UNITED STATES OF AMERICA
DEPARTMENT OF THE TREASURY

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ADVISORY COMMITTEE ON THE
AUDITING PROFESSION

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OPEN MEETING

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TUESDAY, JUNE 3, 2008

The Committee met at 10:00 a.m. in the Cash Room of the Department of the Treasury, 1500 Pennsylvania Avenue, 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
ALAN L. BELLER
AMY WOODS BRINKLEY
MARY K. BUSH
H. RODGIN COHEN
TIMOTHY FLYNN
ROBERT R. GLAUBER
KEN GOLDMAN (via telephone)
GAYLEN R. HANSEN
BARRY MELANCON
ANNE M. MULCAHY
RICHARD H. MURRAY
GARY JOHN PREVITS
DAMON A. SILVERS
SARAH E. SMITH
WILLIAM D. TRAVIS
LYNN E. TURNER
PAUL A. VOLCKER (via telephone)
ANN YERGER

OBSERVERS PRESENT:
SOPHIE BARANGER (OBSERVER-DELEGATE FOR MICHEL PRADA)
ROBERT H. HERZ
MARK W. OLSON
ZOE-VONNA PALMROSE

TREASURY OFFICIAL PRESENT:
ROBERT K. STEEL, Undersecretary for Domestic Finance

TREASURY STAFF PRESENT:
KELLY AYERS
GERRY HUGHES
TIMOTHY HUNT
KRISTEN JACONI
STEVEN LAUGHTON

PANELISTS - PANEL I:
JEAN BEDARD, Timothy B. Harbert Professor of Accounting, Department of Accountancy, Bentley College.

KAYLA J. GILLAN, Chief Administrative Officer, RiskMetrics Group

JOHN BIGGS, Chair, Audit Committee, Boeing

WILLIAM KINNEY, Charles and Elizabeth Prothro Regents Chair in Business, and Price Waterhouse Fellow in Auditing, University of Texas in Austin

ANNE LANG, Chief Human Resources Officer, Grant Thornton LLP

FRANK K. ROSS, Director, Center for Accounting Education, Howard University School of Business

PANELISTS - PANEL II:
HARVEY GOLDSCHMID, Dwight Professor of Law, Columbia Law School

DAN GUY, Former Vice President, Professional

Standards and Services, AICPA.

BARRY MATHEWS, Deputy Chairman, Aon Corporation

NELL MINOW, Editor and Co-Founder, The Corporate Library

JULES W. MUIS, Former Vice President and Controller, World Bank

KATHRYN A. OBERLY, Vice Chair and General Counsel, Ernst & Young LLP

REX STAPLES, General Counsel, North American Securities Administrators Association

MICHAEL YOUNG, Partner, Willkie Farr & Gallagher LLP

PANELISTS - PANEL III:

MARK ANSON, President and Executive Director, Investment Services, Nuveen Investments

CHARLES W. GERDTS, III, General Counsel, PricewaterhouseCoopers LLP

KENNETH NIELSEN GOLDMAN, Capital Markets and SEC Practice Director, J.H. Cohn LLP

JAMES KAPLAN, Chairman and Founder, Audit Integrity

BRIAN O'MALLEY, Senior Vice President and General Auditor, NASDAQ Stock Market

KURT N. SCHACHT, Managing Director, Centre for Financial Markets Integrity, CFA Institute

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(10:00 a.m.)

CHAIRMAN LEVITT: Good morning. I'd like to call the meeting to order, and welcome the Members, observers and the public to our open meeting of the Advisory Committee on the Auditing Profession.

I'd like to remind those around the table to turn off their Blackberries, because they do interfere with reception. Panelists and Members and observers should press the button on the microphone when it's their turn to speak, and once again when you're finished, to turn the button off.

There are going to be three panel sessions on the recommendations in the Draft Report and a final session to discuss an addendum to the Advisory Committee's Draft Report.

With regard to the panels, each panelist will be limited to five minutes of oral testimony. And after the full panel has delivered oral statements, Members of the Advisory Committee will be able to pose questions.

I'd like at this time to welcome Sophie Baranger, who is representing Michel Prada, who has probably become one of the outstanding regulators throughout the world, and we are delighted and honored to have you with us this morning, Madame Baranger.

MS. BARANGER: Thank you very much.

CHAIRMAN LEVITT: As the first panel is focusing on the Human Capital Chapter of the Advisory Committee's Draft Report, the first individuals permitted to question these panelists will be the Members of the Human Capital Subcommittee.

Each Member will be limited to a five minute question and answer period. Members will be able to send questions to the panelists after the meeting, thus allowing all Members the ability to have their questions answered.

I'd like to mention that since we've had a large number of panelists request to appear on a number of issues, the composition of every panel does not precisely conform to the topics considered by the panel.

John Biggs this morning, who is on the first panel, will be talking about the issue of reports important to audit committees, not strictly according to what the first panel will consider.

I'd like now to call upon panelists Jean C. Bedard, Timothy B. Harbert Professor of Accounting, Department of Accountancy at Bentley College.

MS. BEDARD: Thank you, Art. Bentley College is -- was founded as a School of Accounting, and today, its accounting programs are nationally ranked at the undergraduate and graduate levels. To date, we have graduated 17,898 individuals with accounting-related bachelors and masters degrees.

I'm a member of a three-person task force also including Professors Joe Carcello of the University of Tennessee and Dana Hermanson of Kennesaw State University, who was requested by the American Accounting Association to respond to the Committee's draft recommendations.

These comments were submitted to you in writing by Professor Carcello on May 15. Our written response and my remarks today reflect our own personal views, not the views of the American Accounting Association.

In making Human Capital one of its three key areas, the Committee has signaled to investors, corporations, regulators and academic institutions that students in our accounting programs are crucial to the future health of the capital markets.

As professors of auditing and accounting, we've been telling our students this for years, and I, for one, am pleased to have this be officially recognized in

Washington.

The Human Capital section of the Committee's Draft Report has a number of recommendations regarding who enters our university programs and on the learning experiences they have once there.

In the short time allotted to me, I want to mention three aspects of our task force's response. First, recommendation one suggests that curricula of accounting programs should continuously evolve in adaptation to changes in the professional environment. We certainly support this recommendation, but note that changes in the environment almost always involve adding course content rather than deleting or substituting content. Thus, the required knowledge base of auditors, especially public company auditors, continues to build.

In the past 20 years, many state boards of accountancy have recognized this by adopting requirements for a fifth year of education prior to the CPA exam. And in response, many accounting departments added masters degree programs, or augmented existing programs to meet the demand for education beyond the baccalaureate.

At most schools, this type of incremental content referred to by the Committee is primarily covered in the fifth year. However, some states have recently reduced their requirements for taking the exam, and my understanding is now 18 states currently allow candidates to sit for the exam after 120 hours.

If candidates are eligible to sit for the exam after four years, the advance level courses in which this new knowledge is covered won't have been taken. This constrains the ability of the CPA exam to cover topics that relate to auditing in an increasingly complex world.

One possible solution is to have an additional layer of testing for public company auditors that is beyond the normal four parts we have now, that would be taken after a graduate degree and several years of experience. This is only one possibility, but that's one way we could cover that advanced knowledge that is needed to -- at the partner and manager level in complex public company engagements.

The second point in our comments I want to emphasize is that while the Committee's recommendations relate to the education of accounting students, the future health of the auditing profession is also impacted by the education and values of other business students who will some day be managing corporations.

The external auditor begins his or her task of assurance with a baseline of financial reporting quality that is represented in the unaudited balances prepared by management. If business schools educate students in all majors in the importance of reliable and transparent reporting, and in the need for sound governance and internal controls, presumably the quality level of the unaudited numbers would increase.

While general business education may seem outside the Committee's charge, we believe it is as crucial as accounting education to insuring the sustainability of the auditing profession and maintaining the health of the capital markets.

Third, we support the Committee's Human Capital recommendation five which encourages study of the future structure of higher education in accounting, especially as it pertains to public company audits.

Among the possible options is the professional school of auditing model, which Professor Carcello outlined in his previous testimony before this Committee. This model envisions free-standing, professional schools that are clearly and consistently oriented around the role of the auditor in investor protection.

Because there are many issues to consider, a joint commission of practitioners, academics and other stakeholders would be a necessary first step. Again, thank you for the opportunity to be here today.

CHAIRMAN LEVITT: Thank you. I would now like to call upon John Biggs, the chairman of the Boeing Audit Committee and former chief execute officer and chairman of TIAA-CREF. John.

MR. BIGGS: Thank you, Chairman Levitt, Nicolaisen, and the Members of the Advisory Committee, many of whom are long term friends of mine.

I'm happy to have a chance to testify in favor of our public auditing firms preparing their own financial reports, which would be audited by an independent -- another independent audit committee.

My career, like many in the financial world, has devolved into serving on audit committees. I'm on about seven or eight, at this point, mostly nonprofit, but several for-profit. I consider it a sort of purgatory for the -- my sins in the past in the corporate world to have to serve on that many audit committees. Actually, I do enjoy doing it.

I think you're all aware, fully aware, of the increased responsibility, power, risk and work that has been imposed on a lot of the committees by the changes in the New York Stock Exchange listing requirements, by Sarbanes-Oxley, and I can assure you that the audit committees are working hard, and are aware of the risk involved.

The term, "financial expert," is another that many of us end up with and many lawyers, my personal lawyer for one, feel that that is a very dangerous position to be in. Because when things go wrong, the audit committee will be looked to, and the financial expert on that committee in particular will be looked to.

The question, I think, that many would ask is, why would it be valuable to have financial statements prepared by the audit firms. I think first off, there are a number of events when an audit committee in a company should be thinking about understanding the audit firm they are about to employ or that they're going to continue.

Obviously, when you have a rotation or a new auditor because of some disqualification, you want to ask every question imaginable. Even at the five year rotation of the lead partners, we ought to do a special in-depth examination of who the next partner is going to be and what the process was in the firm to create that position.

And there should be an annual review with a checklist for audit committees, goes on and on, page after page, but one of them is to review the audit firm's performance and background.

What are the benefits that might come from that? It's interesting to me too, when the informal process that we now use, there's a great reliance on the reputation of the firm. If you ask the questions about financial stability, financial background, you get all sorts of answers.

One that's sort of interesting to me coming from the banking world is, there are too few to fail. That simply the government cannot let that happen in the future. But on the other hand, you immediately learn that there are large professional liability risks that are uninsurable in the current insurance markets. I think those are all reasons why we may want to -- an audit committee might want to consider.

But first off, the question you ought to have is, what is the capitalization structure of the audit firm? What are the amounts of money? I have no idea how that would appear, but I think it would be useful for an audit committee to ask those questions.

What are the litigation risks? Does the firm invest in improving audit quality in terms of its infrastructure, review, discipline, and even controls. What are the relative size of revenues and profits from non-audit practices? Public companies disclose compensation, why not the audit firms? Why should they be exempted from that requirement?

This is not a new idea. It has come up in previous groups that have studied the audit profession. But what was interesting to me particularly was the U.K. experience, and I read two of the statements and just brief items from each of those in the KPMG statement.

They have it under the heading, Transparency in Financial Reporting. "Transparency underpins," this is a quote, "underpins the group's commitment to quality and integrity, and is vital to the wider confidence in financial reporting in global capital markets. KPMG in the U.K. has produced audited financial statements since 1995," and so on, which is in my statement.

In the Deloitte & Touche, some questions are asked. They had a question and answer format. Some questions are asked about the transparency about the audit business and firms. What is your response?

"Briefly, the audited," quote, "The audited financial statements in this report includes significant information on each of our business divisions. Key data regarding our audited practice includes among other items, only one-fifth of the total firm revenue is coming from the audit practice." I think that would be an interesting piece of information to know.

In summary, I make two points. Audit committees have a lot more responsibility and a lot more risk today. We need all the information we can have. The relationship with the auditor is probably the key relationship that we have, and the audit firm's finances tend to be a black box and it's time we opened up the black box. Thank you.

CHAIRMAN LEVITT: Thank you very much, John. I'd now like to introduce Kayla J. Gillan, formerly general counsel for California CalPERS, presently the chief administrative officer of RiskMetrics Group, and formerly a distinguished PCAOB member. Kayla.

MS. GILLAN: Thank you, Chairman Levitt and Chairman Nicolaisen and members of the Committee. It's a pleasure to be with you, sort of back with you, today.

Before I begin I'd like to make sure that the record is clear that I am speaking to you today as a former and founding member of the PCAOB, and as a long time investor advocate, I am not speaking on behalf of my current employer, RiskMetrics. The views I express are my own, and not necessarily those of RiskMetrics, its subsidiary ISS, its Board of Directors, or its staff.

Thank you again for your kind invitation to offer my comments on your Draft Report. Let me say first that this is an extraordinarily thoughtful report, highlighting the critical issues that face the auditing profession. And I commend you for the thoroughness of your analysis.

Your Draft Report contains five primary recommendations concerning the human capital issues impacting the auditing profession. Although I'll only touch on three of those due to limited time, I do think each is critical.

However, in my view, the first recommendation, that is concerning implementing market-driven, dynamic curricula that help prepare new graduates to perform high quality audits, is the most important.

The fact that our accounting and auditing curricula is so lagging the real world is the cause of many of the other problems that you've identified throughout your report.

It's like the children's game of Mousetrap, where a ball transcends through a rickety device, triggering other events as it makes its way through the course. For example, if our colleges and universities were better able to prepare accounting students to hit the ground running upon graduation, then accounting firms would be able to decrease their considerable commitment to providing basic auditing education to new graduates, and they in turn would be able to provide more resources to funding the development of faculty and faculty research, as suggested in your third recommendation.

I also applaud your second recommendation, concerning increasing the representation of minorities in the auditing profession. However, when reading the report

I was startled by the absence of any discussion of the representation of women, and in particular of the wage disparity that continues to exist between the genders within the profession.

According to the U.S. Census Bureau women between the ages of 35 and 54 with a Bachelor's degree or higher who work as accountants or auditors represent 42.6 percent of the profession, but earn only 72.9 cents of every dollar earned by their male counterparts.

According to a recent study conducted with the support of the AICPA's Work/Life and Women's Initiatives Executive Committee, women make up 19 percent of all public accounting firms' partners; while this is up from 12 percent a decade ago, the pace of advancement that is seven percentage points in ten years -- is disheartening.

We cannot expect women to join a profession in which their earning capacity is so disparate. I urge you to consider this issue as you finalize your Report.

As I mentioned, your third recommendation concerns increasing the supply of qualified accounting faculty through, among other avenues, increased public and private funding of academia and research. As I no doubt you're aware, as you have Members of the PCAOB on your body, Sarbanes-Oxley includes an interesting provision, through which monetary penalties assessed by the PCAOB -- PCAOB against registered firms and persons are to be used exclusively to fund merit-based scholarships for accounting undergraduate and graduate students.

This provision also includes certain procedural requirements, including approval by Congress through an appropriations act that, I believe, makes implementation both difficult and inconsistent with the need to put these funds quickly to work. As we speak, a civil penalty of over $1 million, collected by the PCAOB last December, sits ready to contribute toward this important cause. I suggest that, if you have not already done so, this Committee consider recommending eliminating the unnecessary procedural obstacles contained in the statute.

I'd be remiss if I did not also comment on a suggestion by the task force established by AAA to monitor the activities of this Committee. Specifically, in its comment letter dated May 15, the task force suggested that this Committee encourage the PCAOB to grant academics access to confidential inspection data for the purpose of conducting audit-practice research.

I have long advocated greater transparency of information derived from the PCAOB inspection process. This being said, I am concerned with providing greater access to this information only to academics. If the Committee believes, as do I, that more transparency of PCAOB inspection data and findings would help promote higher quality audits, then I would urge you to make this information available to all, particularly to consumers of audit services, not just academics.

Before closing, Chairman Levitt asked me to comment on two issues contained in the addendum to part six. Should audit firms be protected from catastrophic liability through caps or some other device? If so, should this protection be in exchange for greater transparency about audit firm financial structures and resources? And should the PCAOB be charged with discretion to determine how much of the firm's financial information should be made public?

Clearly, the issue of auditor liability has been discussed and debated for decades. And quite frankly, I've seen nothing, during my time on the PCAOB, before or after, that has convinced me that caps on auditor liability are either necessary to protect the sustainability of the auditing profession, or wise public policy.

In my view, the best protection auditors have against catastrophic liability is to faithfully follow the professional standards that are in place. I know of no instance in which an audit firm, or auditor has been found liable for damages sustained by investors when they followed professional rules and standards.

And lastly, should the PCAOB be charged with determining how much financial information concerning the firms should be made public, or should be kept confidential. Clearly, this is a decision for you and Congress.

However, I urge you not to underestimate the considerable pressure that would be put on the PCAOB should you recommend that they be given this kind of pressure -- this kind of discretion. I really urge you not to pass the buck. If you think this information should be made public, recommend that it be made public, but don't pass it on to the PCAOB to make that recommendation.

Thank you again for your invitation to speak. Congratulations on your work.

CHAIRMAN LEVITT: Thank you very much, Kayla. I now would like to introduce William Kinney, the Charles and Elizabeth Prothro Regents Chair in Business, and PriceWaterhouse Fellow in Auditing at the University of Texas in Austin.

MR. KINNEY: Thanks for the opportunity to speak with you today. Human capital is the core of any profession, and independent professional scholarship, that is education and research, is an essential element of capital.

Today I'll comment on the decline of independent audit scholarship that I believe underlies three of your recommendations.

Professional education in research typically involves study of current and alternative professional practices. For example, it is difficult to imagine becoming a surgeon without learning how practicing surgeons typically approach a particular surgical procedure.

Similarly, current surgical practices are analyzed and tested against alternatives by university-based researchers, researchers who are not paid by practicing surgeons or by their regulators. And to protect the public interest, courts and legislatures use knowledge about the best surgical practices to regulate surgeons' performance.

For several decades prior to about 1990, the same knowledge creation and transfer process described the public company auditing profession. Large firms shared practices with professors through audit manuals, training sessions, journal articles and audit methods conferences. They often provided firm data such as audit adjustments, fees, audit labor hours, as well as access to personnel for participation in research studies.

The contact improved classroom instruction and allowed research about the effectiveness and efficiency of alternative auditing practices, research that brought insights and solutions to practice problems using broad knowledge adapted from psychology, judgment decision making, economics, political science, governance, statistics, game theory, and computer science.

Practitioner/professor contact declined after about 1990. Some observers believe that the decline was due to firms' increasing concerns about litigation. Others attribute it to cost and competitive disadvantage that they perceived, while others say it was a reflection of the emphasis of auditing in the mid-1990s.

Whatever the cause, the decline accelerated after SOX and formation of the

PCAOB. And, the PCAOB itself has not been a substantial vehicle for substantial knowledge transfer and, to my knowledge, it does not employ audit-trained researchers.

Today, we know a great deal from archival research about the output of auditing, that is, research about auditing. We know how stock prices are related to financial information, to restatements of financial information and whether management judgment or fraud were involved, whether analysts' forecasts are met.

In fact, leading scholarly journals in accounting today publish more studies of analysts' earnings forecast behavior than about how auditors determine audited earnings.

As to costs of public company audits, we know that audit fees of about 2600 accelerated filers audited by Big Four auditors from 2003 through 2006 increased by 93 percent. And as to benefits of auditing, more than half a dozen scholarly studies suggest that financial statement audits lower the cost of capital for public issuers by 25 to 70 basis points.

Archival research has flourished, because archival data are available on stock prices, audited earnings numbers and analysts' forecasts. But the studies are largely devoid of knowledge of the audit process. In contrast, research in auditing, such as new statistical applications and behavioral issues, largely has ceased to exist.

Behavioral research conducted before 2000, however, shows that auditors exhibit known and substantial biases when making audit judgments. These judgments are strong enough to appear in laboratory settings without the incentives to please others. Behaviorally biased judgments become critical in today's age as judgment-based accountings such as IFRS and fair value accounting are implemented.

The audited results will increasingly reflect human judgment biases of both auditors and management. Management must then -- or, auditors must then make judgments about judgments of management and standards setters must write standards evaluating judgments and evaluating judgments about judgments. These are very difficult tasks.

The audit process may be shifting from, “given the rules, is management's number right,” to “given the principles, could management's number be right?” This seems a bad time to abandon behavioral research in auditing. Because the public needs to know, are audits worth their cost, are financial statements reliable?

Today, auditing is largely, we need to know also whether the inspections process is working and whether standards themselves are adequate. Why do some audits fail when others succeed? What are promising alternatives? As with surgery, independent research is needed to find out.

This black box that we have today as concerning audit practices, hurts all parties involved. It hurts students at the university, it hurts promising PhD students who are estopped from becoming researchers in meaningful auditing scholarship and auditing and it hurts practice, investors, and the public.

I support at least three of these recommendations of the Committee. Recommendation 3(b) concerning practice sabbaticals. I also support the idea of at least encouraging legislation to provide data for research, and also Professor Carcello's suggestion that perhaps, professional schools is a way of getting the necessary specialization today.

Thank you. I hope these comments will be helpful to the Committee.

CHAIRMAN LEVITT: Thank you very

much, Professor Kinney. I'd now like to yield the floor to Panelist Anne Lang, who is the Chief of Human Resources at Grant Thornton.

MS. LANG: Chairman Levitt, Chairman Nicolaisen, members of the Committee, Treasury staff and observers, thank you for the invitation to present Grant Thornton's views on human capital in the sustainability of the audit profession.

I am Anne Lang, the Chief Human Resources Officer of Grant Thornton LLP, the U.S. member firm of the global public accounting network, Grant Thornton International. Grant Thornton LLP has more than 5,500 personnel in more than 50 offices across the United States. The member firms of Grant Thornton International are in over 110 countries, with some 2200 global partners and 27,000 international firm personnel, including those in the U.S. firm.

The people of Grant Thornton are dedicated to serving the public interest by conducting business with respect, integrity, professional excellence and leadership. This culture drives us as we serve clients of all size in the United States and through the member firms of Grant Thornton International, around the globe.

The talent we bring to the marketplace must be sustainable in quality, depth, diversity and quantity. The heart of our firm's culture is what we call the "Grant Thornton Experience." That gives every person in our firm the chance to achieve his or her aspirations within our organization.

The Grant Thornton Experience offers every person meaningful and challenging work, career development to support professional growth, recognition and fair pay, an environment where they can feel appreciated and connected and a culture of pride by enhancing our reputation in the marketplace.

My testimony today is based on the Advisory Committee's May 5 Draft Report, which does an excellent job of addressing many of the factors that contribute to the sustainability of a capable, committed and diverse public accounting workforce.

A more detailed discussion of Grant Thornton's views is presented in my written testimony. The vibrancy of this profession depends on a diverse population of incoming professionals who are at the top levels of achievement and who are educated to begin work in a public accounting firm.

We cannot be complacent about the current adequate supply now entering the profession. In the not-to-distant future, the profession will very likely find itself face-to-face with very troubling demographics, coupled with the accelerating demands of global businesses. Without a secure pipeline of competent talent, the profession and all of those who rely on us will suffer deeply.

In considering the subject of curricula and content for accounting students, we ask you to consider three enhancements to the current draft. We'd like to reinforce the investors' needs, and perceptions are very important and we ask you to be sure to take them into account as you consider the nature of accounting and auditing education.

Educating students and seeing the future through their lens will help ensure that financial statement audits retain the relevancy and come as close as possible to what users expect.

Second, firms like Grant Thornton that serve large, global public companies must be able to recruit and retain individuals who have specialized knowledge in addition to accounting and auditing. We ask you to make specific reference to the need for programs and curricula that impart the particular knowledge necessary to review, judge, and pointedly question accounting decisions with skepticism, all in a world in which global companies are creating complex financial instruments at a rapid rate.

Standard setters are working toward global accounting and auditing standards. Communication of information is quickly moving to more electronic and interactive formats and regulation is evolving rapidly at international and national levels.

And third, we ask you to consider how information is imparted in a dynamic curriculum. We have found that interactive, simulation-based small group learning produces more understanding and retention than traditional lecture and PowerPoint formats.

Support for additional research into how curricula can be engagingly delivered to improve knowledge, retention and application would be very beneficial.

We believe the recommendations in the Draft Report related to the diversity of our workforce will go a long way to addressing the current challenge. In particular, we are intrigued with the idea of further exploring community colleges as a pipeline for identifying and attracting talent into the profession.

We believe that accreditation of two-year college accounting programs at community colleges should be explored, because they can be a cost-efficient way of completing required course work in anticipation of a four-year degree.

We also note that the ability to hire and keep diverse talent, and all talent, for that matter, is highly dependent on perceptions about the vitality of the profession and the personal risk that goes along with it.

Another issue that you appropriately highlighted is the shortage of PhDs. This country simply does not have enough PhD-level faculty members to train the next generation of auditors and academics. Practitioners can be compelling educators but PhDs are critically important to ensure that accounting remains an academic discipline buttressed by meaningful research that explores the critical issues. We support the recommendations in the Draft Report that focus what is needed to bring more PhD into the system to resolve the shortage.

The Advisory Committee's fifth recommendation that would establish a commission to study the future of higher education structures for the profession is a very sound as well. In considering the commission's membership, we hope that a broad range of investor, business and academic interests joined with the profession, is involved in the process.

As the Advisory Committee continues to ponder how to interest more high school students in accounting careers, we ask you to focus on accounting course content and the delivery in a way that challenges college-bound students.

The current vocational focus should

be augmented by college preparatory courses that are dynamic, intellectually stimulating and representative of the many opportunities in public accounting. Pilot projects underway would be a good departure point for expanded implementation.

I again thank you for this opportunity to present Grant Thornton's perspectives. The people in this profession are the foundation of a sustainable, strong, competitive and vibrant auditing profession and I am pleased to see that the Advisory Committee has recognized their essential role in the capital markets. I'm happy to address any questions you may have. Thank you.

CHAIRMAN LEVITT: Thank you very much Anne for a very informative and passionate report. I'd like to call on Frank Ross, the Director for the Center for Accounting Education at the Howard University School of Business. Mr. Ross.

MR. ROSS: First of all, I would

like to thank the Members of the Committee for the opportunity to testify today regarding your Draft Report. My written testimony focused on recommendations two, three and five. I would like to spend my five minutes today on recommendation two.

I believe that I offer a unique perspective. I am a man of color who entered a profession that was virtually all white, who earned my CPA license, and who worked inside the auditing profession mostly with one major accountant firm as an auditor for a range of clients and a variety of industries for well over 37 years. I know what this profession looks like and feels like from the inside.

I also know what this profession looks like from the perspective of the college campus, the accounting student, and the accounting faculty, since I've also worked as a professor of accounting for some 27 years.

We can all agree that recommendation two reflects one of the profession's higher priorities. We can all agree that minorities are under-represented in the accounting profession, particularly at the managerial, partnership and leadership levels.

