around the time of the entrance to college, or just after that, whether there ought to be as part of this list a recommendation involving secondary schools and the sort of thing that perhaps, again, the industry could do as a collectivity in terms of raising awareness among juniors and seniors in high school, that this is a good career.

I think, you know, we actually had a lot of discussion about that and I do believe that if you want to have more people aspiring and raise the image of the progression it needs to obviously begin before college and that K to 12 is the time when there needs to be some efforts.

And, we talked about things like,

for example, the National Academy Foundation, which does great work now in high schools, you know, creating engineering centers, or math and science centers that really put a focus on the profession. And, this is one area that I don't think we provided a specific recommendation on, but that, you know, some degree of investment and attention driven by the profession itself to create those kinds of innovation centers in high schools have a huge impact on the way, you know, these high school graduates think about the profession, kind of getting to Mary's point of making it well understood that it is an exciting, dynamic, business-oriented profession, and I think that is something that actually deserves merit.

MS. WOODS BRINKLEY: One anecdote on that. Several of us, just outside the work we did, put together some groups of younger partners in firms, just to interview them and get their thoughts on what they liked about what they do, what they didn't like about what they do, promised not to tell their superiors anything they said, and, you know, we had some very interesting discussions.

And, one of the stories that was told to me that had been very interesting to them were some programs they did to go out into the high schools, and what they did was, not describe the educational process, they started with, let us tell you what we do as partners in firms, and they got just fabulous responses and real enthusiasm and excitement, and they focused as well on minorities. I mean, they were, part of this was to be sure that they were very broad based and included, and then the questions became, well, if I want to do that then what do I go study? And so, leading with a description of what the work is really about was hugely impactful.

So, I think there are things to build on there.

MS. PALMROSE: Yes, I just wanted to make a comment on the community college recommendation, which I think is a really important one, and it resonates with me. Unlike Mary, who is a product of the University of Chicago, I'm actually a product of a community college. My father was a Founding Trustee of the community college in our community, so I'm very proud to say I started at the community college.

But, I've noticed one point that might be worthy of a sentence in your recommendation. As a faculty member, both at Berkeley and at USC, it's not just to track these things, which we try to do and encourage students, and have outreach programs, there's an important transition element. The first semester when you transition to the four-year university is one that really needs a little bit of help to make that transition, and it's not just the university, it actually means the professor in the classroom needs to help a little, too.

And so, that's probably worthy of a

little note there, the transition process.

MS. MULCAHY: Great, thank you.

MR. PREVITS: I just would comment that we have the black letter recommendations and the explanatory language, and I'm hopeful that we can capture the richness of some of these suggestions and what I'll call observations. We haven't introduced those yet, but we are going to need some additional room to make sure we are as comprehensive as we can be, without creating such a long report that no one is going to, you know, consider it.

CO-CHAIR NICOLAISEN: Bob?

MR. HERZ: On the issues of both minorities and making -- going into auditing exciting, just one observation, and it's only one set of data points, but we have a program where we bring in the top people from -- graduated from five-year accounting schools, and they stay with us for a year on an internship. And then, they, generally, go into public accounting.

And, I've noticed over the last five or six years that almost all of them, chose to go into the large firms, what they call transaction services business, not into auditing, all but one or two. And, I've been very -- I go and talk to them and try and encourage them to go into auditing rather than that, but I think it's really two reasons. One, they go in with a somewhat higher salary, and secondly, they perceive that as more exciting, and being able to be more challenging and all that.

So, I only offer that as a somewhat -- I've been disappointed with that, that we are bringing in some of the top people who were nominated by their schools especially for a program, and they then end up in that part of the public accounting business.

CO-CHAIR NICOLAISEN: Like that financial engineering.

Bill?

MR. TRAVIS: Thanks, Don.

I hope these comments don't sound too much like they are from the department of redundancy department, but I'd like to also say that these comments probably are as applicable to Barry's discussion of the second recommendation.

I think Chairman Volcker's points are right on. I found the career to be rewarding, challenging, and I believe it's an honorable career. And, unfortunately, some of the bloom is off the rose lately, and I think it's up to the profession and others to help us get ourselves back in good stead.

So, I would encourage your recommendations to really look at what we've just been talking about, of how do we do a better job collectively of promoting the importance and the value of the career, And, I think getting face to face with young people is certainly a very, very important element of that, especially for minorities.

The second thing I would encourage you to do is, strengthen the wording as it relates to firm and -- audit firm and corporate support of scholarship programs, especially, not just for students, but for PhD programs as well. The AICPA Foundation, led by Chairman of the Board Bill Ezzell, is undergoing a significant program to fund additional PhD students, trying to raise, I think, it's $17 million or more. The Big Four are all in to the funding mechanism, other firms are being requested to participate, so that we can create additional slots, and certainly many of those slots can support the minority initiative as well.

So, I really want to make sure that the profession steps up and the corporations step up. This is our collective problem, and we need to make sure that we are funding the solutions and building the image of the profession.

So, I absolutely support your

recommendations, just ask for a couple of those clarifications.

CO-CHAIR NICOLAISEN: Lynn.

MR. TURNER: It is a great career. I think it's a great profession, and I'd say that the rose is blooming brighter than ever before. Just because all the challenges and everything we have, it's been more fantastic than ever, and as Michel has said, it spawned some fantastic intellectual discussions on topics like fair value accounting.

So, I think it's just marvelous, and when I taught in a classroom with students, which I do each year, it is that the students are also spectacular, too, so we've got a great situation to work with here.

And, I'd like to commend Tim, the report notes what his firm has done in the education area and, perhaps, more so than any other single firm that I've seen in the education area, at AAA meetings, and funding of this, I'd just like to commend Tim and his firm for the spectacular work they've done in funding minorities and doctoral programs, and also I do hope others will follow their lead, in essence.

On the particular issues, you note that one of the large firms are recruiting at the HBCUs, I would hope that you would say, all six of them, or certainly all four of them, should be out recruiting at the majority of these particular universities. The fact that we only have one out of all of them is not a proud story for the profession. I think you ought to specifically state that the others ought to be there.

On the issue of --

MS. MULCAHY: Lynn, just a point of clarification, one that was recruiting at all of them.

MR. TURNER: That I understand.

MS. MULCAHY: There were sporadic efforts that were not quite as intense from all others. Okay.

MR. TURNER: The other issue, I think sporadic is the key word, that was my experience, too, we should have the firms all making a more concentrated effort in getting out and offering opportunities, quite frankly. We don't offer the top opportunities for minorities, why would they come? You know, why would they enroll? And so, I think we need to do that.

And, the same applies with the community colleges. In the past, community colleges have had somewhat of a stigma attached to them. If you go, for example, for a AAA annual conference, there's a difference between a professor and how a professor is viewed at one of the major universities or state schools versus a professor who is at a community college, so to speak, you know?

And, if you are telling minorities here, and this is what's not clear to me in the recommendation, it comes across as, hey, community colleges is a good place for minorities to go. Yet, we all know that it's -- right now reality is, it's the second tier, community colleges. And, I would hope that you'd clarify that we aren't saying, let's use the community college for minorities. I think it should be, we should be raising those, but if we are going to raise them there also ought to be a recommendation here that major corporations, as well as all of the Big 6, should be in here, because if they aren't willing to recruit here, quite frankly, then it's erroneous for us to recommend people to go there and all.

So, I think you have to work through that issue, because right now I'm nervous about, does this really say, you know, let's send a population of people to community colleges, which right now are not where people recruit in the profession, not where --

MS. MULCAHY: Yes, let's just be clear, what it says is that, not send people disproportionately there. That's where they are, and a lot of this is about just the financial realities, quite frankly, and I think that the idea that community colleges are sub-standard is an old idea. I think there are a lot of community colleges that are first tier in terms of the kind of training they provide.

And, I think part of that is, is that we've neglected to actually focus on community colleges. With that, I think the recommendation talks about the need to look at things like accreditation, and make sure that the, you know, curriculum is appropriate for the kind of sourcing, but the fact is, is that we really do need to focus on community colleges, both from a quality perspective, but from a recruiting perspective, because that's where the students are.

MR. TURNER: And, if they are, in fact, not second class, and really are first tier and top notch like you say, and I have seen some top notch students out of those schools as well --

MS. MULCAHY: I mean, that's not--

MR. TURNER: -- then we've got to deal with the fact that the Big 4 firms for the most part don't recruit there.

MS. MULCAHY: Yes, that's the point.

CO-CHAIR NICOLAISEN: All right, Phil, and we are going to take this as a last comment on this, in part because I think there is really strong support.

MR. LASKAWY: I just want to say that I think the recommendations are excellent. I'm a little dated in my experience level here, but I do think the overall discussion, and maybe it wasn't the charge, since I'm an observer, not a member, so I apologize, there's no -- I don't think there's discussion about retention. And, I think at the end -- is there -- at the end of the day I think, as somebody who was in the profession for 40 years, the biggest challenge is retaining people, and to issue a report on human capital without spending significant time in discussing and trying to deal with the retention issue, I think is a major shortcoming.

MS. WOODS BRINKLEY: I believe Gary mentioned in the opening comments that it was one of the topics we spent time talking about, but it did not hit our top five or six list.

And, we certainly stand to hear data to contradict this, but the retention issues, as we talked through them with different people within our Committee, and as we talked outside, it did not seem to be -- we assumed it was a huge issue, we did not seem to find that it was as serious as we thought.

A couple of points. There clearly are people who move from the auditing professions into the corporate sector, but we view that that is a natural -- that's a good thing, that we need those individuals moving, and that knowledge base moving into the corporate sector, and it is part of the supply chain management that needs to go on.

There was a single issue, we probably heard anecdotally, which was -- there were two issues, I guess, that people raised as retention issues, one is the risk that the individuals feel they face in accounting firms, and the second was work/life balance. Although there was a lot of suggestion that the work/life balance issue is improving, that programs have been undertaken. I think the risk issue may be discussed in one of the other Subcommittees.

But again, we welcome to hear differently, but it was not raised, and, Tim, you may want to comment on it, as one of the biggest issues facing the industry.

MR. MELANCON: Before Tim does, the only other point that we discussed, too, was that, yes, to the extent retention is an issue, that's true, but it is sort of universal to the business world in general, and, you know, there is not -- there was not a lot of data to support that it was totally unique in the profession. There was a lot of evidence that the profession was being proactive with it.

MR. FLYNN: I think the firms have put a good deal of focus the last five years on retention of our people, and I think it's moved from mid to low 20s to the mid to high teens, and there's been some pretty significant improvement. There are still pressure points, second to third year, people starting families, that we're working on, but overall I think the point that's been made is retention has been something, the demand has been strong, we want to encourage it to be strong, the work has been more exciting than maybe in past years, and retention has been better, for my firm specifically and for the profession right now.

So, it's still there as an issue, mid teens is still a high number for industry, but it's one that we've digested pretty well in the last number of years.

CO-CHAIR NICOLAISEN: Great, strong support. I think there's a few suggestions along the way, and retention, obviously, if someone who comes in to the profession doesn't have a continuing role model up the ladder it becomes difficult. So, I think there are some things that we ought to try to think about there, but there seems to be very, very strong support for what we are talking about, and it's about providing opportunity, and that's what this country is about. So, I think there's some greatness to this particular recommendation.

Gaylen, I'm going to ask that you communicate over lunch or whatever, trying to keep this moving, and we are going to move on to the fourth recommendation, Gary.

MR. PREVITS: Thank you, Don.

The fourth and final recommendation, a one-sentence recommendation, may be deceptively simple, but sometimes may be essential, "Develop and maintain consistent demographic and higher education program profile data sets."

without the data, it's going to be very difficult in the future to make effective, reflective judgments about the supply and demand issues, about the quality of individuals.

Indeed, we lack a lot of information, and this effort has provided us, through the Center for Audit Quality, with examples of the kind of data that can be useful in supply and demand management, for example, to see the data about the number of individuals, in fact, hired by the firms in recent years, the expected hiring profile for the coming year, as a way of informing universities, for example, you know, whether they are five year, four year or two year programs, about the expected demand level. So that, instead of having, you know, very pronounced shifts in supply and demand, and, you know, unfortunate relationships where programs may be required to either cut back drastically or shutter programs, and I've heard that term used in some of the discussions, we can provide some basis where people making informed decisions about how to adjust their supply and better predict their demand.

We don't have a great deal of information about the CPA profession as a whole, except through a series of, you know, evolving data sets. AICPA membership trends are helpful, they are kind of a surrogate for having a CPA census. We did not recommend going to the Department of Commerce and the Bureau of Census, and, you know, modifying the current bookkeeping, accounting and auditor-type data, but at some point it's going to be very valuable to know the age demographic and profile of the practice community, and we are hopeful that by a cooperative effort involving groups such as the AICPA, AAA, and those others who develop information, that we can begin to get a better sense of what the trends are demographically, so that we can foresee where the shortfalls will come.

David Leslie's study, which was given in the first -- was one of our first pieces of information, was fortuitously arranged last July, I think, you and I had a discussion, Barry, in New York, and the AAA hired Dr. Leslie. If we had not had that data I don't think we would have spotted the specific weaknesses in the supply chain relating to the doctoral demographic.

And, similar discoveries that could occur by maintaining data sets I think will pave the way to help us make better decisions throughout the profession.

So, thus, the basis for our recommendation.

CO-CHAIR NICOLAISEN: Any comments on that recommendation? If not, we have a couple of minutes, and, perhaps, those things that you thought might be in this human capital area that we haven't heard about, if anyone has something that they anticipated and is not here, it would be a good time to ask.

I have one, so I'm going to use my prerogative to start it, and that is whether you thought about or discussed whether there should be a certification or training, particularly, in specialized areas, post CPA examination. I know there are requirements for continuing education, but the question is more if you are going to audit a bank should there be some certification that you are obligated to have.

MR. PREVITS: I am not aware of that being a particular item of discussion. It may have been an incidental kind of discussion. But, specialized, I believe the Institute has a number of programs, but they are not necessarily -- they are more function than industry, right?

MR. MELANCON: They are not in auditing.

MR. PREVITS: Yes.

MR. MELANCON: I think if we look at -- if the test is quality auditing, obviously, skill sets in a particular industry that one is servicing is an important aspect, as you all know from your years of experience.

But also, you know, people serve diverse industries, and sort of the variety actually brings, sort of to the curriculum point, this broader footprint of knowledge. So, specialties can work against you in that particular area as well.

But, we did not discuss it, that's just my personal opinion. We did not discuss it from that standpoint.

CO-CHAIR NICOLAISEN: Yes, it might be worthwhile, you know, at least having a little discussion on it.

Bob?

MR. GLAUBER: Don, just to

emphasize, in the securities industry, NASD, which does certification, has various levels of specialty certification. And so, there, it's found to be very useful, and one can think of certification along industry lines, too, but also against -- along the lines of functional specialties. And, if we are talking about audits that involve the appraisal of values of assets in the capital markets, for example, one could imagine having a certification of a specialty of that sort, it could be very valuable.

CO-CHAIR NICOLAISEN: Good. Yes, I think it might help this image of professionalism to have something to aspire to.

Gaylen.

MR. HANSEN: Off line Gary told me they weren't going to go into the partner rotation, five years, seven years, that thing, and I'm not suggesting that topic be brought up, but the idea of rotation is it impacts the lives of partners.

I have been contacted by a number of partners, and I might say they are not from my firm, other firms, Big 4 specifically, that have said that that is an impact in their life, and I wonder if the Committee had had an opportunity to discuss that and the impact on this area.

MR. PREVITS: Gaylen, it came up late, very late in our agenda, because it was, we thought, perhaps, being considered by another Subcommittee.

Personally, I'm very empathetic, sympathetic to the notion of the impact on the quality of life. Personally, having studied as an academic the matter of independence and scope of services for 20 some years, and tackling that tar baby and thinking about independence in five to seven, whether five is the right number, seven is the right number, it's almost personally to me mox nix. I think we would have support in our Human Capital

Subcommittee to consider the subject if there's great interest in the rest of the Committee that we do so.

Right now, it's not clear that it's a burning issue. If it were a burning issue, I suspect that we would be inclined to take it up and consider it.

MS. WOODS BRINKLEY: I would say that, again, in the small group settings that I described, it was raised by some of the younger partners as being a concern. But, we didn't have a broad enough set to hear about it as a concern. I think it is something to be considered, and fits into that work/life balance issue, amongst other things.

CO-CHAIR NICOLAISEN: Bill.

MR. TRAVIS: Thanks, Don.

Two related topics. Did you consider retention of women in the profession, which when you look at the percentage of partners who are female, very low compared to entrance. I think the numbers are something like 56 to 57 percent of college graduates are women, and about 15 percent or so, on a good -- in a good situation, are women.

And then, second of all, the question of the adverse impact of seasonality on work/life balance and retention.

MR. PREVITS: We had specific testimony in our Subcommittee hearings in January, presented by Dr. Julia Grant, who has done extensive work in the area of the demographics of retaining women in the profession throughout their career, and the chronological differences when women tend to drop out of the work force, and how they tend to come back in.

I think the impression that I got, the consensus from the Committee was that, while it's, again, an important issue, not very much on unlike retention overall, it's being much better managed today, and it didn't get to the level of being, you know, one of our recommendations.

It may be in our language, if we have the permission to do so, something that we will articulate a very meaningful paragraph as an observation.

But, yes, we have a lot of data, and we had a lot of testimony, and I ought to let maybe Anne and Amy comment.

CO-CHAIR NICOLAISEN: You'll have permission to do that.

MS. MULCAHY: I think it was, you know, facts yielded that the retention and both pipeline and promotion of women at least are directionally right, while the hiring and promotion of minorities have not yielded in the profession. So, we put our efforts there.

MR. MELANCON: The last question was on work -- just real quick -- we talk about work load and work issues at a high context, and tied in to the work/life balance issue that Amy discussed. And, we recognized it. And also, the type of work, because today, at least at the entry level, some of the type of work is much more compliance-oriented than it was even a few years ago, which has this sort of image of the profession reinforcement in a negative way, at least today.

But, we, again, in an effort to narrow down top priorities, we thought that it's an important issue, but the retention issue itself we felt was a little bit less -- it was at the next run to the top of these.

CO-CHAIR NICOLAISEN: Well, let me -- go ahead.

MR. MURRAY: Just a very quick observation. This has been a most impressive discussion this morning, and deeply appreciated.

It strikes me, listening, some of the most important findings of this Subcommittee are issues that are not -- that are well on their way to solution or not as severe as they are generally perceived to be.

I wonder if we might, ultimately,

find in our report that there is value in articulating a list of things that are on their way to resolution, because we will otherwise be omitting a great deal of the collective progress of this profession over the last few years.

CO-CHAIR NICOLAISEN: All right, great.

MS. WOODS BRINKLEY: Can I just comment? Sorry, Don.

I do believe that there are many aspects where we, you know, found that there was already progress underway. There are dedicated efforts on the part of many that are involved with the profession around certain things.

Having said that, there were areas where I think we believe there are a huge amount of emergency needs to be undertaken to move with all expediency. And, I would say, for example, being sure from a content and curricula standpoint that we will really have the talent pool that we need five years from now.

So, there certainly were areas of urgency. I think the whole qualified faculty question we would say there's not enough going on, and there's a sense of urgency, and then, certainly, as Anne has said, around the minority piece.

So, while there was work in all cases, we think acceleration, urgency, and then behind all this, as Chairman Volcker has pointed out, just the need to create a whole different perception and understanding of what this is really about, the profession is about.

CO-CHAIR NICOLAISEN: Great. I just want to do a quick check.

Sarah Smith, are you on the phone, and do you have anything you'd care to add?

Sarah is also a member of this Subcommittee and couldn't attend today.

MS. SMITH: Yes, thank you, Don.

I just dialed in. Unfortunately, I

missed some of the morning, but from what I've heard, no, I think my Subcommittee members and Chair said it all.

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

Thank you, Human Capital Subcommittee. I think the discussion was terrific. We are going to see if we can replicate this for the next two Subcommittee dialogues.

We are going to have lunch, remember, promptly at 1:15, which means we still have a lot to do before that, but what we will do is, we'll take a break until 12:10. We have about ten minutes, then we are going to begin with the -- pardon -- I think that clock is off -- 12:10. On that clock it would be 11:10.