I believe the success or failure of diversity efforts will ultimately turn on the level of commitment from within the profession and the ability to sustain that commitment year in and year out for many, many years to come. All of America's large accounting firms initiated minority recruitment efforts years ago. However, the lack of professional staff and partners remain and quite plainly show about how far we still have to go.

I strongly believe that increasing the number of minority new hires is just the first step. To achieve our long term goal for minority representation, we must be laser-focused on retention. I believe the Committee can make this point more clearly in its report by expanding the sub-recommendations on the recommendation two, to add emphasis to the area of retention.

Recommendation two states that the profession should improve the representation and retention of minorities in the auditing profession. However, none of the following sub-recommendations (a) to (d) deal specifically with retention.

Absent greater emphasis on retention, I worry that the profession may misconstrue the Committee's meaning and conclude that additional work on retention is not necessary. But I feel strongly that retention is essential to any effort to expand the presence of minorities in the auditing profession.

At their heart, I believe successful retention efforts must largely be about building young professional's belief that they can succeed and advance. It is about building their confidence. For many minority professionals, confidence is fragile.

Some graduates of historically

black colleges and universities may be intimidated by competing against graduates of elite universities for the first time. In some cases, minorities graduated from elite universities may perceive that they are being singled out as a minority within the workplace and they will feel the sting of various biases that go with that status. It is a feeling they may not have experienced in college.

Furthermore, minorities regardless of the college they're from, are still not always perceived as smart as their white counterparts. Therefore, they are not given the more challenging assignments and will often be evaluated at the lower end of their group. We all know what happens then.

Indeed, surveys show that a large percentages of minorities believe they have to work twice as hard as white colleagues to earn equal recognition. Minorities often feel that they have to prove they can do the job right, while their white colleagues have to prove they cannot do it.

That is why I believe that the auditing firms need to be sure that their retention programs aggressively focus on confidence building. I cannot think of anything that will boost retention more than helping to improve the self-confidence of a young minority professional than having a senior member of the firm, and I stress senior member of the firm, take a personal interest in his or her success and become an advocate or a sponsor, not just a mentor, not just a counselor.

I was fortunate to have senior advocates in my corner when I was young. Believe me, it made all the difference to my success. We must change perceptions so that minorities can plainly see a career path, with an upward trajectory. I'm confident that if minorities believe they have real opportunity, they will commit to our profession in larger numbers and put in the hard work to succeed.

Again, I'm honored to testify today regarding this important subject, and I hope my comments will help as you prepare your final report. Thank you.

CHAIRMAN LEVITT: Thank you very much. Before I turn to Gary Previts, I'd like to ask the panelists a question or two.

Ms. Bedard, when you talked about firm structure and finance, you talked about some sort of quid pro quo that would exchange operational control within audit firms for some kind of litigation reform. Could you briefly expand on what sort of operational control you might call for the firms to give up that you see as being of use to the investing public?

MS. BEDARD: Well, this was an idea that was based on research that was done on what happened after the Private Securities Litigation Reform Act in the `90s. And there are several studies, I think we cite there, that provide not a lot of research, but some that provides some indication of the decline in quality at that point.

So, I think we want to be careful to -- if some litigation reform relief is granted, to make sure we have something off-setting. Like for instance, the more transparent reporting that the Committee is recommending, or perhaps more regulation on firm governance that might come out of the PCAOB to make sure that the firms have in place the governance and cultural structures needed to make sure that the individual partners on engagements perform in a manner such that it's aligned with the interests of the firm as a whole and the investors.

CHAIRMAN LEVITT: Is the transparent reporting -- are you touching upon the release of audited financial statements of the firms? Is that what you're referring to?

MS. BEDARD: Yes, that is certainly one possibility, certainly. Yes.

CHAIRMAN LEVITT: Thank you. Mr.

Biggs, you argued in favor of audited financial statements similar to those being used in the U.K. You are probably aware that the counter argument to that is that the litigation environment in the U.K. is much more benign than here in the United States.

They have no third-party claims, or even class actions. Could you expand on how giving out financial statements would be helpful to audit committees, and respond to that compelling counter argument with respect to the litigation environment in the U.K. Thank you.

MR. BIGGS: A couple of comments about the U.S. system. I think the plaintiff's bar has enormous financial incentives into breaking into the black box of the accounting firm's finances. And when they go to trial, I think they probably have all the information they need.

Audit committee chairmen do not have the resources and time to do that kind of investigation. And so I think the information is there for the plaintiff's bar, even without a published financial statement. It might make it a little easier. They'd have to spend a little less money getting the information, but they'll get it in any event.

I think the value of the information, though, to the general public and to the audit committees, which is my primary point of view, could be quite significant. I don't think we've -- that audit committees have made a lot of noise about this, pressed for it, but I think once those statements exist, they would be read very carefully by audit chairmen in a -- and questions would be raised as a result of them.

So, I think there is a benefit. There is a loss. I'm not interested particularly in giving the plaintiff's bar a way to reduce their costs in getting information. But I think they get it one way or another, and their incentive is so great to get it, that they would find it.

And they can also as simply use the naivete of our jurors to think that these huge firms, by listing the number of people they have, must have huge amounts of capital. It would be useful to just have that specific amount.

I have -- another interest to me is it would appear that from what's been said, that the audit firms don't even have a financial report that they distribute among their partners. I can't quite believe that, that the key information isn't made available.

But one of the great sources for me of information has been, having been CEO of several companies, was reading carefully the financial report that we came out with. And I frequently discovered things in my own company, through a careful reading of an audited report. I think there would be that benefit as well.

CHAIRMAN LEVITT: Thank you, very

much. Gary Previts.

MR. PREVITS: Thank you Arthur. I appreciate the time and energy of all the panelists. And the notes that I've made I can assure you that we are listening very carefully to suggestions about the elimination of unnecessary obstacles in the case of the PCAOB process that was mentioned, Ms. Gillan. And I think that's very appropriate.

I thank Professor Ross for his insights into the need for not just mentoring, but advocacy. It's a quite different concept. It's somewhat more intensive, and I appreciate that note and all the other comments that were made.

I'd like to hone in on a couple of the comments that were made by Bill Kinney. And Bill, I ask you to share with us your own experiences in this research data issue. Because the sensitivity here is running very high with the litigation risk and so on. And then I have a follow-up question for Jean, and

I have to do that all in my five minutes.

So I would appreciate your experiences Bill, about what's happened to your own doctoral clan at UT Austin over the years and how the lack of access to research material has affected the ability to prepare younger academics.

MR. KINNEY: Thank you, Gary. The decline of scholarly study of auditing on campus is almost complete. This is true at the University of Texas at Austin as well, which is one of the largest suppliers of PhD students. We now have one student considering specializing in scholarly auditing and one more that may join us this fall. So this is two out of about 18.

And the primary reason is that students do not have the capability of competing for journal space in conducting scholarly research in audit process. Now, if you call auditing research, studying how stock prices react to analyst earnings forecasts, and the audited earnings, and the audited earnings of course had been audited -- if that's auditing research, then there's a lot of auditing research going on on campus.

But it's not about how audits are done. Audits are treated as a black box on campus by necessity because of lack of contact with practitioners. It's a lack of contact that did not exist when I was a boy. When I was a boy, practitioners were anxious to get the latest thinking on campus to try to get new ways of solving emerging practice problems, whether it involves statistics or behavioral science.

Because humans don't process information nearly as well as we think we do. Auditors don't do it. Management doesn't do it. But management also has incentives to act opportunistically and so those behavioral biases from which they suffer are compounded when the auditor tries to audit those numbers. And we're heading toward even more of that for the future.

So, it's vital, but on campus, we -- those interested in behavior are turning toward the accounting part of this, instead of the audit part.

CHAIRMAN LEVITT: Thank you, Bill. And Jean, the issue of recommendation five, you commented about the future architecture. I presume that this is not an instant thing, this is a long range suggestion. And I'm curious as to your thinking about recommendation five.

MS. BEDARD: It must be. There are a lot of issues to be considered when we think about changing the educational model to a professional school of auditing. Certainly, it would have the benefits of having the strong focus on investor protection and the public service, which is not part of the business school's -- the rest of the business school's mantra, would have sufficient time to develop knowledge and skills necessary for public company auditors.

There are -- probably the biggest obstacle I see is cost. It would presumably be a longer program. It would be expensive. And so the Committee's focus on funding for more PhDs, funding for students, is certainly well-taken here.

I just want to mention as an example, the KPMG's PhD Project, which shows that a relatively small amount of money given to individuals to help them get education really truly works. It doesn't have to be a lot of money. A small amount of money helps. So, you know, that program is a model.

But, I think as we move towards this, we need to think about how families are going to pay for education. It's difficult now. It's getting worse. So, anything we can do to help those accounting students with the cost would be appreciated and important.

CHAIRMAN LEVITT: Thank you. I'll defer to whoever else on the Human Capital

Subcommittee has questions and I assume there will be many. Amy Brinkley.

MS. BRINKLEY: Thank you. One comment first, and then I have a question for Ms. Lang.

Ms. Gillan is it -- Gillan, sorry. Thank you for your comments with respect to women in the profession. And we spent quite a bit of time on that subject. A lot of discussion both amongst ourselves in looking at data that we could find, as well as talking with panelists throughout the industry.

And we did have data that suggested in a recent AICPA survey that the entry level is at about 54 percent. So, there's a strong pipeline coming in. To your point, though, you want to see what the progression is and I think as of May of `08, 23 percent of partners is what we had were female, and fortunately, a high point in history.

When we talked with people informally, we were trying to get a sense, is the progression encouraging, or does it seem to be stymied. And we had a sense that there was fairly positive progression. But with your comments, I think we should go back and look at all of our information and so we do appreciate the comment and would, you know, we'll look further at it.

Ms. Lang, one comment, or a question for you. You, in your second bullet point on page three, you reference as you're talking, about the requirements to go beyond the type of curriculum that we see today.

But the last sentence, I'd like you to expand on, if you would, "Therefore, that we ask the Committee to consider advancing the concept of alternative, programmatic and curricular options as entry points to the profession." Could you expand some, please?

MS. LANG: Yes, thank you very much for the question Ms. Brinkley.

I think that overarching as we take a look at really the dynamic changes in business and where we're going as kind of a global environment, and what that really means to us as good stewards of the public interest.

I think it's important for us to try to expand in a number of different ways, how we can ensure that we're attracting the very best talent into our profession. And that there isn't just one area of doing that.

There's actually several different ways. One of them could be tapping into the two-year community colleges in trying to identify individuals there as feeders into the four-year colleges, as well as looking at individuals with other types of degrees that can really help us bring forth a well-rounded, holistic approach to the talent that we need to put together for the public audits.

MS. BRINKLEY: Thank you.

CHAIRMAN LEVITT: Mr. Melancon.

MR. MELANCON: Thank you, Mr. Chairman. I have a couple of quick questions. First, to Mr. Biggs, and I appreciate

Chairman Levitt, you asking the question in the context of the transparency and the liability issue.

But you cited from an audit committee perspective, which I certainly respect the notion of quality being part of the information flow that this information from the firms, or at least an audited financial statement might depict.

I guess, and you've cited that you've read many, no doubt, many, many, probably more than anybody in this room, financial statements given your involvement on the investment side, et cetera. But I question how a set of audited financial statements is going to bridge that gap to quality.

I think the notion of helping an audit committee understand the quality investment is a fair point. I'm just trying to help bridge that gap from a set of audited financial statements that sort of in general, as we know, audited financial statements are intended to paint a, you know, to communicate a certain set of information, yet quality might not be what's coming through that set. Do you have any thoughts on that?

MR. BIGGS: Well, a couple of ways. I've found it interesting reading the two British statements that they spent a lot of time in the preamble, the management report discussing quality of their audits. And the primary emphasis was on that.

In the statement itself, you get some information about what percentage of their business was actually auditing, not something else, and what were the margins on auditing versus the margins on other business, upon where we've had lots of misleading information, as you well know.

MR. MELANCON: Right.

MR. BIGGS: Various groups have talked about auditing being a loss-leader. I don't think it is. But I think if you had that information reported out accurately and analysts from the AICPA and others could be looking at these ratios, I think we'd find a lot of things that would be pointed toward quality.

For instance, where, is the question you could ask, it might be automatically revealed, is where is the margin money, is on the various businesses being reinvested in the business to improve quality? It seemed to me a financial report could bring that out with credible numbers provided they're audited by an independent group.

So, I think there would be the ways for the industry to look at quality, individual companies. I mean, there's limited resources that we have as an audit committee in an individual company. So, if the information isn't fairly transparent and easily available, we're not going to get it.

MR. MELANCON: Of course, some of those reports could -- some of those factors could be in a report that would not necessarily be audited.

You cited the U.K. example and just for information for the committee, and also for you, John, I think that the nexus of that requirement in the U.K. though, was not related to the audit function as much as it is related to all LLPs under the U.K. structure.

So, there are audited information coming out of any type of entity that operates as an LLP, not just the CPA firm. Just, I think, that frame of reference is important from that standpoint.

Kayla, if I could ask you just one follow-up question on your liability point, and you cited the caps point. And I'd like to just take that caps question off the table, if I could, as to not picking a solution.

But you stated, and I don't remember the exact words, but that you saw no evidence of a liability -- you saw no evidence of a need for caps as a solution. Would you also see no evidence of a fact that liability is a concern from a sustainability of the auditing firms, particularly larger auditing firms?

MS. GILLAN: I have a problem with protecting one potential defendant class above all other potential defendant classes. I have a significant problem with the securities litigation system in this country. I think it's an enormous and obscene waste of capital.

But I think if you put a band-aid on one side of it, you're just squishing the liability concerns to someone else. I don't think issuers should get a disproportionate -- bear the burden disproportion of burden, and I don't think harmed investors should be left holding the bag.

Rather, I support a more systemic, holistic view of re-looking of the litigation system, the issue of auditor, audit firm sustainability should be one factor, but it shouldn't drive -- I just think that it's a much bigger picture than that.

MR. MELANCON: But the bigger picture is a legitimate one, is what you're saying?

MS. GILLAN: I think so, yes.

MR. MELANCON: I can't see a timer, I think I'm on a yellow light. A real quick question for you, Mr. Ross. You cited the retention issue. We have talked about the retention issue. We feel that retention is a broad-based issue that all businesses and all companies and everything face.

But you cited it as it related to the minority aspect. And you talked about mentoring, and things of that nature. I often talk about the minority -- the fixing the minority issue, or helping as role models. You're obviously a role model in the minority aspect of our profession.

Do you see that retention issue really trying to drive that role-model notion, or is there something else there that I'm missing?

MR. ROSS: I believe that the retention issue, you know, there's two parts to it. One is by increasing the retention of minorities, you will ultimately increase the role models. And by increasing the role models, I think a young minority will have someone that they can personally call and just interact with and build their confidence. If Frank Ross made it, I can make it. If so-an-so made it, I can make it.

So, yes, that's one way. The other retention, you know individuals thinking of the profession, young high school students, and I work a lot with high school students. When they're thinking of what profession to go into, they do not think of public accountant.

Now, the AICPA and the profession have done a lot of trying to get the benefits of the accounting profession out in the community, and I compliment them for that.

But the individual's thoughts to

look around and say, Who do I know that's an accountant? Who do I know with my own background that's an accountant? That's a CPA? Does a person go to my church? They know a lawyer that goes to that church. They know doctors that go to their church. They know college professors that go to that church. Very few will know a CPA that's going to their church.

So, that's why to me, retention becomes very critical that if you're going to solve the issue of you know, entry into the profession, increasing the numbers, you really have to deal with once they come in, let's retain them, and let's get them up to the partner and into the leadership positions in the firm.

CHAIRMAN LEVITT: I think you make a hugely important point that minorities are particularly vulnerable, I think, in a profession which it's been well-established as not having those minorities. And to keep them on board becomes even of greater importance because of what it represents to the pool of minorities that may be considering admission to that profession.

You didn't speak about it, although you wrote a little bit about compensation being a factor. Could you amplify upon that.

MR. ROSS: Well, I'll share an experience that just happened last night. I got an email from a father who I don't know, of a young professional, two and a half -- less than two years out of college. He's passed the CPA exam.

He is now being pursued by, "headhunters," offering him $60-65,000. Father thinks he's going to make a mistake leaving the profession, and his father wants somebody to help him see the light. Okay?

So, money, you know, can sway. But when you talk to this staff accountant, why is he thinking about it now that he's a CPA? I go back to, I have no role models. I don't see anyone in my firm, in my office, that I could really just sit and talk to very informally. And that's really -- money will play a role, but I think if that young man connects with the right person, that young man will stay with the firm. And if his performance calls for it, he will probably stay and become a manager, or maybe a partner.

But if he doesn't connect with the right person at that stage, he's lost to the public accountant profession, and he'll be a success in corporate America.

CHAIRMAN LEVITT: I think that's a hugely important point, and I suspect we are at a turning point and that the arguments you make today, were you before us two or three years from now, would take a very different turn. I certainly hope so. Ann Mulcahy.

MS. MULCAHY: Yes, thanks to the panel. I actually think we picked up some really good ideas and observations. Just a couple of, maybe just testing a couple of observations and then a question.

The first one is, is that almost all of the panel talked about content curriculum, and made suggestions as to what you think needed to be added or what needed to be the focus, whether it was investor focus, or general business, you know, education, or complex financial instruments.

And I think it's becoming increasingly clear, that although we need to update the curriculum, that we're not going to be able to squeeze all of these requirements into a four-year program, and that the recommendation to really look at this in terms of professional schools is becoming more and more important in a field that, you know, really does require the kind of specialization that we're all talking about.

So, maybe just, if you think differently, I'd love to hear from you. But I don't think we can possibly absorb the amount of topics that we've heard about that are becoming increasingly important to get the best-qualified folks in from four-year schools.

This one, for Anne Lang, just because we did -- when we talked about curriculum, we talked about teaching materials. We spent some time on insuring that there was on-line access to the, you know, kind of materials that are required for students today.

But I think I heard something a little bit different from you, and that was that what we really ought to be thinking about as well as interactive training, web-based training, particularly with some of the constraints we have on faculty.

MS. LANG: Yes. And I think that that's a great question. I think that when you take a look at the kinds of individuals that we're attracting and want to retain within public accounting, people that are very smart that really want challenging work, and want on-going and continuous education, we have to really think of what are the best ways to be able to go after each of those people and help them really retain what we're hoping to impart upon them.

What we find at Grant Thornton is that we've been able to do some foundational, which is some web casting, some pretesting immersion, which is real-life, with partners, all the way through staff, kind of immersion training.

But to your point, and most importantly, is then the reinforcement. How do we make e-learning, other mobile learning, accessible to our people when they are in the field, so that they're really reinforcing that retention.

And so I think that's very important, and something that we're striving to do as well.

MS. MULCAHY: Thanks. And finally, Frank, I think I totally agree with your observation that we need to put more focus on retention. I think our focus was on increasing a pipeline to get critical mass, to begin to create an environment where you do have role models.

But I think the need in the interim for advocates and mentors and people who really are watching out is really an important point. So, that's one I think we should focus on. So, thanks.

CHAIRMAN LEVITT: Thank you. Sarah.

MS. SMITH: Thank you. I'd just like to echo thanks to Mr. Ross for his comments. We had talked about this and been stuck, and was stumped on what to do. And so as Anne said, increasing the pipeline in seemed the way to tackle retention, but I think we as a committee will think more about that.

And perhaps I would just put that back to you for a moment to say, is there, you know, is there something very specific and concrete we can recommend that would help here? Is it compensation? I mean, maybe it's obviously a combination, but is it something specific over and above compensation, a formal mentoring programs?

You know, I was struck by some of the statistics in the report you put out there that, 70 percent of the staff accountants had concerns about how to navigate office politics. So, there are messages coming through as to maybe there's a targeted education program, and so forth, so perhaps I'd just ask you if there's anything very specific we can add?

MR. ROSS: I would say that there are probably two very specific things. One is, definitely, this committee can make the statement around retention as one of the sub-recommendations. I think that will go a long way towards acknowledging that retention is as much -- is as important as just bringing in, or increasing the numbers.

The other is, something that the center is working on in working with the various firms. There's the need for minorities to overcome that lack of confidence in their first year or two. I've seen too many of my former students that are now successful in corporate America, not being successful in public accounting.

In the classroom, they were very successful. They will challenge me. They will be ready to go and look up in the book a statement and try to come and prove to me that their answer on an exam was wrong -- that I marked it wrong, et cetera.

They had confidence. However, that same person for the first couple of years, didn't show that confidence when they were working, so therefore, their evaluations didn't reflect the true person.

What we need to do, and the center is running a program that deals with helping them, helping new minorities in the various firms, increase their confidence level through leadership skill training and dealing with some of the nuances about networking.

You know, you walk down the hall. You see a partner, don't be intimidated. Talk to the partner. If the partner talks to you, talk back to the partner, discuss your problems with the partner. Don't be intimidated. But they need to know that.

Because after that period, they become very successful in their second or third job. They're CFOs in major corporations. You know, they are -- you define success. They are successful.

MS. SMITH: Thank you. You've given us lots to think about.

CHAIRMAN LEVITT: Thank you. The floor is open to other members of the advisory committee. Alan? Don?

MR. BELLER: Thank you, Chairman Levitt.

I agree completely with a point that Anne Mulcahy made about the apparent content of curricula having to be expanded, updated and the difficulty of imagining how that fits into even a four-year cycle and how one thinks about I guess the recommendation about a professional level education.

But I -- there's also a tension between that and the pressure on a professional, educational system to generally produce better qualified candidates faster. And Mr. Ross made that point in his written testimony about the economic and other costs of a longer educational cycle.

And I guess I'd like to ask the professor, there is a real tension there that we have talked about, and it's difficult to resolve. And I guess I'd like to ask Professor Bedard, and Ms. Lang how does one successfully resolve that tension? Is it to refocus the curriculum? Is it to rely more on continuing education? What should we be thinking about?

MS. BEDARD: To make sure I understand, so the tension you're referring to specifically is the length of the program, the cost of the program, vis-a-vis the content keeps going up, as I said in my remarks.

Certainly, that's the big issue that I see with any proposed expansion. Gary Previts gave me, and I don't know whether everyone has access to this, the National Academy of Science's proposal to expand science and technology education in the United States, being that this is a fundamental pillar of our economy.

Well, is not auditing also a fundamental pillar of our economy? And that's a -- if you haven't seen it, I'd urge you to get it. It's visionary. It's truly fascinating. But a multi-pronged approach to supporting students and supporting professors, teachers in that case, it needs investment. And there's a cost.

But haven't we already seen the cost to not investing? So, we pay one way or the other, is the way I look at it. And further investment in education should yield stronger financial markets which will end up saving us money down the road.

I may not have answered your question. But certainly I agree there is a tension there. But I think investment is necessary on the part of both the academy and the profession in the students.

MS. LANG: I definitely agree with Professor Bedard as you take a look at it, it's a multi-pronged approach. But I think there are a couple of things that I think are something to launch on, if you will.

And that is the use of individuals from public accounting in the classroom to help impart some of the real world, bring some of those experiences to bear, as well as having faculty join for a period of time into the public accounting profession as well, to get a better understanding of really what's going on.

And contributing to that, we most recently just had a faculty fellow, Dr. Martha Eining join us. And it was very, I think, eye-opening from both of our perspectives in terms of what we could bring to the table.

In addition, I do think that what we're looking for going forward in business, and especially with IFRS et cetera, is really having curriculum that goes beyond kind of our current approach right now, to really taking a look at critical thinking skills and information systems as well to help support the quality of the audit.

So, I think there are a number of factors that play there.

CHAIRMAN LEVITT: Thank you very much. Mr. Ross, I wanted to compliment you on a fantastic career. And I thank you very much. You're a real credit to your profession and the people, the young people, I'm sure really do look up to you.

I had a sort of a general question as we increasingly specialize in the audit area and we bring in more and more experts, and national office types. That sort of old role of on the job training that had been consistently applied now perhaps is not measured as much with distant learning and use of specialists.

And I'm just curious. Is that something that the profession is losing that it ought to look back to? The one-on-one ability to help a person as they advance in their career? Is that really measured? Is it valued within a firm today? And Ms. Lang, you can feel free to respond too.

MR. ROSS: Well, I will just give you my views. If I understand the question, I would say that the profession definitely needs to strengthen the professional practice aspect and use their professional practice offices, the way that I think they're starting to from what I'm seeing while I was in the firm as well as I think they have increased it since I retired.

And I do think it's a great way to develop individuals within the profession. This is a very technical profession. You have to have the technical knowledge to deal with the clients that you're talking about, the public companies and all clients.

To be a successful auditor, you have to be number one, technical. And how best to become technical than to deal with technical issues. And how best to deal with technical issues on a regular basis than to be dealing with them from a professional practice perspective.

So, I would support that very strongly. And I think hand in hand with that goes the mentoring, the advocacy that I'm referring to. More African Americans should be, or minorities should be in those departments of those firms, and they should be selected and given the opportunity to prove that they are as technical as anyone from any school or any college.

MS. LANG: And I would also add to what Mr. Ross had to say in terms of coaching and mentoring. And I think what we find, at least in the research that we've done with people coming into the organization and staying in public accounting, is that meaningful and challenging work and the opportunity to advance, based on an individual's career aspirations, is really what keeps our people longer.

And certainly a piece of that is coaching relating not only the technical competency that needs to be there in order to perform a high quality audit, but also some of the other factors that go along with that in terms of keeping our people.

So, I think one-on-one coaching, too, is very important.

CHAIRMAN LEVITT: We have a lot of

questioners in a relatively limited time frame. I'd like to get as many of these questions out. And if we can't get them all in, I will ask you to submit them for response by the panelists afterwards.

So, those of you that feel your questions are absolutely critical, I will try to call upon you. And those of you that think you can submit the questions after the meeting, we will do so. With that in mind --

(Laughter)

CHAIRMAN LEVITT: Rodg.

MR. COHEN: I'll try and be very brief. My first one is for John and remembering his comment about purgatory. Do you think it would be helpful if corporations had separate risk and audit committees?

MR. BIGGS: I feel very strongly about that, particularly financial institutions after the recent difficulties. As you know, JPMorganChase did have separate committees.

One of the most useful aspects of that is, we had to divide carefully what were the risks and audit committee topics. And we broadened then the membership of the total board in dealing with those important issues.

So, we had well over half the board on either the risk committee or the audit committee. And I think for financial institutions especially, I think that's a very important change to make.

MR. COHEN: And then, very quickly, from Ms. Gillan, it's the third rail on this litigation. Your concerns about universal approach, would this also apply to say, standards that the Department of Justice should adopt for when they should prosecute an audit firm as opposed to a different type of organization?

MS. GILLAN: Was that question to me, sir?

MR. COHEN: Yes.

MS. GILLAN: I don't know if I have

concerns about a universal approach.

MR. COHEN: Well, you, on litigation, I thought you wanted a universal approach on securities litigation.

MS. GILLAN: I wanted a macro, you know, forum.

MR. COHEN: And, but when it comes time to the Justice Department and its prosecution, should there be a different standard for the audit profession when you would go after the entire firm, versus the individual who was responsible?

MS. GILLAN: I certainly think that's something that should be looked at, but I'm not sure that the audit profession is alone in that, needing that special look.

CHAIRMAN LEVITT: Tim.

MR. FLYNN: Thank you. Mr. Biggs, just -- maybe I can ask the other members of the firm to comment on it. I appreciate the thoughtful way you presented your case. I just wanted to comment on one thing regarding financial statements in firms today and speak to my firm, because there was a reference that maybe we don't have them within our firms today, or how we share with our partners.

We have a full audit committee of our board of directors. We have independent partners on the audit committee. We publish financial statements to all of our partners with footnotes, certified by the audit committee.

As chairman, I sign off on a rep letter like any other chairman would do. So, there's a lot of rigor around that whole process within the firms today.

Secondly, in terms of just availability of financial data outside the firms, to plaintiff attorneys, and we'll have a number of people speak today, but I think it's important that the firms have been very successful in not presenting that information to plaintiff attorneys in litigation. And the general counsel that will speak today can cover it better than I can.

But we've done a survey for the center for audit quality and it's been a very rare instance and a handful of times when punitive damages have been looked at, and that's -- otherwise, they may be able to keep the financial statements outside the court system. I think that's an important note for us to have as we explore the pros and cons of the transparency in litigation we've talked about today.

And then, for Mr. Ross, on the whole retention issue and mentoring, with NABA, an organization that you helped found, is there a role that we should explore where current and past members of NABA, those who may have completed their career, or are far along in their career, could have a national mentorship program that would cut across firms on a profession-wide basis where we could even mentor or have relationships set up that could expand firm boards and look to help drive minorities to success within firms?

I know in my firm, the first year of a minority African American turnover is almost one and a half times normal graduates out of college in terms of -- it's that whole issue that you talked about that mentoring, reaching out, someone to help them navigate through that first year, and that confidence that you talked about to challenge and to understand like they do you as a professor, in the actual work environment.

So, you might want to think about that, and maybe our committee can look at that. But is there a national program they could put in place?

MR. ROSS: I think there are ways that the firms can work with organizations like NABA, the way they can work with organizations like the programs that the Center for Accounting Education puts on.

Because one of the unique aspects of NABA and of the other organizations like

NABA for the other minority groups, one of the advantages is at our program in June, we call it the We're About Success program. You get about 25 individuals from each of the firms plus minority firms and some smaller firms and we have about 125 people at that session, all within a year out of college.

And what happens is, the firm -- they develop a relationship with each other, it crosses firm lines. And as a result, they develop, we do not do it, but they develop their own email network, website, or whatever it is that that generation uses. And they connect. And they correspond from that day forward.

So, they in effect, are developing their own support system, because they cannot get that type of support system within the firms. But the firms need to develop that type of support system to keep the turnover rate much lower.

CHAIRMAN LEVITT: Gaylen.

MR. HANSEN: I'll try to move through these questions very rapidly. Professor Kinney, on the bottom of page two, and you mentioned in your oral testimony and it really caught me, you talked about behavioral research. And I'll quote here, it says, "The audit process may be shifting from given the rules as management numbers right, to given the principles could management's number be right," that really hammered home I think, a message to me. But I wonder if you might be able to expand on that.

If I take this properly, are you saying that there hasn't been research done on principles, bases, rules, standards as far as you're concerned?

So, then if I could move along to Kayla. You had made a comment -- and good to see you again. "Don't pass the buck on transparency onto the PCAOB." Having been a recent PCAOB board member, I wonder if you might be able to expand on the consequences of that, or maybe just expand on it a little bit.

Jean, you talked about the 150-hour testing for the exam. And I think when the five hour -- or, the five year program was initially adopted, it was assumed that that would happen. And then now, there's only 18 -- there's already 18 states that are testing off of 120. I wonder if you might be able to just comment on what the AAA's position on that is. And if possible. I don't mean to put you on the spot, but, and also what recommendation that you might specifically have on that.

And then lastly, Anne, not to put you on the spot, but you talked about the global area that we're moving into, updating curriculum. When do you -- and a big part of that is the IFRS and international. When do you see for your firm being fully loaded for all of your staff, professional staff, all the way up through partner, to be able to fully function in that environment.

CHAIRMAN LEVITT: Quick answers, please.

MR. KINNEY: My thought was that if management has a wide range of choices, which model to use, which assumptions to make, which approach to take in determining the book value, that gives more discretion. And this is subject to biases that the management has, and the incentives that management has.

This problem then, or this flexibility, this wide range of outcomes, is only partly undoable by the auditor. Because the auditor now begins with management's number and see's whether management has a basis for that number and doesn't try to say what is the best possible number. That's the nature of the audit process. That's what I was attempting to say.

MS. GILLAN: I think the role of this Committee should be to recommend what good public policy is with regard to transparency of audit firm financial statements, and rather than passing the buck to folks that are -- you know, have a different public policy mission.

And I think that if you -- if the Committee wanted to recommend these financial statements should be public unless the PCAOB determines X, Y, Z, that that might be an appropriate use of, you know, allocation of discretion.

But without that, you're going to put them adrift. There's a lot of pressure from the firms, political and otherwise. And I think the end result would be five years from now we'd be here debating the same question again.

MS. BEDARD: You asked for me to give the AAA's position. I, of course, can't do that. But I will give you my own view, which is, that the entry level CPA exam that we must currently use, because as you say you know, the states vary on their requirements, really prevents us from testing the higher level content on.

So, it seems to me there needs to be another tier that would test this material, that would for instance along the lines of the CFA exam, get through one level, get to the next one.

But, again, that may be under the current structure, or it may be a national level exam, nationally regulated exam. I don't know.

MR. LANG: And Mr. Hansen, as it relates to IFRS and getting everyone fully functioning from partner to staff, I think that's an area that I'd need to go back and get some additional insight from my colleagues and I'd be happy to get back to the Committee in short time.

CHAIRMAN LEVITT: Thank you, Damon.

MR. SILVERS: Thank you, Arthur. I'll be very quick here. First, because Mr. Ross was acknowledged, and I think properly so, I just want to acknowledge John Biggs and

Kayla Gillan, who I think more than most Americans are responsible for the extent to which the audit profession has improved since 2002.

Secondly, I'd like to ask the panel to think about something and maybe get back to us in writing, which is the tension that Don -- I'm sorry, that Alan talked about, I think is a critical -- this tension between layering on responsibilities and hopefully content and training and then making the profession harder to enter, is I think a real one.

And my question is, could one imagine an educational process that maybe had that additional and more intensive training later in the career where the firm might be able to pay for it, and where it would be less of an obstacle to say the diversity we're trying to achieve in the profession.

And also, could that be disconnected. Can we disconnect the question of whether we have a separate auditing school, from the question of how much time and how much money is it going to cost to go to that school?

Now, the question I'd like you all to answer today is this. One of the panelists made the remark that there's an issue of personal risk in being an audit partner. This strikes me as sort of a peculiar phrase.

From where I come from in representing police officers and mine workers and so forth, personal risk has a somewhat different quality to it than I think what audit partners experience. And they get paid a little more for the personal risk they have than certainly coal miners and police officers do.

But I think there is a sort of serious issue here, which I'd like you all to reflect on an answer, which is, we're never -- I don't think there's any possibility that the audit profession will pay either its junior or senior members the kind of money that some of them may be able to access in other parts of the financial world.

I just don't see it. I don't see them ever being paid what a successful hedge fund manager makes or even a successful investment banker. And we are asking them as a profession to take certain risks. I mean, the whole nature of professional involves that if you don't do the, if you don't meet the professional obligations, there are consequences, and they are serious.

That's true for lawyers, that's true for auditors, that's true for a variety of other professionals. In that, given those things are true, what is our model here for attracting and retaining people in that dynamic? And how do we think about the fundamental human capital challenge and human resource challenge here in the profession?

I think we've made a stab at it in our draft, but I think we'd -- I'd welcome further thoughts.

CHAIRMAN LEVITT: Are you directing toward anyone, Damon? Anybody has a thought? Kayla?

MS. GILLAN: It's a profound question. I think it deserves more thought.

(Laughter)

CHAIRMAN LEVITT: It's a great response.

MR. SILVERS: That will save you time.

CHAIRMAN LEVITT: Thank you. Bill.

MR. TRAVIS: Thank you, Arthur. I'll try to be brief. Anne, if you could comment on whether you think the inclusion of retention of women should be a part of our report.

Kayla, if you could comment on whether you think that the market could stand a loss of one of the big four firms due to litigation and whether the risk of that loss is at an acceptable level.

And John, if you could comment on

whether you think the audited financial statements should be the worldwide association, or the U.S. firm, and if you could be more specific about what data you want and whether that could -- the audited financials are the best vehicle for that, or whether a more concise, specific document would be more helpful.

MS. LANG: Thank you, Mr. Travis. I definitely think that retaining the very best talent is important to all of us, and important to the profession itself.

I think all of us have made tremendous strides as it relates to women, and certainly recruiting women into the profession is something that we've done extremely well for the last several years.

I think advancement of our women is something that we still need to pay attention to. Although we have increased women into the partnership ranks, I think it is necessary for us to continue to look at ways to continue to advance them.

I know most recently with Grant Thornton, we've been able to look at 30 percent of our women partners hold leadership positions, which is a significant increase for us over the last few years. So, I do think it is something we should continue to look at and advance. Thank you.

MS. GILLAN: Could the market bear a loss of one of the big four? Yes, with significant involvement by regulators and the profession itself. Is the risk of such a loss acceptable? Yes, I believe it is.

MR. BIGGS: I would hope that ten years from now we would have global auditing firms, and global legal structures. I think we're probably too greedy to ask for that today. So, I would favor recognizing the legal limits and have an American audited statement for the American firms.

I'm very encouraged by the E&Y announcement that they're consolidating a major number of their international firms, but not with the U.S. firm. But, hopefully, that will happen some day.

I never thought we'd be this far along in international financial reporting standards. And I think that's been remarkable, remarkable change. And I think it will happen in the auditing profession eventually.

CHAIRMAN LEVITT: Okay. Thank you very much. We will -- oh, there are two more. Sorry. Sorry, Bob.

MR. HERZ: This is for Jean. The human capital five recommendation would encourage the AAA with the AICPA to study establishing professional schools of auditing or accounting. And so, you've done some advance thinking on that in your task force.

And I just kind of wondered whether the thought was that all auditing students would have to go through those schools if they wanted to go into public accounting, at least to be registered with the PCAOB firms, or would it be just some, or?

The reason I ask that, is my recollection is probably a little dated now, is that the large accounting firms source intake from not only accounting schools, but liberal arts, varied, lots of other things. And in fact, I think the statistics over time has shown that a number of those folks over time did better than some of the folks that had specialized in accounting or auditing in their careers in the university education.

MS. BEDARD: Well, this is a fairly new thought to us, so much remains to be done. But personally, I wouldn't want to see us cut off any avenues. I've taught in a program that brought people in from all kinds of professions, and turned them into accountants in 15 months. And so that model is good too.

I don't think we can afford to simply focus on this professional school model for training. And I think, speaking for Joe

Carcello here, whose idea this was, I think that he perceives this as more of a public company auditing model.

In other words, certainly, we need accountants broadly, right, not just for public company audits. So, we would I assume retain standard undergraduate programs as well. But all this remains to be worked out.

And the task force I was -- you mentioned, I think, the two parties, the AAA and the AICPA that the Report recommends, and I think that we perhaps should have a broader representation on that. Andy Bailey and his comments mentioned other stakeholders, and I think that would be wise.

CHAIRMAN LEVITT: Thank you very much. It's been an extraordinarily productive panel. We will break now for ten minutes while the next panel takes their place. Thank you.

(Whereupon, the above-entitled matter went off record at 11:44 a.m. and resumed at 12:03 p.m.)

CHAIRMAN NICOLAISEN: Well, let's get going. This next session, Panel II, of three panels, is dealing with the area of Firm Structure and Finances. It's a very large panel, so we're going to ask each of the panelists to try to keep your comments to the five minutes that we've allotted for each of you in opening remarks.

And we'll do the same thing we did with the earlier panel. We'll then open it up to the members of the subcommittee for the first round of questioning, and then broader, to the rest of the Committee.

We're going to try to drain as much information as we can out of this panel in the time that we have. So it's going to be -- if you think about later today, we're going to have a meeting of just the Committee without another panel. And that discussion is to deal with the Addendum to this subcommittee's work.

But because much of the testimony

that you're going to hear right now relates to that Addendum, you want to make sure that you get your questions in as a Committee early and often, but please, as briefly as possible because we're going to have a lot of people to try and cover.

So, let me start. Again, Blackberries off please, or at least distant from the microphones. We'll ask each of our panelists to engage us for about five minutes with opening comments. And we're going to begin with Harvey Goldschmid, Dwight Professor of Law, Columbia Law School. And I know him best as the Commissioner at the SEC while I was there. Harvey, it's very good to see you.

MR. GOLDSCHMID: Same here, Don. And thank you for inviting me. Co-chairs Levitt, Nicolaisen, members of the Advisory Committee. I am delighted to be here today.

I'm going to focus my remarks on transparency and the issues raised in the Addendum. But please feel free during the question period to ask me about anything and I'll give you whatever considered response I can.

I've got to do two things first. One is to apologize. Bob Glauber jokingly said at the break, I really profited from your statement reading it. And of course, I didn't have a written statement.

(Laughter)

MR. GOLDSCHMID: May is an impossible time in the academic world. And then I was overseas at a conference last week. But I do apologize.

Second, I need to give you a disclaimer, which I thought I was finished doing when I left the SEC. I'm a member of the governing board of the Center of Audit Quality, a public governor of FINRA, a member of the PCAOB advisory council and on a number of other nonprofit groups with interests with the issues before this Committee. I represent none of them today and I speak only for myself.

Let me provide you with my bottom line on transparency at the beginning. I urge the Committee to adopt the full transparency approach set forth in the Addendum, including the alternative to making financial statements public.

My rationale parallels the rationale for disclosure in public companies. For public companies, the key values are investor protection, efficient allocation of capital and, as John Biggs was suggesting this morning, effective corporate governance. The board learns a lot at the same time as the shareholders.

In this area, full transparency for large auditing firms will build public trust in our financial numbers since auditors play a unique role.

Second, given the securities laws, auditing firms have been given large responsibilities and also since every public company must be audited by independent auditors, a public franchise. Particularly today when we have so few audit firms, at least large auditing firms, this public franchise conveys substantial market power.

And the public has a right to know about the profitability of firms, their capitalization, their effectiveness and their sustainability. Under Sarbanes-Oxley, thinking of consumers of auditing material, audit committees must retain, compensate and fire where appropriate after evaluation, independent auditors. Shareholders of public companies are often voting on the auditors. They too need and should have full disclosure and full information.

Now, turning to the scope of the disclosure that I think makes sense, one, I would do it only for large auditing firms, at least at this time, in terms of mandatory public disclosure. The number you use in the Addendum of 100 audit firms that do 100 audits or more may be about right.

Two, I would, well, basically let me support the package in the Addendum with the addition of public disclosure of financials. If I understand the package being put forward, first, there would be disclosure required basically by the EU's Eighth Directive, Article 40, and that is modified by PCAOB. I think that does make sense.

And these are overlapping areas. Then there would be key indicators of audit quality as determined by the PCAOB. That makes sense too. There will be some overlap between the EU and what we have in Item 2, but the PCAOB can work that out. And also, the PCAOB should have the right to add what makes sense from their 2006 reporting proposal.

Finally, and I know most controversial, would be audited financials. The target date used in the Addendum is 2011. That makes sense. There's an ambiguity in the proposal which suggests that the auditing firms would be able to pick out either the GAAP or IFRS. I would close that ambiguity to say whichever system is applicable to public corporations, but not a choice of either one.

I think the SEC would make a mistake to give a choice for public companies. You lose comparability, you lose all kinds of ability to compare. You give too much choice. And I don't think this Advisory Committee ought to suggest anything else.

For smaller firms, I agree with at least my reading of the Addendum, that the PCAOB should determine what disclosure requirements would be made and which parts, if any, of the disclosures required should be made public.

Why treat large public auditing firms and small ones differently? The answer I think is obvious. The vast bulk of auditing is done by a few firms in terms of cost, in terms of other things. It simply makes sense to put the burden on them. And that's where we have the main part of our public emphasis and our trust.

The small auditing firms, imposing public standards and imposing costly standards without the PCAOB being able to screen might lead to exit from the profession, might set entry barriers. I wouldn't go there as a bottom line.

Why not limit public disclosures to that mandated by the PCAOB, is the last subject I'll address. Or, the alternative, one, allowing the PCAOB discretion on deciding when to make things public.

My answer is, public disclosure is simply too important in a place like the United States. Congress, the corporate community, investors, shareholders, the media, other market participants, have a right to know what's really going on in the large auditing firms. It's an enormous safety valve in terms of how our system works and how people will react.

The 1933 and 1934 Securities Acts have created substantial market power by way of making independent audit as the sole access for public companies and for their periodic reporting. The public has a right to know about profitability, about risk, about sustainability, about the quality of what's going on and effectiveness.

Your report, as I read the Draft Report, worries, and I think quite correctly in Chapter 7, about catastrophic risk among the firms. The public is recognizing a need to look at the large firms and keep them healthy. And that means the public ought to have a right, as well as the users of the material in terms of audit committees and shareholders, a right to know what's going on. Thank you.

CHAIRMAN NICOLAISEN: We thank you very much. We'll now move to Dan Guy. Dan was a former Vice President, Professional Standards and Services at the AICPA. Dan.

MR. GUY: Thank you. It's a pleasure to be here. Let me try this again. That's better, isn't it.

Thank you for my credit-- for me being here before this distinguished panel today. I appreciate the opportunity that I have. I'm going to refer to the paper that you have. I'm not going to "read" anything into the record, or anything of that sort. So, I'm going to refer to it, and it's advantageous to have that in front of you as I make the few comments I'm going to make.

The first page I need to do is, on page 2, there's a correction I want to make because it doesn't make sense. On page 2, if you would go to Roman numeral II, under the Draft Report Recommendations, the very last sentence, I left out a very important word. Where it says, "Direct effect material acts," should read, "Direct effect material illegal acts." So, my apology. It doesn't make sense as presented.

I want to commend the recommendations you, and the recommendations you've made about creation of a national center to facilitate the development of best practices relating to fraud prevention and fraud detection and also to give a fresh look to the audit report to determine if it needs to be improved to do a better job in communicating the arduous responsibility, especially the arduous responsibility for detection of fraud, and of course those direct effect, illegal acts that I keep talking about from time to time in the paper as well.

The comments I'm going to make focus on fraud. And I provided in the paper on the first page kind of my background so you would know where I'm coming from. I do litigation consulting as indicated there. I'm not a plaintiff expert, or defense expert, although some in the room might think I'm a plaintiff expert.

But I do work at the SEC for

example, both for and against and for large firms, both for and against large firms. I've been doing that since I took early retirement in 1998 from the American Institute of CPAs. So, the comments I'm going to make are my observations of having spent hundreds and hundreds and hundreds of hours on fraud-type cases and seeing things that I'm sure that based on what Bill Kinney was saying, a lot of the academics would like to see as well, because it's very, very insightful.

I should also tell you that I provided a list here basically of my observations and my opinion, why auditors do not do a better job in detecting fraud. Why auditors do not do a better job in detecting fraud is the key question and my observations relate to that question.

I want to recognize a limitation that exists, and that is most of the observations I have relate to audit engagements, of course, that were done pre-

Sarbanes-Oxley 2002, of course, and 2003.

As you know, those of us who do litigation work, practice behind the times. We're always dealing with things that are three or four years, sometimes five or six, eight or nine years back. But we're not applying the current rules and regulations because that's not -- the litigation process takes a long time to run to get to the process where a matter is, discovery is over, and a matter is brought to trial, for example.

If we look on page 3 and 4, I want to have a list of bullets, as I focus on fraud, a list of bullets about why auditors don't do a better job of detecting financial statement fraud. And basically, it deals with -- I don't have problems, for example, I rarely have been in a situation where I wished, even when I'm working on the plaintiff's side, where I wished a standard, an audit standard, for example, or an ethical requirement was more explicit.

If we look at my experience, the first and foremost problem is a failure to exercise professional skepticism. I note that you address that in the Draft Report. I mention here one of the interim standards that the PCAOB adopted when it came into existence on due professional care, and that's a great standard. The only problem is, the exculpatory language in that standard overwhelms the duties and responsibilities of the CPA.

And a lot of times, in a deposition for example, when an engagement partner has been deposed, it's almost a deer in the headlight look when you bring up the responsibilities that are clearly set forth in for example, AU230.

We also have a problem that almost a lot of times, frequently, of course, I'm looking at the bad situations, but you have a situation or frequent situations where there's an acceptance by the audit team of whatever management says.

And we don't demand that we generate persuasive, competent, sufficient audit evidence. A failure to recognize, document and respond to fraud risk indicators that are in the SAS99 today, are what I refer to frequently as red flags.

Also, over-reliance on management representations, without obtaining required supplemental information, we have of course a management representation and inquiries, those are important evidential sources. But they have to be supplemented by other, more pervasive kinds of audit evidence.

I mentioned over-reliance on PBCs, what we called documents prepared by clients, as you know. And there are numerous situations involving the fraud cases that I have dealt with, where a client produces a PBC, and the auditor starts auditing at that point. And the PBC doesn't tie into underlying books and records, and there's no work done to tie it into underlying books and records.

Another thing is a sort of a mind set, I refer to this at the bottom of page 3, as a fill-in-the-blank mind set. And that is --

CHAIRMAN NICOLAISEN: Dan, if you can keep going, because, we're --

MR. GUY: Okay. And that is basically a situation where we have an audit program, and it's just sort of check the numbers and mechanically run through it.

I see a lot of situations where there's a failure to comply with GAAP. There's a lack of knowledge of what GAAP is. And it's not the real complex GAAP standards. It's sometimes the very basic GAAP standards.

One of the things I wanted to mention today is independence. And a large percent of the matters I deal with have independence questions that are issues, major issues where the audit team did not recognize, independence requirements did not recognize conflict of interest requirements so those questions come up. I know that that's dealt with in the next chapter of the report, not in the one that we're dealing with here.

I applaud your objective, or recommendation to codify the very complex, independence rules and the conflict of interest rules.

Finally, the last thing I want to say is from time to time, I still see too frequent occasions where there are comments either in the financial papers, or in courts of law, where the statement is made that, as an auditor, the audit standards were not designed to detect collusive management fraud. Of course, that is totally false.

And sometimes we see comments when there is an allegation of an audit failure, the first thing it says, that the audit person says is, I was victimized. And they make that statement before they know whether there was compliance with auditing standards and compliance with ethical requirements.

Bottom line, what I wanted to say today, is that the problem we have today, I think, deals with the failure to apply existing standards. I don't see a need for a wholesale need to amend existing standards or create new standards. Thank you very much.

CHAIRMAN NICOLAISEN: Thank you. We'll move next to Barry Mathews. Barry is a deputy chairman of Aon Corporation.

MR. MATHEWS: Thanks Don. And thanks for the promotion, by the way.

Aon or its predecessor firms have acted as brokers and advisors to the US accounting profession for more than 70 years now. Currently, Aon provides professional liability brokering and/or consulting services to 43 of the largest hundred accounting firms in the United States. Aon works with the accounting firms to help identify, manage and finance the costs of their professional risks.

This Committee has heard considerable and sometimes conflicting input on the topic in what to say and do about liability risks facing accounting firms. Therefore, I believe it's incumbent on me to be very clear in offering my perspective.

I want you to know that at no time have we encountered a situation in which there existed as substantial a threat to the sustainability of the audit firms as that created today by the potential for mega-professional liability risks brought in United States.

We have read the Firm Structure and Finances section of the Advisory Committee's May 5 Draft Report which contains recommendations for measures, such as sharing best practices and working toward better corporate governance of accounting firms.

We also see that the Concentration and Competition section of the Draft Report views the threat of civil litigation as real and notes a concern for market disruptions that would result from the loss of another firm.

We feel strongly, however, that limitation of liability measures are a necessary part of any strategy to address the danger of a loss of another firm. And that such measures be dealt with, excuse me, as an integral part of any such strategy, not as an afterthought.

We note, for example, that the Draft Report calls upon various parties to explore the possibility of firms appointing independent members to firm boards or advisory boards. The Committee acknowledges that any exploration of this idea would necessarily touch upon liability concerns.

Indeed, without some assurance of liability protection, it would surely be unlikely that persons of sufficient stature, reputation and capabilities, could easily be persuaded to accept such appointments. Yet in urging the SEC and PCAOB to enable the appointment of outsiders to firm boards, the Draft Report calls for them to do within the current context of independence requirements and the liability regime.

In papers given to this Committee, Aon has provided information on the inability of the commercial insurance market to supply necessary coverage sufficient for large firms' needs at a reasonable price. One witness who has appeared before the committee, has argued that the view that top firms can get sufficient insurance is not well documented.

This witness has suggested that firms may in fact opt to use captives to provide insurance simply because they're better than external insurers at assessing and managing risk, and evaluating and administering claims.

I'd like to set the record straight. From a financial management perspective, such captives are usually viewed negatively because capital committed to the captive, reduces capital that would probably be used more profitably elsewhere, for example, in making investment into new technologies, or simply supporting new business initiatives.

The same witness has argued that there is evidence that insurers offer and firms buy, external insurance to arrange for claims managed and funded through the captives. The fact is, the commercial insurance and reinsurance markets currently provide only a very small part of the risk financing solution needed by the audit profession.

It has also been argued before this committee, that even if it can be established that available commercial insurance is currently insufficient for firms' needs, it is not obvious that defects in the liability system are the cause of the situation.

In response, I'd say, insurers need

to have an ability to accurately define the risks that can lead to insurable losses. There must be some degree of certainty attached to what may be considered a negligent act. Yet, there is no single right answer to many auditing and accounting issues. The questions are complex and require judgment.

Auditor litigation almost invariably involves the assessment in hindsight of whether the auditor's exercise in judgment was reasonable or unreasonable. In a lawsuit where the damages claimed are in the billions, and the stakes are therefore enormous to both the defendant and their insurers, if they exist, can anyone informed place a bet on an anticipated outcome where the rules of the game may be uncertain?

Only where there can be greater certainty as to the nature of the risks and quantum facing the profession, will commercial insurers be attracted once again to offer a stable form of insurance protection.

As I stated at the outset, at no time have we encountered a situation in which there existed as substantial a threat to the sustainability of audit firms as that created today by the potential for mega-professional liability claims brought in U.S. courts. I urge you to be unequivocal and emphatic on the need for policymakers to address the unlimited nature of litigation risk. Thank you.