(Whereupon, at 12:11 p.m., a recess until 12:27 p.m.)

CO-CHAIR NICOLAISEN: All right, we are going to get started. That ten minutes turned into 20. All right, if we can ask everybody to quiet down, we are going to resume. I think it's a good thing that we are enjoying the dialogue around the edges here, and I think that's fantastic, but we do have two pretty tough Subcommittee groups to get through, and some of it will, I think, have quite a bit of dialogue.

We are going to begin with Bob Glauber's Subcommittee in just a minute, and the same rules will apply as we followed for Human Capital, we are going to look for input from all of, particularly, those who are not on the Subcommittee, for their views as to the recommendations, and also for your questions as to, you know, what did you expect that's not there.

So, everything is fair game. All of us have a lot of things. I think we have looked at the recommendations as they've been distributed to us, and with that, let's get it started.

Bob.

MR. GLAUBER: Well, I first want to thank the Co-chairmen for setting the high standard of the first Subcommittee, as one by which we will be judged. Thank you.

And, I want to thank you secondly for being good enough to seat us all together. I view there to be safety in numbers.

I do want to start by thanking the Subcommittee, Tim Flynn, Gaylen Hansen, Jeff Mahoney, who, of course, is now sitting in for Anne here, who I believe is happily at home with her newly-born daughter, which is very good, and we wish her well, Rick Murray, Bill Travis and Lynn Turner.

What I think I'm going to do is briefly, as we go through these, introduce each of these issues and recommendations, and then invite the members of the Subcommittee, and my colleagues, to add their views as they see would be useful, and then, of course, open it up to the discussion of the entire

Committee.

We have been fortunate, indeed, that the Co-Chairs have allotted to our Subcommittee a number of important issues, and for that we also thank you.

CO-CHAIR NICOLAISEN: Somehow it's the sincerity that I question.

Please, continue.

MR. GLAUBER: I would say that at the start of our consideration of these issues, there was considerable differences of view among the members of the Subcommittee. We have heard a great deal of testimony, and received a good deal of data, both of which have informed us, and I think together with protracted discussions in which we have all shared our views, the testimony and the data have allowed us to move forward towards consensus on some of the issues, and we are going to present four recommendations around those issues.

There are also, as you might

imagine, a couple of very important issues around which we are still working diligently to reach consensus, and on those issues we will present some observations.

So, let me start with the first recommendation, which you have before you, and just describe it as, essentially, having three parts. First, we recommend the creation of a center under the sponsorship, we suggest to you, of COSO or the CAQ, to facilitate the sharing of fraud prevention, experiences, practices, data, and to commission research, basically, an exchange of ideas and information.

Second, to have audit firms, investor groups, financial statement users, issuers, academics, work together to develop best practices, that we believe in this field sharing and development of best practices is an important step forward in both reassuring the users of financial statements and the public at large on the very important issue of fraud detection, and that these best practices would be developed in consultation with a collection of regulators.

And then third, to work on what is clearly an expectations gap in the area of audit firm or auditor responsibility for the detection of fraud, what auditors are actually responsible to do to find fraud, which is mainly around process, and what users expect auditors to do here, I think in many cases differs. And, we think that the users and the public would be much better served if at least the audit report, auditor's report, made very clear just what is it that the auditors are responsible to do.

As I say, I think there is an expectations gap.

We also believe that there is virtue in working to close that gap, and we recommend that the PCAOB continue to work on that standard, and work towards closing the gap from adjusting the standard as well.

With that as my introduction, let me ask the other members of the Subcommittee to contribute their views, and then, Mr. Chairman, we can open it to the discussion of the full Committee.

CO-CHAIR NICOLAISEN: Terrific, thank you.

MR. GLAUBER: The Committee has, through most of its deliberations, been very reticent, and so this is no --

MR. HANSEN: I won't hesitate.

MR. GLAUBER: Gaylen?

MR. HANSEN: Since you are going to give me an opportunity, I'll take advantage of it, as I have during the Committee discussions.

I wanted to talk about the audit report, and after our last Subcommittee meeting I had the chance to go back and re-review the global markets -- let's see what the publication is called, it's "Global Capital Markets and Global Economy," and just very briefly, and I'll just read one sentence, and this is a paper that was put out entitled, "A Vision From the CEOs of the International Audit Networks," and it says, "Perhaps, no single issue is the subject of more confusion, yet is more important, than the nature of the obligation of auditors to detect fraud or intentional material misstatement of financial information by public companies."

And, that is, really, I think the crux of one of the issues that our Committee has really significantly had, you know, a lot of discussion about, but haven't come to complete resolution. And, I think in discussing this with the investor groups, they are less concerned about the fee issues, and the cost, and the time, and the firms seem to be more oriented towards the fees, and the costs, and the time.

And, it seems to me that one of the issues here is the legal responsibility of the auditor and the professional responsibility of the auditor.

It's been my observation that auditors, in general, feel that they have this responsibility. Investors feel that that responsibility is there, but the underpinning authoritative literature is not consistent with that. And so, somehow we have to be able to bridge that gap.

Thank you.

CO-CHAIR NICOLAISEN: Thank you. Any other member of the Subcommittee.

Bill.

MR. TRAVIS: As it relates to recommendation number one, I've been giving a lot of thought to the dialogue and the differences of opinion that we have had on most of the subjects that our Subcommittee has been addressing. And, I have three comments.

The first comment, as it relates to recommendation one, is that as Rick Murray pointed out, when we start talking about creating centers and sharing best practices, that that in itself creates additional risk for firms and individuals who provide audit services.

So, it seems to me there's a root element in the litigation concern itself, that when we stop thinking about, or when we have concerns about doing the right thing in the best interest of investors and users.

The second thing, root issue that I think about is, it's not clear to me what investors really want. I have read and heard recently that investors are willing to spend more dollars on audits, which means having auditors dig deeper and go farther in their testing, which is understandable except at what? And so, I think the question of how far is the audit, how deep is the auditor's responsibility with respect to fraud, and how deep is the responsibility of the companies themselves to have procedures in place that prevent fraud.

And, the third comment that I'd

like to make is, there seems to be a little bit of a root issue or an undertone that some segments of the discussion don't trust and respect that the firms are willing to try to do the right thing. And, having been in that environment for a long time, both in a firm and in the profession, I believe that firms absolutely are willing and able to do the right thing, and we need to approach the issue from that perspective.

What is the right thing, so that the firms are able to do the right thing. I don't really see a resistance to doing what is in the best interest of the capital markets and the public interest.

CO-CHAIR NICOLAISEN: Bill, I'm not sure I quite understand, are you coming from the concept that you are not in agreement with the recommendation, or are you --

MR. TRAVIS: Oh, I'm sorry, I agree with the recommendation, but the point I'm trying to make is that -- is that as we talked about this particular recommendation there was a concern that the litigation environment is such that by creating a best practices forum you add risk to the firms.

CO-CHAIR NICOLAISEN: That doesn't lead you away from the recommendation.

MR. TRAVIS: Oh, no, no, I'm sorry, Don.

And then, the other two comments are, I think really focused on clarifying what investors want, and I believe firms will try to do the right thing. That's my point.

CO-CHAIR NICOLAISEN: And, that's where the SEC/PCAOB effort would come in to play.

MR. GLAUBER: Don, let me just point out something inherent in what Bill has said, and you implicitly raise it.

The issue of the threat of litigation has framed our discussion and influenced the discussion of many of these issues. We realize that that whole area is something that we have to engage. We have, as you'll see, we have not reached any consensus views on it. We hope to.

But, I think it's an important point to make that in the discussion of most of these issues, and certainly the one that has to do with auditor responsibility for finding fraud, and the standard for that, the whole concern about litigation does color and frame that discussion, as well as others.

MR. FLYNN: And, I think, Bill, not to put words --

CO-CHAIR NICOLAISEN: Tim, and then I think Jeff.

MR. FLYNN: I'm sorry.

Not to put -- not to try and put words in Bill's mouth, but I think what we are really talking about here, in terms of fraud, expectations gap, it's real, it exists. We know it.

And, the firms acknowledge that, and nobody has come up with that position, because it's not right for the investor.

And so, it's clear in that dialogue of the investor, the regulators, the firms, standard setters, they say how do we clarify what it is, clearly articulate it and then state it in the report, veracity as well, so the investor understands it. And, that's important, you can't let the current status quo be where it is, and how do we shrink that gap.

Higher standard, whatever it is, just figure out how to shrink it, and all live up to the accountability to make sure it stays shrunk, if you will, bad English, into that process.

And, yes, that's the spirit of what we are trying to do with this particular part, and we think it's very important.

CO-CHAIR NICOLAISEN: Okay, Jeff?

MR. MAHONEY: Thank you.

I am generally very supportive of all of the Subcommittee's preliminary recommendations to date. I'm, particularly, pleased with the Subcommittee's preliminary recommendation number four, requesting that the SEC require audit committees to provide to the public a plain English explanation of the reasons for any and all changes in the public companies' external auditors.

That recommendation is consistent with the best practices policy that the Council of Institutional Investors general membership unanimously approved at their fall 2007 meeting, after months of research, analysis and deliberations on the issue by the Council's board and staff. That research revealed to us that the SEC's existing disclosure rules in this area include some serious deficiencies, that every year permit hundreds of public companies to conceal from investors the truth about why their external auditors were dismissed or resigned. Requiring more disclosure about this information will provide valuable data to investors, auditors, the auditing profession and others, both of the quality of audit committees, the quality of external audits, and the quality of audit firms, generally.

Having such information available to investors is of growing importance, because of the growing number of public companies that have adopted provisions requiring annual share owner votes on the audit committee's choice of external auditors, which, incidentally, is a recommendation of the next Subcommittee, which I also strongly endorse.

In a nut shell, the preliminary recommendation number four, to require disclosure of the reasons for all auditor changes, is one that's good for investors, and it's good for the auditing profession, and though it's still preliminary I would personally urge the SEC to respond to the request of investors and to this preliminary recommendation, hopefully, a final recommendation of the Committee, and act promptly to pursue rulemaking in this area to implement that recommendation.

Thank you.

CO-CHAIR NICOLAISEN: Okay. Rick.

MR. MURRAY: With respect to recommendation number one, I am supportive and comfortable with what's been achieved. It has not been easily achieved, and these are, obviously, difficult issues. The question of what should be the extent of responsibility of auditing to prevent and detect fraud, and what should be the consequences of any occasion in which that isn't accomplished, had been around as long as I have, and I would rather not contemplate how long that is.

Generally speaking, with almost no advancement of either process or understanding coming from the many attempts to deal with this issue, I believe that these recommendations, while not dramatic do advance the subject. I believe the first two sub-recommendations will significantly enhance the prospects of more frequent prevention and detection, which, by the way, is a process that is, generally speaking, more successful than not in the practice of auditing.

One of the difficulties in even discussing the subject is the only publicly-available information on which to try to take measurements are the failures. The successes are deeply embedded in the confidentiality obligations of the firms, and having been in various practice roles and responsibilities I take pride in what is an improving and longstanding practice of success and an improving percentage of success. But, that data is not accessible to us, so we end up focusing on the failures.

I, particularly, believe that the third recommendation for addressing the expectations gap and inviting PCAOB further attention to the expectations gap, advances the form of the dialogue and provides a path for continuing improvement of a subject which

I believe is simply incapable of a clear consensus on. This is the right answer, let's go do it.

And so, as a product of a great deal of discussion and collegial disagreement on occasion within the Subcommittee, I am strongly supportive of the recommendations as they stand.

CO-CHAIR NICOLAISEN: Great. I think we've heard everyone say they are supportive.

Lynn, we haven't heard from you, I'm surprised, but if you would like to, a couple of minutes, summarize your view then we would have heard from all the Subcommittee on this particular --

MR. TURNER: First of all, I'd just like to thank Bob Glauber for chairing this subcommittee. We put him through difficult times, and he and the Treasury Committee staff, Kristen, have absolutely done a tremendous job. So, I would like to say thank you to them for their work.

And, they are difficult issues, as Rick mentioned, because they are issues that affect the pocketbooks of the firms and affect the pocketbook of people on both sides of the table. So, they are not easy issues, and they are issues where emotions tend to rise on both sides, and I think as Bob has aptly noted, we've still got some work to do.

I think it's very clear we've heard from some investors in the private Subcommittee meetings that they do expect the auditors to find the fraud, and I'm not sure the profession is the same place as them, so some clear communication on that I think is good.

I think we've got to go further in finding other ways to better communicate between the auditors and the investors. I don't think that is occurring, just as boards on public companies are trying to improve that communication, I think we've got to still find ways to improve the communication between the auditors and investors as well.

I think the notion, and, certainly, I've heard from Tim during the meetings, that the auditors understand that investors would like to see more on fraud and fraud detection, which I think this one is all about.

I'm still not convinced we got the right groups looking at that. You know, in the past, auditors haven't done a real good job, internal auditors haven't done a real good job of actually finding the problems, and, quite frankly, investors, in doing their own homework through filings, haven't done a real good job at times either.

And, I think it was in the Big 6 CEO report that they talked about looking back to the forensic accounting types, and maybe what we have to do is think about going back more to a group of forensic accounting types and some of the hedge fund types. We've certainly heard from one, Rich Grubman at

Highfields, the people who have actually been successful, and maybe in Recommendation One we need to look more to them, because they are the ones that have exhibited some success in coming up with the answer to number one, rather than what we are talking about in Recommendation number One as well.

I do think that in general, given the number of billion dollar misses that we've had, half billion, billion dollar, and we've had numerous of those, there is an expectation that something at that magnitude will get caught and detected, and so I think the bar has to be risen to that level.

At the same time, I think it's unrealistic that, say, at General Motors you are going to always find 100 percent of fraud, that just isn't going to happen given the selective testing. So, some of that is dealt with in 1B, perhaps it needs to be further developed.

I think recommendation two, about

getting the regulators all in the room, and having them all talk together, I mean, that's almost, again, motherhood and apple pie, like having good curriculum and text books and a professor, you know, getting all the regulators in a room so that they can all talk to one another and figure out how to --

CO-CHAIR NICOLAISEN: Let me just check process here.

Bob, did you want to go to recommendation two?

MR. GLAUBER: It's all right with me.

CO-CHAIR NICOLAISEN: I didn't know if you were leaving this open for all of it.

MR. GLAUBER: Well, my intention was, and it's up to the Chair, was to have the discussion on Recommendation One, then move to Recommendation Two.

CO-CHAIR NICOLAISEN: That's fine. Is that okay? Good.

What I'm hearing is broad support

for the concept, some uncertainty as to the eventual outcome of what a revised standard on fraud ought to look like, and what that public audit report would look like to the investor community. And, it has probably mostly to do with how much work actually it consumes.

MR. GLAUBER: Right, but strong support, I think, in the Committee to deal, at least in part, with the expectations gap by a clearer statement.

CO-CHAIR NICOLAISEN: Yes.

MR. GLAUBER: Just what it is that auditors do and are responsible for.

CO-CHAIR NICOLAISEN: Well, let's throw it open, and I'm going to start with Chairman Volcker, followed by Bob Herz, and Michel, and we'll see what other input we can get.

CHAIRMAN VOLCKER: Well, this Recommendation broadly seems to make sense to me. There certainly is confusion, and I'd like to see the confusion dealt with.

What I wonder is, the Subcommittee recommends that PCAOB and SEC clarify in the auditor's report the auditor's role on detecting fraud. Does the PCAOB and the SEC have a clear view of what that role is that they can clearly report?

CO-CHAIR NICOLAISEN: We have representatives, if they'd care to address that, or if you'd care to defer I'd understand that, too.

MR. OLSON: With respect to the standard, the question had come up earlier within the Standing Advisory Group, as to whether or not the standard ought to be revisited. The standard has been in effect now for, I think, just slightly less than five years.

When the initial recommendation was made, the determination was that we should evaluate the effectiveness of SAS 99, and then revisit it. But, given the importance of fraud detection, it's certain an appropriate admonition that we continue to look at the standard.

And, in addition to that, a lot of the focus of our inspection process is aimed at making certain that the manner in which the auditors are going through the requirements of AU 316 is done in a way that is not a mechanistic process. And, in fact, that it is an effort to really carefully look at auditing to the extent that they can for the potential for fraud.

And so, a lot of -- and so, it is a subject matter that we are constantly gaining our attention on.

But, the specific question is should we look again at the standard is an appropriate admonition for us.

CO-CHAIR NICOLAISEN: Zoe-Vonna, do you want to add anything?

MS. PALMROSE: Sure, but, and, of course, everybody knows, I don't speak for the SEC, even though I'm here as an observer for them. I have to disclaim that I can possibly speak for them.

But, I can wear an academic hat here, too, in addition to being an observer from the SEC, and just say that I think everybody appreciates that fraudulent financial reporting is one of the critical issues that the profession faces. When they get challenged, it's largely over the failure to detect fraudulent financial reporting.

So, it's an enormous challenge, and there's this tension here that's being discussed, really, between the standard, which is one of a duty to search for material fraud, versus the detection of it. So, there's this tension here between the duty to search, which is a reasonable assurance function, now I really sound like an academic don't I, I apologize, and the detection of it.

And so, it's just an enormous challenge, and I think articulating that is what the Committee is recommending here.

CO-CHAIR NICOLAISEN: Great, and I'm going to suggest that we are not going to try to solve that today.

Bob?

MR. HERZ: I'm just wondering whether the Committee considered an idea that was, I think, floated probably predates the creation of the PCAOB, so it was in the wake of the scandals that happened that led to Sarbanes-Oxley, and the establishment of PCAOB. But, the idea that was floating, I think it was actually Jim Copeland, and Deloitte was kind of promoting it, the idea of an analog to the National Transportation Safety Board investigation whenever, you know, there's a big plane crash they go in and within a certain amount of time they tell you what happened, in, presumably, a thorough objective way.

And, I think the idea was to create some kind of mechanism like that around major financial frauds that hit the market. That's, obviously, an after-the-fact kind of way of promoting confidence in the system, and maybe it's effectively happening some other way now, although I'm not really aware of it.

CO-CHAIR NICOLAISEN: Michel?

And, I want to save a response on that, because I recognize it would be difficult to --

MR. PRADA: Thank you, Chairman. I will put my hat as Chairman of the Technical Committee of IOSCO on this one, although I'm not committing the Technical Committee of IOSCO in this.

There are very different proposals within the recommendation one, and, obviously, some of them are very specific to the organization in the U.S.

I was interested by the first one, which is this creation of a center, and I understood it, and I don't know if I'm right, as a way to exchange experience and to update auditors with the evolution of fraud techniques.

If it is the case, I would raise the issue of having the possibility to organize it also at the international level, because I see, and we see that more and more of these frauds take place in a very complex way, through international organizations, and it might be useful that auditors organize themselves globally to exchange their views and experience.

I recognize that there are issues of confidentiality, but this can be addressed.

I'm not sure there are issues of liability, because I understood this proposal as a way to improve the understanding and to exchange experience on what happened so that people are aware that they should look into possibilities of fraud which they have not thought of before.

So, I would propose on this one that we contemplate the possibility to have some kind of link with international bodies in that.

MR. SILVERS: The question of the expectations gap, I think as Tim put it, around fraud and auditors has been, you know, with -- sort of kicking around the public policy arena for some time now. It's really, I think, from the very first meetings of the Standing Advisory Group of the PCAOB this has been a concern that investors have been raising vis-a-vis the standard that Mark mentioned.

I think there's been continuous dissatisfaction with the current state of affairs broadly in the investor community and, therefore, I think these recommendations directionally are very welcome.

I would add one more sort of thought substantively, which I'm not suggesting you have to incorporate or respond to, but which I think is critical to understanding this.

I don't believe that it makes any

sense to have a sort of absolute liability standard here, that the real issue is not can you say to audit firms you must -- you must generate a particular outcome or we will punish you in some way, either you'll be found deficient in your inspection, you'll be open to civil liability, whatever. The issue is, what is the -- what are the -- what is the standard of effort that goes into this, and what can investors -- and communicating that standard clearly to investors.