CHAIRMAN NICOLAISEN: Thank you. I'll move now to Nell Minow, the editor of the Corporate Library. And I apologize for not having my speaker on now.

MS. MINOW: Thank you very much. And it is a real honor to be here today. It's very encouraging to me that as we wrestle with these very thorny issues, the people that I admire most in this profession all seem to be in the same room. And so, it's a real pleasure to be here with you.

I'm going to speak just very briefly about one kind of meta-issue. And that is the -- just the overall approach. You know, it's always, I spent eight years as a regulator, or as I really should say, four years as a regulator, for years as a deregulator, before I went into corporate governance.

And I think you have to have a lot of humility about imposing a lot of prescriptive standards on people. Because two things happen. First, you, what you hope is going to be the floor, becomes the ceiling, and everybody adopts a compliance mentality and sort of burrows under.

And second, particularly as you see in your report here where you are understandably pushing off on to various entitles, we should have the SEC look at this, we should have the PCAOB look at that, in -- you know, I want to say this as nicely as possible, those efforts tend to be co-opted by the regulated community and end up benefitting them.

So, I want to really just overall say, we should take a very much cost-benefit and risk-benefit analysis as we think about imposing widespread rules. And whenever possible, I would really recommend to this Committee that you try to encourage, sort of leverage market forces and encourage innovation, rather than trying to suffocate it by kind of a comply or explain approach.

So, with regard, I'm sure we're going to talk further about, with regard to the issue of transparency, rather than saying, "Well, public companies have to meet GAAP, and why don't we just apply GAAP to these private firms." Let's try to take a more open and creative and market-based approach.

And with that, I think I will defer the rest of my comments and leave as much time as possible for questions.

CHAIRMAN NICOLAISEN: Great. Thank you very much. Jules Muis who had been the vice president and controller of the World

Bank.

MR. MUIS: Thank you, Chairman, members of the Committee, it's a privilege being here.

I've already carpet bombed the Committee with a 15-pager. So, I will just here, pick some raisins out of the porridge and leave also the room for further questions.

Revisiting the wording of the audit report that I have to get off my chest here, that I think that almost a nonstarter, I mean, I think the syntax is fine, it's all compliance. And in desperation, I proposed a couple of years ago that we should ban the clean audit opinion just to wean the profession of its addiction.

And I'd just like to remind this Committee that in the public sector, we have auditors who actively know how to use, other than clean audit opinions. The GAO does it for the U.S. Federal Government, and it happens in the EU on the same basis. So, I think it's a matter of compliance.

I would reserve that proposal not for the audit profession, but for the oversight bodies, i.e., the regulators themselves. And in my submission, you've had a very strong plea for getting regulators to include at least a bottom line assurance statement in their annual report that basically says that there are no systemic issues walking around that may affect the auditing functioning of the financial markets.

Had we had that for the last ten years, I think this particular crisis would have gone in a different way. If I can predict the crisis two, three years ago, just by keeping my ear to the ground, surely the regulators could do so too. And this also would give the profession itself a lot more attraction.

Engagement partner signature, three times bravo, for reasons stated in the draft proposal. I think it's a magnificent combination of personal responsibility and collective responsibility.

Transparency, I've considerably less difficulty than Nell with this proposal. I understand the big firms have argued that they have difficulties producing GAAP accounts in three years time. My recommendation would be they go to their European partners who will do it for them in six months at a very reasonable fee.

Litigation, it's all black box. I will not enter into kind of the specific U.S. setting of litigation other than saying proportional liability is obviously the way to go. And if that takes, you know, bringing things up at Federal level, then fine.

I'm just stunned to see how little information there is in the report on the actual exposures at this particular moment. I can't see how this Committee can accurately come to conclusion there unless it has more information.

Transparency, I've added a few requirements on, a few paragraphs on transparency. I would love to see also a requirement to include consolidated financial statements of the firms. There's just too much, fortunately too much, unified management at this particular moment that you really can draw conclusions.

Also, against the background of the contingency plan, which I'm not calling a bailout plan, but a rescue plan, I think that one should need, one would need the information of the consolidated or the combined pictures of these firms in order to come to some sensible conclusions.

Which brings me really to the other side of the coin where I've been, where my plea has been, and has been for a long, long time, for creating a more enabling, not just a more policing environment for the profession, but also a more enabling environment.

And I simply cannot see it, how

this profession can do it if regulators are not held to account more on the systemic remit. And hence, I've been arguing, arguing, arguing, for results-based assurance statement on systemics only, on matters that may affect, materially affect the orderly functioning, not the fair functioning, the orderly functioning of the financial market.

And the world would have looked different had regulators, I think, been forced into a straight-jacket like that. I wouldn't expect them to come with a clean opinion. I would actually expect them to come with a disclaimer.

But the nice thing about a disclaimer is that it gives you so much more information than a clean opinion. Because, they would have to specify from systemic risk to systemic risk what bothers them.

And again, I'm putting in here as a bit of a challenge, if I can do it as an internal auditor, two, three years ago, then I simply cannot see how regulators cannot kind of step up to the plate on that on the same basis.

They're the most unaccountable agents at this particular moment that roam around in the financial world. And that does not give the profession adequate direction to actually do its job. Thank you very much.

CHAIRMAN NICOLAISEN: Thank you very much. Next we'll hear from Kathryn Oberly, who is vice chairman and general counsel at Ernst & Young. Kathryn.

MS. OBERLY: Thank you, Mr. Nicolaisen, and to everyone involved in the work of the Committee. Thank you also for holding this hearing this morning.

CHAIRMAN NICOLAISEN: Microphone on, please.

MS. OBERLY: Whoops. Thank you.

My comments today focus on litigation. I believe the nature of the litigation risk faced by accounting firms would have been inconceivable to the authors of the federal securities laws. As the comments of Chief Justice Cardozo in the 1931 Ultramares case reflect, courts were at one time concerned about exposing accountants, "To a liability in an indeterminate amount for an indeterminate time to an indeterminate class."

But the requirement for privity, or a clear relationship between the plaintiff and the defendant in Rule 10(b)5 actions was unfortunately abandoned several decades ago.

And then under the Supreme Court's 1988 decision in Basic v. Levinson, accountants became liable not only to people with whom there was no privity, but also to people who didn't even rely on what the accountant said or did if such a person purchased or sold a security in a so-called efficient market.

And finally, courts in every circuit, but not the Supreme Court, held that the scienter requirement for Rule 10(b)5 can be satisfied with a showing of mere recklessness, rather than actual knowledge.

The end result we see today is potentially enormous liability. And without consideration by Congress, by regulators, by this Committee, of the broader implications, accountants essentially have become equivalent to insurers of the nation's securities markets.

Unfortunately, a commitment to audit quality is insufficient to protect a firm. E&Y spends well in excess of $100 million every year in the U.S. alone on audit quality initiatives and improvements. And there is incredible focus by the profession on audit quality and the profession's obligations to the investing public, a fact that is, I believe, generally recognized in today's environment.

But during my 17 years at E&Y, I've supervised the handling of hundreds of lawsuits against the firm, and I've found that the risk that can result from a single case just keeps getting bigger, no matter what we do about audit quality.

The amount of exposure generally stems from externalities, the client's market capitalization, and some action that caused a stock price drop. So, in recent years as the market cap of our audit clients has increased several-fold, we've also seen an enormous expansion in our liability exposure.

It's been said that perhaps there's not enough data to establish that. But there is data before the Committee showing that the sixth largest firms currently confront 90 cases with claims in excess of $100 million each. This includes 27 lawsuits with potential damages in excess of $1 billion each, and seven lawsuits with potential damages in excess of $10 billion each.

No firm has or can purchase insurance coverage for the largest claims. No firm has the capital to pay the largest claims. And no firm could retain partners while slashing earnings by an amount necessary to pay the largest of claims.

Because of the bet-the-firm nature of these claims, audit firms are effectively denied access to the judicial system. That is fundamentally wrong. I've heard it said, even before this Committee, in fact this morning, that lawsuits won't bring down a firm because plaintiff's lawyers won't take it that far.

But aside from the obvious peculiarity of devising public policy based on the assumed good graces of the plaintiff's bar, I believe that assumption is incorrect.

The plaintiff's bar includes not only the so-called usual players, but also one off, or outlier lawyers who would never even consider foregoing the litigation bonanza if one were within reach.

So, what can be done? That's why we're all here. The most meaningful solution would be to involve some mechanism to cap liability. And I know that the idea of caps raises hackles in some quarters. But I have to say I'm genuinely puzzled as to why some seem to shy away from even discussing it.

In my written testimony, I note how the idea of limiting civil liability is not a new one. And I cite the work of Professor Louis Loss on behalf of the American Law Institute in the 1970s and 1980s in which he advocated caps on auditor liability.

More recently, the European Internal Market Commissioner, Charlie McCreevy announced that the European Commission would soon adopt a recommendation for every member state in the European Union to cap auditor's liability as is already the case in countries like Belgium and Germany.

Short of caps, my written testimony details purely incremental improvements that I don't think are a big enough solution to the problem, but also do warrant serious consideration. Such as, exclusive federal jurisdiction over certain claims, an actual knowledge standard, the need to address fragmentation of class action litigation, issues involving claims by litigation trustees and appeal bond limits. These are important areas of the law that deserve more attention than my five minutes this morning allow.

Let me briefly address financial transparency from a litigation perspective, since it's been talked about by several of our panelists this morning. If additional financial disclosures are to be required from audit firms, I strongly believe they should be made to the PCAOB which can in turn decide what may be relevant and necessary for others.

I agree with Nell and her comments, that just because audited financial statements may be good for some, they may not necessarily be the right answer. They may be a mismatch, frankly, to the problem here that people are focusing on, which is providing investors, audit committees and the public with the information they need to assess individual audit firms. But some of that information just isn't found in audited financial statements.

I think a better transparency approach is to be found in the 8th Directive, Article 40, Transparency Report where the specific features in that report actually do go to the information that investors, regulators, and the public would find most meaningful to their concerns.

Conversely, there is no doubt in my mind that providing the plaintiff's bar with access to the information in audited financial statements would worsen the very litigation crisis that this Committee is concerned with. And thus, I think it is critical that we move cautiously before assuming that audited financial statements are the right answer here.

The Committee's Draft Report acknowledges the civil litigation risk as being real. It states the Committee's belief that the loss of one of the larger auditing firms would likely have a significant negative impact on the capital markets.

So, in closing, I would urge that the final report be more pointed, even in those comments in the draft, in recognizing the unlimited nature of the litigation risk exposure and the impracticalities, if not impossibilities of taking a bet-the-firm case to trial, or even settling it on fair terms.

The Committee's final report should be clear in calling on policymakers to address these issues at the earliest possible opportunity in order to avert threats to capital market stability and the investing public. And I look forward to comments and questions.

CHAIRMAN NICOLAISEN: Great. Thank you, Kathryn. I'm sure there will be a few.

(Laughter)

CHAIRMAN NICOLAISEN: Rex Staples

is our next panelist. And he's general counsel, North American Securities Administrators Association. Rex.

MR. STAPLES: Thank you. Thank you Chairman and members of the Committee. It's a pleasure to be here to address you today. It's interesting that I get to follow Kathryn. We may have, disagree in some areas.

By way of background, NAASA is a nonprofit association of state, provincial, and territorial securities regulators in the U.S., Canada and Mexico. I represent the securities regulators in all the 50 states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands. We were founded in 1919. We're the oldest international organization devoted to protecting investors from fraud and abuse in the offer and sale of securities.

We have a particular interest in the recommendations of the Committee particularly as it pertains to litigation. The recommendations may have a profound impact on the ability of investors to seek redress in cases of auditor misconduct.

If the Committee were to recommend exclusive federal jurisdiction, or more burdensome standards at the pleading stage, it's NAASA's view that many victims of auditor misconduct, negligence or recklessness with meritorious claims would lose the opportunity to have their day in court.

The further -- the Committee's recommendations may also affect the very role of private actions as a deterrent against securities fraud. Congress and the courts alike have recognized the importance of private litigation. The Senate report that accompanied the PSLRA described the importance of private rights of actions as follows:

"The SEC enforcement program and the availability of private rights of action together, provide a means for defrauded investors to recover damages and a powerful deterrent against violations of the securities laws."

It's noted by SEC Chairman Levitt, "Private rights of action are not only fundamental to the success of our securities markets, they are an essential complement to the SEC's own enforcement program."

To the extent that the Committee's recommendations may erect unwanted barriers to recovery in private actions, an important deterrent that benefits the market place as a whole could be undermined.

And we understand that a formal recommendation by the Committee to Congress that certain lawsuits against auditors be argued in federal, rather than state court, would certainly provide substantial relief for the auditing industry from damages.

However, as a threshold matter, we question whether such belief is warranted, and whether investors are truly served by such a recommendation.

In the deliberations of the

Treasury Committee on the auditing profession, the major auditing firms continue to push hard for a recommendation supporting litigation reform for them. Auditors are intent on limiting their liability for securities fraud, and are heavily lobbying to make this happen.

Within the past year, there have been no less than three reports calling for additional limitations on investors' rights to recover damages through civil litigation against auditor defendants. Recommendations for limiting auditor liability have included capping damages, creating safe harbors from liability for certain audit work, enforcing the arbitration of claims.

The reason the auditing firms to NAASA seek to limit their liability is obvious. Auditors have stood in the eye of the storm in connection with the largest corporate meltdowns in recent history due to massive financial fraud, and failed to perform as gate keepers for investors.

Indeed, auditor defendants were named in the top four largest securities class action settlements in history. In 2006 alone, 68 percent of federal securities actions alleged violations of Generally Accepted Accounting Principles.

We strongly believe that investors should be allowed to pursue individual actions alleging state law violations to pursue legitimate claims and remedies from auditor defendants, rather than accept what may be unreasonable or artificial limits on auditor liability under the federal securities laws.

The Treasury Committee on the Auditing Profession has a tremendous opportunity to make recommendations and to provide a positive impact on the profession. As others have pointed out, this Committee follows in the footsteps of other committees that are certainly impressive in their own right.

In each of these instances, the

committees took significant amounts of time to research, analyze, get public input, and discuss the issues they studied. And for one example would be the Cohen report -- the Cohen Commission, rather. And they met monthly beginning in November of 1974, and issued their final report in 1978, after a total of 66 meeting days, a series of research reports, and more than 60 meetings of professional and business organizations.

We hope the Committee will take its time and avoid what may be the inevitable pressures to rush to put out a report within some predetermined time frame that it is not within the discretion of the Committee.

To assist the Committee with its research and deliberations, and to insure a quality report based on adequate research and facts, substantial amount of data was requested by the members of the Committee to enable them to make informed decisions with respect to the issues before it.

Unfortunately, we understand that the firms have refused to provide certain data with respect to a number of areas, particularly with litigation. In particular Committee members requested in October of 2007, certain of the following information regarding litigation, number of federal securities action filed against the ten largest audit firms in the U.S. and each year since the passage of PSLRA, broken down between those filed in federal courts and those in state courts.

That same information and with the additional information as to which were dismissed by the courts, the number of settlements, court verdicts, jury awards, in each of the last ten years against each of the ten largest audit firms related to an audit of a public company.

The average, mean and median amounts of the settlements, verdicts, awards in a) above, the average, mean and median amount claimed by the plaintiffs in each of these cases, the number of settlement, court verdicts and jury awards in each of the last ten years for each of the ten largest audit firms broken down by awards that are related to a), audits of public companies, b), audits of private companies, c), income tax services, and d) other information that may be relevant.

Five, a detailed breakdown analysis of the 25 largest settlements and/or jury awards in the last decade and with a series of items that were requested to be broken down by.

And finally, a legal analysis of the impact that PSLRA and the Supreme Court decisions in the matters of Central Bank and Dura Pharmaceuticals or other significant cases have had with respect to the ability of plaintiffs to bring federal securities litigation against independent auditors.

It is our current understanding that to date, the firms have refused to provide any of this data to the Committee. It is our belief that in order to fully serve the public interest, we believe the Committee must have the full cooperation from those who have and control the data.

We believe the Committee should take all necessary steps to insure it receives the data in order to make a fully informed and proper recommendation.

Of course, as early as 1995 with the PricewaterhouseCoopers' Report, auditing firms have been calling for litigation reforms through exclusive federal jurisdiction and changes to the pleading standards. It appears that the audit firms want the pleading standards to be fraud, not recklessness.

On the other hand, investors have argued for a standards that includes negligence, such as SEC Rule 102(e). Firms frame this as a desire for a clear, uniform standard, when in fact, it is a desire for a higher pleading standard, one that does not include negligence or recklessness.

Recently, the Supreme Court introduced a new standard for pleading standards in the Tellabs decision. Speaking for the Tellabs Court, Justice Ginsburg notes that on the reckless issue, "We have previously reserved the question whether reckless behavior is sufficient for civil liability under Section 10(b) and Rule 10(b)5."

Every court of appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly though the circuits differ on the degree of recklessness required.

The Tellabs case on the pleading standard was decided less than a year ago. This raises a question as to why in light of this decision, there is need for further Congressional action prior to close examination as to how this decision as well as others such as the Dura case cited impact litigation.

Finally, NAASA believes that investors clearly benefit from the availability of state law causes of action with broad standards of liability. These generally prohibit larger categories of conduct in federal securities claims in either 10(b) of the Exchange Act, or Section 11 under the Securities Act of 1933.

Many state law claims such as misrepresentation and common law fraud prohibit entire categories of fraudulent conduct outside the mere preparation and dissemination of company financials. These claims are generally unavailable to plaintiffs in the federal context.

In contrast, the federal securities claims, many state statutes and precedents set out their own schemes of liability and damages quite distinct from the rule for Federal 10(b) claims as set forth in Dura Pharmaceuticals v.

Broundo. For example, violations of many states securities acts do not require proof of causation.

Before embarking on a -- and there are many topics that have been expressed by other panels here today that are of tremendous interest. And I wish I could comment on all of them because it's really a fun exercise.

CHAIRMAN NICOLAISEN: Well, we're going to have to ask you to sum up here quickly.

MR. STAPLES: So, now, I will sum up and say I wish I could comment on them. Thank you, very much.

CHAIRMAN NICOLAISEN: Thank you. We'll turn next to Michael Young, who is a partner of Willkie Farr & Gallagher. And I'm sure Michael may have some different views.

MR. YOUNG: Mr. Chairman and members of the Committee. I have spent more than 25 years working with and defending the accounting profession. And what I'd like to focus on is what I perceive to be the core problem with accountant's liability, which in my own view the draft Addendum does not really come to grips with.

Let me start with the proposition, if I may, that at its core, our system of justice is not skewed against the accounting profession. I am familiar with the concerns that accounting is too complex, that juries are unsophisticated, juries don't have the experience, juries can't come to grips with all the complicated stuff.

I disagree with that. My own experience -- I mean, I acknowledge and I accept, and there are challenges in accountant liability trial, don't get me wrong. But on the whole, in my own experience, the system works. And the great thing about a jury trial, in an accounting matter in particular, is that it forces the litigants to break down really complicated things into their fundamental components and to present those fundamental components to a group of every day people in plain English, and to make an appeal to those every day people to apply their common sense and their experience and judgment and seek to come to a sensible result.

Now, it's true, it is absolutely true, there is an inherent risk in going to trial. And sometimes you lose even when on the merits you deserve to win. Unpredictable things happen at trial, and that's just the way it is.

But an experienced litigant knows that while you may lose sometimes when you deserve to win, over time, the system works, and over time justice prevails.

The core problem, in my experience, is not that when it comes to accountants, our system of justice doesn't work. The core problem is that the accounting profession cannot take advantage of our system of justice because it cannot run the risk in the firm-threatening case of presenting its case at trial.

And at this point, everybody in the Committee knows the reason. And that is the increasing levels of market capitalization of public companies, combined with the expansion of the securities laws that Kathryn just finished talking about, have taken damages to a level where they are simply in the stratosphere.

And you can't afford to present your case to trial, because you are running the risk that that will be the end of the firm.

You know, I had a conversation with a general counsel once where I thought we had a really good case. And I said to him, let me take this case to trial. And he said, Mike, listen to what I have to deal with. If we're going to take an approach of trying these cases, I have to win. Not just your case, but the case after that, the case after that, the case after that. I've got to win all of them, and that's not going to happen.

I cannot assume I'm going to win all those cases. So, get out there and settle. And of course, that's how the cases end. You know, the most recent statistic is that there have been 2,105 class actions, 2,105 class actions commenced pursuant to the `95 revisions to the securities laws.

Of those, according to Risk Metrics, six have gone to verdict. Six out of 2,105. And by the way, the score is three wins, three losses. The two most recent verdicts really tell the story by themselves.

In one, the plaintiffs sought $20 billion. The result, a defense verdict. The defense won. In the other, I don't know what the plaintiff's sought, but the result was a verdict against the defendant. Companies in both cases of $280 million. Now, I should add as a footnote, the case for $20 billion where the company won, the defense verdict, it cost between $50 and $80 million of defense costs.

So, the win was only 50 or $80 million, depending on which information you go to.

Those were two cases against companies. A public company has to deal with this problem, if its unlucky, once, if it's really unlucky, twice. The accounting profession has to deal with it nonstop. It is a regular feature of daily existence that there are firm-debilitating cases in the inventory.

And I want to pause here. Because I want to pick up on something Kayla Gillan said earlier. And I think it's something we all agree with. And that is the system needs to be fair. The system needs to be fair.

The thing that goes through my mind on the issue of fairness is that a public company when it comes to our securities laws, is at risk for its own market capitalization.

It's different for the accounting profession. Each accounting firm has potential risk for the entirety of the combined market capitalizations of all of its clients. And I think the total right now is, each of them is, the big six firms collectively, are facing a total claim damages of $140 billion.

And I'll just wind up with this point. The irony here is if the profession could actually try its case, present its case to a jury, it may win. It may do just fine. And the first case to go to trial, and today, it may be the only one. There may have been another. In the first case to go to trial under the revisions to the securities laws in 1995, classic case.

There was a fraud. The auditors missed it. They had been given forged documents. It was presented to a jury in a four-week trial, the jury's verdict was for the accounting firm. The accounting firm was exonerated. The problem is, why could that case go to trial? The claimed damages were only $32 million. The accounting firm could afford to lose.

As I told the American Assembly at Columbia, the core problem is that you can't get your day in court. I'll take my chances in front of a jury, the problem is, I can't get there.

CHAIRMAN NICOLAISEN: Great. Thank you very much. Panelists, thank you very much. I think we're now going to have a lively discussion. And as you expect, these are old issues. They've been hashed around for a very long time. So there's people who feel passionately on all aspects. And what I'd ask, and that's fine, what I ask is that we respect each other and do our best to really dig out nuggets of information that we think are important to present today.

So, I'll turn it over to Bob Glauber at this point. But if I could, Kathryn, if I could just ask you one question. Actually, two. The sensitivity to disclosing, to issuing audited financial statements you believe would create additional liability for the firms. And you quoted a lot of numbers, and a lot of information in your submission. And some of that seemed to me that you said at least as I read it, ordinary day-to-day litigation might run in the 50 to 100 million category. Those are not what you're talking about. You're talking about catastrophic losses. Catastrophic losses you would favor caps for. I assume that's a cap in excess of 100 million, or some number more than what you're talking about there.

But if you could at least highlight what you meant by caps, and then also, what is it that would be in those financial statements if you can answer, or chose to answer, that is going to so excite the plaintiff's bar that they see value that they haven't seen before?

MS. OBERLY: Sure. As to the first question, I know that a number of different methodologies, if you will, for approaching the cap question have been talked about. Some might be a percentage of audit fees in the particular matter, some might be related to the size of the audit firm, and there are other methods.

Some could be related to the alleged losses to shareholders. But -- and there are different sized firms for whom those present varying issues to consider. So, I would say here, that it's something that requires further work to come up with a system of caps that's fair to all participants in the system, but still protects the audit firm from the catastrophic liability that might put it out of business.

And I'm not prepared to say this morning that there's any single right answer to that. It's a difficult problem. I recognize it is. But I think we could solve it if we put our minds to it since I've heard these various different views.

But I think probably the simplest might be a percentage of the audit revenue earned on the particular engagement. But there are alternatives. If -- and I can elaborate more on that if you'd like.

On the audited financial statements, right now, as a private partnership, and I think all of the firms are organized as private partnerships, we do not provide audited financial statements actually even to our partners. We do give them -- someone suggested in earlier testimony we don't even tell our partners financial information. Of course we do.

But we don't do audited financial statements, and we certainly don't provide that, and are not required to provide audited financial statements in court litigation.

We do provide insurance information. We do provide overall firm information, the firm financial information. Whenever a client or a prospective client wants to know about the financial stability of a firm if they're considering hiring that firm as their auditor, I, or our CFO, or both of us together, sit down and talk with the audit committee, with management, with whoever really needs to know and we talk about the particular information they need to know.

And that helps them with the information they need to make a decision, are they hiring the firm that's financially stable and sound and will be there to serve them when they need their audit opinion issued.

We don't provide, because it's not required under either federal law, or generally under state law, we don't provide that financial information publically in court. And therefore, the plaintiffs, while they might guess, or might think they have some idea, the plaintiffs don't have information.

That only serves to drive up the settlement value, if you're hypothetically the plaintiff in this little dialogue we're having, and you have that information, then it's only going to skew the settlement negotiations as to how much do you think you can get out of Ernst & Young without putting us out of business.

Whereas, I would prefer to conduct the settlement negotiations both on the merits of the case, and on comparable settlements in similar cases, as opposed to looking at what can we take from Ernst & Young before it's just short of bleeding.

And that doesn't seem to me the right approach for resolving the litigation. It doesn't provide necessarily the information that people who do have a legitimate interest in firm financial information actually most need. They need to know what is the firm spending on quality. What is it spending on training.

They need to make sure that the firm is setting aside reserves for litigation so its going to be around to complete the audit. But the actual audited financials provide a level of detail that doesn't help, I don't believe, the investing public or the audit committees or management to making sure they have the right audit firm, but does disadvantage the audit firm in the litigation process.

And let me just finish with saying, this is not about us, in terms of saving E&Y or the other big firms. It's about the importance of all of the firms to the capital markets, to the system that we have, of audited financials being provided by -- to issuers, being provided for the benefit of investors. We can't afford to lose another firm.

And anything we do that might tilt in that direction without knowing why are we doing it, and are we putting out information that's really the most relevant to the decision makers who profess a need for greater information is something we just really need to look at very carefully.

CHAIRMAN NICOLAISEN: Okay. Understand. I would debate that with you, but I'm sure others will. So, turn it over to Bob Glauber.

MR. GLAUBER: Thank you, Mr. Chairman.

Let me start with the obvious. Confronted with this large panel, I feel like a guest at a banquet. I know I have to choose among what's on offer, and I will. So I apologize to those of you to whom I don't address a question, but I would like to try and stay within the confines of my time.

Let me start with Professor Goldschmid, and first say, Harvey, as a professor as well, I'm well aware of the time at the end of May. And I understand of course why you didn't prepare a written statement. I think the fact that you were willing to carve out the time and just show up and speak with us is a wonderful thing, and thank you.

But I've been the beneficiary of

Harvey's wisdom on a number of issues, most recently as head of NASD, both before he was a commissioner at the SEC, and of course, also while he was a commissioner at the SEC. I seek that wisdom whereever I can get it.

MR. GOLDSCHMID: You're very kind.

MR. GLAUBER: Let me ask you if you might talk about something you didn't in your presentation. That is the recommendation of the Committee that deals with litigation reform and the idea of jurisdiction exclusive in federal court for certain categories of claims. Let's talk about that.

Mr. Mathews, perhaps you could talk a little bit about what changes in the liability regime you think would be useful to make audit firms more insurable.

Ms. Minow, I guess I would like to ask you to talk about something you also didn't mention in your oral comments. You referenced it in your written comment. And that is the recommendation of the Committee to encourage the addition of outside members of boards and how both -- how that might be done, and whether you think that that would be useful.

I want to just add a thank you for your comments as regards principle-based regulation and the notion of cost and benefits. I could not be more in agreement with you.

And then finally, Mr. Young, perhaps you could return to this issue of just how you believe additional transparency and financial statements would in fact be used against the firms. Because there is, as you can well imagine, tremendous sympathy on the side of transparency, and it would be helpful, I think, to the Committee. So thank you very much.

MR. GOLDSCHMID: Bob, I'm going to cheat on you, if it's all right, by addressing the transparency issue that Don correctly raised and you have raised too for a second.

Let me be clear on this. Transparency is terribly important for all the reasons I've gone through. To argue on the other side that opening up financials of the largest firms is going to change litigation much as I respect Kathryn, it's unreal.

When you're suing E&Y, you know their size. You know their personnel. You know the enormous scope. The jury is going to get that information. The fact that they'll have financials just is not important in anything but the most marginal way.

But for the public, for all the reasons we've gone through, it is critically important, and I don't want to lose that perspective.

Answering the question I was asked about moving things to federal court, there's a powerful case for doing so. But with these qualifications in terms of the Addendum, one, it ought to be made clear, and I think the Committee means to do so, that you don't mean to change present law.

10(b) will remain -- the recklessness standard under 10(b) will remain, which is found in every circuit. The 33 acts standards will remain. 102(e) for the SEC will remain. None of that I take it, the Advisory Committee would want to effect, nor should it.

A second thing is the proposal about bringing things into federal court should exempt government action and quasi-government action, the PCAOB. The PCAOB brings cases in administrative ways not in federal court. The SEC brings 102 actions in its administrative process. You clearly don't want to bring those things into Federal court, nor should you.

The meaning of care becomes important here. It's not fraud and recklessness. That, you're not touching. But some definition, whether people have suggested 102, some sense of what you mean would be useful.

The federal courts will not be terribly good courts for plaintiffs in many ways. That I think you can live with. Tellabs, Dura, all of the cases mentioned, have closed off plaintiffs' claims. Kathryn is pessimistic, and Michael is worried about exposure.

The truth of the matter is, it's been a much better set of years recently for defendants in federal courts. But one place, in the aiding and abetting area, it would be useful to suggest to Congress also that that be included in a package, if you're going to put these in federal court. Thank you.

CHAIRMAN NICOLAISEN: Mr. Mathews.

MR. MATHEWS: That's a very good question and not being a lawyer, I'm going to say a few things that probably other people might not like.

Obviously one of the biggest issues that we run into the U.S. versus other countries, is simply the lack of certainty as to what's a negligent act and that's what I said in going up front.

And that, when in contrast the U.S. to the U.K. for example, perhaps that's tempered somewhat in the U.K. because it's a professional judiciary as it is here, but it's a judiciary rather than a jury system, that decides on liability issues and on damages issues.

CHAIRMAN NICOLAISEN: Pull your mike.

MR. MATHEWS: Closer? So, I mean, obviously that to me is an important issue.

The jury system, I don't think necessarily does the same job certainly that we've been looking for on the insurance side to decide when an auditor is at fault or not for a loss.

I think obviously discovery issues come to mind as a potential problem. I mean, just discovery as an ability to search for problems that may or may not have existed at the time. That seems to me to be a major issue.

The appeals system in the U.S., again, having to potentially bond a great, provide an appeal bond to allow a firm to appeal a judgment where the judgment is just astronomical in size is almost an impossibility to get these days.

And the, certainly, the firm itself needs to have an ability to have somebody else take a second look at something when the judgments are huge.

Caps on liability, I think they're important as well. As Mike was saying before, simply an inability to take a claim to court in the U.S. is an important issue from an insurance perspective, because the insurer cannot be certain as to when he's going to pay a claim for which his client is liable for, or when he's going to pay a claim simply because the client can't afford to take the loss to judgment.

And certainly, lately in the last ten years, we've seen a growing number of such matters where they, for all intents and purposes, the view of the defense and the view of the insurance company is that this claim should be won. But the insured firm simply cannot afford to take the matter to trial. So, those in particular I think.

CHAIRMAN NICOLAISEN: Thank you very much.

MS. MINOW: There's always a lot of appeal in the idea of adding independence. I mean, my gosh, you know, this whole country was founded on the Declaration of Independence. We're all about independence here. Independence is great.

A number of academic studies, in fact, all academic studies on the subject have failed to document any particular benefit of independence. Not because independence isn't important, but because we're not very good at defining it. And here's one area where I think the SEC could really improve their disclosure requirements because we don't know who is and is not independent.

And so, consistent with my principles-based approach, I also have a bias in favor of performance standards rather than design standards. Having said that, I like the idea of encouraging the accounting firms to open themselves up, and as I said in my written remarks, I would encourage a variety of approaches.

There's, you know, a dual board involving the clients in the nominating process. There are a lot of different things that they can do. And my own experience in this is based in part on the fact that my father served on the independent oversight board at Arthur Andersen, which was discontinued just at the point that Arthur Andersen, shall we say, took the wrong path. So I think that's not coincidental. I think there's tremendous benefit there.

MR. GLAUBER: Thanks.

MR. YOUNG: Well, I can speak to my experience. The question you asked me was on the issue of transparency.

MR. GLAUBER: Right.

MR. YOUNG: And its usefulness to the plaintiffs. In my cases, they don't get it. I can't recall ever once giving to the plaintiffs information -- financial information about my client accounting firm. Not for lack of trying by the plaintiffs. They are rapacious in their desire for the information.

And part of the reason is self-evident. They want to know what is the last drop of blood that I can get. And ironically, the most recent thing I've seen on this is what John Coffee told you in your earlier session. When he was talking about his desire to get financial information about the defendant accounting firm.

And he said, on page 140 of the transcript, "I've had some dealings in my cases with insurance and even when you're in a settlement context, it is extraordinarily difficult to get to the bottom of what's out there."

And then he goes on to say how he took Arthur Andersen to trial and for five weeks, because he wanted to get the financial information, at page 151 he said, "We said to Arthur Andersen, you claim to be broke. Prove it. And it took five weeks of chasing around a courtroom before they finally agreed to show us their books."

Right? Now, that tells you a couple of things. One is, he's not getting the information. The second is, he wants it. He wants it badly enough to take Arthur Andersen to trial for five weeks to get it. And the third, he thinks it's going to be of value to him in litigation.

CHAIRMAN NICOLAISEN: Thank you

very much. Chairman Volcker, are you still on the phone? He's at lunch.

(Laughter)

MR. VOLCKER: Sorry, I'm here.

CHAIRMAN NICOLAISEN: Oh, there you are.

(Laughter)

CHAIRMAN NICOLAISEN: I wanted to give you an opportunity to ask anything you might care to ask.

MR. VOLCKER: I don't have anything at this point. I think this whole thing is rather one-sided in terms of the risks that the accounting firms takes. And I don't know how we balance that somehow or another. It's all a part living in that, but I think it's coming to be a real problem.

CHAIRMAN NICOLAISEN: Yes. Great. Thank you. Tim Flynn.

MR. FLYNN: Thank you Mr. Chairman. Mr. Guy, you talked a lot about, what I recall, evidence of bad audits, or audit failures, or did not, failure to detect fraud. And you covered documentation issues and lack of evidence and auditing by inquiry.

Can you relate some of your experience post-Sarbanes-Oxley and post-PCAOB inspection? And how, what have you seen in the recent years on audit quality today. How far back do those anecdotes go in terms of the times those audits were performed as opposed to audits being performed today?

MR. GUY: Basically, the work that I've done primarily is pre-Sarbanes. I have cases currently that are post-Sarbanes, and just anecdotally, I mean, this is certainly no basis would support a foundation that I could support this with, but certainly, documentation is a heck of a lot better. And documentation was a real, real problem under the old SAS No. 41. It's a lot better.

So it looks like things are getting better. Probably if I had to anecdotally here again say that where problems still exist, relate in around the ethics and independence. I still see in those post-Sarbanes cases where there appears to be a lack of knowledge of what the independence requirements are.

And here, again, I admit they're very complex to begin with.

MR. FLYNN: Mr. Mathews, can -- I'm just -- we've had a lot of discussion about insurance and the business model for the accounting firms today with unlimited liability, really not having access to outside capital and not having insurance, and then the issues, Mr. Young talked about actually being able to go to trial with that business model.

Can you contrast the insurance available to an audit firm today for catastrophic-type loss compared to a normal corporation?

MR. MATHEWS: Sure. It's very different in the corporations. Because I think as Michael was saying, the corporation has one risk, while you have the risk of all of your public companies.

So, we're talking about two different issues here, an aggregation of losses as well as a severity of loss. Right now, we -- for firms based in the United States, there is perhaps on a first loss basis, very little insurance available.

On a second loss basis, perhaps as much as $100 million, excess of some very high retained amounts for the firms. Contrast that with 20 years ago when any one firm could buy 200, 215, $230 million worth of insurance, with several limits at each level. There's just -- it's night and day these days.

And right now, perhaps the largest D&O in the market is getting constricted right now somewhat because of sub-prime. But perhaps limits right there for D&O could be perhaps up to $300 million.

MR. FLYNN: Thank you. Mr. Staples, you talked about a number of items in your testimony and you went through a litany of information that you stated wasn't provided. Have -- can you talk about what you have seen that was provided to the -- from the firms what was provided in aggregate from the firms, and give me a sense from what you did see that was provided from the firms, two questions around that.

You know, the first question really is, does the potential loss seem disproportionate to the ability to pay? And do you see the threat of liability issues as a potential threat to the existence to the firms, or a firm?

MR. STAPLES: To the first question, I have not seen what's been produced. I know, I've been told what has not been produced, and that is nothing, or very little.

Secondly, as to whether or not what effect ultimately the notion of catastrophic suits has on the viability of these firms, I think we first have to establish one, is there actually the threat of catastrophic suit? It seems to me that there's a lot of numbers thrown around, and I think that's fair. And you know, there's certainly data on both sides.

But until there's some universally agreed upon standard where we can say, all right, well this is the exposure, this is where we sit and this is where the industry is as a whole, I think it's very premature to say we're facing catastrophic risk.

And let me draw just a brief analogy if I could. I was lead counsel on the Salomon Smith Barney case in the analyst independent's action. I was co-lead counsel for what was then Citigroup Global Markets.

In both of those cases, if we can get to the discovery issue, is that, did they want to give me everything? No. They didn't want to give me anything. They didn't want to give me a single email, telephone conversation, note. Nothing. They wanted to give me nothing. It was knock down, drag out, bloody battle. That's litigation. That is the nature of litigation.

And then ultimately, what we get at the end of that process, it doesn't always have to be that way, but what you get at the end of that process is the truth. What you're not looking for is, you know, believe me, when I was -- and I think I speak for most prosecutors, when I was prosecuting these cases, I was not interested in assuming the role of Dracula.

I was not looking for the last drop of blood that would satisfy my thirst. However, I was looking for the truth. And you cannot get the truth without a crowbar sometimes.

So I think there's two issues there. When is it appropriate to use the crowbar, and is there really this catastrophic risk? I mean, how catastrophic is it? I'm -- that sort of brings up the idea of caps. Am I in favor of caps? Sure. I am in favor of caps. But it has to be at a catastrophic level.

What's catastrophic level? Do we have agreement around the table about what a catastrophic level is? I'm not so sure. I think more data needs to be gathered.

MR. FLYNN: Well, I appreciate your comments. I think -- I would encourage you to take a look at the data that was submitted. Because it's pretty extensive and is advocated by the largest firms. And Kathryn can send the numbers that the firms have provided as part of the process. So thanks very much.

MR. STAPLES: Sure. Thanks.

CHAIRMAN NICOLAISEN: Gaylen Hansen.

MR. HANSEN: And I think this is probably directed to you, Dan. We've had a lot of discussion about the possibility, you said that there's not a problem with standards, but we've had a lot of discussion about the auditor's report itself. And it seems to me like there's a communication issue here. And can we re-look at the auditor's report, address the expectations gap, narrow that gap, and if we were able to do that, couldn't this address a lot of these liability issues that we've been talking about here today if we could not communicate that?

Now, so my question to you, have you seen in these long form reports, in particular, some of them that are being used in the U.K., would that not address some of these types of issues?

MR. GUY: Basically, I spent a lot of my time at the AICPA dealing with the expectations gap. It seems like this same thing coming around again almost, same questions that I'm sure, with some differences of great consequences.

And one of the things we did, of course, is looked at the audit report and made some changes. The current report we have today dates back to the old expectations gap problem.

I don't really see problems with the audit report. In fact, I would say that maybe it needs to be tweaked a little bit in terms of, the meaning of misstatement in the audit report is certainly not understood and it needs to be tweaked perhaps a little bit. But I don't see where it really solves much in the way of the expectations gap.

When we did the SAS that I devoted a couple of years to on fraud, that was `53, and then later on, SAS `82. I thought that was going to be the end-all in terms of solving the problem. And with the new report out there, we were going to bookend this and the problem of the expectations gap would in large measure basically be substantially reduced.

That really did not happen. I think, for example, one of the things as I read your report that if we say that, hey, we've got a new fraud standard, or make recommendations to the PCAOB and a new standard comes about, and we have changes in the audit report, I still think we have the same old, same old.

I don't think it's going to do a whole lot in terms of changing either what users want and expect from the auditors, or what auditors will do in terms of performance.

There's a whole lot more. And that's the premise of what I was trying to get across. All these other standards, due care, client representations, measured representations, all these other things need to be really, we need to pledge allegiance to them. And that's where I think to a large degree the problem resides.

I'm not at all optimistic that a change in the audit report will really do much of anything, long form or short form.

MR. HANSEN: And if I could follow up then with a different question for you, Ms.

Minow. Because in your report, you did talk about the expectations and said specifically that the expectations of auditors should not be lowered.

But they, I think you're implying, that they should be raised, but you didn't really go on to say in what manner, to what extent. So maybe if I could ask you what you had in mind in terms of performance.

MS. MINOW: Thank you very much. I'm really surprised and happy that somebody picked up on that part of my testimony. Because you know, as I read the draft, it seemed to me that that was the key point. And it was kind of glossed over.

It frustrates me tremendously when I talk to people in the audit profession who say, when you're talking about the expectations gap in a value-neutral way. I think it's really their responsibility to understand that they need to meet the expectations of the clients and the investor community and not to, not to get the word out, not to hire a P.R. firm to say, you know, no, that's actually not our job.

That is absolutely their job. And as I said in my remarks, I'm not saying that the litigators calm down here. I'm not saying that they need to be the guarantors of the numbers. But I think my approach to this would be a very process oriented solution and to have them disclose further.

If you want to compare it to something, compare it to the way that people respond to Section 404 of Sarbanes-Oxley. Some of them do it better than others. But a good example that I will mention to you is Sunrise Homes, which has had a lot of accounting problems.

But they responded to it in an extremely detailed way explaining what the procedures were that they followed to turn things around. And a bad example, I might say, Apple, and their stock back dating scandal. Where they basically said, we looked at it, it was okay.

And I think that gives you our range of what is out there. And what I would ask, what I would ask for is more along the ranges, the category of Sunrise, where to have them say, these are the procedures that we followed and our goal was to make sure that to the extent humanly possible, we are able to provide an assurance that fraud did not occur.

But they should be explicit about their goals and explicit about the procedures.

CHAIRMAN NICOLAISEN: Thank you. We have four more members of the subcommittee that we want to hear from. I would appreciate it if those of you who are not on the subcommittee would put your tents up, if you would like to have questions answered also.

As you can see, if we can keep the questioning to a very, very tight time frame it would be helpful. Also I'm going to ask each one who has a question to ask one question only and direct it please. Thank you. Rick Murray.

MR. MURRAY: Mr. Chairman, in the interest of spreading the time around, I will have just one question, which will probably surprise and please you.

I'd direct it to Jules Muis. And by the way, Jules, I'm delighted to see that your power of provocative thinking didn't stay behind at the World Bank.

One of your comments illustrated an issue that has been a challenge for this Committee throughout. And by the way, I think this entire panel in its extraordinary quality and willingness to engage illustrates the difficulties that we are wrestling with.

You have suggested, at least I understood from your testimony, that you consider the liability problem to be an informational black box from which this Committee presently does not have the capacity to reach reasoned conclusions and recommendations.

There may be some confusion underlying that which I would like to clarify and get your reaction to. It's my sense that this Committee is not seeking to advantage the audit profession as contrasted with anyone else. And it's important to know that we are not addressing the issues of the burning cost of liability, even though that burning cost we now know to be 10 to 15 times greater as a proportion of revenue than any other industry, more than any other segment of the profession including the audit profession that is not responsible for public company auditing.

So there is a massive burning cost differential of just being a public company auditor. But we have treated that as an unfortunate fact, but one that is the problem of the firms to solve in the way they conduct their business.

And we have focused instead on the sustainability of the firms that are vital for the capital markets and for the public interest. And I suggest that the audit profession is at least as threatened a species as the polar bear. Beyond that, we may have little agreement.

I'll close up quickly with my question. What we do know based on the information that has been submitted to the Committee is that there are for example, in excess of 40 pending cases against the six large firms, with claims of $500 million or more accumulating to more than $100 billion in total claims.

I believe we know, or could reasonably conclude, that it is not possible for those firms to protect themselves from those cases by trying them all, even if they were quite defensible, because as Mr. Young so well put it, you have to win them all in order to try any of them. And that's not reality in anybody's business, much less auditing and its difficulties.

So that makes the profession hostage to demands of the claimants. Those claimants include trustees, foreign companies, entities with no reason to be expected to have sympathy for protecting the sustainability of the audit profession. And we know that Laventhol and Horwath and potentially another firm in the Florida proceeding may well be destroyed by that combination of exposure and demand.

And finally, I think we know that there is no secure safety net in place to prevent the unilateral destruction of a firm by someone who holds such a claim.

My question is not as argumentative as I mean it to sound. Because one could draw a variety of different conclusions about what we should or should not be recommending on liability. My question really is, what is it that you believe we do not now know or that is locked up in a liability black box, that would be relevant to drawing reasonable conclusions of any kind on the question of whether the profession ought to be given polar bear status?

MR. MUIS: I think the answer can be very short. Basically what I'm missing in the report and it may be there, is just a breakdown of the whole record of pay outs of the nature of the claims. What sort of engagement were they, et cetera, et cetera.

What I only wanted to say is what I see is just the outside border, the outer limits. And what I don't see, and I don't know how a Committee can come to a conclusion on what action to take as a result of that.

We've had that long discussion also in Europe now on litigation and liability. And indeed, I think the push from the European Commission is to go for proportionate liability definitely.

But anyway, I think that you at least, I would need a lot more if this Committee wanted me to comment on what the ultimate future of litigation and liability would be. And I've just given a sympathetic note to proportionate liability. And I understand there's still big holes in that because of state and federal law.

So I can't go any further than that. I was trying to stay out of this topic, actually.

(Laughter)

CHAIRMAN NICOLAISEN: Thank you. Bill Travis.

MR. TRAVIS: I'd like to, thank you, I'd like to direct my questions to Mr. Goldschmid and the transparency issue.

I've been troubled through this whole process by an underlying tone from a number of sources about a general mistrust in the audit profession and the firms in the profession.

I'd ask you to comment on how you think transparency could help that issue. I'd also like you to comment on how you think your transparency recommendation would affect the competitiveness of the mid-sized and smaller firms who either would provide information that would be smaller numbers than the big four, or smaller firms who would not provide information and what that would do to their ability to compete in the market place. Thank you.

MR. GOLDSCHMID: Sure. The auditing profession has obviously had better years and weaker years, but it's critical to America. And I do, as a personal matter, have great regard for the profession itself.

My suggestion that we have transparency, don't forget, only involves maybe eight or nine firms. Mark would have the number, but full transparency, mandatory transparency for those who are doing over 100 public audits, that's a small number of firms.

For the smaller firms, I'm trying, and I think the Committee, the Advisory Committee's report suggests being very flexible, letting the PCAOB feel for what will work and what won't, what will create entry barriers or won't.

And so, if you have the major largest firms putting out information, I don't think that will hurt the smaller firms. They won't have the cost of doing it. They may get pressure from clients, presumably, that will say, where's your information? And they'll have to deal with that and any competitive company would.

But there will be more flexibility for them. And I think that's why this system will work. Does that answer?

MR. TRAVIS: I guess I would like you to think about if a mid-tier firm is number 987, and their numbers are smaller than the big firms, will that have a negative competitive affect on those firms?

MR. GOLDSCHMID: I don't think so. I think, I mean, we find in the law that small firms can come in and say, look, we have the best litigators. We have a lot of talent. We're flexible. We're nimble, come with us.

I think the arguments you'd make now were the arguments you'd make then as a smaller firm, and they may well work.

CHAIRMAN NICOLAISEN: Thank you. Lynn Turner. This is going to be tough, Lynn, one question.

(Laughter)

MR. TURNER: Well, I must say that this is clearly the most controversial and toughest issues for the whole Committee in limiting us to one question. This indicates a lack of real study of the issue. But having said that, let me --

CHAIRMAN NICOLAISEN: Let me say this, as we have said earlier, there are follow-up opportunities. And we would appreciate additional questions, and I'm sure the panelists will respond to those questions and share the results with all of us.

It's just that we're --

MR. TURNER: Actually, I'm a guy that likes lunch a lot.

(Laughter)

MR. TURNER: I've been watching the clock. I've been watching the clock myself and I know we're seven minutes over, so I'm with you on that one.

But I would also like to note some members of the panel have raised the question about disclosure. And I would note that the panel did provide a request to all the firms back in November of data, much of which data was never forthcoming, especially on settlements. The firms talk about claims, but claims are not even a relevant number.

And I hope this thing gets made public, and I hope that what the firms had submitted gets made public so it doesn't remain secretive, and then let people themselves make their own decisions as to what is available and what the firms did and did not respond to.

So I hope that the Committee can find some way to operate in that fashion, in a transparent fashion themselves since we're telling the firms they ought to be transparent as well.

I have two questions actually. One for Kathryn, and then one for everyone. Okay.

MS. OBERLY: Do I get to answer twice?

MR. TURNER: You get to answer two questions, Kathryn. The first question to you is, Does your firm currently provided GAAP basis financials on a quarterly and annual basis to its partners? Not cash basis, or tax basis, but actually GAAP basis financials?

MS. OBERLY: No, we do not. We provide -- obviously the partners are the owners of the business. And so we do provide them with what we believe to be comprehensive financial information that they are entitled to as owners of the business. But we do not provide them with GAAP basis financials.

MR. TURNER: The second question to everyone then, on the liability issue, and by the way, Michael, I note you brought up the Arizona Baptist case with John Coffee, and I suspect that Dan Guy on the other end, since he was the expert, may have some views on that as well. But in that case, both audit partners lost their license and been involved with two other --

CHAIRMAN NICOLAISEN: Lynn, can you pull the mic closer. This is web cast here, so.

MR. TURNER: B-- had been involved with two other situations. In fact, an outside CPA firm in that particular case had twice called Andersen and told them they're issuing financials that were wrong and they never withdrew them. So, maybe there was a reason John did spend five weeks going after that case.

But here's the question for everyone. And that is, do you believe that an auditor who is found to have been aware of a financial reporting problem, but never reported it to the public, should be the subject of liability caps or some type of litigation reform protecting them?

MS. OBERLY: Personally?

MR. TURNER: Personally or to the firm.

MS. OBERLY: Since you said I get to answer twice.

MR. TURNER: Shoot away.

MS. OBERLY: On the personal level, I think that the appropriate way to deal with that situation is the disciplinary measures that are in place either at the PCAOB or the SEC, if an individual auditor has so far departed from professional standards that he or she should not be auditing. As you know, the firms themselves have an interest in making sure that auditor doesn't continue to audit. But there also are very effective disciplinary measures in place.

I think those are more effective and more protective for the public, make more sense than putting an individual auditor potentially into bankruptcy.

MR. TURNER: So you don't think investors should have a right of action there?

MS. OBERLY: I don't. I think that if you're talking about market cap loss in the billions which we often are, the right of action against the individual auditor doesn't really mean very much and it's probably much more important to the public interest that that individual auditor not be auditing again. Because --

MR. TURNER: And do you think investors should have a right of action against the firm?

MS. OBERLY: They do. But I think that you have to balance how much they should be able to recover from the firm if it's going to put the firm out of business, meaning not necessarily again, looking at it just from the stand point of Ernst & Young or any one firm, but looking at it from the stand point of is it a bad thing for investors that one more major audit firm disappear from the face of the earth. And is --

MR. TURNER: That's not the question.

MS. OBERLY: Well it is the question.

MR. TURNER: No, it isn't the question, Kathryn. The question is, investors don't have caps on their losses. So the question becomes, when an auditor, and we've seen it in the top 25 cases, in many of the cases, the auditors were aware of the problem. The partner -- it's never one partner signing this thing. It's two partners. There are 52 partners and managers in Enron.

And the question becomes, should there be some type of restriction on investor's right of actions when the audit partner and/or firm, because the problems on

Enron were made aware to the firm. There's memos documenting that. Should there be a limitation on the right of action from investors in those scenarios? It's a very simple yes or no.

MS. OBERLY: Yes. And the answer is yes. I think there needs to be a limit for the protection of society, including those very same investors that you're expressing concern on behalf of. Because I don't think they're well served in the long term by losing another audit firm.

So I think we need to rely on the inspection process. We need to rely on the disciplinary process. We need to rely on the audit quality investments that the firms are making. But the idea that for every penny an investor loses, while nobody wants that to happen, that somehow the audit profession, even the four largest firms, is somehow able to provide the capital to compensate those loses is so unrealistic at the order of magnitude that we're talking about, that we need to be looking at different solutions.

MR. TURNER: Okay.