And, I think that the investor community believes today that, A, that standard is completely opaque, and, B, that it's inadequate. And, I think the reason why this language in this document is probably quite the right language is because the question of defining that degree of effort is a subtle and complex question, and I think best handled by the PCAOB. It's very unfortunate that it hasn't handled it yet, although I think the PCAOB, in terms of some of the work it's been asked to do in the intervening years has some good -- has been somewhat busy.

But, I wanted to put that gloss on what this is about, because I think that that is -- that's an appropriate and achievable goal, and it seems to me that's where the Subcommittee is asking people -- the PCAOB and the SEC to go, and I think it's long overdue.

CO-CHAIR NICOLAISEN: I think that's very helpful. If we could limit it to two more, Mr. Chairman, you can, obviously, respond to any of this as we move forward, but I just --

MR. OLSON: I just want to make sure that the terms best practices and regulatory requirements are not used interchangeably. I think that is critically important. So, let me make that distinction, because there's a critical hierarchy, I think. You start with a standard, and I think the standard on fraud is something that ought to be almost perpetually looked at, to make sure that the standard is appropriate. I don't mean every meeting, but I mean on a consistent basis, and that we continue to look at the manner in which the accounting firms are auditing consistent with that standard.

There is a term that the regulators use called regulatory creep, and that isn't the person that comes to your door to inspect the institution, but there is -- but regulatory creep occurs when you confuse the regulatory requirement with best practices. And, I think that there is a very important role, back from my banking history days, I thought that the development and the dissemination of best practices was one of the most important things that happened, especially, in a very dynamic world.

And so, I think from the regulators' perspective, we ought to be involved to the extent that there isn't an inconsistency between the regulatory requirement and best practices.

But, the best practices, I think, are best done by the industry, to the extent that it is done, with our looking at it to have some assurance that there isn't that inconsistency, and I think that that, perhaps, also then helps -- it's a limiting factor on the potential for liability.

MR. PREVITS: Just quickly, Bob, to comment that I think there's some synergy between one of our recommendations and recommendation one, using COSO as an intermediary, and that is, in order to have the kinds of thinking and reflection about this it's going to require access to audit data, through a process that we are encouraging so that research can be undertaken, and we can leverage the academic community and the talent that we have. I think that's one of our recommendations, and it fits very nicely into this, but without enabling that access by whatever process is involved for the adequate protection of the interests of those involved is, once again, clearly -- recommendation one in my view won't fly without having the ability to involve the academic researchers that could, with the access to the data, assist in this process.

CO-CHAIR NICOLAISEN: I think that what you are hearing is there is support, at least what I hear is there is support for the recommendation. There are lots of concerns around actual implementation, probably a lot of that falls in due process if and as the PCAOB and SEC deliberate, crafting a specific standard of reporting and standard of due care.

So, I think it -- I think I would anticipate you'll probably get more feedback from other members of the Committee at large as you progress in drafting this particular recommendation, but it does seem like it has a good basis to it.

I'm going to leave this one up to

you, Bob. We have about 20 minutes, and then we have a hard break for lunch. So, if you want to move to recommendation two, if you think that's possible, we'll do that, or we'll move to a different one if you think, you know, there's one that's less difficult.

MR. GLAUBER: Why don't we move to four, one of our favorites, and, indeed, as Jeff has said one that gathers a great deal of support.

Essentially, we think that the disclosure of the reasons behind the event of an auditor resigning, being terminated, or not seeking to be reappointed, should be illuminated far more clearly in 8K disclosure than is presently the case.

And so, what we recommend is that it be required in 8K disclosure by the audit committee, the disclosure is filed by the company, but it would be the audit committee's disclosure that would be filed, any time an auditor resigns, is terminated, or does not seek to be reappointed, and that the explanation of why this has happened, the reasons, would be communicated in plain English, a term of art at the SEC I realize, but, nevertheless, we think that this would really contribute importantly to public confidence in the whole auditing process and investor confidence.

And, as part of this, we would require that the auditor respond to whatever the company files and states.

Presently, the SEC requires disclosure of an auditor change, but not generally the reason, at least in most cases. There are certain specific cases in which it is required that there be a statement. Those involve disagreements over financial or accounting matters, and we would, indeed, preserve that, but we think it should happen in all cases, and it should be just explained straight up and why, a company makes its statement, the auditor responds. So, it's a fairly straightforward proposal, and I think one that has a great deal of support.

We've already heard from Jeff the support of the Council. I hope the rest of the members will speak their views on it.

MR. FLYNN: From a detection standpoint, we support the recommendation.

CO-CHAIR NICOLAISEN: All right, this is one that sounds like coming out of the Subcommittee has very good support, so let's open it up to the rest of the Committee.

Phil.

MR. LASKAWY: My experience, this is again dated, is that if the profession needs to respond, as is recommended, there's also a recommendation and a requirement that the corporation give the explanation, but sometimes that's the bigger part of the problem than the profession responding to it.

So, if we want to have some type of mandatory reporting, we have to make sure it's equal in the sense of the filer also giving a clear and open description of what happened.

CO-CHAIR NICOLAISEN: Today I think it comes from the corporation, have you given any thought to that explanation being from the audit committee?

MR. GLAUBER: Indeed, the proposal is that it come from the audit committee.

CO-CHAIR NICOLAISEN: Okay.

MR. GLAUBER: The corporation files the 8K, so in some sense --

CO-CHAIR NICOLAISEN: Right.

MR. GLAUBER: -- it has to be the corporation's filing, but the corporations would file the explanation from the audit committee.

CO-CHAIR NICOLAISEN: Very good.

Others, Mark, did I see your hand up? No. Ken? Ken, I think you need to get the mic on.

MR. GOLDMAN: I guess I come from the perspective of, it's already very difficult to change auditing firms, as we've seen, and I was listening to the comments before about why it's good for everyone except for companies was left out.

And so, I just wonder whether we are going to add more friction to the ability to change -- consider changing auditing firms, which has gotten very rarely now for a lot of reasons by large companies, as well as now this request for the disclosure of changing engagement partners. As a matter of fact, if I had anything, I'd rather have the rule go from five years to seven years, instead of five, because I think -- my opinion is five years is too short.

So, I actually disagree pretty strongly as a CFO of a number of technology companies, audit committee member of a number of companies, it is already very, very difficult to look at changing firms with all the independence rules, whatever, and to me this just adds more friction into a system that does not need more friction.

And then, I think it also sets you up more lawsuits as to what's the reason why, and then you spend all the time trying to figure out how to word it both on our side as well as the auditing firm's side, so you don't end up with another lawsuit.

So, I must -- I must admit I am really pretty much against item four.

CO-CHAIR NICOLAISEN: Anne, you are seconding that?

MS. MULCAHY: Yes, I am, and I hesitated because it sounds defensive, but this is -- this is the law of unintended consequences, I have to tell you. It is a monumental decision today.

And, the reality is, is that, you know, sometimes public disclosure on details like this do not serve the best interest of any of the constituencies in terms of the detail that's required, and, you know, I really hesitate on this one to say that you will clearly just kill any, you know, market-based orientation to make that change with the requirements associated with disclosure on this kind of basis.

And, the CFO can speak better to it than a CEO, but, quite frankly, it is a huge disenabler for making that change, which could be very healthy.

CO-CHAIR NICOLAISEN: Others. Mary.

MS. BUSH: I will add my voice to being a very, very strong skeptic on this. I can just see it setting up all kinds of arguments and disagreements between the auditing firm and the company, which have to be disclosed in some way. Lengthy negotiations as to what the disclosure looks like, and as one of these key people said, without getting into suits.

So, I would not -- I don't think I would go in this direction either.

CO-CHAIR LEVITT: I have to disagree with great respect for the prior two speakers, and I understand from my own corporate experience how difficult that kind of disclosure is, how difficult the disclosure of the reasons for changing auditors, for that matter as well.

But, I think it's very difficult to explain to investors, in the kinds of environments we have seen and are going to see, why we would resist such a change.

And, I just don't -- I think and understand the pressures, but I think the trade off in terms of public confidence is worth that pressure.

CO-CHAIR NICOLAISEN: Lynn.

MR. TURNER: Thank you, Don.

I would probably, I do support the recommendation. I probably would have worded it a little bit differently. I would have said, if you change your auditors, simply tell the truth to investors about why you changed your auditors. It's succinct as that.

And, having been a CFO, as well as

chaired a number of audit committees, if I have a difficult time telling the people I'm working for, telling Phil Laskawy or someone why I'm changing, you know, if you are saying why am -- I'm having a difficult time, I can't explain, or I don't want to tell people, that's exactly the information that investors probably would consider material and want to have as they vote on the auditors each year.

And, as we know, more and more companies have been submitting this vote to the investors, the audit committee in accordance with the law, makes their decision, and then submits it for ratification. That's a piece of information that if you are asking the investors to vote on, which I think you should, they absolutely ought to have.

So, I would keep the recommendation very simple and all, but just tell the truth about why you changed the auditor, very principles-based, and if you can't answer that question, and aren't willing to, then it probably answers the question as to why you need the disclosure.

MR. GLAUBER: Mr. Chair, I simply interrupt because I failed to note what, indeed, you have. We also recommend that auditing firms notify the PCAOB if there is a premature change of partner short of the normal rotation period, for other than retirement.

MR. OLSON: For the purpose of our risk-based supervision, not for the purposes of additional disclosures, is how we are interpreting that.

MR. GLAUBER: Ken, I'm sorry to interrupt, but, indeed, that is a part, and you noted it in your comments.

MR. GOLDMAN: Yes, I'm just saying, I'm just trying to go back further from what you are saying and Chairman Levitt is saying, is that we are also suggesting strongly that it should also be disclosed publicly, because I have the same issues there, too, relative to my earlier comments.

MR. TURNER: First of all, would I support that? Yes, I would. That's not where the Subcommittee has come out, as Bob aptly noted, that would be a private reporting matter before -- between the firm and the PCAOB, so they can go do their risk assessments, and we do know that in a number of of the big blow ups, where there were unreported items, billion dollar projects, in several of those there was a premature rotation of the partner, that, ultimately, was one of the contributing factors to investors losing billions, tens of billions.

CO-CHAIR NICOLAISEN: Ken, can I ask you a question as a CFO? If you had a call from another CFO, you changed auditors, you had a call from another CFO, the CFO says I see you changed auditors, you know, what was that about, would you say I'm not going to talk about that, or would you, in fact, maybe have a conversation that says it was about fees, or it was about quality of service, or it as about that combination of those things. But, we put a lot of effort into thinking about it, and at the day we decided to change firms. Because if you would, in fact, do that, then you are depriving the rest of the world, I'm not -- you know, in fact, you don't need to answer that, but some people would do that, and I think then you deprive the rest of the investor community the opportunity to have that same understanding.

So, I'm quite supportive of where this Subcommittee has come down on this, because I think they have thought about it a lot, there has been a lot of dialogue over the years about, you know, does the audit firm also have its chance to express its view, and in the interest of society where we really are looking for transparency over things that are significant, I'm there.

But, respond if you like.

MR. GOLDMAN: Yes, I would.

What happens if I say, and first of all I'd say, the chance of changing firms is probably slim to none in today's world. It's just too excruciating, both successor partners, as well as successor firms, will look at the same set of facts in some cases differently. And so, the risk you have of a new firm looking at the same set of facts, or even a new engagement partner looking at the same set of facts differently, is reasonably high in today's world. And, you may not know that, but that is really the case.

Okay, so let me give you an example. What happens if I say, geez, I'm changing -- this is hypothetical, but maybe I'm changing firms because I happen to think one firm in the Bay Area may be better auditing technology companies. Do I want to have that out there, that Ken Goldman thinks, the company thinks, that one firm might be better? It's an opinion I might have.

CO-CHAIR NICOLAISEN: At the end of

the day it's an audit committee decision. You may have input into that, you may make a recommendation, but the law is pretty clear that's an audit committee decision, and the audit committee, presumably, has some informed judgment upon which to make a decision to change auditing firms, or, for that matter, to retain an auditing firm.

MR. GOLDMAN: No, but you asked me if I was talking to someone else.

CO-CHAIR NICOLAISEN: Yes.

MR. GOLDMAN: And so I'm saying, that might be the reason I'm telling someone else.

CO-CHAIR NICOLAISEN: And, if that was your reason, you know, what's wrong with expressing that?

MR. GOLDMAN: I don't honestly see how the market is helped by that, personally.

CO-CHAIR NICOLAISEN: Okay. What would you say then?

MR. GOLDMAN: Well, it's

hypothetical, I don't know what I would say, because I haven't gone down that road, but what I know is, I wouldn't say that. That's what I know I wouldn't say.

CO-CHAIR LEVITT: (Off mic comments.

MR. GLAUBER: Yes, probably the major -- another major reason why. I mean, again, with trying to create more competition amongst firms, all this, to my way of thinking, is another way that we've eliminated -- have hurt competition, because what made it so draconian, to make a switch and then, you are right, the investor, you are absolutely right, the investor's analysis would, you know, you look at the stock price when a CFO leaves, or the stock price what happens when you change a firm, and it only goes one way.

CO-CHAIR LEVITT: That's nothing new, the change of a firm is probably one of the most traumatic events any corporation can go through.

CO-CHAIR NICOLAISEN: All right, we are going to do two quick responses. Zoe-Vonna first, and then Phil, and, Jeff, yes, I'll give you a shot at this, although I think you expressed your view earlier, that you are 100 percent in support of this.

MR. LASKAWY: Firstly, to Ken's point, I don't know the number, but hundreds, if not more, thousands of firms, change every year. So, obviously, firms are not finding it difficult in changing.

I just think, to me, what's important is that the answer -- the filee's answer, or the company's reason, and the accounting firm's reason, if they are not the same should be disclosed, because I think what I found in my time, that there was too much of a desire to have a common answer when sometimes the answer isn't common. Sometimes there are different reasons from each side, and I think that would, even though probably my brethren in the profession wouldn't agree with me, I think that would be helpful, and I think it's something that the public is entitled to know.

CO-CHAIR NICOLAISEN: Zoe-Vonna.

MS. PALMROSE: I guess there's just one other dimension here that might be useful. We've been talking about disclosure as if it was 01, it occurs yes or no. But, I think the challenge is really to craft disclosure so it doesn't become boilerplate.

And, that might be worthy of thinking how to word a recommendation to avoid sort of the boilerplate result.

CO-CHAIR NICOLAISEN: Yes, I think we all recognize that as a real risk.

Jeff, and then we are going to close with Chairman Volcker.

MR. MAHONEY: All right, thank you.

As Mr. Laskawy said, there's been more than 1,300 auditor changes the last several years, about 30 percent of the time there has been a reason given, but 70 percent of the time there's been no reason given as to why the change has occurred.

As far as competition, we've had testimony from Ed Nussbaum, as well as Andy Bailey, and I believe one or two other witnesses, indicating that this disclosure would actually enhance competition among the firms, particularly, the second-tier firms with the Big 4. So, I think we do have something in the record to say this will support competition, enhance competition.

I'd also point out that Grant Thornton has done a survey of 135 chief financial officers and senior comptrollers at public companies, found that 2/3s of those respondents favored having more disclosure about auditor changes. So, I wouldn't necessarily believe that the views we've heard today from some of the corporate representatives represent the corporate community at large.

I'd also point out that, as I

mentioned briefly in my earlier statement, which I apologize, I jumped the gun on. But, about 70 percent of the S&P 1500 have an annual share owner vote on the selection of auditors. Investors need some data points. Share owners need some data points to make that decision, and I think this would be an important piece of information to help them in that regard.

CO-CHAIR NICOLAISEN: Thank you, Jeff.

Chairman Volcker.

CHAIRMAN VOLCKER: Well, just to be quick, just a little idiosyncratic concern that efforts to create perfect transparencies sometimes create perfect confusion.

But, was there any consideration here on the desire for disclosure that this increases the leverages on one side or the other, when there's a dispute, and the auditing firm can say, well, you fire me, I'm going to tell you, this is a big issue, or vice versa, if you don't -- the company says you don't agree with me, I'm going to say I'm firing you because you got four auditors or something.

I think this is more than just disclosure.

CO-CHAIR NICOLAISEN: I do, too, I think it's behavioral aspects too.

CHAIRMAN VOLCKER: It's behavioral, and I don't know if it's good or bad.

CO-CHAIR NICOLAISEN: Yes. I don't either, and I don't think we are going to decide that --

MR. GLAUBER: If I can just answer directly Paul's question, the answer is, we did give consideration to that. I think it is a consideration, a concern. One doesn't quite know how it would play out, but we decided on balance that this is the right kind of recommendation to make.

CO-CHAIR NICOLAISEN: All right, we are three minutes behind. We are going to adjourn for lunch. We are going to start promptly at 2:00 back here, in order to remain on schedule. We'll continue with this panel.

We'd ask that you get back here, though, at 1:55, so that we can have some speed to it.

Subcommittees are still meeting by themselves in separate Subcommittee groups. Our guests are invited to participate, and we have a lunch, we have plans for you. So, we'll make sure that everybody gets to their rooms.

So again, back here at 1:55.

(Whereupon, at 1:24 p.m., the meeting was adjourned until 1:55 p.m., this same day.)

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

2:11 P.M.

CO-CHAIR NICOLAISEN: All right, I think we have enough of our group to call it a majority, so we will call this meeting back to order.

And we're continuing on the Subcommittee on Firm Structure and Finances. We've covered two of the recommendations. We have two more to talk about. One is a little bit arcane and perhaps could be covered quite quickly on the state activities, but I say that tongue-in-cheek because I don't really know. Maybe there are some difficulties with that.

MR. GLAUBER: It is arcane, but important. But we will take advantage of people being here immediately after their luncheon period.

CO-CHAIR NICOLAISEN: Okay, and then we would like to save at least 15 minutes and finish promptly at 3 o'clock so we'd like to save 15 minutes for those areas where recommendations have not yet been crystallized.

MR. GLAUBER: We have called them observations.

CO-CHAIR NICOLAISEN: They'll be

observations or they'll be -- we're working on this and maybe the status, without getting too deeply into the dialogue of those things because I'm sure they're quite emotional.

So let's get started.

MR. GLAUBER: Thank you, Mr. Chairman. Let me deal now with Recommendation Two which itself deals with state licensing regulation and the harmonization of federal and state oversight and enforcement. And here, there are essentially three parts. The first is to enhance the mobility of auditors who are state licensed by encouraging the states all to conform to the mobility provisions of the UAA, that is the Uniform Accountancy Act, and to do more than just encourage them to, but to give them an incentive which would be that if they fail to, that we would urge Congress to preempt this issue if the states have not conformed by and we've picked the date of December 2010.

Obviously, the issue of mobility is

very important for the industry, for the audit practice, and we should point out that some considerable number of the states already have it.

Gaylen, how many have already?

MR. HANSEN: Fourteen have.

MR. GLAUBER: And there are a number that are very close.

MR. HANSEN: Yes.

MR. GLAUBER: This would give them a, what we have called, a nudge.

The second part of this is to convene -- well, let me say it the other way. It's our view that there are often duplicative and inconsistent federal and state regulations here, as there are in banking and many other places. And equally important I think inconsistent and sometimes uncoordinated enforcement actions at the federal and state level.

We think it's important to deal with that and the mechanism that we have chosen to recommend is to convene regular roundtable discussions of the federal and state regulators and enforcement agencies to work towards the elimination of this often-duplicative and inconsistent regulation and enforcement.

And finally, we have included a recommendation which deals with the states and that is to urge the states to give the state boards of accountancy more financial and operating independence.

I'm going to end my part of this and defer to Gaylen who has led the discussions in the Subcommittee on this issue.

So Gaylen, why don't you start and then the other Subcommittee members can contribute?

MR. HANSEN: On recommendation number 2A, and this is the mobility issue and we heard from a number of the witnesses, the firms, as well as issuers, that having difficulty with cross-border practice in this age of global practice and internet practice. You can literally perform audit procedures in one state over the internet with emails and transfer of documentation.

Our profession may be a little bit different in the sense that we are on call 24 hours virtually to come to the beckon of a client, perhaps on the other side of the country. Each of the states have their own requirements for licensing and practice privilege. Well, in many of the professions that isn't the same. Certainly, if you're an attorney you can advise your client, go to another state if you're a CPA. That may be an illegal act. So dealing with this mobility issue, the idea is a CPA is a CPA, we don't have different GAAP standards from state to state or auditing standards, so therefore, if you have similar educational and experience requirements, why should there be these barriers to practice.

Everyone needs to be licensed in

their state of residency and so that really kind of is the background for 2A. This was intended to be somewhat of a nudge. We want to give states the opportunity to get behind this. AICPA as well as NASBA has been leading the charge and as Bob had indicated, there's a number of states that have passed legislation. There's a lot more that have it in the pipeline and are discussing it as we speak.

So hopefully, having a deadline for those states that resist will give them the message that they need to maybe move this along a little bit quicker, because I don't see that not doing something is a solution.

Then on B, this would be regular and formal meetings of state and federal regulators. We're at NASBA, we're in favor of that. We don't see any harm in certainly talking and trying to eliminate some of the duplication of effort that does seem to happen from time to time, the sharing of that information. It would be important. And so we're in favor of that.

And then the last item is urge states to have more financial and operational independence of their state boards of accountancy. Some of the state boards are underfunded. Some of them are controlled by other state agencies to the point where they may not have the level of autonomy necessary to exercise independent judgment in the areas of their responsibility and so we feel that -- and I agree with this recommendation that we encourage the states to look at the financial independence, the budgets of their boards and try to beef that up such that the boards might be more effective in carrying out their missions.

MR. GLAUBER: If any of the other Subcommittee members have anything they'd like to add?

Mr. Chairman?

CO-CHAIR NICOLAISEN: If not, then let's move to the Committee at large. Are there questions, comments, suggestions?

Barry, we'll start with you.

MR. MELANCON: I'll be quick. Just first off, on the first recommendation on the mobility nudge as you described it, Bob, I certainly support that and I think there is tremendous support, I would echo Gaylen on that.

I would urge the Subcommittee's recommendation to be tweaked by just one year on that date. I am more in favor of urgency on this than anyone, but I do believe the art of the practical here is that many state legislatures, in fact, meet every other year, for instance, and we are making significant progress. And I think if we put an attainable outcome, we're going to have a much better shot at actually getting there than creating a frustration point. So I would urge that point.

Second one also related to it, I note that you've extracted from the UA just a mobility provision and you pulled out the sort of regulatory cooperation through the roundtables and I understand that point. At least in your observations, it might be useful to some of these other regulatory coordination points if you could see a way to observe that other aspects of the UAA being adopted on a state-by-state basis, similar to mobility.

It might be good for creating uniformity as well, particularly with concern to this -- it's inappropriately called double jeopardy, but the double enforcement aspect where we've already had enforcement in one place and it seems to be a lumping on on the other. I think if you made reference to that, that would also be helpful in trying to make some movement in that direction.

MR. GLAUBER: I don't want to speak for the Subcommittee, but we have discussed making some comments about it. We don't want to raise it to the level of the recommendation that we have on mobility because we think it's important to focus just on that. I think we can probably add some words and color.

MR. MELANCON: Thank you.

CO-CHAIR NICOLAISEN: Ken?

MR. GOLDMAN: There's no way to have -- some way or another have this more of a federal license as opposed to a state-by-state license. In today's world, the mobility and globalness and -- I mean it just seems to be redundant to have state-by-state and -- so anyway, just a question.

MR. GLAUBER: The answer is of course it would be possible, I suppose. At this point we haven't engaged in that. We may be able to talk some more about that at a later time in our reports.

MR. GOLDMAN: Wouldn't that be something we would like to encourage?

MR. GLAUBER: That's an interesting idea.

MR. TURNER: I think what the recommendation, the way it's written, it literally does put you in the position of say, for example, you're in California, you can as long as you're living in California, you can go practice in any of the other 49 states with that California license without having to get a license in the other states.

Now if you move into another state, then you've got the reciprocity issue. But as long as you're in California, not living elsewhere, just going across the border. And in fact, as written, because the reference to the UAA, you don't even have to notify the state board when you go into that other state. You are subject to their jurisdiction if you screw up, quite frankly, but you're down to getting one license.

CO-CHAIR NICOLAISEN: Anyone else? If not, let's move on to your next recommendation, Bob?

MR. GLAUBER: Our next which is Recommendation Three deals with governance. As all of you know, as partnerships, audit firms are generally governed by boards of inside members. We believe and as embodied in this recommendation, the governance would be both more effective and more reassuring to investors and users of financial statements if independent non-executive members and those having full standing on the board could be added to these boards. Or alternatively, most companies have advisory boards which do indeed have outside members and an alternative would be or an additional measure would be to have these boards given meaningful governance responsibilities.

Now that indeed is our recommendation.

We are well aware that there are liability issues that would face any such outside members and I think we need -- these have to be dealt with. It's not obvious how one deals with them. This is to become an outside member of such a board might be an offer many people would find very easy to decline. But we realize, it's our view that there could be great value in this. We also realize in our discussions that there would be a significant cultural change for audit firms to have non-inside members on those boards, but again, I think it is the consensus view of the Subcommittee that there would be a virtue.

We do this because we believe that the effect of these governance changes could well be to enhance audit quality and public confidence through, among other things, enhanced transparency. So that's the spirit in which this is proposed. It is proposed not without understanding that there are practical barriers to it, but we think on balance this would be a useful step. I invite the other members of the Subcommittee to comment.

CO-CHAIR NICOLAISEN: Tim?

MR. FLYNN: I think we've had a really good discussion about this and I've had a chance to talk to the firms as well on it and I think there is certainly a willingness to really explore this at how it might work. I think there's a recognition, like any organization, that if you get a broad diversity of people with broader experiences, they're helping you govern an organization, lead an organization and give value to management in that process, it could be very powerful and very useful.

I think the key here is that as the firms look at it, and fully support it, it's that this board would have the same accountability that a public company board does to the shareholders, to the partners of the firm in terms of that degree, and elected by the partners and so forth and put in place.

So I just think it's something that is very much worth exploring and to get the right caliber of people with the right backgrounds could be a very helpful thing as you look at governance moving forward in the firms.

MR. GLAUBER: Mr. Chairman, I just

might add and Tim has underlined that in the recommendation it makes clear that these members would have the responsibilities to the entity, to the shareholders, to the partners as indeed is the responsibility of directors or a public board.

CO-CHAIR NICOLAISEN: You draw a contrast to what else might be viewed as outside board members?

MR. GLAUBER: Well, no. I mean I think what I'm trying to do is emphasize the parallelism of this to a public board that non-executive members of public boards have their duty of loyalty to the corporation.

CO-CHAIR NICOLAISEN: Would it be comparable -- it wouldn't be viewed as an independent oversight?

MR. GLAUBER: No, nor responsible to any particular outside interest, but to the entity as is the case in a public corporation.

CO-CHAIR NICOLAISEN: Bill?

MR. TRAVIS: The only thing I would

add is I think the addition of outside board members would, in their fiduciary responsibility to the entity, ensure that the long-term success of the organization and doing its best to serve the public interest would be better brought to bear in the discussions and decisions that are made at the board level because they would not have a short-term compensation focus. They would not be reporting to the CEO of the firm, which can work fine in some cases and may not work fine in other cases. So I think the independent expert on the board would be very beneficial to the firms in the right scenarios.

CO-CHAIR NICOLAISEN: Rick, did you want to say something?

MR. MURRAY: Just a very brief observation on the way in which liability potentials as a deterrent to obtaining the number and quality of people you would like on the boards connects to the voting or nonvoting role assigned from an insurer's perspective.

I think it's fair to say that insurance would likely be available at a reasonable cost on a so-called side A protect the director basis for outside directors that did not have voting power, whether they were regular members, part of an advisory board or whatever. That would be, I think, almost impossible to provide in the event that voting power was assigned.

So while endorsing everything that's been said about the desirability of this as the right direction, the only question I would raise is at what point in moving down that direction do we take one step too far and undermine the goal.

CO-CHAIR NICOLAISEN: Chairman Volcker?

MR. VOLCKER: My comment may reflect the fact that I have my experience with the management of auditing firms is maybe not up to date, but I was surprised to read this recommendation talking about boards and votes. What I remember is having some responsibility at Arthur Anderson at the time for a brief period of time, given some sweeping responsibilities. I actually said well, “get the managing board together.” And they questioned -- there was a long silence.

“Well, we have a formal board, but we don't really meet. We don't get together. That's not the way this firm runs.” And this was presumably a fairly unified firm.

Maybe they run differently now, but they certainly didn't have a board getting together considering issues and taking votes, that's for sure. When it came to an issue well, that's up to the partnership vote and if it's an important issue we've got to refer to all the partners and so forth.

So this sounds like a corporation we're talking about and maybe you ought to recommend they become corporations which is an interesting issue, but I haven't seen that considered here.

And I was a little bit startled, I

do have a little experience on being on various advisory boards and I've never been on one that had any meaningful corporate governance responsibility. And I don't think -- how do you have a meaningful corporate governance responsibility when you're an advisor, that they may or may not want around?

I'm not sure the advisor wants that responsibility.

I just was kind of startled by this thing. While I have the floor, and then I'll shut up, I was a little surprised in seeing something labeled structural and financial considerations. I haven't seen any financial considerations in any of these recommendations which I think are important.

CO-CHAIR NICOLAISEN: It's the elephant.

MR. VOLCKER: Well, I'll give you another elephant. The finances, of course, are all tied up with the services that are provided. And this has been a big issue over time and I don't think it's been fully resolved. But I don't see how you escape some comment on what is appropriate for an auditing firm to do and what's not appropriate for an auditing firm to do. And where the squeeze really comes has been so illustrated and unfortunately with KPMG recently, that when you come to make that decision an auditor is looking to see that people follow the rules.

And an aggressive tax practice is dedicated to finding for people how not to follow the rule. The first guy, presumably the good guys, are paid an hourly fee; and the other guys are paid a success fee. And it kind of affects the financing of the firm and the tensions within the firm and gives rise to a problem which I don't know what the answer is because I'm not saying you can only do very strictly defined auditing stuff. But it's hard to do stuff that seems to be -- to take a kind of psychology that is, in fact, 180 degrees from an auditing psychology.

So with those unhelpful comments at this stage in your discussion --

CO-CHAIR NICOLAISEN: That's input that has been discussed and I think the Subcommittee is preserving time because we will have some dialogue about some of these issues as we go forward. But Michel, I know you have a comment.

MR. PRADA: Thank you. Just a comment to give you a flavor of the European reactions on this. This is highly debated in Europe too. We've seen discussions on this issue of board members, who by the way, two different contents really. One was the one which is present here in the recommendation where the presence of independent board members is meant to participate in better governance as it is supposed to be participating in the better governance at least at companies.

So it's true, as Chairman Volcker said, that we're not dealing exactly with the same kind of structure, but I guess we're trying to accommodate the system in a way which would give a governance which might be similar to the one of listed companies.

And indeed, this is a proposal which, I guess, broadly supported in Europe. It has another aspect which will possibly be addressed in the next Subcommittee discussions which is the opening up of equity, the capital of the company, but this is a different one. It's a proposal to address the issue of concentration and the possibility for small firms to grow more rapidly and this one is very controversial and people are not really necessarily in favor of it for many reasons. I will come back to that later.

The second point I wanted to mention to you as a point of information is that to address this issue of transparency and governance, the EU Commission has made a rather bold decision which was to make compulsory within the so-called Eighth

Directive, the publication by the firms of an annual transparency report which is fairly comprehensive. It describes the structure and ownership. It describes the way the network functions. It gives a detailed presentation of governance structure. It talks about internal quality control and the ones who are supposed to lead the firm have to commit themselves like for listed companies on the efficiency of this internal quality control.

There is a list of the public interest entities for which the audit firms have carried out statutory audits. There is a detailed description of the firm's independence practices. The policy, this is interesting from the point of view of our first discussion, the policy followed by the audit firm concerning the continuing education of the auditors and then financial information on the way the firm functions, the turnover, the fees of the different nature and tax -- the information on fees and tax advisory services.

CO-CHAIR LEVITT: Is it as comprehensive as a corporate --

MR. PRADA: This is very recent, but I think it is a phenomenon which will, in my view, develop and will become more and more comprehensive and comparable to the one of an annual report, really. It's not an annual report in the way we know it for firms, but it's a transparency report which is a starting point which might be developing in the future. So I just wanted to mention it to you because it is something which has to be implemented all over Europe now.

MR. GLAUBER: Mr. Chairman, could I just make a comment on behalf of the Subcommittee?

CO-CHAIR NICOLAISEN: Sure.

MR. GLAUBER: I'll respond first to Chairman Prada's comments on the EU transparency report. This is something the Subcommittee has discussed, and in fact, when we get to the last part, our observations on the issue of transparency and liability, it's one of the things that I want to raise because it's a very interesting initiative.

Second, if I might, to Chairman Volcker's point, just to point out I think there are three different points embedded in what you said. One is the issue of the governance structure and whether there is any board to which outside people meaningfully could be appointed, which is a fair point and it varies, I suspect, from firm to firm.

Second, the whole issue of corporate form and we have discussed this. It has obviously some attractions in terms of raising capital and also provides a structure of governance that is well articulated. And then the third, of course, is a very important issue that we have had some discussion and I know there will be more in this committee, about the range of activities in which an auditing firm can engage.

CO-CHAIR NICOLAISEN: Barry, you had a comment, and then Tim.

MR. FLYNN: I just want to comment. Chairman Volcker, your comments on governance are significant and appropriate. Just to speak for my firm, for example, we made 15 meaningful changes in our governance and many of them you referenced. And we're a much different firm today, very much an independent board of inside partners, but elected by the partners, separate committees, executive sessions, lead director, many of the things you look at in a corporate board, although internal members, but as you look at the structure and context.

In the other firms themselves, I know have made change as well, recognizing the importance of having strong governance, recognizing the importance of our responsibility to the public interest. And so as a profession and as a firm, my firm particularly we did things we're not very proud of in the past, but looking where we are today, we're a much different profession, I believe, and a firm as well. And we are moving forward very much in the right direction. And I appreciate your comments.

CO-CHAIR NICOLAISEN: Barry?

MR. MELANCON: I would echo even beyond the Big Four that those structures are predominantly in place as well to Chairman Volcker's point.

To the Subcommittee, I would ask as you consider the -- and I agree with the points that were made in the Subcommittee's recommendation about there are hurdles to overcome here. And as Tim said, I think the profession is generally supportive of this, assuming we get over those hurdles.

The point I would ask you to consider, however, is we have about 800 firms that do public company audits. And so it might be appropriate in this type if there is a recommendation that comes forward in this to have some type of line of demarcation because I think that maybe if you audit a Fortune 1000 company or something. I think the practicality again, I'm trying to get to something that's implementable if that's the recommendation and you overcome these. The practicality of a firm that does two or three audits, a public company that's very small, and going through these steps when it's a small part of their practice, you know, is a consideration.

CO-CHAIR NICOLAISEN: Damon?

MR. SILVERS: I think that the committee's recommendation in this area which is to push in the direction of outside directors in the context I infer of what would continue to be an auditor-owned enterprise is the right approach. And the question I have about it, I suppose maybe to Rick, is you raised a concern that it would be difficult to ensure outside directors in the context of such an approach, assuming that they were genuine directors as opposed to members of an advisory board.

To what extent would that be a function of the fact that we're talking about making them directors in the governance of a partnership versus potentially in some manner or another an entity that had some of the liability limitations that one would find in a corporation?

MR. MURRAY: Damon, I don't think that form affects this very much. The issue that concerns me is that as you put it in the context of auditor-owned enterprises, the board is currently the ultimate power within the firm for policy and the manner in which policy is implemented.

And if there is deemed to have been a performance failure that arises by virtue of any weakness in leadership direction, the chain of responsibility will make its way to the board. The reason we haven't seen any claims against directors up to this point is because there have been no outside directors in suing the firm. In a limited liability partnership, you don't need to worry about that. But I think the minute that a -- if Paul Volcker happened to have been a voting member of a firm which encountered a large-scale liability, it would be assumed that there would be both financial and career benefit to the attorney who chose to add Mr. Volcker's name to the complaint if he had participated with the vote on any aspect of the firm's operations.

MR. SILVERS: I would observe a couple of things about this. One is that in all of these issues involving the structure, ownership and governance of firms, I believe that one of our goals ought to be to enhance the professionalism of those structures and thus, I think this is the right way to do that, meaning that movement more in the direction as has been discussed extensively I gather in Europe, movement more in the direction of turning audit firms into just one more public corporation, I think diminishes that matter. And we really ask audit firms to do something that's outside -- that's somewhat distanced from an economic, from a sort of databased economic calculus. And I think we want governance structures to reflect that. And that's why I like this.

I'm a little puzzled and this is a much longer discussion and I don't want to have it now, I'm a little puzzled about the insurability issue as boards are routinely insured in organizations that are exposed to catastrophic risk in the public company context, all the time. And I could go on ad nauseam about examples of that. So I'm not sure I get it, but that's probably a conversation for another day.

CO-CHAIR NICOLAISEN: I agree. I think we'll leave it at that.

Lynn?

MR. TURNER: I do think Damon

raises a good question and some of which has been discussed. In the text write up, Damon, you'll see a sentence in there that says this is recommended in the context of the current independence and liability regimes that are out there. It's not intended to change those in any way, fashion, shape or form.

And while I wholeheartedly support this and do think it's the right thing to do, I am not yet convinced from a legal perspective and from an independence perspective it's doable. I think there's going to have to be a lot of research into how you pull that off in the context of an LLP and insurability issue, as well as the current independence regime. So while it's a great idea, it's got a lot of work to do.

MR. GLAUBER: I think that's a fair description.

CO-CHAIR NICOLAISEN: Any others? Let me ask a question about this, too. When I think about the growth rates of the non-audit practices that are part of the firms versus the audit practice itself, it would strike me that at least for a number of firms and I think we've heard this in testimony too that their allotted practice, particularly of public companies is not the majority of what the firms do or derive their income from which would to me also equate to then perhaps the ownership of the firm is not really an audit ownership or controlled firm and maybe you could talk a little bit about whether you've thought that there should be or maybe there are veto rights there. There may be things that the auditors can ensure occur in order to protect the viability and quality of the audit practice in something that has significant outside ownership.

MR. GLAUBER: Again, by outside, you don't mean public ownership, you mean ownership of individuals who aren't part of the audit practice.

CO-CHAIR NICOLAISEN: Right. Who

aren't part of the audit practice.

MR. GLAUBER: I understand.

CO-CHAIR NICOLAISEN: We can raise that later too. If there's no more on this -- should we move to the -- I think we have the essence, I think you have the flavor of what the Committee members have discussed, so perhaps we can move to the what's not yet on its way to a recommendation or observations or whatever.

MR. GLAUBER: As I said at the beginning of our part of this session, we continue to work towards consensus on the issues of enhanced transparency and catastrophic loss liability. Transparency has come up a number of times in our discussions today. I'm sure it will continue to. What's interesting to me is that the Subcommittee on Concentration and Competition has concluded that it's necessary to create a mechanism or at least propose a mechanism to deal with the possible loss of a major accounting firm which goes to this issue of catastrophic loss liability.

So we've had extensive discussions on both of these issues. We have not reached consensus. We've heard a lot of testimony. We've reviewed data that has been provided us. We can make some observations and let me do that just simply to provide a basis for further discussion here in the Full Committee.

On transparency, I think we would note that there have been several initiatives. One of them is the PCAOB's May '06 rule, I think I have the date right, which is as yet not adopted, I take it, to have disclosure of client lists, fee distributions across the various parts of the practice, also special reports triggered by such events as legal proceedings, bankruptcy. That's one transparency initiative.

The second one is the one that Chairman Prada raised a few minutes ago which is the EU Directive 40 which will be adopted, has been adopted and will require from June this year disclosure of, as he said, ownership and governance structure, financial information which includes audit fees, consultation fees, partner pay information, but not Chairman Levitt's question, full financial statements. It does not include those. But I'll get to that in a minute.