MR. MATHEWS: Lynn, I just want to say I think you're looking back into a period prior to the PCAOB. Certainly from an insurance perspective, the structural changes that have taken place in the regulations since 2002 are tremendous. And it's one of the reasons why the insurance community, so to speak, still supports the large accounting firms to a limited extent, because they see that the firms responded very positively to the regulation that's in place.

I can't contemplate the kind of situation that you're referring to happening now in a firm-wide basis. So no, I would agree with Kathryn. The caps should be in place. There's always going to be a mistake made by somebody. But to put the firm at risk because a partner or a manager or somebody made a mistake, whether it's a bad mistake or just an error in judgment, seems to me a little far off the edge.

MR. GOLDSCHMID: Let me take a shot at that. Private litigation is essential to making the system work. The trick is to make that system responsible and fair, but the SEC language for traditionally 50, 100 years almost, not quite, the Commission's only 75, has been private litigation is an essential supplement to what the Commission and the federal government, including the PCAOB, can do.

Let me be clear on where we are in terms of litigation climate as I see it, particularly for the non-lawyers. The federal courts now are tough on private litigation. The cases mentioned, Dura looks at causality from the Supreme Court in damages and says to plaintiffs in effect, you'd better have a strong case.

Tellabs, that case last year, said strong inference of fraud is essential and has demanding requirements. In area after area, this is not a free, wild, easy litigation system.

The federal courts are getting rid of cases, accounting and others, at a much greater rate early in the game by directed verdict, early summary judgments. You don't have to face juries. Michael is right about exposure dangers. But often, 30 or 40 percent in the latest figures I've seen, are going very early. They're weak cases, they ought to go.

One other factor to keep in mind is, we keep talking, or at least today, there's talk about the 10 million, the 80 million you'll spend on defense. Accounting firms are repeat players. Which means if they spend 10 million or 80 million, and defeat a weak case, as they should in court, plaintiff's lawyers are not going to be anxious to play again.

When they lose a case, they get

paid zero. They may have millions of dollars of real time and hundreds of thousands of dollars of expense. They lose a case, that plaintiff's law firm gets zero.

And so, there are things to look at in litigation, but it's not wildly favorable to plaintiffs as some seem to have suggested.

CHAIRMAN NICOLAISEN: Anyone else care to respond?

MR. YOUNG: I would, Lynn, both to your question, and Harvey, to the points that you just made.

The issue of caps, I understand it's controversial. To find the solution, we need to understand the problem. One of the problems with the way our securities laws operate now, is that any shareholder can sue based on being deceived by information, even shareholders who never even saw the information.

You can state a claim that you were deceived, even though you never saw the information, you didn't know it existed. We've expanded the securities laws to that point.

That is one thing that could be looked at. But I will tell you, there is no appetite for looking at that whatsoever. That means you've got to go to the other end and that means you've got to look at damages.

I don't see another way around it. Now Harvey, I credit and agree with you on what you said, or part of what you said about Tellabs and that's a decision, the plaintiffs say it's not so bad. But it does favor the defense.

That's at the threshold motion to dismiss stage. Most cases get past that. And once you get past it, you still can't go to trial. And there's another trend that's coming, and it's not a legal trend but we all need to be sensitive to it. And Bob, you know exactly where I'm going with this one.

And that is, the evolution of

financial reporting. The evolution to, for example, fair value accounting which investors want very badly. The consequence of this evolution of financial reporting is going to be increased volatility in reported numbers, and probably the biggest factor that results in the commencement of securities litigation is volatility.

You know, you can look at all the different factors. The reason securities litigation went down over the last year and a half, now it's skyrocketed again, it went down coinciding with a lack of volatility in the stock market.

Now, with fair value accounting and the sub-prime mess, that volatility has taken off. And what has happened? Securities litigation has taken off.

The future of financial reporting, improvement in financial reporting, is going to introduce the volatility of reality increasing the financial reporting. And unless we do something, the securities laws are going to be an increasing problem.

MR. STAPLES: If I could just respond to that.

MR. YOUNG: Please do.

MR. STAPLES: I would agree that there needs to be a change, improvements in the way we financially report. But to suggest that somehow financial reporting affects the VIX or the iTraxx crossover, which really is what drives volatility, really doesn't make a lot of sense.

MR. YOUNG: I'm sorry. No, I meant to say that volatility leads to the commencement of securities litigation and with improvements in financial reporting, we should expect increased volatility.

MR. STAPLES: With improvements you should expect increased volatility?

MR. YOUNG: With improvements in financial reporting, we should expect increased volatility in reported numbers.

MR. STAPLES: Oh.

MR. YOUNG: I'm sorry. I was not clear.

CHAIRMAN NICOLAISEN: We're going to save the market value discussion for another day.

(Laughter)

CHAIRMAN NICOLAISEN: Ann.

MS. YERGER: I think this is going to be two quick questions. First to the panelists, who endorsed some kind of Federalization of claims against audit firms, could you talk specifically about what types of cases you think should go to federal court?

And to Ms. Oberly in particular, it would be very helpful if you could put these federalized sorts of claims in context. So could you tell me specifically how many claims is E&Y looking at right now. How many of those claims are currently in state court? Could you characterize those plaintiffs for us? And then also just describe how you think those claims would be handled differently in federal court than they are, would be, in state court?

MS. OBERLY: As to your second question, I would feel -- I want to make sure you get the accurate answer, so I'd actually like to submit that answer, and I will, after the close of the hearing and provide it to you. Because I didn't memorize the numbers. I could give you a rough idea, but I'd rather be more accurate.

As to the types of claims that would be brought in federal court, right now, most claims under the federal securities laws are brought in federal court already. But there are what I'll call for lack of a better term, copycat sort of claims that can be brought in state court. They may be the state receivership actions. They may be litigation trust actions. They may be state regulatory actions. They may be plaintiffs who can bring a tort claim or a negligence claim under state law and establish jurisdiction in state court instead of federal court.

And there are a number of problems with that. We've got 50 states, 50 different court systems of frankly varying qualities. Some are outstanding, some are less so.

The federal judiciary isn't perfect, but the general level is higher. And therefore, I would say that it would be an improvement for all of the players in the system if we brought claims against what are essentially federally registered accounting firms in federal court.

I know the PCAOB is not technically a federal agency, but it owes its origins to Congressional action. The firms that are registered are federally regulated firms. And it seems to me to make sense that the services provided by those firms subject to PCAOB inspection ought to all be consolidated in federal court to try to get the uniformity of the level of quality that we lawyers generally expect from our federal court system and tend to get from it.

That is not the only answer. I think it's very important to understand that just bringing cases into federal court doesn't mean that lock, stock and barrel, state law has somehow vanished. And so you also have to deal with what law is going to be applied once the case is in federal court to make sure that what is now the disharmony, or the disunity among all the varying state laws, isn't just moved across the street to federal court. Because that would not be a sufficient solution.

But basically, I would take any PCAOB registered firm, for example. If there's a claim against that firm for professional services, I think that should be brought in federal court.

MS. YERGER: Harvey, could you?

MR. GOLDSCHMID: I think Kathryn has it basically right. They'd be couched in state court terms in fiduciary duty, or maybe malpractice or some other such rubric. But they'd fundamentally be aimed at some kind of care formulation.

And if we move that to federal court, I'd not be troubled with the protections I mentioned. I do think that the auditing profession doing public company work has now largely operated, given the PCAOB and the SEC and other things, under Federal law, and I think it should be there.

CHAIRMAN NICOLAISEN: Let me give you an option here. I don't want to cut this off on the one hand. On the other hand, we do have another panel that's scheduled to start at 2:15. What we could do is have sandwiches brought in for the Committee in the room behind us, and have you take them at your leisure and we'll continue with this until 2:30. Or we could break.

I don't know how long your questions are, but we have five or six people who still want to ask something, and I really do hate to cut it off. If that would be okay, then we'll plan to start -- we'll plan a very short break and we'll plan to start the third panel as quickly after 2:30 as possible.

So that's the game plan. See what you've done to us, Bob.

(Laughter)

CHAIRMAN NICOLAISEN: I know, the subcommittee has met many times. Damon Silvers, and then let's just continue right around, there's a loop here.

MR. SILVERS: A dangerous thing to do, Don, to kind of give us a sense of expanded time.

(Laughter)

MR. SILVERS: This issue that I think the majority of this panel seems to be devoted to, which is the set of liability issues and their interface with the disclosure issues, have been, sort of bedeviled this Committee, I think, a fair amount.

I think that may be the point of Don's comment to Bob. And they've been in the press recently, which really disappoints me. And I want to make an observation and then direct a question to you all.

The observation is, if you, the panel, and the various interests that are represented on the panel, look at us, the Committee and the various points of view and interests represented on the Committee, I think you could imagine without too much of a stretch two possible outcomes.

One outcome is that we will address this issue in a way that we all come together and say something meaningful and in the public interest. And the other outcome is that we each express the particular point of view we brought to the table.

The former outcome would seem to be in the interests of the citizenry of the United States in whose building we sit. The latter outcome would seem to make at least some part of this a waste of time.

Now, in order to get to the former outcome, meaning some kind of consensus, there's got to be some commitment to information sharing and some commitment to not pushing the dialog in a direction where people are going to inevitably break with each other.

And in that respect, I find this panel to be somewhat disappointing, frankly. And you know, I find statements like, you have to win all cases in order to try any of them, to be just facially ridiculous. That's not how litigation is managed by anybody I've ever heard of or worked with.

And I find a number of the comments about insurance on this panel and on prior panels also to be just kind of off the mark. And I want to outline to you what I think about these issues and see if anybody thinks I've got it wrong. All right.

First, the litigation system, investors like to recover in the litigation system. It makes us feel warm all over. But the reality is, that's not what the litigation system is about. The recoveries are small percentages of the losses in all the cases, particularly the awful, painful ones. The litigation system is about deterrence.

And it's about deterrence in a context which I think Harvey mentioned, that there's just, there are limited resources at the regulators. There always have been, there always will be.

In that context, I'll observe one other thing, which is that all businesses have routine litigation costs. I think Rick referred to them as the burn rate or something of that nature. That's a technical term I wasn't familiar with, but it's that idea, right? All businesses spend a certain amount on litigation.

All businesses, all have catastrophic risk. All businesses have catastrophic litigation risk. I'll give you an example, and one that goes to this sort of every day thing.

Every day, Wal-Mart brings into this country, I don't know how many thousands of shipping containers. In each one of them, there may be an atomic bomb. That's a catastrophic litigation risk.

Can Wal-Mart insure against that? No. My observation about this is this, you have a run rate problem, a burn rate problem, so to speak. And I put that in quotes, a "problem." Because what it basically means is that the auditing firms are paying more on a kind of routine basis than they'd like to.

I'm sympathetic. I'm sure it's painful to do that. I don't see how that raises a public policy issue in terms of the data we've seen.

Secondly, there is, and we've noted it in our Draft Report, a catastrophic liability risk issue. Audit firms are open to catastrophic civil liability. Now, what evidence there is about at least large firms is, is that that's not what killed the one large firm that's been killed.

What killed that firm was essentially loss of client confidence together with the fact that they were facing criminal prosecution. But there is catastrophic liability risk.

Now, insurance is about either one of two things. It's either about managing the cash flows and the burn rate, or it's about actually covering catastrophic liability. I submit to you that no accounting firm ever has been able to get insurance to cover catastrophic liability, and neither has any operating firm.

Wal-Mart cannot insure against a nuclear bomb, right? And an accounting firm cannot insure against the possibility that it will in a reckless or intentional way blow up General Electric. Neither thing is possible.

Now, given all that, it strikes me

that there have been some statements by the firms and by their advocates that suggest that there are aspects of the litigation system that treat them unfairly. We've heard from the firms that they get hijacked by appeal bonds, that there are other aspects of the diversity of state court procedures that might be viewed as unfair to them. And that might raise national issues.

All of this, by the way, seems to me to be about securities law -- I mean, not to be not about securities law, it is about claims largely made by their clients, not by investors, under state duty of care.

My sense is that the discussion about federalization really is about that rather narrow question. Now, that's how I see it right now. If I've got it wrong, if there's something about that analysis, and I don't mean the points I made earlier about what has merit and what doesn't.

But the basic analysis that a)

there's catastrophic risk of liability, there always have been, always will be. It will never be insurable no matter what we do, unless, other than we cap it, that we pretend it doesn't exist. Right? Which is not how our litigation system works generally, a) is always there.

b) That's not what insurance is about. Insurance is about smoothing cash flows. Currently that's cheaper for them to do in a self-insured manner than through the insurance companies. It's not a public policy issue as far as I can see.

And c) that when we talk about sort of unfairnesses and procedure, it's really sort of limited to these issues under state law. If any of that's wrong, tell me.

CHAIRMAN NICOLAISEN: I think Damon is asking a question that may in fact better be responded to in writing just in interest of time here if nothing else, but the essence of his dialog is correct. Where are we? What are the issues and he's stated two possible outcomes. I don't see any other outcomes in those either. That either we all walk away with the same views we came in with, and we can express those. Or we can try to work towards some kind of a consensus. Working towards a consensus is going to require more information than what we have at the moment. There has to be a commitment to deliver that. And I think that's a very sound message and Damon, I thank you for it.

MR. MURRAY: Mr. Chairman, isn't that the dialog we're going to pick up with this afternoon and undoubtedly have more sessions on before we --

CHAIRMAN NICOLAISEN: Yes. This Committee will be able to have a very healthy dialog around any of those issues, including the way forward. And we need to have that. But we won't belabor the panel with that.

MR. MURRAY: The only issue I would take, Damon, with your did-you-say-anything-wrong has to do with the panel. I think the panel added great value to the raw material we're dealing with today.

MR. SILVERS: I agree. I think it is -- if Rick agrees with my analysis, we probably are closer to the consensus than I thought we were.

MR. MURRAY: I said that's the only one I'm going to observe.

CHAIRMAN NICOLAISEN: Mary Bush.

MS. BUSH: This question is to Mr. Mathews, and it is about insurance. In your written testimony, you make the point that part of the reason that there is such an unwillingness to do more in terms of insuring the industry, is that so many of the cases involve the issue of judgment. And then it's a hindsight look at judgment, so that it's very difficult to judge or to measure the risks that you would be taking on.

Two parts of this question. And actually, you touched on part of the first part in the last comment that you made. And that is, would greater transparency, more access to the PCAOB assessments of the audit firms, and I don't know how much access you have now, because there are two levels to that assessment that I'm aware of, would published financial statements, would indicators about audit quality, would any of those things have a more positive effect, or an effect, let's say on your ability to judge things, to judge risk in the audit firms?

I still understand the fact that you have this overriding issue about their judgment and the hindsight look at that. So that's one part of the question. Would that help the insurance issue, more disclosure around those kinds of things?

And then the second part, relates to a point made by Jules in his written testimony. And that related to the sometimes dispersed management of audit firms. And the risks that might be involved with pressures, political pressures, by governments and others put on local audit firms to do things in a certain way.

So would one management, one clear management of a firm worldwide, one system of governance, one set of ethical values, you know, if that can be transmitted through a firm, would those kinds of things have any positive effect on your viewing the insurability of the firms?

MR. MATHEWS: That's a very interesting set of questions. The way that insurers go about at the moment deciding whether or not they're going to insure a large accounting firm, requires some pretty in-depth analysis of the firm itself and the industry.

At the insurance companies that deal with the big four, BDO and Grant Thornton, the underwriters, and the leading underwriters in particular are very, are professional. They've been doing this for this specific group of companies for a very long time.

So they're well-schooled in the accounting issues and they're well-schooled in the firms themselves. At the moment, from a transparency standpoint, I don't think the ability to access details about the firm's financials is really going to do very much for the insurability of the firms.

Details as to their risk management procedures, not just in the U.S. but globally, details in the leadership and the leadership's responsibilities, are already part of the information that insurers receive. So that they actually have a very significant amount of information relating to the firms themselves, how they carry out their governance, and how they're expected to carry out their governance over the ensuing periods.

The issues that the insurers grapple with, because as you might be aware, it takes some time before an alleged act of malpractice or an act of malpractice leads to a claim, or leads to anyone believing there might be a claim in future.

So as we sit today as the firms generally insure themselves, we're actually thinking about work that has been done in the past.

As we move forward, given the changes in regulation, there's a better possibility of getting insurance for the firms because the PCAOB, the SEC, the firms themselves and the way the firms have responded to the changes in regulations has upped the insurers' interest in participating on insurance programs.

Unfortunately, it hasn't actually expanded the amount of insurance that we can get. It's expanded the amount of players. But because the risks are so large, and really haven't changed from the perspective of the insurers themselves, we've got a lot more insurers taking a lot less risk each.

So they tend to have very small

participation in programs now. And frankly, they're waiting for an opportunity to provide more insurance. But in the current environment, you know, they're all profit-making entities. They're afraid of losing a great deal of money.

So we don't see an insurer providing first loss cover. We see insurers providing some second loss cover and third loss cover. But the amounts of insurance available still remain relatively small.

CHAIRMAN NICOLAISEN: Zoe-Vonna Palmrose.

MS. PALMROSE: Thanks, Don. Two quick questions, fairly narrow. The first, for Kathryn. Could you give us a sense of those cases that would involve public clients, registered PCAOB audit firms, moving from state court to federal court, that involve catastrophic claims? Do you have any sense of what percentage, in other words, this proposal would move in the way of catastrophic cases from state to federal court?

MS. OBERLY: They would, I think largely be the cases brought by the receivers, or the litigation trustees, of bankrupt companies who can now file suit in state court and can somehow miraculously come up with hundreds of millions, or even larger amounts in alleged damages arising out of the demise of the company and in which the attempt of the plaintiff litigation trustee is to lay that demise of the company at the feet of the auditors.

Those would be what I think could be the largest claims that would be moved.

MS. PALMROSE: And that will show in the data that Ann has talked about, so those -- okay.

And then the second is, I think both you and Michael have given a sense that the information set would change for the plaintiffs if audited financial statements were publically available, that that would change the information set.

And you've implied that that would change the strategy for defending the firm. Is part of that strategy change, is part of that problem that you are managing a portfolio of cases and the plaintiff is looking at an individual case, looking at the pie and saying, I want the pie? Where you're looking at a portfolio, does that affect the strategy here?

MS. OBERLY: Part of the problem is certainly too many mouths to feed who are all looking to a small number of accounting firms to feed all those mouths. So yes, that would be. That's part of the problem.

MS. PALMROSE: But how would that affect then your strategies for defending? Does it mean you'll settle significantly higher amounts, settle more cases? Is that really what --

MS. OBERLY: I think in the settlement dynamics right now, plaintiffs already have significant leverage because they have some idea, even if they don't have audited financial statements, they have some idea of the size of the firms, and as Michael has talked about and as I've talked about, the idea from the plaintiff's side is to find out how much can we get from the accounting firm without putting them out of business.

And this is more firm data, if you will, to help them in analyzing the case from that perspective. Whereas, on my end of the settlement negotiation table, I want to be talking about the merits of the case, are the auditors really responsible, not what can we pay and still survive, but what is a fair settlement.

And so, this is another piece of data that doesn't at all bear on what's a fair settlement of the particular claim, but just provides additional leverage which in turn is what prevents the audit firm from risking taking the cases to trial in the first place.

And so, even if we're not put out of business by the catastrophic claim, the reason may often be because we can't afford risking taking the catastrophic claim to trial. And so we overpay in settlement in order to avoid the potential nuclear bomb.

MS. PALMROSE: But you're saying that that would be exacerbated significantly by possibility of --

MS. OBERLY: It would be exacerbated because it's more information being -- that -- I mean, I agree there are legitimate transparency needs of various participants in the system, whether they're regulators or investors, this Committee, others, in terms of what the firms are doing for audit quality, the strength of the firms, their ability to, you know, their focus on setting reserves to make sure that they can withstand the general -- I choke at the notion that my written testimony talks about run-of-the-mill litigation that was 50 or $100 million. But it does because that's how much it's changed in the time I've been doing this.

But that sort of information should be out there for investors and regulators and audit committees and clients to have confidence in the stability of the firms. But to give that information, to give more information to plaintiff's counsel, when they already have the same information we're talking about, it just doesn't seem to me to serve any public policy purpose, other than it's interesting to them. But it's not what the investors and the regulators need to make sure that the firms are able to do the job we want them to do.

MS. PALMROSE: Well, I guess that's the fundamental question though. Does that increase confidence? In other words, is it a stabling device, or is it a destabling device essentially. I mean, especially if you have multiple cases out there that are what you call catastrophic claims. Is it destabilizing, rather than stabilizing. I guess that's really sort of --

MS. OBERLY: You mean to provide the information?

MS. PALMROSE: Yes, exactly.

MS. OBERLY: I think it's destabilizing from my perspective because it's just that much more that I have to deal with in trying to negotiate a fair resolution to the case, or in trying to decide whether the firm can afford to take the case to trial.

MS. PALMROSE: Do you have any sense of what it would be in the market place as a stabilizing or destabilizing device?

MS. OBERLY: I'm not certain I'm following the question.

CHAIRMAN NICOLAISEN: We'll leave it as a rhetorical question at this point. But if you care to respond, you know we certainly can do that in follow-up. Bob Herz.

MR. HERZ: This may be a completely off-base comment, or a brilliant insight, but

I was struck by some people on the panel saying that as opposed to individual commercial firms, the audit firms are in theory responsible for the market cap of all of their clients.

And I started to think of some analogies and the rating agencies came to mind in terms of their ratings and reliance on that. And I remember Harvey said, well, but the audit firms were kind of given a franchise. I think the rating agencies have been kind of given a franchise as well.

And then I note in Kay's -- Kathryn, sorry.

MS. OBERLY: Either one is fine.

MR. HERZ: Okay. So testimony says, "The rating agencies are subject to protection under the First Amendment." And I think recalling that may have derived from a Supreme Court case even.

And I kind of, just as a man on the street in terms of thinking about protections and reliance and capital, and more broadly about architecture of a capital market, without making a normative judgement as to whether the credit rating agencies should be subject to the same liability as the audit firms, or vice-versa, or somewhere in between, the disparity just strikes me as nuts.

MS. OBERLY: If I could expand. Because I didn't have time in the oral testimony. But in the written testimony I noted that underwriters, rating firms, lawyers, frankly, all sorts of other participants in the system have ability to protect themselves that is not available to audit firms in part because of SEC rules on independence, or rules prohibiting indemnifications from audit clients. All those rules serve good public policy purposes.

But they leave audit firms as perhaps the most exposed and vulnerable participants in the system without the means to invoke the contractual protections that you're reading from in my testimony there.

CHAIRMAN NICOLAISEN: Right. Thank you. Sophie Baranger.

MS. BARANGER: Thank you, Chairman. Maybe two quick comments and one question. The first comment relates to the transparency issue and the debate around should the firms publish their financials or not.

Just to highlight the fact that under the current 8th Directive, which needs to be transposed, I think, next September, there is a content that is listed in the Directive and the content of the transparency report that would have to be published, does not per se specify that the audit firms would need to produce their financial statements.

But there are more qualitative data, qualitative comments that are referred to in this transparency report such as the description of the organization of the firm, the description of the network, the list of the public entity clients, the elements regarding the internal control and the quality assurance elements regarding the education of the accountant.

The financial data that are contemplated in the Directive only relate to the fees received and the breakdown between non-audit and audit fees. But it's true that it is the current situation. And we've seen that in several countries, there has been initiatives by local firms to publish their transparency report in advance to the 8th Directive.

And it was, in almost all situations, we could see that those firms, on a voluntary basis, decided to publish their financial statements, audited. So that was just a comment, that at least some firms did not consider that it was a major problem. And on the other hand, it would enhance the way the public could consider their profile.

The second quick comment relates to the liability issue, which is also a very tough subject in Europe. The European Commission published a consultation document, when was it, I think two years ago. And when you consider the response received, the member states were very, very divided.

So we are effectively expecting a recommendation on the recommendation from the Commissioners, which is supposed to be out before the end of this year. And it would be, well, I do not -- I cannot say what the content of the recommendation would be, but the recommendation would say something and it would be up to the member states to decide whether or not they would implement what's in the recommendation. So just to give you this perspective.

And the third point which is a question related in fact to the Addendum that has been distributed before the meeting, which discussed the possibility to expand the auditor's report. And I've been surprised to see that it has not been, you know, discussed during this session.

And we, at IOSCO, with the other hat, not the European hat, but with the IOSCO hat, we had a big meeting in June 2007, Lynn was one of the panelists. And really one of the top issues that came out from the discussion was the fact that the standardized wording of the audit opinion wasn't very helpful to the users and it would be maybe a good thing to reflect on the possibilities to expand more the audit opinion.

We, still at IOSCO, decided to still reflect on the outcome of this roundtable and we did publish last week on the 27th of May, a press release explaining where we are on this issue. I've asked Kristen to circulate the public release for your information.

And just to give you some more precise input, it's really something, an issue which we thought, with my French hat now, is of key importance. And when we had our own

Sarbanes-Oxley law which dates back to 2003, we decided to introduce in the law a requirement for the auditors to expand a bit the audit opinion on the point which is called the justification of assessments, the assessments of the management on the main issues that give rise to judgment and to estimates.

We ask -- the auditor is asked to develop and give come comments on these estimates, even if the opinion is unqualified.

So now the question. What would be the kind of information the panelists think would be of interest to find in addition to the current content of the audit opinion? But it might be a very big question, and I'm conscious of the time. But I wanted to raise the issue.

CHAIRMAN NICOLAISEN: Thank you very much. I think that's very helpful. And it shows that it's -- that these issues are complex everywhere in the world.

The content of what the report might look like, I think, is legitimately a discussion that will occur. The way in which this recommendation is tentatively framed at least, is that it would go to the PCAOB to make that ultimate decision, but that there are areas of detail that are not addressed today. And I think there's a pretty wide range of those. So it would really fall to the PCAOB to make a decision.

MR. GLAUBER: Mr. Chairman, just as a matter of clarification, everything, of course, you've said is exactly right. But the recommendation from the subcommittee is indeed that the elements of the Article 40 of the 8th Directive, should be the foundation of the transparency requirement and that the PCAOB should determine what parts of that are --

CHAIRMAN NICOLAISEN: I think she was in the auditor's report.

MR. GLAUBER: -- appropriate to this particular context. That part of this recommendation was strongly supported by the subcommittee.

CHAIRMAN NICOLAISEN: Very good. Alan Beller. One minute.

MR. BELLER: One minute. I guess I actually found this panel at one and the same time quite informative, but at the same time, emblematic of the conversations that have been going on at the Committee and among members of the Committee for months now.

One of the things this Committee, I think, is charged with doing is to look over hills and look around corners and see where we might be. And I'd like to look around a five year corner.

Five years from now, it is, I think, a certainty that the U.S. capital markets will be less than 30 percent of the market cap of the global markets. It's in the low 30s today, I think. It was in the high 30s five years ago. So it will be less than 30. It might be 25, it might be 22, it might be 26.