A description of the quality control system and quality assurance review reports.

There is a third initiative that we have taken note of and discussed and that is the UK which presently requires published public annual reports which disclose fully audited financial statements in the UK, as well as governance structure and performance metrics.

So those are different regimes of transparency. I think to reflect the discussions in the Subcommittee I should point out that they exist in the context of different regimes of liability exposure than is the case here in the U.S. And it's I think something to keep in mind. That's why indeed our discussions have often been around both of these issues together.

On the issue of limitations of liability exposure, to the possibility of catastrophic loss, we've reviewed a number of mechanisms that might deal with such a risk and indeed, these have been discussed in the testimony that we've heard in the various sessions: appeal bond caps, modified pleading standard, federal court jurisdiction over actions involving audit firms or at least increased access of audit firms to federal court, alternative measures of calculating damages. Professor Grundfest discussed those out in Los Angeles. More general issues of securities litigation reform as well as, of course, the issue of liability caps which has been raised.

CO-CHAIR LEVITT: Bob, do you say that there is a linkage of some sort between transparency and liability?

MR. GLAUBER: What I'm saying is that in our discussions people have noted that these different transparency models, transparency models which go beyond the current one in the U.S. that exist in mainly the EU and even before that in the UK, do exist in the context of a set of liability exposure and regimes different from ours.

CO-CHAIR LEVITT: I know, but that's not what I'm asking. I know they are different, but are you of the belief that we can have no further transparency without in some way impacting the level of liability?

MR. GLAUBER: What I will say to you is that when we go down the path of transparency or even to take something we discussed earlier today which was enhanced standards of fraud detection, very quickly the issue of liability comes into the discussion. And the concern that were the standard, for example, of fraud detection to be raised, that this might expose firms to further liability and so in fact, actually we had a discussion over lunch of --

CO-CHAIR LEVITT: But in your judgment, does increased transparency raise the bar with respect to liability?

MR. GLAUBER: I think you have to -- it depends on how you increased it, but I think the answer is it could. I don't claim to be an expert on it, but I think it could. But more important, I think in the minds of the people discussing these issues, they feel the constant environment of liability as they talk about changes and I think it does frame the debate and the discussion.

I suspect from what you say, you don't agree.

(Laughter.)

CO-CHAIR LEVITT: I'm trying to relate this to our nation's success in terms of increasing corporate transparency and I don't know that I would necessarily make the argument that that increase has created -- has had an impact on liability.

And if it has, maybe that's an acceptable impact.

MR. GLAUBER: It may be. I don't want to debate whether it's acceptable or unacceptable. I think that the two issues do join. They certainly do in the minds of people debating this as I've listened to the debate. I'm very frankly about as rank an amateur in the area of accounting as you've got in the room here. So most of this has been for me first impression. But as I've listened to these debates, it strikes me that the liability environment does frame the form of debate and the positions of many of the people who discuss it.

CO-CHAIR NICOLAISEN: Lynn?

MR. TURNER: Very clearly in the Subcommittee, the profession, the firms have linked getting additional transparency to the liability issue, I take it and so there's been this debate about linkage or not, and people get caught up in that and I think it would behoove everyone to stay away from that. The way I view it is we've got an objective here to improve audit quality and protect investors, and so I look at what are we trying to achieve and we're trying to achieve better quality audits which we're talking about with the fraud stuff and there's some things we've still got to work on there. Bob Herz, I think, made an excellent point earlier today I made a note of.

So I think we've got to look at that.

I think there should be greater transparency without a doubt. I don't think it's hurt anyone to be transparent and I think Michel noted that the EU 40 Directive which has some things, but I think personally fall way short. I like the annual report that all the forms are already filing in the UK which I think is much better and goes further and it sounds like where Michel thought things were going to get up anyway. And so I think that's good.

On the other hand, I do think there is an issue here of a sense of fairness. We really haven't got any evidence. We asked for the evidence and didn't get the evidence from the firms with respect to making a case that there is a catastrophic risk here and something going down. I wish we had had that because it would have made it easier to deal with, but we didn't get it. But I do think there is a sense of fairness issue here to be dealt with as well. And the way I look at it is dealing with all those issues to improve the audit quality and investor protection. I dislike the notion of linkage, but I do like dealing with all of the issues and quite frankly, there's some issues here we haven't dealt with. We haven't dealt with improving that audit report which the CFA Institute had pleaded with us and given us overwhelming evidence on.

We really haven't dealt with the big elephant in the room and that is ultimately who pays the auditor fee and that's ultimately what causes all the independence rules and issues and we walked away and punted on that issue as well. So there's some good issues here, but they've all been teed up and I think debated fairly well in the committee and debated thoroughly and Bob Glauber has given tons of blood over that debate, so again, I congratulate him. I think we've got more work to do.

CO-CHAIR NICOLAISEN: Tim?

MR. FLYNN: I think Lynn said it well. I think there is a healthy debate and there's a lot of recognition on both these fronts that there's things that we can do. I think there's no question that the profession would like to move to more transparency. I mean we've talked about it before the EU and said at a baseline, you ought to start there as a baseline. It's more than we're doing today. What else can we do that's critical to audit quality? The point Lynn just made, what do we do with other transparency issues that are critical to audit quality.

There's also, maybe it's an unfounded fear, but there's a fear that if there's more transparency on financial information, that goes right in the hands of plaintiff attorneys in terms of more settlements, what you can pay and all types of things. Again, that may be unfounded, but it's there. We have to deal with it. Think about it. So I think there is some connectivity there, but we have to work our way through that.

There is a little bit of difference in our world of really not having insurance. I think we need to look at the corporate world and transparency. Most corporations, most business models have access to insurance and firms are self-insured over a certain dollar amount. So I think that's something that it's just a part of reality of the business model today.

And if there's some things in the reality coming out of our discussions is that firms can't take things to trial. We're not talking about caps or special provisions here. I think what we're really talking about is that there are some things in our liability regime today that would get things from state to federal courts or some things in a lot of different pleadings standards and/or different standards for dismissal and put things on a field where in the model we have today that firms could go to trial to defend things as opposed to basically settling and being forced to settle with an open transparency financial statement that might make that more difficult.

That -- we all have major points of view on that, but that's part of the discussion we've had in our discussion. And so can you not break them apart? Yes, you can break them apart. Are there consequences of breaking them apart? Possibly?

Do we have to have more debate around it? Yes. Are the firms acknowledging more transparency? Absolutely. And we'd like to evolve this.

Do I think that Chairman Prada's comment that over time it will evolve? I think that over time, just like in the U.K. we'll evolve to much more transparency and they'll be almost in competition with the firms at some point in time in order to be transparent. But that has to evolve in the context of the overall environment a little bit too.

And if that's what we're trying to have a discussion, I think that's the kind of dialogue that we've had in our Subcommittee.

CO-CHAIR NICOLAISEN: Anyone else? Zoe-Vonna?

MS. PALMROSE: Thank you. This is to build on what Tim and Lynn have said.

Actually, in talking about this issue or thinking about this issue of transparency, I think about it as an issue of disclosure, although transparency sounds -- sounds much more positive and like a good thing irrespective.

But instead of that, maybe asking what problem are we trying to solve here. What is it, what problem are we trying to address through disclosure here?

And that kind of sets a path towards audit quality as Lynn has said and as Tim has said. Really, the connection here between how users can get more disclosure to assess audit quality for a firm.

And so I guess one of the surprises for me is that is there -- companies spend a lot of time thinking about their key performance indicators, KPIs, and yet in auditing after what, all these centuries or decades or whatever, we don't really have any agreed upon set of key quality indicators.

So I'd just like to set that on the table as maybe worthy of discussion and note in that regard that there is a comment letter in the file to the Treasury from a retired partner who sets some ideas out for that and also --

CO-CHAIR NICOLAISEN: Your point is absolutely valid. It is part of the next Subcommittee.

MS. PALMROSE: Actually, it isn't going to be part of the next Subcommittee I don't think.

CO-CHAIR NICOLAISEN: It's a question that will go to that Subcommittee because it is an element of how does the audit committee determine that they have the right audit firm? What information did they use? And I think there's a whole lot of reasons for that.

MS. PALMROSE: That's great. I'm pleased to hear that.

CO-CHAIR NICOLAISEN: I'm going to

express a personal view here. And having been part of the profession for a very long period of time, I would also say just to expand upon Lynn's comment about what we're trying to accomplish, one of the things that we are also trying to accomplish is to make sure that we have a sustainable audit profession, one that is going to be around. One that people really want to join and that is an attractive place to work and where you feel good about what you do.

At this point in time, I think the audit profession is viewed as not being particularly cooperative and exposing its financial information, its governance practices or for that matter if you look at what CEOs and CFOs are obligated to do under Sarbanes-Oxley. They report on compliance with policies, procedures, and controls.

I think there's a very strong case to be made forgetting about litigation for a minute, but from the standpoint of the

American public, the investor community, and the smooth functioning of our capital markets to be able to say that those who lead the large accounting firms also take responsibility for those controls and policies and procedures that affect audits of public companies.

We've talked about, and I know it's still on the list of things within your Committee as to whether an audit partner should sign his or her own name to an audit opinion. I feel strongly they should and I have that -- those reasons for -- from a lot of experience and I respect that other people may feel differently, but quite frankly, when an auditor goes to an annual meeting of a major public company and is introduced, that name is quickly forgotten because it didn't appear any place else. And the audit partner, may or may not be asked to respond to something within the shareholder's meeting, but quite frankly, I believe the investor should have the opportunity to know who it is who ultimately is accepting responsibility on behalf of the accounting firm to make sure that all the pieces came together.

Obviously, they have to rely on the firm, but pulling those pieces together I think do matter, does matter.

I think there are some protections that are forwarded elsewhere in the world to those who signed those opinions. I, for one, would be supportive of that kind of protection, relief, whatever you want to call it. But I think we have to move this dialogue along or we're essentially wasting our time as a Committee if we can't deal with what has been fundamentally a concern amongst the investor community. I'll leave the investors here to speak for themselves but I heard it while I was at the SEC. I heard it while I was an auditor. I just personally believe that the profession would benefit from being open in dealing with the public and dealing with the marketplace and dealing with audit committees and giving some objective data that can be looked at so that people can say you know, this is the right firm for us to use for this engagement. We do feel good about this.

And I hope that we're able in the days and weeks ahead to move this forward. I know that that's the desire. I know there's a tremendously good faith desire on everyone's part. I'm not trying to pre-empt any of that. I'm not trying to dictate an outcome here. But I will express a very strong view on this, and I would hope that we'd be able to continue to work. I'm not sure that we in today's session are going to necessarily solve much at this level, but I would encourage the Subcommittee to work.

We have about another five minutes. If there are other members of this larger Committee who would like to offer something, I'd be delighted to hear it. So we'll start with Mary, David, and then Barry.

MS. BUSH: Just to pick up on one of your comments, Don, about the investors knowing who the partner is who has ultimate responsibility. I would fully endorse that. I see similar situations sometimes in the legal profession, where a legal opinion is signed by a firm rather than an individual. That doesn't help me very much. I want to know who the individual is, what that individual's reasoning process is so then I want to know who I can hold responsible. So I think the same for the auditing profession.

With regard to Mr. Flynn's comment about disclosure over time, I guess I just don't quite understand why it needs to be over time rather than stepping up to the plate now. And then as you said maybe we'll cover some of this in the next Subcommittee, but in terms of audit quality, I mean there are two levels of what is revealed to the public by the PCAOB and that second level, you know, even the audit clients of a firm never see it. And maybe there are some things that are so sensitive because they are legal in nature that perhaps they have to be held close for some period of time, but I would think that those are the kinds of things that could help one judge audit quality and a firm's ability to do quality audits.

CO-CHAIR NICOLAISEN: Right. Damon?

MR. SILVERS: I want to make a couple of comments, not about the disclosure issues, but about the other sort of additional item unresolved here which was the legal, the liability regime.

I would hope that the Subcommittee in the further deliberations would keep a couple of things in mind. I mean, we have a liability regime generally in the United States that calls people to account for the failure to meet legal duties of various kinds. We're all open to it, right?

In particular, professionals are

vulnerable to it and we ask professionals who are given all sorts of rights and privileges and in return are asked to meet a higher standard of care in their work than the rest of us are in our daily lives in general. The question that, I think there's been several areas of discussion, I'm not suggesting in the Subcommittee, but sort of in the world recently about this that are sort of misplaced.

The first is that there is something nefarious about the exposure to liability on the part of auditors. We have this system in order, fundamentally, to get incentives right at the front end and in particular with auditors in a set of economic relationships, where there's a very serious principal agent problem, where the people doing the hiring may not really have the interests at heart that we're trying to serve through the process of public auditing, that company management that advises the audit committee may wish to have a weak auditor than a strong one, that the audit committee may lack the information even if they have the desire to be able to figure out whether they're getting a quality auditor. In this circumstance, typical market forces are not as strong as they would be in other circumstances. It makes litigation more important as a setter of incentives at the front end.

Secondly, I think we need to be very mindful of getting insurance issues right. Many, many businesses, particularly professional businesses in our society, are involved in taking risks which cannot be insured. It is impossible to insure a law firm against the full range of risks that the law firm is bringing on every day. It is just impossible. And no one even tries. I mean, insurance is a way of smoothing things out, of dealing with cash flow issues. It is not a protection against catastrophic loss, against the multi-billion dollar claim or not to mention the multi-hundred billion dollar claim.

No such thing can be done in the auditing profession. It never could, it never will. So we're left with two issues, I think, in relation to thinking about, or maybe three issues in relation to thinking about litigation in the auditing profession. One is do we have the basic standards right? Are we asking the right level of care? Do the people who should have the right to sue have the right to sue? Do people that shouldn't don't? We ought to not get in, I think, to questions or solutions that implicate altering our entire legal system. I just think it's not a serious thing to try to do.

Second question is are we looking at a situation where in general the level of litigation cost on a year in year out basis is choking the profession? I think that the data we saw pretty conclusively says no. And in particular, it says no if you separate out claims brought by clients, by businesses against audit firms, versus businesses brought in the class action context. I think the class action issues, which is I think mostly where all the noise is, diminishes significantly.

The third question is do we have in the context of catastrophic risk, which cannot be insured, a problem that presents a public policy issue? I don't think anyone believes that is true in the context of law firms, for example, because we have thousands of law firms. And so one blows up. Other than those directly involved, who are obviously unhappy. There's no public policy consequence of that.

This becomes an issue in the context of what we're about to discuss in the next Subcommittee which is the degree of just the number of firms who can do a big company audit.

That set of circumstances is not a

very good set of circumstances to talk about structural change in -- and we ought to be cautious in respect to defining these problems and looking at solutions to them.

I'm confident, based on what I know about the conversations that have occurred in the Subcommittee which I'm deeply grateful for having not to have been asked to take part in the first instance, that a serious effort is under way and -- but I think it's very important to try to parse out what it is we're trying to do in respect to these issues.

I think that investors are really, really concerned here most fundamentally with incentive issues, behavioral incentives at the front end. Not so much with recoveries, because recoveries are always pitiful, right? And unavoidably, so.

Investors are concerned about the behavioral issues at the front end. And secondly, that investors looking at the legal landscape today, find that there are perverse aspects of that landscape for us, that affect incentives in bad ways.

So it is not as though investors look at a landscape, a legal landscape currently that's perfect, but investors are very hesitant, I think, to open up a sort of open-ended process that have the threat embedded in them of dismantling very, very important incentive structures that at least exist in imperfect forms today.

CO-CHAIR NICOLAISEN: Damon, thank you.

Barry?

MR. MELANCON: I'll be very brief and Chairman Levitt, I'm going to use the linkage word, but in the way that you were asking about.

I think as you look at and hearing what you said, Don, also, I think as it looks to the transparency discussion, I think the linkage is to those things that affect audit quality. And I think that's what we're here about. And I think the profession is going to be and is trying to be responsive to those points where there is a linkage to audit quality.

Now we can debate what that is. I acknowledge that. I do think that the EU 40 and if you look at that list has made an attempt to do that. And so that's just the linkage I put in that bucket.

And then on the bucket to the Subcommittee, to the extent that you discussed the liability issue and I don't think this is far away from what Damon was saying, I think the profession has a concern about its right to defend itself and I think Tim alluded to that in his comments.

There are a lot of things stacked up against a firm to have a viable chance in the system to defend itself because of the way outcomes and activities go through that particular process and it's much too complicated to talk about here. I know the

Subcommittee is dealing with it.

So I think that would be my feedback on those two points.

CO-CHAIR NICOLAISEN: Bob, I'm going to give you the final word in just a minute, but I wanted to say, to express really deep appreciation for the work that this Subcommittee has done. It has been an extremely difficult set of issues that they've had to deal with, that they've had to address. And as we all realize at this point, it's not done. They are going to need the support and input of this larger committee.

And I would encourage you to be sympathetic and empathetic and helpful and see what we can do to accomplish the objective of maintaining a very strong, sustainable high quality audit profession. And we're all coming from the same point. So the fact that there's strong emotions expressed here, I think is probably healthy and it's understandable and it should be read by anyone as any divisiveness within this process.

I believe the process is working as exactly as it should and we will continue to have a healthy family debate as we move forward, but my sincere hope is that what we will be able to present at the end of the day are recommendations that are very strongly focused on a strong, healthy, vibrant profession that is geared to serving our capital markets and protecting the interest of investors. And that's a very complex equation to get through.

Bob, I'm going to give you the final word.

Tim, I know you want to say something. So --

MR. GLAUBER: I am deeply grateful that you are giving me the final word. Could I yield a portion of my final word?

CO-CHAIR NICOLAISEN: Yes, you may.

MR. GLAUBER: For clarification.

MR. FLYNN: Just one thing. I want

to make sure I am clear. As a profession, transparency, disclosure, I want to be clear, baseline at a minimum, the EU 40 standard we talked about, item that based on right now today, what I said is I believe market forces will force us to evolve over time to more of a UK model of audited financial statements. But let me be very clear on that. Audit quality key metrics, EU 40, the professional standards rating did that today moving forward. So I don't want you to get the wrong impression on that. Audited financials over time I think will evolve there.

MR. GLAUBER: And let me just make, as my final comment, I want to return to what Damon said and I think he framed the issue exactly right.

The importance of a liability system is to get the incentives right. I think that is absolutely correct. Therefore, the question in light of what we've said over and over again that we are focused on increasing audit quality is to keep asking ourselves, in what way does the liability system encourage increasing audit quality or not encourage it. That really is the right framework in which to discuss these issues.

And we can disagree on that, but I think you set exactly the right context and framework for us to make those considerations.

CO-CHAIR NICOLAISEN: Well, thank you very much. Terrific job. We look forward to ongoing discussions. Let's move. We're not going to have a break, we're not going to get up, but --

(Laughter.)

But we're going to move directly into the Concentration and Competition Committee. I'm going to yield the floor to Chairman Levitt. I will only say before that that if you like, there is coffee and whatever in the room behind us. But we're not going to have a formal break. We're just going to get keep going. So thank you.

CO-CHAIR LEVITT: Don, you have done so well. I am reluctant to step in at this point. However, the members of the Committee that are here today, Mary and Ken, Rodge Cohen was here, but he is not now. And Damon Silvers is the Chairperson of the Committee.

Why don't you kick it off, Damon.

MR. SILVERS: Thank you, Arthur. We have been tasked with the job of considering issues of market concentration and competition in the auditing industry and profession and within that, a couple of specific issues that perhaps could have gone several different places, including the relationship of the PCAOB to its foreign counterparts, and issues relating to the auditor independence rules.

What I'm going to do is summarize our recommendations. I'll do my best to be brief. My colleagues from the Committee who are with us, Mary Bush and Ken Goldman, will add their comments. I don't know. Is Rodge on the phone? We thought he might be. Guess not.

Let me begin by saying that it's really been an honor and a privilege to serve with my fellow Committee members and our assignees. I guess it's a technical term. I'm slipping from various regulators. We, Ken, Mary, Rodge, Rick Simonson and myself, we've been able, I think, to come up with a set of recommendations we feel are quite substantive, which we are quite, I believe, quite unified and serious about and not hesitant about at all.