Second point, I think it is quite likely that one or more of the big four will have established real global operating, not networks, but real global operating entities that function as single entities with single systems of corporate governance.

It is 100 percent certain to me, point three, that if we do not find a better path, I don't mean to say better path, a different path, from the one we currently are on, the chances are precisely zero that the American firms will be part of those global networks.

And I guess the question having looked around that corner is, how satisfied are we going to be with the status quo five years from now?

CHAIRMAN NICOLAISEN: Barry.

MR. MELANCON: I think those were great observations, Alan. I have a quick question for Harvey and a quick question for

Dan.

Obviously, Harvey, your belief that audited financial statements -- you believe that audited financial statements would not create additional exposure for the firms. And Michael, certainly counteracted that and believed something different.

My question to you, Harvey, is that, if you were to be convinced that those financial statements increased the exposure and given the fact that part of this Committee's charge is dealing with the sustainability of firms, so if you could be convinced of that, would you then feel comfortable with transparency being limited to the EU Section 40 comments, which are directly related to quality. Would that be sufficient if you could be convinced that the liability exposure would be greater under that?

MR. GOLDSCHMID: Well, Barry, I phrased it in terms of perhaps there's a marginal amount in this in what Kathryn suggested and what you're suggesting. It's very small. And the gains are enormous in having transparency among the large auditing firm.

And so, if you could convince me that it's a drop more than zero, that's not very convincing. What's convincing is what make sense in public policy terms. And I don't -- you know, the U.K. has full transparency. Article 40 is good, but you can do more.

I litigate as a private lawyer all my life when I'm not hanging around Columbia, and that's most of the time, on the defense side. We don't look at exposure. You get a big case in, you look at the quality of the claim. You immediately begin thinking, particularly if it's a weak claim, how do I get rid of this early? Can I do it by direct verdict? Can I do it by early summary judgment? You want to avoid the rigamarole of discovery.

Everybody knows among the big firms they're big and they have assets. The idea that this is going to be important, putting out public financials for the largest firms, I said it to Kathryn earlier, it's just unrealistic.

MS. OBERLY: Can I have a second to respond. On the U.K. point, I would just note that there are some, there are two critical differences. One, they do not have the litigation system, thankfully for them, that we have. They don't have the volume. They don't have the class actions. It's a very different litigation environment. They don't have jury trials. They just have a more civilized system in some ways. It might be better, it might be worse, but it's maybe more civilized.

And in addition, they are allowed by contract with their clients to limit liability in a way that we are not in the U.S. So I just think it's inappropriate to look at the U.K. as a model and say, that hasn't hurt them so it would work here. They're not parallel.

MR. MELANCON: And I think that the third point is again, that their disclosure in an audit is because of the LLP. It applies to all LLPs, not just auditing. So it's not an audit public policy decision as much as it is a liability limiting any kind of entity.

Dan, I have a quick question for you. One of the recommendations deals with the individual partner signing the report. And one of the debate points on that issue is does that help from the audit quality perspective? Does it hurt from the audit quality perspective?

And one of the concerns against it is that it actually, you know, audits are delivered by a firm, a system of quality control. It's the totality of the process, not an individual.

And of course, we have enough

challenges making sure that we keep people in the profession. You have obviously seen it from both sides, and a standards setting perspective. Do you have any thoughts on that particular recommendation?

MR. GUY: Well, I think in general that a signature by an auditing partner adds clutter to the audit report and serves no real purpose. Oh, I thought I -- is it on now?

Okay, basically, I think that the signature of an audit partner does really nothing. It adds clutter to the audit report. Given all the engagement documents that the partner and the concurrent review partner sign, I just don't see any real need for it.

CHAIRMAN NICOLAISEN: All right. Well, thank you very much. This has been a good and wholesome discussion. I apologize to this panel for keeping you here longer than you had anticipated. I apologize in advance to the next panel.

We will ask that Panel III be

seated at 2:45. That's a very limited amount of time. So if everyone would just bring a sandwich in, and we're just going to have to work through lunch. We're going to do our best to cover as much territory as we can. Thank you very much.

(Whereupon, the above-entitled matter went off the record at 2:38 p.m. and resumed at 2:56 p.m.)

CHAIRMAN NICOLAISEN: All right. Welcome back to Panel No. III. I think we have some people on, connected by conference call. So, if you could identify yourselves, I'd appreciate that please. If there is anyone. Jim Kaplan, are you on? All right. We'll have to check later on and see if we have other people joining us.

MR. KAPLAN: I'm sorry, this is Mr. Kaplan.

CHAIRMAN NICOLAISEN: Hi there. Good to hear from you. We're just gathering in the room and we're going to get started here in just a few minutes. Do we have any of our members on the phone? No. Okay.

Well, once again, a couple of housekeeping rules. If you would please keep your Blackberries away from the microphones. When you do speak, if you would speak into the microphone, turn it on, you'll have a yellow -- a green light. When you see the green light, I think it's pretty obvious then that people will be able to hear you on the web cast.

We're going to continue this panel in much the same fashion as what we had our earlier discussion. We're now into the area of Competition and Concentration and that subcommittee will, like all other subcommittees, have the first questions of the panelists.

Let's get started. Our first panelist to speak this afternoon is Mark Anson, President and Executive Director, Investment Services at Nuveen Investments.

So, Mark, if you want to kick it off please. We're looking for five minutes or less from each of the panelists in introductory comments. Thank you.

MR. ANSON: Thank you Mr. Chairman. The five minutes or less makes me feel like I'm back at CalPERS.

What I have in front of me is a handout. I would like to pass out. It will take five minutes to get through. I have -- my microphone is on, sir. If I could ask for some assistance. Thank you.

Four slides. Take us five minutes. I'm an investor. It's what I've done pretty much my whole profession. It's my career. It's my profession. It's my life. So I have a very selfish perspective on the accounting and auditing profession.

What can it do for me as an investor? And what happens when the accounting and auditing profession doesn't work? What impact does it have to me as an investor. And not just me, but all the other investors in the United States.

And that's what these four slides are going to try to demonstrate for us. If you could turn to the second slide, titled The Equity Risk Premium. This is the premium that investors demand to hold stocks over bonds.

Stocks are a fundamentally more risky asset class than bonds and you should earn a premium if you're going to hold a stock instead of a bond in your portfolio. Now, the fascinating thing about the Equity Risk Premium is that it is a forward looking premium. You cannot look it up in Bloomberg. It's not published in the Wall Street Journal or the Financial Times.

You have to calculate it. You have to back it out. It's implied by current market conditions? So how do you do that? Well, the first thing you do, if you're an investor like me, you forecast the earnings of the stock market looking forward three, five, even ten years. It then becomes a present value calculation.

You determine what is the discount rate that will discount those future earnings in the stock market back to its current value. That provides you with a discount rate. From that discount rate, you subtract the yield on the 10-year Treasury Bond, a riskless investment, and the remainder is the Equity Risk Premium, that premium for holding stocks over bonds.

So with that background, if we turn to the next slide, let's take a look at the Equity Risk Premium over the last 28 years. One of the first things you'll observe is it moves around a lot. It goes up. It goes down. Its long term average is about 3.9 percent.

I still use this to this day as an investor when I look at the stock market. It's also a measure of investor risk aversion. The higher the Equity Risk Premium, the greater the risk aversion. The greater the risk aversion, the more you must be compensated to hold stocks over bonds. You are more risk averse, therefore, you want a higher return to own stocks over bonds.

So, when the Equity Risk Premium goes up, it means that investors are more risk averse. So, it's fascinating to look at some of the peaks and valleys. For instance, if you look close to 1988 there, that very steep valley is in fact recognizing October of 1987.

I think some of us in the room, myself included, are old enough to remember portfolio insurance. A point in time when everyone believed you could eliminate the risk of the stock market. You could just hedge it away and it would vanish. Of course we all realized what an unfortunate fallacy that was and that led to Black Friday and Monday when the stock market corrected by about 600 to 700 Dow Jones points in the space of two days. It was very ugly out there.

But that was a case in point though, as you can see, where the Equity Risk Premium went basically down to zero. Now, that just cannot be. Stocks are fundamentally more risky than bonds.

When you see the Risk Premium go down to zero on stocks, something is wrong. And what we discovered was wrong was the fallacy of portfolio insurance. It did not work. It was a fiction. And the market corrected with a vengeance.

The other point you can see when Equity Risk Premium goes down close to zero is the at the height of the tech bubble. Remember when the bricks were going to take, or clicks were going to take over the bricks, trees were going to grow to the sky, and technology stocks were going to just take over the world.

But what's also interesting to note is the highest point on this graph. It's not 9/11. The terrible tragedy of 2001. It actually comes in 2002 at the height of the corporate accounting scandals when the Equity Risk Premium over the last 28 years reached its highest point of seven percent. The time when investors were the most risk averse in the equity markets.

You can pick any one of the corporate accounting scandals at that time, Adelphia, Telecom, WorldCom, Enron. But effectively, it was a point in time when investors could not trust the financial statements that were being printed. You could not trust the auditing of the accounting, of those financial statements.

So, if you turn to the last page, and I realize I'm running out fo time, just a couple of points. First, we note that the Equity Risk Premium has approached zero twice. In October of 1987, but we learned the fallacy of portfolio insurance, also at the height of the tech bubble in 2000 when trees were going to grow to the sky and internet stocks were going to take over the world, we realized that was a fallacy too and the market corrected.

But when we look at the highest point of the Equity Risk Premium 2002, again it was caused by the accounting scandals. When there was such uncertainty in the financial markets with regard to the financial statements produced by corporations and audited by the auditing profession, that we as investors could not trust those accounting statements.

And what happened, so a lack of transparent accounting, it destroyed investor confidence, it raised the Equity Risk Premium, led to eroded stock market values and led to the demise of one of the Big Five accounting firms.

So, when we talk about Concentration and Competition, we have to be very, very cautious. What are you going to accomplish for the investors out there that rely on the accounting profession to provide audited financial statements? If we have too much concentration and not enough competition, does that mean we could have another high point like 2002? Possibly.

So, I put some data, hardcore data on the table trying to distill some of the theory that I've heard about in the back of the room today. Some data points with regard again from a very selfish perspective, that of an investor, but it does concern me as an investor when there are too few accounting firms out there and not enough competition.

It could lead to higher risk aversion in the market when people do not trust the accounting statements. And that can erode billions of dollars of stock market value. And I'll conclude there. Thank you.

CHAIRMAN NICOLAISEN: Very good. Thank you. We'll move on to Chet Gerdts, who is general counsel for PricewaterhouseCoopers.

MR. GERDTS: Chairman Nicolaisen and members of the Committee, thank you for the opportunity to be with you this afternoon. And in particular I'm pleased to be able to address the recommendations of the Subcommittee on Concentration and Competition included in the May 5th Draft Report.

As a general matter, we at PricewaterhouseCoopers believe that the key factual findings underpinning the Subcommittee's recommendations are well founded and well supported and that the recommendations themselves are properly directed towards the twin goals of improving audit quality and sustaining the profession.

We believe that the Subcommittee's recommendations are premised on three fundamental findings with which we agree. One, based largely on the 2003 and 2008 studies by the Government Accountability Office, we believe that there is a high level of concentration persistent particularly at the highest levels of the accounting profession.

Perhaps more important for this Committee's work, however, we also think that it's an important finding that that concentration has not negatively affected audit quality. In fact, we believe that there is an emerging body of evidence that audit quality has improved in recent years, notwithstanding that concentration.

We believe that that audit quality improvement is largely attributable to what at our firm we believe are the constructive changes that came through with Sarbanes-Oxley Act and the other acts similar to it.

Third, the catastrophic risk of litigation is real. And that reasonable and responsible steps should be taken to try to preserve the major accounting firms.

Now, as to the major recommendations, we have the following observations. First, we agree with the --

with recommendation number one, and in particular its sense that the emergence of another firm to compete with the four major firms is at best a long term prospect.

Second, while the preservation mechanism described in recommendation two of the Draft Report, we think creates a useful exercise around scenario planning, we believe we need to be realistic about the possibility of success if that scenario were -- actually had to be employed in a real life situation.

And third, that the recommendation calling for the identification of quality metrics is a very useful concept, in large part because it would enable the firms to compete on the question of quality, through a transparency report that would be quality driven.

That recommendation in particular seems to drive audit quality and would sustain the profession through the fostering of greater competition. This would result in the kind of report described by Dennis Nally, PWC's chairman when he was here in December, very much along the lines of the EU 40 recommendation that has been discussed earlier today.

Now, in the interest of being brief, I was going to stop my remarks there. But, I am mindful of the fact that I am the General Counsel of PricewaterhouseCoopers and I do have some interest in the topics that were discussed earlier today.

Having said that, I'd be happy to take any question on those topics when we get to that point in the proceeding. Thank you.

CHAIRMAN NICOLAISEN: Chet, thank you very much. We'll move next to Kenneth Nielsen Goldman, Capital Markets and SEC Practice, J.H. Cohn LLP.

MR. GOLDMAN: Chairman Nicolaisen and members of the committee. I certainly appreciate the opportunity to be here and speak with this august body, representing J.H.

Cohn, which is the seventeenth largest accounting firm in the United States.

Competition and choice have improved in recent years for public companies with a market cap of a billion dollars or less. Whether this trend continues, remains an open question.

Certain external challenges facing mid-size firms could be mitigated resulting from the recommendations of this Committee. Many decision makers in the choice of an auditor either worked at one time for a large firm, or have significant experience with large firms. And it is understandable that a certain bias exists.

On the other hand, if there's a genuine public policy need to expand the number of public company auditors, authoritative information needs to be available to present a more balanced view.

Two of the recommendations of the Committee, I believe, help this situation.

First, the recommendation for more complete information on auditor changes would better enable market participants to understand the rationale behind the changes.

Second, we would support the recommendation that the PCAOB determine the feasibility of determining key indicators of audit quality and would welcome the opportunity to work with them and other market participants to study this area.

In addition, more opportunities, such as this testimony for leaders of mid-size firms to participate in important public policy decisions, would over time enhance the public's understanding and establish awareness of mid-tier firms in the eye of the public.

Certain recommendations put forward by this Committee, however, may prove to be disincentives for the smaller, mid-size firms. Few smaller CPA firms would be able or willing to easily handle public voting members on their boards. It is possible that the non-

SEC partners within those firms would object to such a concept.

Public disclosure of firm financial statements would also perhaps pose insurmountable difficulties, causing some firms to withdraw from the public company audit market.

They would view such disclosure as placing them in a negative competitive position with respect to the larger audit firms and potential plaintiff's bar as we heard in the last session.

Annual shareholder ratification of public company auditors, if adopted as a requirement, we believe might lessen the ability for mid-tier firms to participate in the process. Currently the audit committees have the wherewithal to interview firms and meet with the firms, and make an informed decision. Leaving that decision up to the general investing public may result in larger firms being selected simply because of name recognition.

There are a number of recommendations that could help the smaller firms. The development of best practices for fraud detection could be extremely beneficial. The amendment of the auditor's opinion to better discuss fraud and the responsibilities therein, would be important.

And as we've discussed in the last session, the liability issue is one that we believe needs to be addressed. For smaller firms as well as larger firms, one significant audit failure could do enough damage to either the reputation or the financial viability of that company to threaten the existence of that company.

The recommendation to require public disclosure of agreement provisions limiting auditor choice is an excellent one. We might add that our opinion is that these agreements, which we have run across, really focus on the liability issue once again.

We are in agreement with the Committee's recommendation to compile the independence rules. We find that the rules are extremely confusing and there are various constituencies that have created rules. We would ask that the SEC and PCAOB rules be combined along with the Department of Labor rules and any others. We would encourage a codification similar to that which the FASB has undertaken.

And lastly, on the partner rotation rules, we feel that concurring partners having the same five year standard as the engagement partner creates a disproportionate difficulty within the mid-tier firms. Often when a new engagement is brought on board, the concurring partner and the engagement partner are assigned at the same time. And unfortunately, at the end of the five years, both have to rotate off, thereby losing some of the transition information that would be beneficial to the client and the market place.

And once again, thank you for this opportunity.

CHAIRMAN NICOLAISEN: Kenneth, thank you very much. James Kaplan, are you on?

MR. KAPLAN: I am.

CHAIRMAN NICOLAISEN: All right. James Kaplan, chairman and founder of Audit Integrity. If you'd care to give us your opening comments.

MR. KAPLAN: Thank you, Chairman. I'm going to take this one at a time and go through the first three items, when we talk about reducing barriers to entry for smaller firms. I think it's important to recognize that as the industry matures and the accounting industry is a relatively mature industry, one would expect concentration among the few, but competent players. It's not atypical of the certain manufacturing or service industries.

I think the concern here is to

ensure that a) there's access to other firms, but most importantly to ensure that risks that are borne by the major accounting firms can be managed and/or mitigated, which leads me to the catastrophic risk component, which at the end of the day, becomes a very important issue in respect to investor confidence.

I would note as was made apparent by other speakers, that it really only requires one or two catastrophic events in order to upset or disturb the market place. And clearly, more information needs to be gathered and collected to ensure, or at least assure, that the number of tragic incidents like that are minimized and mitigated.

So any work in that particular arena certainly would be important in respect to investor confidence.

In respect to developing key indicators of audit quality, I have passed out a little chart, using our own measures, which are measures based on governance and accounting practices of various corporations and are rated by Audit Integrity, but also rated by other managers, other, –independent, hopefully objective sources.

And the point of this little chart is to show that among the top six auditing firms, the distribution of rankings is really very, very similar -- i.e., the very aggressive ratings which would be considered the most risky ratings, really are distributed very evenly among the big, in this case, the Big Six. And you notice that the very conservative ratings, the most transparent ratings, are also fairly evenly distributed among the 2,000 approximately, or, excuse me, 4,000 audited statements that the Big Six are providing.

If you look below at all the other auditors which comprise roughly 2400 of the audits, you see the distributions are a little bit wider. From our measurement, but yet again very similar to all of the auditors that were included in this study.

So, at the end of the day, the issue isn't so much about competition. The issue is about the quality of the audit report itself and the assurance to the investor that the audits are done rigorously and transparently and can be identified by the investors as such.

And in that respect, it really boils down to transparency and the ability for tools like this or other tools to measure in a more objective, quantifiable way, the quality of the audit. And if we find comfortable -- if we find comfort in the quality of the audit, then I think we have managed to overcome the biggest issue of all, which ends up being a catastrophe, whether you're big or small, it must be managed and managed intelligently.

So, frankly, given our bias, we firmly believe that the PCAOB and others who are actively involved in this process, spend more time and more energy on providing quantitative and reliable tools in order to ferret out any problems before they occur. Thank you.

CHAIRMAN NICOLAISEN: Very good, thank you very much. We'll turn next to Brian O'Malley, who is senior vice president, general auditor, NASDAQ.

MR. O'MALLEY: Thank you, Chairman Levitt and Nicolaisen for your invitation to address the important issues that affect finance reporting in today's complex capital markets.

We appreciate your leadership on what we all know are some very, very difficult and far ranging issues.

NASDAQ OMX is a central player in the global capital markets. We are a public company with all the responsibilities of financial reporting imposed on our --

CHAIRMAN NICOLAISEN: Could you bring your mic a little bit closer.

MR. O'MALLEY: -- imposed on our listed companies and a regulator of public companies that enforce comprehensive listing standards.

We rely on the work of auditing firms, corporate board members and executive managers. There is much at stake to get it right. As we have seen time and again, the very functioning of the marketplace can be brought into question when auditor conflicts arise, manager behavior is called into question, or board members wilt from the very serious responsibilities.

As the Advisory Committee points out, there are four accounting firms that perform 98 percent of the 1500 largest public company audits, and 22 percent of companies with revenues of 100 million or less.

Thus, while concentration in the small or mid-size public company realm seems acceptable, larger companies audit work appears to be locked into the realm of the Big

Four accounting firms. In reality, this concentration is a concern. The very tangible possibility of the Big Four becoming the Huge Three is only one lost firm away from reality.

As it relates to the specific recommendation, recommendation one suggests that smaller firms can be incubated toward joining the Big Four as globally staffed, experienced firms that can handle the demands of more complicated audit clients like ourselves.

The Advisory Council wisely sets the expectation that this recommendation would have a long term time line. The most interesting intermediate recommendation to effect this change is requiring public companies to disclose, in annual reports and proxy statements, any provision and agreements with third parties that limit auditor choice.

As the Committee noted, within the IPO arena, some participants such as lenders, investment banks and credit rating agencies insist that some companies be audited by a Big Four audit firm. In many cases, these requirements are driven to have an IPO with a good housekeeping seal of approval.

Functionally, this practice over time severely limits competition among audit firms. The idea to disclose this kind of third party requirement may at least add transparency of participants. However, the root cause remains. And it will be interesting to see how often this disclosure is used.

Ultimately, the real or imagined negative perception of the market place needs to be measured in some fashion so root causes can be identified and change can occur.

Recommendation two deals with the pre-eminent issue facing the audit industry, the boogie man scenario. That is, how do we prevent the Big Four from being the Big Three.

The Advisory Committee again correctly advises that the PCAOB monitor for all potential sources of catastrophic risk involved in the audit exercise and that mechanisms for the PCAOB and SEC to assist a troubled firm be developed.

Accounting firms at the end of the day rely on the credibility of their name and its brand. As we saw with Arthur Andersen, an entire firm can melt away when clients flee a damaged name brand. With the global nature and the importance of the remaining big firms, such a catastrophe today would certainly carry negative global capital markets impact.

Like we have seen in the banking industry, government regulators have a role and a responsibility in crisis situations. The regulators, industry and Congress need to examine in simulated real time, how they would handle another crisis of confidence of a large accounting firm.

Perhaps structural changes within the firms could be pursued to firewall the damage and prevent a firm-wide meltdown. I'm sure the majority of partners at Arthur Andersen were capable and reputable, but they paid the ultimate price for those that were not. Could the market sustain another loss? I would say no.

Recommendation three raises an important issue for public debate and regulator consideration. This portion is well-intentioned, but still a grandiose undertaking. The challenge continues to be consistent and quality execution by a multitude of audit teams that span across the globe.

The accounting roles have become very complex. Perhaps the focus should be on how these large firms perform their own quality control and quality assurance, so that under or over auditing is identified through self-awareness versus the regulatory oversight of specific audits.

An important concern in the global market place is that U.S. listing companies are over-audited and endure, in certain instances, needless costs. Any measurements should include determining how firms can control this increasingly costly problem.

While enhanced disclosure is a fitting objective, defining a set of metrics as indicative of a good audit, could in the long run prove counter-productive. We would hate to see an audit industry that tried to manage itself toward some set of pre-conceived metrics that may sway them from the good goals of serving investors and alleviating them of their professional responsibilities.

And with that, with time, I think I will give up the mic. Thank you.

CHAIRMAN NICOLAISEN: Thank you very much. This panel is definitely on time. Kurt Schacht, is the managing director, Center for Financial Markets Integrity at the CFA Institute. Kurt, thank you for joining us.

MR. SCHACHT: Thank you, Chairman

Nicolaisen. Can you hear me okay? And thank you to the Committee for having us in. We're with the CFA Institute which is the organization that administers the CFA Exam, the Chartered Financial Analyst Exam. We have 98,000 members around the world.

The recommendations of the Subcommittee on Competition were of great interest to us for a couple of reasons. First and foremost, this is a topical area; increasing competition, reducing concentration. It is no small task to undertake. I think probably Alan remembers when we talked about this at the small issuer committee at the SEC in terms of capacity to take on Sarbanes-Oxley 404 work.

So, we've talked about it even back then and I think we've struggled with this notion of increasing capacity and skills of audit firms beyond the top tier. Even after all the work, I think all the input and discussion here, the six recommendations I think we've still struggled to fully hit the mark in terms of trying to increase capacity.

Second, as professional analysts, there are a few things that are more important to us than the quality and reliability of financial reporting. And that quality depends on two things. A review depends on the quality of the accounting standards, but the companion piece of a high-quality public company audit practice. So very important issues for us.

In our written comments, we track your six recommendations. Allow me to embellish just a couple of points here. First off, I don't know if your numbering is any indication of your ranking of importance, but we would say that in our book, number six is really tops.

To us, and again, this might not get necessarily at the capacity issue, but it's key to have an independent regulatory oversight of this profession, particularly as financial reporting standards are globalized and begin to converge, having some level of rigor and consistency in overseeing audit practice that is really the purview of a network of PCAOB-like organizations.

Rather than just PCAOB coordination with weak examples of audit oversight, a network of country PCAOBs, if you will, with consistent standards, monitoring expertise and enforcement capabilities. So, we like number six a lot.

Recommendation one, I think a key recommendation as it relates to concentration and capacity. Making sure that public companies can efficiently change audit firms for service reasons or for cost reasons and that there not be artificial barriers in the way or financial penalties put in the way.

We noted in our written commentary that the PCAOB should confirm that where audit firms are changed, that the predecessor firm is not playing games in terms of charging excessive fees to reissue opinions, or to produce work papers or information for the successor firm, or to deal efficiently with that.

We hear that that's a growing issue and the PCAOB is certainly in a position to look into that. And I think this really does get at the issue of the practical problem of getting second tier firms into the mix, making sure that it's cost-effective and efficient and the least disruptive.

I would also just make this comment about the switch. I think many companies are under the impression that investors demand only a brand name firm, otherwise they are less attractive to investors. We are planning some additional survey work on that point. But investors care really first and foremost about the quality of the audit.

The brand and reputation do have some weight, but they want the quality of the audit. And we know that quality exists much more deeply than just the Big Four accounting firms out there.

We like the recommendation of having small firms raise their profile to involvement on significant committees. We think that's important.

We also mention that smaller firms can strengthen their recognition by participating in the consultation process and doing consultations on the technical consultations put out by global regulators and raising their profile and bolstering awareness of their firm in that way.

With respect to recommendation two, we were a little bit confused by this. Because we think markets and investors already expect that the PCAOB is, as part of its on-going examination process, looking at key risk areas. So, we hope that that is already happening. And I think what's really being asked for here in number two, is an even more proactive effort to look over the horizon, anticipate emerging issues, and look at those in more detail and ask questions before the storm.

Number three, again, I'm not sure that this directly gets at capacity, but we love recommendation number three. It is no easy task, obviously to create key indicators of audit quality, but we have provided in our written testimony for you, some of the indicators and disclosures that our members and investment professionals thought are in fact reflections of a higher quality and more useful audit report. So they're there for your perusal.

We look at things like, specifically indicating the highest risk areas of the financial audit and the report and looking at some of the biggest changes in that risk profile.

Number four, very quickly, clearly again an issue that I think everybody wants to be on the same page with, everybody knowing what is the proper auditor independence standard. And I think more importantly for investors, and one thing that we might add to this recommendation is that investors want to make sure that infractions are detected and enforced in that regard.