We will see whether you feel the same way. Oh, yes, and we've benefitted in certain respects, particularly from the help of Alan Beller, who I think will be helping all of us but who was kind enough to take on a bit of drafting with our preliminary recommendations.

Let me begin by describing a little

bit of the process. We came to an inquiry, we made, fundamentally, I think, given the title of our Committee, we asked the first question of is there adequate competition in auditing and, particularly, auditing of public companies, and if not, why, and if not, how could that be changed?

We were fortunate, I suppose, in that shortly after we began our work the Government Accountability Office released an extensive report addressing this very question, so we had the benefit of that report and the benefit of the ability to consult with the GAO.

We had sessions at each of the full committee's public hearings on these questions. We heard from small and large firms. We heard from issuers. We heard from regulators, both U.S. and foreign regulators. We heard in a very interesting fashion from individuals involved in the underwriting process. And then we heard in Subcommittee session extensively, from both the regulators of the accounting rules and the auditing profession and from present and former people involved in the Justice Department's oversight of competition issues.

We -- what we concluded from this process in relationship to the fundamental question and which really informs, I think, our recommendations is really two things. One is that there's a pretty broad body of evidence that at least insofar as people who make competition and antitrust issues their careers, that the audit -- that the market in general for public company auditing, even in the large company area is not technically a noncompetitive market. And I phrase that very carefully.

That seems to be a widely held view among people, among those who are most knowledgeable.

It is clearly a more competitive market and it's become significantly more competitive in the last five years for smaller public companies. It's less competitive for larger public companies and there are unique issues associated with competition in the area of global enterprises where it's not just a question of the size and scale of the U.S. affiliate of the global network, but whether or not you have a robust global network to deploy.

I believe that the general view of our Committee was that this conclusion is not entirely in sync with people's experience, that on an experiential level it feels like a small room for companies, particularly companies who believe that they have a need to tap non-audit capacities of major audit firms.

Now we also noted, but could not get good data that the market for those non-audit services is not as concentrated and is quickly becoming less concentrated than auditing per se that the fact that there are four major -- four very large global audit firms -- does not -- is not a description of the market for tax services or IT services or mergers and acquisitions consulting.

With that as the sort of empirical backdrop, we developed the following recommendations which I think you will find hopefully address, has something to do with the
-- with the landscape I just described.

First, we -- first, we noted, and through -- from the testimony that we received in public meetings and from our meetings with the regulators who watch the industry that today, as I said earlier, we have -- we have a marketplace where there are four very large firms with comprehensive global networks. Several firms that are somewhat smaller, whose global networks are varying in size.

And that there are real questions as to what the strategic direction of some of the smaller firms are in terms of whether they aspire to be larger firms. And a number of significant structural obstacles to their attaining comparable size to the next tier, attaining the comparable size to the large firms in any short period of time.

However, we felt that fundamentally, to the extent that we felt uncomfortable with the current size of the large company audit market that it should be a public policy goal, all other things being equal and a goal subordinate to the primary goal of audit quality, it should be a public policy goal to encourage the growth and emergence of additional very large firms over the long run.

And those caveats are extremely important. The fundamental policy goal here throughout ought to be the promotion of audit quality. However, there are many circumstances in which that goal, that primary goal of audit quality is, in fact, in sync with the goal of promoting the emergence of further large firms and there are other circumstances where one could imagine policy makers making decisions that were neutral on the audit quality area, but promoted the growth of the smaller firms.

We have one specific suggestion in that respect which drew, which came out of the evidence, the information we gathered about the workings of the IPO market and the underwriting business. That specific suggestion is that when external actors are limiting company auditor choice, that that ought to be something that investors are aware of, and that the public is aware of and that perhaps the regulators are aware of.

So our Recommendation 1(a) is that there should be disclosure of any contractual provision with a third party limiting a public company's choice of auditors.

Secondly, and here's -- this is an item we're particularly pleased with, secondly, we have to address the issue that, as pointed out in the GAO report and elsewhere that there could be serious competition consequences to a shrinkage, a further shrinkage of the large firm market from 4 to 3 or 2 or 1. We have a recommendation designed to create a flexible mechanism to make that less likely consistent with the kinds of incentive issues that I was mentioning a few moments ago.

This is what we call preservation and rehabilitation mechanisms. Our recommendation is is that these mechanisms, is that a variety of parties would have to make a variety of changes, look into creating a two-step process for the preservation and rehabilitation of firms faced with catastrophic events. The first step is that we recommend is that firms voluntarily adopt a streamlined internal governance mechanism that can be triggered by catastrophic risk.

Again, this is something, the specifics of this mechanism we didn't write in our document. We assumed it might differ from firm to firm. And then the second step is to create at the SEC a legal power to apply for and receive from a court essentially a trusteeship over a large firm threatened with catastrophic, with the possibility of a catastrophic event.

It is our view, and based on the information, the testimony and information that we have received, that those sorts of events tend to flow from audit quality failures and that there is some history of it being difficult in certain circumstances for firms to act in the firm's best interest in managing the consequences of those sorts of audit quality failures and that the creation of this type of mechanism would enable someone to act in the firm's best interest and in the public's best interest to resolve the consequences of a very serious audit failure to deal with civil and criminal authorities and potentially to deal with plaintiffs on a basis somewhat removed from the various kinds of more narrow interests that might have been represented by those who got into the trouble in the first place.

And that this mechanism would be the most effective way of ensuring that in such a circumstance there is not a flight of clients, a flight of human capital, a flight, potentially, of financial capital from the firm, and that those who are across the table from a firm in that circumstance, whether public or private actors, would be much more likely to assume a more reasonable and less punitive stance in dealing with representatives and dealing with people who are not the guilty parties, so to speak.

And again, we envision that this is going to require some changes to existing laws and regulations. We don't specify exactly how to do that. We don't think that is our purpose.

Our third recommendation addresses areas relating to auditor independence. Here we heard a fair amount about the fact that there are a number of different bodies of rules affecting auditor independence.

In the public company context, there are, the vast majority of those rules are promulgated and interpreted by the Securities and Exchange Commission. There is a small body of rules relating to scope of service that is the province of the PCAOB. Then there is another large body of rules affecting the entire practice of auditing, not just public companies, but in the private context administered by the AICPA and sort of interwoven with state regulation of the auditing profession.

We heard that there have been a fair number of instances involving small companies and small audit firms where it appeared as though audit firms and companies, unused to the public company regime, inadvertently understand that the much, much less stringent rules applying to the private practice of auditing applied to the public practice. Our recommendation in this area is to compile these rules in one place. The SEC and PCAOB rules have AICPA clearly note in its materials where their rules leave off and the public company rules begin for any naive reader and to make this material easily available.

There is also an issue at the SEC with the interpretations of the independence rules being a little hard to locate and the idea is to compile them all in one place. We did not recommend a substantive effort to harmonize these rules. And the reason why we did not is because it is not really possible that there's only two different ways of harmonizing. Both are not, would not be good public policy.

One way of harmonizing them would be to make all auditors in all circumstances, and private companies as well as public, follow the public company rules. That would be, no one would agree to such a thing. It would not be suited at all to the reality of economic life.

The other approach would be to reduce the public company rules to the private company level. And I think we've been through that recently and there would be no public, there would be no investor or public support for such a thing. So the appropriate thing to do, to make it much easier for people practicing in this area to understand what is the relevant body of rules to what they are doing.

Secondly, our second recommendation in this area is that there is a unified concern among the Committee and its observers about a check the box mentality that has developed, that as we've strengthened independence rules in this area, some practitioners have come to the conclusion that independence is a matter of a series of bright line rules and not a systematic attitude of, as Zoe-Vonna puts it, skepticism -- what is the modifier, Zoe-Vonna?

MS. PALMROSE: Healthy professional skepticism.

MR. SILVERS: Healthy professional skepticism, and that this is something that cannot be effectively, in our views, cannot be effectively taught in a lasting way to people at the beginning of their careers, who have no experience with the tensions involved. But that needs to be reinforced for mid-career professional training, case study-based, hopefully, informed by the history of failures around independence issues that we now know about through the work of the inspection work of the PCAOB.

Our fourth recommendation has an interesting history. At one time or another, it was the view, I think, of each member of the Committee that it was a requirement that public companies submit their auditor selection to a shareholder vote. Each of us learned, at one point or another in the process that that wasn't true; that, in fact, there's no such requirement, and that only 70-80 percent of public companies, indeed, do so.

This was kind of a no-brainer for all of us. We all felt that really all public companies ought to do it. Our recommendation is that be adopted as a listing standard by the NASD, by NASDAQ and by the New York Stock Exchange, and that it be strongly encouraged to all companies, including those not listed on the national exchange. And, again, this comes to the issue of trying to infuse competition through attention to the principal-agent problem.

Finally, we received presentations from IOSCO staff, and our thanks to Michel Prada and his colleagues, and from the PCAOB on the importance of international collaboration in the area of auditing, and auditing oversight and regulation, which dovetailed with our prior attention to the importance of audit networks in the competitive arena, and understanding the degree to which the competition for audit services is a global competition. And in that context, really all we had to say was that we thought that that type of PCAOB coordination and cooperation between regulators in this area is a good and positive thing, and we encouraged PCAOB to continue to do so.

I think that we were very careful in the way that we drafted this recommendation to be cognizant of the fact that the PCAOB, and we presume foreign regulators, each have their own obligations under their own statutory frameworks, and that we're not trying to tell people exactly how to mesh those, but, rather, that as in all areas in an increasingly global economy that collaboration, information-sharing, mutual assistance are all good things.

With that, that concludes my summary. I then turn the mic over to my colleagues to add what I've forgotten or mischaracterized.

CO-CHAIR LEVITT: Before we turn to that, Damon, I'd like to ask you to outline the elephant that is not in the room on this one. We've heard, for instance, with respect to Bob's Committee the various issues that have not yet been attended to. What do you think of the hot button issues that need to be defined with greater precision than we have already?

MR. SILVERS: Well, I must say, Arthur, I'm quite satisfied with the document. I'm personally quite satisfied with the document that our Committee is delivering to you. I do not feel that there are - but I'm going to - don't interrupt me yet, because I'm going to answer your question. I'm not going to duck.

(Off the record comments.)

MR. SILVERS: There are in this document matters where, obviously, there are opinions where there's a wider range of opinion, certainly, perhaps on the Committee, certainly in the wider world, than is expressed in the document. I think that the issue that where we have really spent a lot of time trying to come to grips with are the varying opinions that exist around the current status of the independence rules. I mean, I have reflected, I think, where we were able to come together and make a recommendation in terms of some steps that we could all agree upon. I think that there certainly are views in the business community that there are problems around the lack of a de minimis standard on auditor independence.

I didn't - my initial presentation is very long. I didn't get into this particular matter. I think that there there's a number of paradoxes that we could explore, if the Committee so wishes. It's not actually as bad as it seems from the business perspective, but that's a concern that's out there.

I also think that there are B- and so that is - talk about elephants in the room, I would say that may be the most significant elephant in the room. Another elephant in the room, which I'll say bluntly is that if one - we did not get into, because we didn't really feel we had the capacity to challenge the GAO findings, fundamentally. If one believed that in a market as significant as the audits of large public companies there was an unacceptable concentration that was either causing costs to be - either causing price gouging, essentially, or the failure to get good quality. If one believed those things were true, the GAO does not, if one believed those things were true, there are obvious and time-tested remedies for those sorts of things that involve splitting the baby. And we didn't get into that at all, because I think we - because we took those GAO findings as indicative of the way that people who make anti-trust enforcement their living would look at this issue. And, thus, that there really wasn't going to be a basis for that kind of thing. That's certainly an elephant. I'm not sure it's one that has much relevance.

CO-CHAIR LEVITT: Well, I think you've come with an extraordinarily creative document and taken on issues that have never really been addressed with this kind of open-mindedness. Am I correct in assuming that what's before us now is generally receptive to the members of your Committee? Ken?

MR. GOLDMAN: Yes, I'll speak for myself. Yes, absolutely. Absolutely. I mean, I'll add some more comments later, but absolutely.

CO-CHAIR LEVITT: Mary?

MS. BUSH: And I would say absolutely yes, and the one comment I would add at this point is that the mechanism that Damon described, we just feel is critically important, because it is critically important that we not lose another major firm. And when you talk about choice and competition, we, a little bit different from the GAO, feel that losing another major firm would just not be a good thing, so I feel very strongly about that, and we agree. I agree.

CO-CHAIR LEVITT: Before I move to the rest of the panel, Ken, I'd like to give you an opportunity, and then, Mary, you to amplify what your Chairperson has set forth. Ken?

MR. GOLDMAN: Thanks. And first of all, I'd like to personally thank Damon and Kristen, in particular, for this yeoman's amount of effort on behalf of our Committee. They have done a lot of legwork here, so I personally want to thank them.

I would say relative - I'll make a few comments on mostly each of these, just to sort of add to what Damon said. I think we went into this with the, at least, I did, with the idea of: can we not find a way for some of the non-four becoming a five, or a six, and we ended up with the conclusion that, very honestly, it didn't seem to us that any of the non-four want to be a four, in all honesty. And it also seemed that the concentration, whatever data you want to look at, is extreme amongst the top four.

Having said that, when we looked at all the data, we couldn't be convinced that it is anything but a competitive market still. So, as Damon said, we went to three or, heaven forbid, less. That would be a very different environment, but we're convinced that with the current situation, that it, in fact, is a competitive environment. And we're also convinced, at least, I'm convinced that none of the non-four honestly want to take on the extra risk, liability, and globalness, if you will, that it takes to really support being in the, whatever you want to call it, top tier, which has a negative connotation. So that gets into Item 2. And I actually have a few other thoughts.

One of the things I was thinking about as Damon was talking, how I got on this Committee was a very good venture capital friend of mine nominated me. And he nominated me because he couldn't do it, or didn't want to do it, I don't know which. He said, "Ken, you go represent Silicon Valley", so I said, "Thanks." But if I sort of suggested - I mean, his concern and perspective, and I hear this from others, is boy, the auditing profession is just hard to work with today. It is really, really tough. And so I got to thinking boy, you go into - if you buy a car, or you buy a boat, or you buy this and that, there's always these surveys. I actually went to the hospital a couple of months back and I just got this nice long thing, hospital even asking me a survey of what I thought. And, so, I don't see a lot of surveys in this profession, honestly, in terms of how well they're doing, in terms of working with their clients. And that was just something that all of a sudden came up to me, is I wonder whether this profession needs to do a better job of promulgating how well they're doing survey-wise, and then see what comes of that.

Relative to our comments on Item 2, I do fully agree. I think we need to flesh out how we still implement this, some of the wording we're still not comfortable with. But, certainly, the intent is clear, that we want - (a) I feel very strongly, we do need transparency. I do feel very strongly that, frankly, the auditing firms ought to be more transparent with their numbers. I like some of the comments, Don, you were saying relative to internal controls, and reporting of their metrics, and so forth. Because it's not like a law firm which goes away, there's another 10,000 someone says. The reality is here, I mean, these firms are doing a public, in so far, almost a public good, and so it is extremely important that the investing public has confidence in their wherewithal to continue as going concerns, and has confidence in their quality controls, their internal controls to insure quality control. So some idea of doing report, I think is good.

I do have to say, I sort of listened to Tim about this Board, and I have to say, I wasn't convinced with an independent board - I mean, a non-independent board, internal board. It reminded me of having a staff meeting at a company, as opposed to a real board, so I'm not sure. I mean, now I've obviously got you worried here, I'm an auditor of two KPMG companies, so I'll probably - a careful audit going forward.

(Off the record comments.)

MR. GOLDMAN: So I'm worried about taking notes here, but in all seriousness, I do think having - even though you're private, having the auditing profession have more reporting and transparency, vis a vis public companies, given what you're doing, I think would be helpful, and so we covered some of that in Item 2. And, again, I think there's still more to be done.

My comment on 3, on independence. What I worry about here is something Damon alluded to, is the materiality, the ability to get tripped up on something that, frankly, could be perceptively non-material, and, yet, creates an independence issue. And then you go through all kinds of effort to convince everyone, including, ultimately, the SEC, that the firm remains independent, because if it doesn't, then you are back into changing auditing firms, and having to explain why.

On Item 4, shareholder ratification, it was surprising to us that it is a requirement because we all do it. I guess I wonder whether we could, and this is really just sort of thinking out loud now - we could add more to that, in terms of the report, so it isn't just a sort of perfunctory approval, even to the extent that maybe like

CFOs list their names, someone mentioned maybe the audit partner and the reviewing partner also list their names, and take full accountability for their audit. So, again, I'm not, necessarily, suggesting, or not suggesting that. I'm just saying it would be good to sort of add a little bit more to what now is almost a perfunctory note in the proxy, to add more to it.

In Item 5, I actually don't have a lot more. The only other thing I want to come back to, I think we B- and I think the question on who will - back to Item 2. Who will review - how will you sort of review the auditing firms to insure they have the financial wherewithal, whatever. Clearly, I think the PCAOB would say that's not in their charter, they're not sort of - they don't want to grab for that, and so it's not - and we actually talked a little bit at lunch. Actually, lunch I wasn't supposed to be at, relative to what is the body, like the Federal

Reserve, whatever, that sort of reviews the wherewithal, if you will, of the firms, very much like they have to - the banks have to have a certain - and so who does the safety and security of - who's looking at the safety and security of the auditing firms, vis a vis what is done in the banking side? And, so, the PCAOB clearly does not feel that's in their charter, so the question is, whose charter is it, or should it be in? So that's how I - I'll sort of leave on Item 2. But I think that's important, because through that, you can really create the mechanism to implement Item 2.

CO-CHAIR LEVITT: Mary?

MS. BUSH: Hi. Just a couple of very quick comments, because we'd like to leave lots of time for questions and discussion. But this whole issue of safety and soundness, what I would simply add to Ken's comments is, it seems that there is a big hole in terms of the safety and soundness of some body, that some body that has jurisdiction over the safety and soundness of audit firms. And then just one other comment, is to, like Ken, compliment Damon for an outstanding job on pushing this Subcommittee along, and Kristen, for her excellent work.

MR. SILVERS: I really feel like I made a terrible error in not complimenting Kristen and her colleagues, who have worked - it just shows that when you prepare this sort of thing, you always forget the most important items, who worked just tirelessly with us, and have always been ready to help with whatever was necessary, whether data, or people, institutions, Justice Department, lawyers, just a whole variety of challenges. And it's just an honor and a privilege to work with them.

(Applause.)

MR. SILVERS: On a more complex note, I also wanted to say something about this issue of safety and soundness, because I did leave it out, and it's very important, in terms of where we are at.

The PCAOB's view, and I think their view was correct, is that their mission is audit quality. It is not safety and soundness. They are not a bank regulator. I think there would be many dangers in turning them into a safety and soundness regulator. However, there is a need ---- the way we phrase this rehabilitation mechanism, we vested the power in the Commission, and I think that's the right place. And there is a need for the Commission to be informed as to when there's a question that would raise the possibility of exercising this power.

I believe the language of the report that we have forwarded to the Full Committee envisions that the PCAOB, that the sources of catastrophic risk for audit firms are inextricably intertwined with audit quality failure; and, thus, the PCAOB, in the course of exercising its audit quality mission, should be aware of information relevant to the SEC's exercise of its powers under this mechanism. And that we would expect the PCAOB to forward such information, as it became known to them, within the exercise of their audit quality mission.

The PCAOB staff has reviewed the language that we have in here now, and I believe have not expressed an objection; although, Mark is here, and if I'm misstating, he can correct me. But what I wanted to convey about this is the Subcommittee's desire to thread this needle carefully with respect for what we think the PCAOB's proper mission is.

CO-CHAIR LEVITT: You know, when you talk about safety and soundness, it means many things to many people, and that can be a very slippery slope. And I don't know that it's the job of - I don't know that it's our job to call for a safety and soundness regime. That's gotten us into a lot of trouble today.

We have a banking regulator concerned with safety and soundness that sometimes has drifted over into being the protective association for their regulated body, so words such as "awareness", or "notice", or "first call", or "early warning", I'm thoroughly comfortable with. Words such as "safety and soundness" mean so many different things, I'm less comfortable with that.

MR. SILVERS: Arthur, we designed the language in this document with precisely that set of considerations in mind.

CO-CHAIR LEVITT: Phil?

MR. LASKAWY: Thank you, Arthur. I just wanted to underscore something that Damon said, and that is the issue of independence. I think part of the competitive concerns that preparers have relates to some of the independence rules and their inability to use one of the four firms. Just let's stick with the four firms, because of de minimis independence issues, and prohibiting them from having as much competition, particularly for non-audit services, as they would like. So I would suggest that really be a focus, and maybe Michel could help, because I think IFAC and outside the U.S., there are differences in how they go about looking at independence. And I could just give you, and I don't want to waste too much time on this, but I think this is a crucial issue, because I think it goes right to the heart of competition.

I could not be on a board, or an audit committee of an Ernst & Young client, and I wouldn't want to be. But I was approached after I retired to go on the board of one of the major investment banks, and I was not independent, because Ernst & Young did, I think, audits of two minor mutual funds, where maybe the fees were $50,000. And, yet, if I would go and get a lump sum pension payment from Ernst & Young, I could go on the audit committee or board of an Ernst & Young client, which I would never do, because

I do have personal feelings about Ernst & Young, obviously, and loyalty. So I think the independence rules would - changing the independence rules, or tweaking them, not substantively - substantively, but not impacting the raison d'etre, could go a long way to dealing with the competition issue.

My second point -

CO-CHAIR LEVITT: Phil, who do you think should be charged with that responsibility?

MR. LASKAWY: I think it has to be the SEC. I'm not -

CO-CHAIR LEVITT: But don't they already have that responsibility?

MR. LASKAWY: Yes, but I think we're talking about - well, Damon, you've done the homework. I really haven't.

MR. SILVERS: This is a delicate matter, and I hope Zoe-Vonna will cut me off if I say the wrong thing, but the way in which this issue is operationalized is that should there be a violation of independence, and there is no - the term de minimis doesn't exist in these rules, should there be a violation of independence, then the Commission cannot - will not receive the audited financial statements which have been audited by - not by a compromised auditor.

Now, that being said, there are issues about inadvertent breaches, inadvertent, and sort of, I don't know what the - this is where I need Zoe-Vonna's help.

MS. PALMROSE: Inadvertent, and inconsequential.

MR. SILVERS: Inadvertent, and inconsequential breaches of independence standards. And there is a staff at the Commission that handles inquiries that relate to these considerations. And the - I think we concluded that this system is very limited, and there's great concern that it not be altered, or enhanced in such a way, so as to create an incentive for people to do things they shouldn't do, and then come to the Commission and seek blessing for those things.

CO-CHAIR LEVITT: But is it adequate to, responding to problems that might develop? I mean, are you taking the position that what's there now is pretty much written in stone, and changes should be extraordinarily difficult to implement?

MR. SILVERS: No, this, again, I think the - the Committee did not receive any evidence that the current process is under-staffed, too slow, unresponsive. It is not a de minimis standard. All right? Merely being small, a breach of independence is merely small, is not enough to - there's no one who will excuse you for something that's merely small.

There's a fundamental problem here, which I think, Arthur, you've alluded to in your question, and the fundamental problem is, if we had a de minimis standard, who decides what's de minimis? And the - I don't think there's much practical consequence in saying well, let's change the terms from what the terms are currently to de minimis, and leave trying to sort that all out in the hands of the SEC staff. I don't believe that that improves much in any direction.

I think any effort to lay the determination of what would constitute "de minimis", in the nexus of the preparer of the financial statements, the auditor, the audit committee, is a recipe for a lot of trouble. There might be other schemes about, but they really flounder, I think, around this question of what constitutes de minimis. In an environment in which I think investors have reason to be concerned about a situation where one audit partner at one end of a firm may have an interest in something, pick up the phone and call another audit partner. The rules are designed to really insulate the auditing process from those kinds of dynamics. The lack of a de minimis exception is part of that insulation.

CO-CHAIR LEVITT: Are you saying that the rules, in your judgment, are as close to perfect as they could be?

MR. SILVERS: I would never be so foolish as to say something like that. What I'm saying is that I think that as we looked at this, and as we surveyed the existing regime, that it was not obvious what a substantial -

CO-CHAIR LEVITT: I should amend that and say is the process as perfect as it can be?

MR. SILVERS: We did not, in the time allotted to us, have the ability to come up with a better one.

CO-CHAIR LEVITT: Lynn?

MR. TURNER: Arthur, I'd say those rules as you voted and proofed them, are pretty darned good.

(Laughter.)

MR. TURNER: And as five of the

firms agreed to them in their letters, so what can I say? Who am I to argue with all of those people? I will say on the de minimis issue, I went through this with a large Fortune 200-size company while Don was there, actually, and it did pop up. And as common, it has to do with bookkeeping in foreign countries. Also, had to deal with it as CFO once, too. And it's - actually, in that regard, the rules have actually increased competition, because they cause companies to go use other firms, including the smaller firms, for work along that regard. And, so, rather than reducing, it's actually increased competition. And I know when I was on the Board at Sun, a lot of the audit committee members actually wanted to go use other firms other than the auditor for other things, and we did, and so it actually tended to increase competition. So, from a competitive perspective, it was pretty good. And when we had our particular problem over the de minimis on bookkeeping, we were able to work through it with the SEC staff. Don was there, was very reasonable, and we worked through it, and disclosed to our investors what our problems were, and went on down the path. The process, for us, worked actually pretty good in that particular situation.

Back to the recommendations, in general, very supportive of them. I would note that on the one on training, my experience has been that firms do do a fair amount of good training. And, in fact, my former firm with Bob in it, did a tremendous amount of training. And then, for some reasons, partners and people ignored the training, and the firm got in trouble, so I think it's more than training. It's somehow instilling in the people in the firms, their professional obligation under those rules, and the necessity to follow them. And I've seen all the firms give excellent training, and then just people ignore them, which is probably the biggest challenge that the firms have. And that's certainly been my experience, and just an obligation. In fact, PWC, courtesy of Bob and Don, donated about 2 million bucks, 2-1/2 million bucks to the profession to do training, with a little encouragement. And it was actually, at times, even tough to get -- the training materials turned out good, but sometimes it even got tough to get the universities to use the training materials.

On the trustee thing, I am supportive of that. I remember in January 2002, Arthur and I were here in town at the time getting ready to testify, and Arthur Andersen had come to Arthur and asked him if he'd be willing to set up an oversight monitor, oversight committee, something to that effect. And Arthur asked me if I thought he, or others, or we should do it. And my comment to him was, "We're no longer at the SEC. We had a tough enough time getting that firm to change when were at the SEC, and that without that express type of power, we never could." And, eventually, we never did that. And I think that is the type of thing, we talked that morning, that it would be a good thing to be able to do, but unless you've got that leverage and ability to force that firm to change how they're behaving, it doesn't work. And I think if that mechanism had have been there, we'd still have that firm, perhaps today; perhaps not, though.

At the same time, I do think that if you've got a firm that goes so far down the road that you'd actually have to put a trustee into that firm, it will not save the firm. The firm will be gone. People will not keep that firm as their auditor. And what I hope the mechanism really does, is cause the firms to change their behavior, which I think it will, which is why I think it's a great idea. But you've got to understand that that's where you're going to move here, is in a behavioral way, because if you ever have to put the trustee in, it will be over. You will not be able to turn around and save that firm.

And I would note back to Ken's notion on surveys, I think Ken's notion of this profession having to survey investors, and other people that they deal with more, is an excellent idea. I think it's been too inside-focused, and not focused enough outside, and that's why we need more transparency. We need better governance, and so I think that's excellent.

The other thing I'd ask you to think about in the context of talking about safety and soundness, and really back to Don's point about financial stability, and wherewithal, I know the three of you weren't enamored with the tax thing on education this morning, and I'd probably be in the same place you would be. But, at the same time, this profession is, because of the current tax codes, is unable to always keep and accumulate capital, because we have to distribute everything, because it's all taxable income. And I'd just ask you to consider that I think there should be a revision, because of the public interest here.

This is a difference. This is not education across many bounds. It is a very special, very difficult profession. And I think the tax code ought to be changed here to say that to the extent the firm is going to keep, maintain, and accumulate capital to help maintain their viability, should they decide to do that, that that should not be taxed. They should be able to do that. I think that would help.

MR. GOLDMAN: Just as a follow-up, if I could, would that across all firms, and not just an accounting firm?

MR. TURNER: That - no, it would - because of the partnership thing, and it's because of the public interest. The government, in a way, screwed this thing up either through their FTC decrees, or through permitting all the mergers, because the mergers are really why we're down to four firms today. And the government has a role, especially in light of the public interest, I think to allow these people to sustain and keep capital in a reasonable fashion, if we really want to maintain it. If we're not - if we say that from that perspective you've always got to keep distributing all the capital out, which is the reality of what the code requires them today, then you can't expect these firms to have capital into them. And when you've got a company of this magnitude with no capital, you've got financial stability issues. You can't avoid it.

MR. VOLCKER: Banks couldn't keep a reasonable amount of reserves in anticipation of crisis.

MR. TURNER: A lot of them went out of business.

CO-CHAIR LEVITT: Bob?

MR. HERZ: Damon and the Subcommittee, recognizing that Recommendation One seems to be couched in probably a realistic, but aspirational kind of way, just two points. One, this is something that was raised, actually, by a fairly senior SEC official about a year ago in terms of getting more expertise to the small or medium-size firms. He talked about the limitations that some of the large firms have on their partners going and lending that expertise, obviously, for pay to what would be, potentially, competitors. And that seemed to be, in part, viewed as a barrier to beefing up that quality of seasoned expertise there, so I don't know whether you considered that, or whether you figured that's just a private partnership, that's just a matter that needs to be dealt with at that level.

The second thing, this is a little bit more cosmic, but if I were one of these people, which I'm not, at the far end of the market, just let the market work. It cures everything. One would say gee, in a situation like this, what you need is more innovation, the ability to innovate, create new product, satisfy the customer, which I think is the investor in the capital markets. And, therefore, one might pose the argument as to whether or not we're in a situation where there's a proper balance between the regulatory constraint, the concentration, and the ability to actually create product that satisfies the customer demand, or not. You say well, maybe we're not. Maybe that's part of your agency problem. I don't know, but it seems to me the question is really on the issue of what equality in satisfying the ultimate customer there, whether or not you thought about competition in that kind of vein, rather than just there's competition on other planes right now. And it gets to the KPIs that Zoe-Vonna mentioned, and the like.

But if we're going to have this either d'etant at four firms with protecting the four firms, so to speak, and other people not really want to get into it because the way the other mechanisms work, then it's a very difficult situation, which was the province of your Committee.

MR. SILVERS: Should I respond to that?

CO-CHAIR LEVITT: Zoe-Vonna.

MS. PALMROSE: Would you like to?

MR. SILVERS: Well, I mean, just very briefly, Bob, we did not think - I don't think we thought about this question of employment agreements at the partner level; although, it has come up on a couple of occasions in external discussions in a different setting, in terms of thinking about how you would try to hold a firm together under stress. But I think it's something we will now think about, and maybe gather a little data on.

The cosmic question you raise, I think that we went through a period during the 90s, over Arthur's objections, when we kind of let this profession operate in a pure market basis, or close to one. And it turns out, and this was, I think - here, I'm not speaking for the Committee, but rather in relation to the comments I made earlier about professionalism - that we are asking auditors to do something that is not entirely in any way that's really relevant to the public interest economically rational. We are asking them to sit there and make sure that the financial statements are accurate, no matter how much money is offered to them to do otherwise. All right? And that requires a significant regulatory structure in order to try to hold that non-market behavior in place.

The question of are we doing other things that really don't achieve that, but merely limit entrance, is something that the Committee wrestled with a lot. And I think we have recommendations that are designed to try to rifle shoot things that we learned about that appeared to really be constraining competition in ways that had nothing to do with audit quality, or the regulatory scheme; such as, what we learned about the underwriting process, and third-party covenants of various kinds, such as having a shareholder vote be more or less mandatory. And I think that the Subcommittee continues to be open, as we go forward, to learning about and making recommendations in relation to other barriers of that type.

It's, unfortunately, just a fact about the way regulatory schemes work, that they're inevitably infiltrated by various kinds of protective devices that serve no public interest. And keeping an eye on that is a Sisyphean sort of task, but we try. You're familiar with that.

MS. PALMROSE: I just wanted to make two points. One very quickly, and that's to kind of correct the record here. It's not that the SEC's rules don't recognize inconsequential and inadvertent violations. Currently, they do so just in a narrow sense with related - relates to individual and financial interest, not for a firm, so there aren't any rules, or recognition of inconsequential, inadvertent violations for a firm, only in the context of individual and financial interest, so that's for the record.

The second is sort of an issue that's probably worthwhile to recognize with respect to what I think is kind of the centerpiece recommendation here, Recommendation Two. And even though - clearly, I don't speak for the SEC, and there are so many people around the table who know the SEC well. And Alan Beller, of course, who was so instrumental here, does know the agency well. But it's probably worthwhile to point out that a number of people would view the SEC's description of the role here as beyond the current mission and authority of the SEC that would probably require legislation. So it's just probably worthwhile to recognize that potential here. Thank you.

CO-CHAIR LEVITT: Michel.

MR. PRADA: Thank you, Arthur. A couple of thoughts. One, I tend to go along with a lost battle, but I can't avoid it, with regard to the issue of concentration and trying to help second-tier firms develop. We have, in France, what we call the "Joint Audit", which is compulsory for listed companies. Now, I know that there are very few people who support the system, and I also know that there are examples where the system has been poorly implemented, with the main firm having 90 percent of the activity, and a small firm having 10 percent, or even less. But I have to say that where it is properly implemented, when you have a big firm, sometimes you have two big firms, which raises the issue of rotation in a more difficult way, by the way. But sometimes you have a big firm, and you have a second-tier firm. And if it is properly organized, it has a lot of benefit, because, clearly, in tricky situations, the fact that you have two different firms dealing with the issue, and having to sign up to the solution, helps identify the question, and talk about the question.

And I have had, on several occasions, evidence that the system had been useful, and it, obviously, has helped the development of second-tier firms. And I think that we have to try and achieve this evolution, because we're not comfortable. I mean, obviously, we can live as we are, obviously, but we're not comfortable.

We've been discussing this issue of concentration for years, and we say finally, it's okay. We can go along with it, but then we raise new Committees to deal with the problems raised, and anticipate the possible difficulties if one of them would go down. So I think this is a situation which is not really satisfactory, and that we need to favor the development of second-tier firm. And I do support the views of the Subcommittee on that, but I wanted to mention the issue of the Joint Audit, which is probably a quite satisfactory solution to that.

I have no difficulty with the proposals made with regard to how you deal with contingency. I just wanted to mention the fact that IOSCO is working on that, under the Chairmanship of Chris Cox, who took over the work launched by Roel Campos a few years ago. They've not come to final proposals. And, by the way, the proposals which are here are very interesting, and I agree with you, Arthur, it is, I think, the first time that we see rather detailed proposals on the table.

I believe, personally, that the regulators have responsibility in this. The way they address the issues raised by flaws in the way firms have delivered their job is very important. If they proportion their intervention to the specificities of the issues raised, they may help prevent a kind of global fire, and we've seen that in the recent past. So I think it's not only an issue for the firms, it's also an issue for the regulators. And I appreciate the proposals here.

On independence, this is an issue Arthur will remember, probably. This is an issue I addressed 10 years ago, I would say, and I think we've made huge progress. But, now, it seems to me that we've come to a situation where it might be useful to contemplate the international work, because it would be a pity if we would have very different independent criteria in the U.S., and Europe, and elsewhere in the world. And I do believe that we've come to a time where probably IFAC is able to deliver sound standards which do not need to be supplemented at the national level.

Now, I know that this is tricky. I understand the point. I just wanted to mention the fact that Europe is contemplating the possibility to implement the ISIS, and IOSCO recently made a statement, we are working in the direction of endorsing ISIS, the same way with IFRS, by the way. So I just wanted to mention this as part of the discussion, because, obviously, each time you talk about independence at the national level, you find small differences across the borders, and we have to recognize that this has become an international issue. And we have to implement it internationally, so yes, this is what I wanted to say, Chairman. Thank you.

CO-CHAIR LEVITT: That's extremely useful, and coming from one of the longest-serving regulators in the world, I think we -

MR. PRADA: Unfortunately.

(Laughter.)

CO-CHAIR LEVITT: - have to place

great weight on your wisdom and your words. Mark?

MR. OLSON: Thank you, Arthur. Just three points, in reverse order of the way Damon presented them, with respect to the PCAOB. First of all, you have been - the Committee has been very thoughtful in terms of allowing us to sit in here as observers, and with each of the Subcommittees we have provided input to the extent that the language would create unintended consequences, or consequences that you may not have thought of, or consequences that we're unintended. And in every case, you have been responsive to our input, and we're very appreciative of that cooperation.

That said, we have not endorsed any of them, nor do I think it's necessarily the Board's role to do so. And you didn't say that, but I just wanted to make sure that was clear. But let me address the safety and soundness issue, because this is a very important one. I want to make sure that it is clearly understood that it is not simply a case that we did not have the appetite for it.

If you go back and look at the statute, the statute is quite clear. The intention was not to preserve audit firms. The intention was to assure quality audits from the standpoint of the shareholder, and so our role is very specific, and very discrete. We are to look at the manner in which audits are conducted through the prism of the audit firms, and, at the same time, regulate the auditors to assure audit quality. And that's exactly what the statute says. And I think that that is important.

Now, anybody that has remodeled a house knows that the three most dangerous words in the English language are, "While you're here". And I want to make sure that nobody thinks that while we're there, looking at audit quality issues, that we could just, by kicking a few tires, or spending a few more days, could address the safety and soundness issues.

We could look at audit quality issues, and we knew, roughly, what kind of a construct we would need within the PCAOB in order to do that. And even having said that, it was difficult to put it together, to hire the people, and we are still learning. We're still in the evolutionary process in terms of looking at audit risk exposures. To go beyond that point, and to pick up some of the risks that would be more like the bank, and Amy knows exactly what I'm talking about, and Paul was still in the chair when we were moving towards the FDICIA legislation, which ultimately was a vote on whether or not there ought to be a too big to fail standard on banks. And could see then - Bob was also very involved there. And you could see the implications of moving to there, to a regulatory construct, which is really round-the-clock. And, so, I would think that not only has the legislation not directed us that way, but there are enormous implications in trying to make what might be perceived as a slight step. So, in that case, the statute was quite clear.

Moving on to the initial one, our role internationally, and with our foreign counterparts, and Michel is very familiar with this. The legislation did not anticipate that we would have counterparts internationally, because we didn't have them at the time. And what has happened in the intervening five years is that almost every - all the developed countries, and many of the developing countries have developed audit regulatory bodies that are in the process of learning how to work with. The Eighth Company Directive of the EU is in the process of being implemented, and will be fully implemented, I think, in August, if I understand correctly, which will give us another 27 countries with which we will develop protocols, and learn how to - and come to agreement as to how we're going to work with our counterparts around the world. So I think the guidance, and I think the direction you're giving is exactly appropriate.

And we now have an international body of audit regulators that is in its nascent stage, so it is really an evolving process. But it is one of the - it is ironic to look back only five years ago, that that was an entity that now has a very important role internationally, that didn't exist five years ago.

CO-CHAIR LEVITT: Amy?

MS. BRINKLEY: Yes. Question, did the Subcommittee consider in its discussion the significant number, and I think a growing number of large global institutions who just given pure capabilities, geographic and otherwise, complexity of issues, are probably limited to the Big Four, and that if other considerations are taken into account, probably could only use one or two of them without some substantial changes being made in someone's business model or the other, or business practices. Was that discussed?

MS. BUSH: Yes. We had extensive discussion on that, Amy. And this is - it's clearly one of the reasons for our first recommendation, that over time, we really need to encourage the growth of some of the smaller firms, because it's really only the Big Four that have that extensive global reach that's necessary for firms, such as your's, and others. And, so, it is a limiting factor on competition that the smaller firms don't have that, and we would like to - I think part of our recommendation is to encourage, in some way, the growth of the global capacities of the smaller firms. Not easy to do, very difficult.

MS. BRINKLEY: And I recognize, and remember some of the testimony we had around that. I would consider it beyond just a competition issue, it's a risk issue. And that there should be urgency around what can be done to create additional capacity that can serve those types of companies sooner, rather than later, because there will be more of them.

MR. GOLDMAN: I think we did look at that. I think the - actually, when you think of the Big Four, so to speak, in certain industries you really have two or three viable alternatives, so we did look at the concentration amongst vertical industries, as well as in total. I think here it comes back to Damon's point of aspirational. I mean, the reality is, I can't sit here and say I have any confidence that any of the non-four would become a four in certainly my lifetime. I hope I live a long time. I mean, I just don't see it, because I don't perceive they have the aspiration to do it, for one. I don't see where they perceive they want to merge with someone else to grow into that. And, so, therefore, if they don't want to do it, and they're so far away in size, I mean, it's not even close in terms of size. That's why we did come to the conclusion, though, that we couldn't see any anti-competitive data relative to what's going on today, and so that's why we came to the conclusion of the preservation of the four. And we thought long and hard on that, that we did not see - we had a lot of GAO data, and a lot of other data - we did not see anything, to us, that said we had an anti-competitive industry.

MR. SILVERS: Just to add a little bit to that, clearly, it's a very different competitive environment for global, for large capital global enterprises. All right? There is pretty robust competition among more than four firms, when you're talking about the $500 million market cap enterprise. But the options for enhancing the number of firms that can compete at the global enterprise level are really limited. I mean, they amount to either breaking up one or more of the Big Four. And it's not clear if you did that, that the pieces would be able to play. All right?

It's also not clear how you would do that, given that we are holding a GAO report saying that there isn't - this doesn't constitute a violation of the Anti-Trust laws, or anything of that nature. That's Option One.

Option Two is, to do kind of what we urge, which is to encourage the organic growth of the next tier of firms. At best, I think one could conclude from the testimony we received as a Full Committee from the representatives of those firms, that opinions within those firms are divided as to what their strategy should be. That's at best.

There is another possibility, which we explored a bit with Michel Prada's colleagues, which is, will we see the emergence of a global network, a fifth global network with the anchor, so to speak, outside the United States, doesn't seem immediately likely, and Michel is shaking his head. There is the possibility, and what we think, sitting in this room under the sponsorship of the United States government about this possibility, I hesitate to say, but there is always the possibility that some foreign entity will decide to shovel money at this issue, the sort of sovereign wealth fund equivalent of an accounting firm. But even that, I think, is viewed by those most familiar with the capacities of those governments that might take an interest in such a project, as being remote. And limited, probably, if ever such a thing were to happen, limited to that particular country.

At that point, we've kind of exhausted the list. If somebody has thoughts that I've missed, I think our Subcommittee would welcome them.

CO-CHAIR LEVITT: Rick?

MR. MURRAY: First of all, I would

like to acknowledge what has been a fascinating presentation, a very creative and imaginative exercise.

Damon, a question running primarily to your Recommendation Two. It seems to me a clear underlying assumption that would cause you to deal with Recommendation Two is your recognition that if an inquiry were made into the safety and soundness of large firms, that, at a minimum, it would be determined that there was an unsatisfactory degree, that there was not a sufficiently high confidence level to be of appropriate comfort to the investment community in the capital markets. And, certainly, that's been one of the driving assumptions behind the dialogues in the Structure and Finance Committee.

With Recommendation Two, I very much welcome, and agree with what I think is the recognition that there is vulnerability requiring concern about the potential loss of one of the major firms. And I agree with what

I think is another of the relevant assumptions, that reliance on those who hold claims against a firm is to voluntarily be gentle in the way they resolve them is not sufficient recourse, and so you have the very imaginative preservation and rehabilitation proposal.

My apologies for taking those moments. The question is, using the current BDO situation as an example, can you help us understand, recognizing that this is a work in development and not yet finished, how that proposal would be of assistance in the BDO situation, where you have a debilitating judgment against BDO, brought by a foreign bank, whose intransigence to any form of compromise has been clearly demonstrated, with a development this week that's not been widely publicized, in which the Court of Appeals has reversed the trial court as to how wide is the scope of BDO's liability, determining that because the global BDO organization declared itself to be, in effect, a controlling party, that every BDO practice around the world now is a defendant under a judgment subject to appeal of over $500 million, which is capable of destroying all of the BDO practices.

Given that, which, obviously, has some echo of repercussions of anxiety for others in the profession, given that, how would you see the stewardship proposal as being capable of reconciling the position of the intransigent foreign bank with the powers that it now has achieved through the courts, and holding the organization together.

And just a final observation behind the question, I think the assumptions as to safety and soundness have two different perspectives in this room, one that you, and I think Lynn have articulated, that says if the safety and soundness of the firms is insufficient, it must be due to an absence of audit quality, and the performance of audit failures. There are others of us who believe that quite separate from issues of audit quality, there is an intrinsic business model risk of uncontainable, undefensible liability that simply goes with the responsibility to audit public companies, whose failures will be repetitive.

In that context, how much comfort, how much confidence, and what kind of mechanism do you see lying behind the stewardship remedy?

MR. SILVERS: I guess I should respond, and my colleagues may -

(Off the record comment.)

MR. SILVERS: Rick, let me begin by saying that while one could arrive at this proposal based on the two axioms that you asserted, that there was a current safety and soundness problem with the Big Four, and that the mercy of creditors is an insufficient thing to rely upon. Those were your two hypotheses, or axioms at the beginning of your remarks.

While one could get to this mechanism from those hypotheses, and I won't speak for my fellow Committee members, because they may have. I did not. The hypothesis that I came to on this was that, one, that whatever - that there are real costs of blowing up a firm, that there are real externalities to that, that it's not a good thing socially to just destroy one of these firms. And that there are - and that the dynamic which appears to destroy firms is a dynamic of mutual unreasonableness on the part of the management of the firm, and people facing off with them in various postures. And that there is a consistent - that while the firms appear to be sound today, that they operate in a business which involves the constant presence of catastrophic risk, well beyond not just their financial resources, but anyone's financial resources, that auditing GE, or Exxon-Mobil involves risks that are beyond the - and not to mention auditing 15, or 20, or 50 such companies involves risks that are beyond any pool of capital's ability to insure. And, thus, you put those things together that there is a need in these circumstances to have the public interest step in.

Now, with respect to BDO -

CO-CHAIR LEVITT: May I interrupt you for a moment?

MR. SILVERS: I'm sorry, Arthur.

CO-CHAIR LEVITT: There's probably nobody in this room that's had more experience with this kind of situation than the Chairman, and he has to go soon.

MR. SILVERS: Oh, I'm sorry.

CO-CHAIR LEVITT: I would like very much to have his -

MR. VOLCKER: I apologize for having to leave, but I think, I suspect they're going to support what you were saying anyway. I don't think I - I just began thinking about this, sandwich at lunchtime, this analogy where safety and soundness of bank, I don't think it goes very far. The bank is a financial institution, has systemic effects, the poor depositor doesn't know what's going on, it's not quite the same. And it also would lead to a lot of regulation, and we already are talking about enough burdens here.

But this mechanism that you've developed, I'm rather sympathetic toward. I will make the assertion, since nobody can possibly say I'm wrong, that if we had this arrangement at the time Andersen went down, we would have saved it. We would have saved it, it would have been much smaller, I think. It probably would have emerged as an auditing-only firm. It would have been international, maybe a little less international than when it started. But now you have an even more favorable situation, because there are fewer firms for people to flee to, which gives you more chance at saving the thing. You would have to get the cooperation of the Department of Justice, which was a crucial absence in the Arthur Andersen affair.

And even if this is never used, and it's not going to be used very much, because there aren't that many firms to use it on, having it in the back pocket seems to me to make a good deal of sense. So it seems to me rather interesting, and imaginative, if you ever could get an agreement with the Department of Justice, as to how it would forestall action they might otherwise be tempted to take, that would be very important. But I just leave you with that, off the top of my head. The first time I saw this is today, but I think it's an interesting idea.

CO-CHAIR LEVITT: Thank you very much, and we're all honored and indebted to you for participating with us, sharing your experience.

MR. VOLCKER: I say one other thing, at my age, I'm no longer so casual about saying it won't happen in my lifetime.

(Laughter.)

CO-CHAIR LEVITT: I'll have to remember that.

MR. SILVERS: I think I made an answer on BDO, if -

CO-CHAIR NICOLAISEN: Damon, I'm a little bit uncomfortable with talking about live things.

MR. SILVERS: I wasn't planning on doing that. I was planning on giving a more abstract.

CO-CHAIR NICOLAISEN: Okay.

MR. SILVERS: But it's up to you, whether you want to - I mean -

CO-CHAIR LEVITT: Let's see. Gaylen.

MR. HANSEN: Yes. I was just going to say on the trusteeship, Number Two, I mean, I can certainly support that. I certainly don't have the stature of the people that have already spoken and just left, but it does seem to me that when that happens, those firms are going to go down pretty darned quick, and so it might be nice to have it in your back pocket. But let me go to a couple of other things.

Limiting the auditor choice in Recommendation One. And, as I recall back in the early 80s, there was initiative by the AICPA about discriminatory contract provisions. And the idea was to discourage those, and not to have financial institutions put those in contracts with companies, because it just didn't seem fair on the face of it. And I wonder if anything more can be done, more than just simply the proxy disclosures? Is there anywhere else, publicizing it or something else, because it just really seems to be a below-the-belt type of thing when you put those provisions in the contracts. I don't see it as much as I used to years ago, but occasionally I still see it, that well, if such-and-such firm does it, then you have another Big Four firm or something that does the same work. Well, they don't even know the people, they don't the competencies of the individuals involved, so I just throw that out there. The issue is more with financial institutions, than it is with the firms.

On the question of independence, and I wonder whether or not you looked at the - there's a threats and safeguards sort of approach to independence, and it's sort of a risk-based approach. And I don't know if, when you say "de minimis", were you going down that path? So, maybe, if you might just comment on that.

And then, lastly, and perhaps it's more for our friends from the SEC, but as I recall, when Sarbanes-Oxley was first passed, SEC auditors were required to take independence training for some period of time, and that seems to have sort of faded. I don't know if firms are still doing that actively, or not. I can tell you, our firm does.

MR. FLYNN: We have an annual training program with an affidavit they've been to it, certified testing after it, so they have to take it, certify, the time is on the computer, and then have to test out of it. And then we also have active live program updating modules, as well, so it's two-tiered.

MR. HANSEN: But the question is, is it required by the SEC?

MR. FLYNN: Yes, absolutely. I don't know if it's by the SEC.

MR. HANSEN: Annually.

MS. PALMROSE: No, I don't think we have any requirement. And I actually think this is B- it's probably good to bring up, that I don't think this is quite what Damon and the Subcommittee had in mind here. It's really more the notion of, I think, not independence training, it's the substance of what independence is about, which is not training on compliance with the rules, it's the notion of back to the professional healthy skepticism.

MR. HANSEN: And I'm with you on that, Zoe-Vonna, but what I heard was we've got independence rules here, and here, and here, and we want to pull them together, but it seems to me that if we have that training annually, people ought to know where these rules are. That should not be a problem.

MS. PALMROSE: I think that was sort of a different issue here on the training. I'm sorry. I should not be speaking for Damon.

MR. SILVERS: Go ahead.

MS. PALMROSE: I think the issue on the rules was just that it's not just for -- the larger firms certainly have systems and communications around them. This is for the smaller firms, where it's a little harder to figure out how to transition from the rules of the AICPA to the SEC, and make sure you know them. I mean, not the desire to comply with them, but the accessibility of them. They're in multiple places, and it's sort of hard to get an easy answer. And it's not just for the firms, but it's also for audit committees.

I think there's a general recognition that now that audit committees are responsible here for auditor choice, and monitoring audit services, and part of that is independence, it's - there's a very real need for a lot of people to understand what the rules are, so that they can carry out their function here in an effective way. And it's also - we've actually done some work in that regard as the SEC. We have a little brochure that I think we've shared with the Committee on how to - communicating with audit committees about what the rules are, and how to find them. But we certainly appreciate that the barriers to finding out what the rules are can be reduced, and I think that's the spirit of this recommendation.

CO-CHAIR LEVITT: Jeff?

MR. MAHONEY: Thank you. Just a

couple of brief miscellaneous comments.

Mr. Goldman's comment on the survey, I think that's an intriguing idea, but I think when we're talking about satisfaction of the auditing firms, we've got to think about who the customer is, who is the customer of audited financial statements? And I believe, I think most people believe the customer is the investor. So if we're going to survey people about auditor satisfaction, we should be surveying the customers, investors, and shareholders.

Second, Recommendation Four, I, obviously support that idea. As I mentioned in my earlier comments, it's a policy that the Council has had for quite some time. We're very happy that most companies are now adopting it. But, again, sorry to go backwards, before I jump forward, but go backwards a little bit. We need some more information to make that bolt, so I think the transparency issue is a very important one.

I'm disappointed that we haven't been able to come up with much in that area, to-date.

Third, Damon mentioned the GAO report a couple of times, so I just would encourage people to read that report. I think there's a lot of interesting information in there. And just to briefly point out one piece of information, is that the GAO carefully, I believe, considered various methods to reduce auditor liability further than it is today, and rejected all of those ideas. And their commentary in that report pointed out that investors that they talked to were concerned that further limits on auditor liability would negatively impact audit quality.

And, finally, the trustee idea sounds like a great idea. I think that all the issues here about improving the auditing profession shouldn't always lead back to reducing auditor liability. I think we need to think broader than that, so I commend

Damon's Subcommittee for looking at different ways to attack this issue through this trustee approach. Thank you.

MR. TRAVIS: I would just like to offer a couple of comments. First of all, I support the recommendations of the Subcommittee. I think I want to focus my comments on Recommendation One. I think there are firms who would like to become - have the size and capabilities of the Big Four. I think that's a faulty assumption. I think some firms are demonstrating significant focus on the types of companies that operate globally, the types of companies that require SEC-capabilities, the types of companies that require deep expertise in certain industries. However, I think it's going to take some time, and so the question becomes how do we help those firms get more experience and greater capabilities?

One of the things that I would look to is for the SEC, the PCAOB, and other government agencies of getting those people involved in some of the committees at this level, so they get more exposure to the talent and expertise of people in the Treasury, people in the PCAOB, people in the SEC. I think the Center for Audit Quality is doing some of that today, by allowing the firms to participate with the Big Four. I think the Big Four have been very helpful in sharing their knowledge and expertise with some of the participants. I think the PCAOB SAG is another way that firms are getting that sort of exposure, but I think there's a lot more that can be done.

A couple of years ago, Barry led a group into Washington, D.C. to meet with the White House staff about getting opportunities to serve on more committees and things like that. I don't think too much has happened yet.

The point I'm trying to make is, I think there are some small steps that can be taken by getting the firms exposed to the talent and expertise of people in the SEC and other organizations, that gives them more exposure, gives them more knowledge and opportunity, and also, ultimately helps them take that credibility back to the marketplace. So I would ask you to focus a little bit more time and attention on what are we going to do to promote the growth?

The second point I'd like to make under that category is, I agree with Lynn's comment about don't tax the earnings that aren't distributed, because that is a real legitimate issue for small firms. The effective tax rate to the individual partners goes up a lot if you don't distribute all the earnings that you're being taxed on, so I think that is a very legitimate comment. Thank you.

CO-CHAIR NICOLAISEN: Damon, I'm sorry I didn't raise this with you earlier as part of the Committee, but the concept of competition, what do the firms actually compete on? And we know, historically, that competition was significantly based on price, and that was not a very healthy environment. That doesn't seem to be the case today, there does seem to be some real competition based upon specialties, based upon quality of service, resources, nearby companies, and that type of thing.

Zoe-Vonna had suggested earlier that it would be helpful to have some measures as to what is it that you'd think about? If I'm an audit committee member, I can think of some things that would be important to me in selecting a firm, or retaining a firm. Are there enough of those that it would be worthwhile putting in some kind of a, if not recommendation, at least some observation of this Subcommittee? So, I would encourage you to think about that. And, Zoe-Vonna, I think you were kind of headed down that path independently. I do think it would be worthwhile.

CO-CHAIR LEVITT: Michel.

MR. PRADA: Thank you. Just a brief reaction to what Jeff said about who is the customer? I have always been struck by the fact that at the very beginning of these discussions, the managers were not part of the discussion. It was really a discussion between the auditors and the regulators, the regulators considering themselves as the voice of the investors, who usually are not very well organized to participate in this kind of discussion. And I believe that the management, or to be more precise, the Board is also a customer, or should be a customer. The Board should consider that external audit is an insurance for them from the point of view of their liability, and their duty of care. And they should look at the issues of audit not as an embarrassment, but as an insurance. And if you try to draw a parallel between audit and engineering quality control, you'll see that we do not have the same kind of discussions when we talk about engineering. I mean, no rational CEO or no Board would have any doubt that engineering quality control is key for the future of a company. And although it's an external control, it is there to make the company more sure that the products are okay, or that - I don't know - the bridge is well built, or whatever.

Why is it that we don't have the same kind of relationship in the field of audit? And this is something I think we should think about. I guess, the Board should consider external auditors as absolutely key for their own security.

CO-CHAIR LEVITT: Thank you. Tim?

MR. FLYNN: I think the Subcommittee has done a good job wrestling with some pretty tough topics. In particular, I think Item Two. I've lived through a couple of different versions of that, in particular, running the audit practice in 2002, and absorbing about four or five hundred clients, thousands of people, and trying to get that all done through the Andersen demise, and then my own firm situation when I took over, so I think it absolutely is important for the capital market to have a plan, to have a process in place, and thoughtfully done. And I think I would encourage some dialogue with the firms to take the concepts you've laid out here, and how could they be actualized, and get some input from it, because I think that we could be very helpful in talking about that. And I think engaging in that discussion between now and the next Committee meeting might be very, very helpful. In particular, when you're talking about changing partnership agreements and things like that, it takes a majority vote, super majority in many cases, and so there's ways we have to look at how to frame that. But I think for the good of the capital markets, for the importance of the investors, a plan, a thoughtful way, understanding I think is very important.

CO-CHAIR LEVITT: I think that's very constructive, Tim. I think it's essential when you talk about a custodial arrangement, a trusteeship, or whatever you have, prior to going down that road, that there's a total buy-in on the part of those who are going to be part of this, or hope never to be part of this process.

MR. FLYNN: I vote for the latter.

MR. SILVERS: Tim, I think that the Subcommittee would very much welcome that advice and consultation. I think that, in particular, we're very sensitive to the fact that there are all sorts of internal firm issues associated with Part One of the recommendation, and that we are not looking to be anywhere near specific around that, for just that reason.

MR. FLYNN: Part one is the key, as Lynn said earlier. If you get to Part Two, we all could talk about what will happen there.

But I think Part One discussion can be very helpful, and Part Two is the end, but that would be very good.

MR. SILVERS: We hope you'll help us frame the Part one.

CO-CHAIR LEVITT: Well, I want to thank everybody. As I look around this table, I see an unbelievable array of busy people who have been largely untethered from phones and Blackberries, and planes, and everything else. You, obviously, care.

There, obviously, are some elephants, maybe baby elephants wandering around the halls that are going to have to be dealt with. We have been pretty specific in certain tough areas, but I urge the committees to corral those elephants, and not to come up with 4-3, or 6-2, or wherever it may be, but to come up with something that we can really be proud of, because failure can be defined in terms of coming up with something that everybody will applaud. That's just an irony.

Success will come up with something that will have its critics, and its supporters, but that we will feel that we gave everybody an opportunity to discuss the tough issues, to seek ways of solving them where we can, and to come up with a product that will really be great. And, Michel, we are particularly grateful to you for spending your time with us today, and your insights from a different part of the world. I hope you will continue to work with us.

So, with those parting words, thank you all so much. And I look forward to speaking to you on the telephone, seeing you soon. Travel safely.

(Whereupon, the proceedings went off the record at 5:01:21 p.m.)