And of course it strikes us in reading number four that rather than just compile the existing independent standards into a single document, that we would work towards one standard. We would eliminate the minor, inconsequential differences and settle on a single standard, nationally. And I think this is the entire point of the discussion about rationalizing regulation and reducing the burden.

I'm not sure why audit firms really need to have to check into three different rule books. And this may sound simplistic or naive, but you know, if we really are serious about this rationalization process, if we can't find and fix something here, what will we end up fixing?

Finally, with respect to number five, I already mentioned number six, the comment that we would make here with respect to number five is, are we simply reinforcing just window dressing? Today shareholders as a matter of routine without much information, simply blindly mark the proxy ballot. That's not really the company's fault.

Maybe it's some fault of the shareholder because they're not quite informed in these decisions, but the question is, even if you gave the vote, without better information, it's completely an uninformed ratification by shareholders. And if that's all that's desired, then that's fine.

But what we say in our written version is that in order for this to become meaningful, it has to be including these audit quality indicators so that they're developed and they're actually disclosed as part of that process as you outline in your recommendation number three.

I believe one of your Committee members has actually spoken on that specifically. So we think that's the missing piece, that an informed decision requires that, that it requires better information for shareholders. And if it's not the shareholders, then at least the audit committee in particular. Are audit committee members for, are they given, are they entitled to enough information about the regulatory background and the financial viability of the firm, and so forth.

So, your Committee has done -- your Subcommittee has done wonderful work. We thank you for the opportunity to talk to you today. Thanks.

CHAIRMAN NICOLAISEN: Kurt, thank you very much. This does sound like an easier discussion than we just had. But I'm probably missing something, so. Let's turn it over to our subcommittee chairman Damon Silvers.

MR. SILVERS: Thank you, Don. Clearly we must have forgotten to invite somebody for this discussion.

You know, it is -- it's nice to hear, I think, such a distinguished and diverse panel be so sort of generally positive. And those of us who worked on this are very appreciative. You know, I think part of -- and I should also say that you know, from the investor perspective, we're very fortunate to have two such, I think, distinguished and respected investor advocates as Mark and Kurt here with us today. Many of us, I think, have looked to them for guidance on a variety of things over time.

The panel's discussion seems to raise a question that I sort of want to put back to you as a group. And I think maybe Ken framed it in a way when he talked about his concern that a shareholder vote on the auditor as a universal standard today, I think it's about 70 percent of public companies, that as a universal standard, it might detract from our recommendation, the kind of direction that we want to try to grow the, kind of grow the marketplace here, grow the effective competitors for larger and larger capitalization companies.

Read together with the other recommendations though, I would like to, the panel maybe to respond to the extent that each of you haven't already, to the question of whether that's really true. Will investors sort of irrationally or destructively look away from smaller audit firms, assuming that we have the disclosures of any deals that anybody's made to restrict them, assuming that we have the metrics, the quality metrics being disclosed and that they've been thoughtfully designed, and assuming that what we're talking about when we're talk about auditor ratification, that shareholder ratification is that, ratification.

Not that we asked the shareholders

to nominate an auditor. But that the choice of the audit committee is voted on, is confirmed by a shareholder vote, is that going to push from the perspective of competition, in the wrong direction.

And then secondly, the second question I have is related to this. And I think it really takes off of Mark's entire presentation, which is I think, very wisely to remind us of the very serious costs, both from a social perspective and from a direct investor perspective, of undermining audit quality.

And I think it's a very nice, concise little study of that. Mark, you concluded by saying that we ought to be attentive to having, you know, vigorous competition for audit services in order to ensure that we keep that premium to a reasonable level.

And it's interesting there, just as an aside, there's another way to think about that which is, sort of the fraud discount the market lays on to earning sort of cash flows. Which is in a way a little more intuitive, I think, way of saying the same thing that you said.

But your point about competition being the critical, the critical -- the critical sort of protectant against that. Some of us on the Committee wrestled with this in light of the sort of principal agent problem that exists in the selection of audit services and our desire to have competition be driven by audit quality, and not by other things.

And one can imagine some rather destructive other things that could drive it, given the principal agent problem. So, any reflections on that set of questions as well would be helpful.

Before you answer these two questions, I want to make a couple of comments, just notes on concerns you all expressed that maybe weren't obvious in the draft.

One, is that we looked, we spent a lot of time looking at the -- we spent a lot of time looking at this question of could you consolidate independence standards, right. Not just print them all in one place, but actually have a single standard.

And the fundamental problem with that, assuming that from an investor and public policy prospective that you don't want to weaken auditor independence standards. The fundamental problem is that the AICPA standards govern both public and private entities and that there are a lot of good reasons why you don't have as strict an independent standard for private -- providing audit services to private entities as you do to public entities.

And given that, when you try to push them together, it represents a lot of pretty profound obstacles. And it seemed to us sort of beyond both our ability and we thought the ability of the policy process was at this point to do that job and get it done right in a way that protected investors.

I don't think that -- and I thought it would be useful that you have some sense of why things came out the way they did. The -- I'm not sure there's any other matters of that sort that came out. No, I don't think so.

Let me again express my appreciation to the panel. Very helpful comments, very thoughtful and we're certainly going to be watching closely and perhaps you could address the questions that I posed, if you remember them now that I've been talking.

MR. ANSON: Perhaps I'll start. What's fascinating if you look at the third page of my handout, which was the graph of the Equity Risk Premium, and I talked about those accounting scandals that we all remember from 2002. When you think about those scandals, there was really only a handful, six, seven, eight.

Yet, a handful of those scandals raised the Equity Risk Premium across the whole stock market. This is the forward Risk Premium for the S&P 500. All 500 companies in the S&P. So a handful of companies with their accounting scandals really did wreck the Risk Premium and erode stock market value broadly.

So when we think about competition within the accounting and auditing profession, what happened in that instance is, investors were discounting the financial statements that were produced by all public companies and audited by all auditing firms.

Collectively, the accounting firms were thrown in to the same basket, even though there was only a handful of audit frauds out there. So, when we think about the competition, we need to figure out a way that one gets back to the oversight, so we can ensure that that competition is a fair game.

There was a suspicion back in 2002

that the accounting firms, if not in fact were colluding, they just couldn't be trusted collectively. At least there was a point in time when the stock market reacted so violently, that they just didn't trust the financial statements that were being produced and the audits with regard to those statements, regardless of whether it was a Big Five firm or a small accounting firm.

So I think when we think about this agent-principal problem and we think about competition in bringing smaller firms into the fold, what we really have to ensure is that their audits are effective.

And that if there are further accounting scandals some time in the future, and there will be, sooner or later there will be another one out there or two or three, we have to ensure that that taint does not broadly brush against the auditing and accounting profession. And that's the key thing that I was trying to raise, and trying to embed by giving you a data point for.

MR. GERDTS: Damon, if I could add a couple of points from the perspective of a large firm. One, I think that our experience has been while there is concentration, there is also competition.

And one of the things that I would not want to lose in discussing shareholder ratification is the view that one of the best things, in our view, that happened through Sarbanes-Oxley, is the elevation of the audit committee as the client.

And in my experience, audit committees go through a very in depth process in this competitive process of selecting an auditing firm. And it often is driven by issues like industry expertise, international coverage, where your resources are, who is the partner that you have available, or who are the key members of the team that you can put on that audit.

From our standpoint, that is still

where the primary decision making should occur. And that process often takes several weeks, if not months. And as I say, it often involves several firms and is a, I think, a very competitive process.

We often view the shareholder ratification vote as much a vote of confidence in the audit committee's process, and their decision on who to select as the shareholder actually deciding whether it should be Firm A or Firm B. And I would not want in this process to lose that aspect of things.

MR. KAPLAN: This is Mr. Kaplan on the phone.

CHAIRMAN NICOLAISEN: Yes, go ahead.

MR. KAPLAN: Good. Obviously, I can't see you, I am struggling a little bit with the reaction, but I do hear a real conflict, and I think it needs to be brought to the attention of the subcommittee.

One is that there is a real

concern, a justifiable concern, that an audit failure, a serious audit failure, it could be catastrophic. The addition of competition in that environment is neither a plus or a minus. It's difficult for anyone to ascertain whether a smaller company is more or less viable than a larger company. And by the way, there are six major accounting firms, not just four.

And at the end of the day, there's probably adequate competition among those, although since I'm not an auditor, I can't really comment directly on that. But usually, six competitors in American place of this size would not be unusual.

Secondly, the more important issue is, that – it’s the quality of the accounting. And that begs a whole different issue which is in conflict with the statements that I just heard.

What would be the rationale for not providing the audit committee's information with respect to the hiring of a particular auditor. They've gone through this process. I believe it's a very deliberate process. But that process is not shared with the shareholders.

There's a big distinction between the shareholders voting on who the auditors should be, and the shareholders being aware of the process and the decisions that were involved in the selection of that auditor.

And I strongly suggest that more disclosure and greater transparency would increase the shareholder's comfort in respect to the auditor selection. Thank you.

MR. GOLDMANN: Again, if I could hitchhike on what Chet said vis-a-vis the audit committee. I think that's the greatest change that I've seen in my 38 years in this profession in auditing public companies, is that the, with the advent of the audit committee, the rules changed.

We were no longer hired by the

client, if you will. We're still hired by a client, but it's the audit committee controlling the process. And at that point, the audit switched, the power base, if you will, switched over the auditors as opposed to the company calling the shots.

Maybe that's a little too far fetched, but, vis-a-vis the shareholder ratification, one of the concerns that I would have would be, what would happen if there were a dismissal in the middle of a year, after the shareholders had ratified a change in accounting firms, or in fact, ratified an existing accounting firm. Would that require a re-ratification?

Typically what we've seen, is that at the annual meeting, that's where the ratification takes place. And I certainly echo the comments of the previous commentator that if there were more disclosure in the proxy possibly of the process that the audit committee went through, and then maybe a request for ratification, that could make sense.

But actually giving the ratification process to the shareholders, that's where I would have, find it to be a little more difficult -- I'm sorry, not the ratification, the actual approval.

MR. SILVERS: I just want to be clear here. So, really, your concern would be if we kind of made the shareholders the nominators and the initial pickers. I don't -- that's not the meaning of the recommendation. I don't think anyone intends that.

MR. O'MALLEY: But there still is a point here that if the shareholders choose not to ratify the selection, that event would create a bit of turmoil and I would dare say, introduce additional risk. Because you'd have to hurry up, try to get somebody on board, especially if the company has, you know, some level of global complexity associated with it.

So, I do believe that the transparency, or perhaps, you know, some best practices or an ISS score for an audit committee on what they did in order to select them. But I do believe being on the inside and having to live with the change, that you know change for change sake isn't necessarily good. There should be some sound, valid business drivers for that.

MR. KAPLAN: This is Mr. Kaplan again. I think it’s important to recognize that 70 percent of auditors are ratified right now. So, I don't know if that's such a dramatic change. I think the issue really boils down to disclosure and allowing investors to recognize what the process looks like. And if they're not satisfied with the process, have the right to vote against it and it would be highly unlikely that they would unless there was some reason to do that.

So, again, I think disclosure is one way of raising the bar for auditors and relieving them of these catastrophic events that often times are a function of non-disclosure.

CHAIRMAN NICOLAISEN: One quick question. Mark, I believe you have to leave at 3:45, which is not far from now. And so I'm going to break just for a second if anyone has a burning question that they really want to direct to Mark.

MR. SILVERS: Don, I'd just like to make a request for them to think about and respond in writing too if they feel moved.

CHAIRMAN NICOLAISEN: Sure.

MR. SILVERS: Several members of our committee have raised, since this draft was released, the question of our addressing the interaction between the increased internationalization of the profession and the regulation of the profession, or the potentially increased internationalization, IFRS and a variety of other issues.

The impact of that on competition

and on our, particularly, on our recommendation one, it strikes me that that's quite a relevant question and I would invite the panel -- I'm sure you're not prepared to do that now, I'd invite the panel to, if this is a matter that interests you, to please send us as extensive comments on it as you think would benefit us.

CHAIRMAN NICOLAISEN: Anyone want to address a question directly to Mark? If not, we'll continue down our process. Mary Bush.

MS. BUSH: Thank you Don. This question is for Charles. You made reference in your statement to indicators about audit quality that have been, that are envisioned by the Chairman of Pricewaterhouse. And we had a panelist earlier this morning, she's a professor at the University of Tennessee, who also in her written testimony, commented on indicators and what they should looked like.

And she has suggested that key

indicators of audit quality that should be disclosed would really focus more on output. She called them output indicators. And I wanted to get your comment on some of the things that she listed. She said, you know, indicators that tell you how, that perhaps there have been fewer frauds based on the way that a particular audit firm audits. That there are fewer restatements. That there is more accurate reporting pre-bankruptcy and less earnings management.

I wonder if you could comment on those and perhaps also on the ones that are envisioned by your chairman.

MR. GERDTS: Certainly. I think ultimately what we would see in the recommendation, the reason we're supportive of it is, that ultimately as is true with Article 40 of the 8th Directive, you would end up with a mix of the so-called output items and therefore the input items.

And I think that questions such as

on the input side, some of the things Mr. Nally discussed when he was here, related to things like partner turnover, staff turnover, investment in training, all -- risk management policies, governance processes, all the things that would tell you something about the firm's management of its practice and how it is trying to direct it towards quality.

I think that to the extent that the PCAOB and others wanted to look at things like the incidence of restatements as an external output, I think that's certainly the kind of thing that could be considered.

I think you get into -- when you get into things like earnings management, you probably introduce an element of subjectivity that's going to make it more difficult to use as a comparability standard.

MR. KAPLAN: I'd like to weigh in on that. This is Mr. Kaplan again via phone. Just as a matter of course, we, as part of our analysis, we actually have created an SEC fraud database, by the way Stanford Research has a fraud database. And a fraud database is certainly one way of looking at an output that is clearly critical in respect to catastrophic risk.

It should be pointed out there are approximately 30 SEC indictments per year that relate to accounting issues. So there’s a relatively small sample, but certainly worthy of looking at, and, as a matter of fact, the document that I passed out is a pretty strong indicator that those frauds are disbursed pretty evenly among the top six accounting firms.

But it is a wise idea to look at restatements and even class action litigation in respect to accounting issues. So these are outputs, these are a measure or indicator of potential problems and there are tools available to look at that, those kinds of metrics intelligently and, of course, we certainly support that.

CHAIRMAN NICOLAISEN: Right.

MS. BUSH: Next question is to Brian O'Malley. And this is a statement that was made with regard to structural changes to firewall the damage, I think in relationship to our internal mechanism, external mechanism, when a problem arises. Could you expand on what you would mean by structural changes?

MR. O'MALLEY: I'm old enough to remember at one point in time CPA firms were personally liable before LLPs and LLCs for the quality of their work. And you know, you have to wonder if there is perhaps a way to create zones of partners or some practice. Another way to perhaps achieve better accountability is to have some capital requirement of partners so that they have a little more skin in the game.

But it just, you know, on one level, it just seems unfair. Maybe it's not, you know, politically correct to say that Arthur Andersen, but there were a lot of very good partners at Arthur Andersen who got dragged down because of one rogue unit.

So, it would be interesting to sit down and see, based on other financial regulatory structures like you have in banking, if there's a way to put up some more ring fencing, or firewalls around that.

CHAIRMAN NICOLAISEN: Mary, any others? All right. Rodg Cohen, are you on the phone? No. All right. Ken Goldman. The other Ken Goldman. Not on the phone either. Rick Simonson. All right. We've exhausted Damon's committee members.

We'll now open it up to questions from, or comments from the rest of the Committee. I can tell they're wearing out. Lynn.

MR. TURNER: Charles, a question for you, and to Ken as well. Do either of you provide quarterly or annual GAAP basis financial statements to your partners?

MR. GERDTS: At

PricewaterhouseCoopers we do not. We provide periodic information to the partners and they also obviously have direct access to management. They comment on what they would like to see in those reports, but they are not GAAP financials.

MR. GOLDMANN: At J.H. Cohn, we provide an annual GAAP basis financial statement to the partners, and we provide, on a monthly basis, the metrics that can get the information to the partners should they desire it. We are a cash basis operation, so cash is much more important to us than a GAAP basis financial. However, that information is provided on a monthly basis, absent of course, the footnote disclosures.

MR. TURNER: Kurt, you talked about getting to a single set of independence standards, and there are as Damon mentioned, differences between, or at least perceived differences between public versus private versus governmental entities.

If you went to a single set of standards, would you -- to get to a single set of standards, would you support permitting, for example, services that are currently prohibited by SOX, or broader business affiliations such as is permitted for private companies or other entities?

MR. SCHACHT: In the private context?

MR. TURNER: No, in the public company -- it's permitted in the private company context. And the question becomes, would you water down -- another way to put it is, would you water down the current public company independence standards to get to a single set of standards?

MR. SCHACHT: That's an interesting question. I don't know the answer to it and those are the sort of things that we'd probably like to poll our members on.

MR. TURNER: Okay.

CHAIRMAN NICOLAISEN: Lynn, any

others? No? Barry.

MR. MELANCON: Chet, you said you had some comments related to the previous discussion if someone asked you.

(Laughter)

MR. GERDTS: Yes, I do. The one thing I just wanted to add is probably because there are relatively few of us who have actually had the experience that you earn as the general counsel of one of these firms.

We are really talking about a segment of our portfolio when we talk about the litigation. And for example, when Damon Silvers was describing the normal way in which litigation operates, and sometimes you decide to try a case, and sometimes you decide to settle a case. And you look at the positives and negatives.

For a significant portion of our portfolio, in terms of the number of cases, we do that. I mean, in the five or six years that I have been the general counsel of PWC, we have put five major cases through trial. We won three of them at a jury verdict. We settled the fourth one on the day when the other side that the jury was coming back after about 20 minutes.

(Laughter)

MR. GERDTS: And they wanted to settle immediately. And we lost the fifth, and that's now on appeal.

Those cases ranged in amount in controversy up into the hundreds of millions of dollars. When I look at the portfolio piece that creates the catastrophic risk, we don't get to make those decisions because the information that you have demonstrates why.

I simply can't go to our management team and say, this is a good case. We have a good audit record. We have a one in ten chance of losing, but the amount at risk is $10 billion. I just can't do that.

And so that's the piece of the portfolio that creates the risk that we're talking about. I just wanted to add that, what I know is anecdotal, but is real life experience.

CHAIRMAN NICOLAISEN: Bob Glauber.

MR. GLAUBER: Thank you, Mr. Chairman. I wanted to ask Mr. Schacht a question from the perspective of his financial analysts group. You spoke very favorably about the value of metrics of audit quality. As you think about, as this Committee is discussing, making available publicly and obviously to your analysts, audited financial statements, would that add measurably to the information they have? Would they find that, as an addition, useful and if so, how?

MR. SCHACHT: I'm sorry. Say that again? So in terms of?

MR. GLAUBER: You were talking about information available to financial analysts.

MR. SCHACHT: Yes.

MR. GLAUBER: You talked about

metrics of audit quality as proposed by the Subcommittee. We are also discussing making available publicly, therefore to your financial analysts, audited financial statements of the audit firms. Would that, as an additional piece of information, hold a great deal of value to them, over and above those metrics of audit quality?

MR. SCHACHT: I'm not sure. I think first things first. I think what we'd like to see is audit quality standards for public companies and then we, you know, to the extent that that is something that also gets into the debate about the financials that are provided by auditing firms, then, you know, that's a little bit different analysis, I think.

CHAIRMAN NICOLAISEN: I actually think Bob Herz was next.

MR. HERZ: I guess this is directly probably to Brian and Kurt maybe. I was actually in Russia over the weekend, actually with Sophie. And part of that group, there were senior, very senior officials from the New York Stock Exchange and from NASDAQ. And both of them as I remember, quoted some recent studies and statistics that said that a listing on, you know, either NASDAQ or the New York Stock Exchange, would get a company a 25 to 30 basis point on average premium over a listing in other major world exchanges, including for example, London.

And so I'm mindful of Mark's kind of macro analysis there on the Equity Risk Premium, but taking this other statistic and thinking about applying that, and analyzing that to the U.S. environment versus the foreign environments. I mean, they at least attributed a lot of that to better listing standards, better legal framework, better auditing, better accounting standards, all that.

And so, I'm kind of interested in, of course, people were in a marketing mode there. They were trying to sell listings to foreign groups broadly. But whether or not it's possible to as we think about just the auditing aspect, to dissect those things like the litigation, like you know, you mentioned, Brian, we wouldn't want people to be over-auditing, things like that.

So you know, whether there are pros, cons, that add to that, the pluses and negatives that add to that overall listing premium that people get.

MR. O'MALLEY: I happen to believe there is a premium. I don't know if it's 25 basis points, what it is. And if I am an investor, and I would not myself invest in a few venues that I won't name, I would like to invest here where you know you have audited financial statements. You do have Sarbanes. You do have tort laws.

But personally, I am -- I was surprised when some of the material deficiencies came out with Sarbanes that there wasn't a discount applied to those companies. That the market place and the investors reacted rather lethargically to some of the data that was coming out.

That being that we, you know, we have a venue here that we list, you know, hopefully the listing companies who ultimately make the decision, will see that premium and make the right decision.

CHAIRMAN NICOLAISEN: Gaylen Hansen.

MR. HANSEN: I started my career about 30 years ago with one of the big eight CPA firms in Los Angeles and Charles, this question is directed to you.

I was in the regulated industries group back then. And not all of the regulated companies that we audited were public. Many of them were private. It -- and as a member of this Committee, I'm an audit partner in a small firm, but I'm also a regulator because I represent state boards of accountancy.

And what I'm trying to square up with, and at your invitation to address other issues outside of the particular subcommittee that you were asked to testify on, it seems to me that at some point, and in your materials, you talked about proprietary financial information.

With the advent of Sarbanes-Oxley, we're a regulated industry now. So how do you square up what is proprietary and what a regulator should have access to. That's kind of what I'm struggling with a little bit here.

MR. GERDTS: I understand. And I don't want to be misunderstood. We probably have two PCAOB inspections going on at PricewaterhouseCoopers right now. And we do support the idea of, and I can't think of an instance while I've been the general counsel, that a PCAOB inspection team asked us for information that we didn't provide.

I think the issue, and we're fully supportive of providing to the PCAOB in the context of their regulatory function, whatever it is in the firm that they need to see.

I think where I think the debate is, is should the firms that don't, as the questions have indicated, currently prepare GAAP financials, go ahead and do so. And then secondly, where do those financial statements end up.

I think the question comes down to, for a group looking at audit quality and sustainability, how have you furthered either of those goals if you decide to go to the point of recommending public disclosure of GAAP financials.

CHAIRMAN NICOLAISEN: Rick Murray.

MR. MURRAY: Mr. Gerdts, if I heard correctly in your testimony, as you were trying to meet our time requirements, you very briefly said that your firm is doubtful about some of the recommendations in the preservation and rehabilitation recommendation. Could you give us a quick sense of two things? Do those reservations go to the efficacy of the ability to achieve the objectives sought, and as a kind of net assessment of the recommendation, do you view the recommendation as one that has overall value, or one that you would prefer not to see adopted?

MR. GERDTS: My concerns are primarily related to efficacy. I think that as we have done things like scenario planning within our own firm to think about what would happen in the context of a crisis like this, whether it was at our own firm, or importantly at one of the other firms, we are constantly running up against the idea that if, for example, in the recommendation you got to stage two of the external governance mechanism, I am very concerned about the ability to keep people, clients and a global structure in place.

And my central point is, I wouldn't think that this Committee should think, well, problem solved. You know, we have a way to keep a firm on life support, and therefore, we don't need to deal with the underlying root cause. That's my primary concern.

Having said that, I don't feel so strongly about it that I would say that the recommendation should not be made because I think it's sort of a chicken and egg situation. Unless we deal with catastrophic risk and its root causes full on, we ought to explore whether a mechanism like this would work, even if you assign it a low probability of success.

CHAIRMAN NICOLAISEN: Damon. You could put it down.

MR. SILVERS: I've been doing this all day. It kind of wears on you. Just -- I wanted to note two brief things in relation to the very helpful and thoughtful commentary of the panel. And I appreciate being given the short time to do so.

One is, Charles, I think and since

we're on the record it was important. This is a thing, what's on the record, it's important to be clear here. You sought to respond to a comment of mine to suggest that I was saying that I didn't think that you might be in a position where the size of a liability would affect your decision-making.

My comment wasn't to that. My comment was that I can't imagine a situation in which someone managing a litigation portfolio would view that if you try one, you try them all. And I think your testimony was exactly to that point. You try some, you don't try some.

And in fact, a prior witness suggested you try one, you try them all. I just don't buy that at all, and I think your testimony supports my conclusion.

To what you did say, I should say that I think that the size of any claim affects one's ability, one's willingness, or is part of the calculation around a settlement. The notion that we ought to make it impossible for a claim that would survive a motion to dismiss and summary judgment in our current legal system, the notion that we would try to block that dynamic from occurring on that claim, I find real troublesome. We don't need to debate it further, I just want to be clear where I stood.

Secondly, and this is actually sort of related. I don't think there's any question but what a firm that got to stage two, right, of that recommendation, would be a firm in very dire trouble. And that if you were formally in stage two, and I've had this discussion with Chairman Volcker, I don't know if he's still on the phone or not, in terms of his sense of how this mechanism might have worked and done valuable things in the context of the Andersen situation.

No question, if you're at stage two, and you're at stage two formally, that the good options may be kind of limited, right, to put it mildly.

I think the Subcommittee sees this mechanism, and I'm not so much responding to your comments now, just sort of generally, hopefully adding to the conversation, I think the Subcommittee sees this mechanism as a way of providing a series of options which would interact with each other and that would lessen the chances against a background of an audit firm having been involved in something that fundamentally undermined the public, the regulators', investors' confidence in that firm.

You'd set up a set of options that would reduce the likelihood of, sort of, damaged our economic fabric, and damage of a kind -- the difference between Chapter 7 and Chapter 11 problems, to use a non-audit firm analogy.

That's what we're trying to do. And I find that your response to Rick's question to be more -- I mean, I know that it sort of leads some place that I may not agree with, but I think your analysis of the recommendation itself is in tune with what we're trying to do. Right?

Which is, in a world in which -- and now I'll stop. In a world in which the actual thing that causes catastrophic risk -- what is the cause of catastrophic risk? It's not -- the cause of catastrophic risk is not our legal regime.

The cause of catastrophic risk is the possibility that an audit firm that is charged with extremely great responsibilities and duties with safeguarding enormous amounts, with safeguarding enormous amounts of money that the public has entrusted to public companies, that an audit firm will fail in doing that in a way that fundamentally undermines the public and investors' confidence and the regulators and the law and so forth in that firm.

There's always a risk of that. We

can't make it disappear. We can minimize it. We can manage it. We can do all these things that I think we've done in many ways successfully since 2002. We can't make it fundamentally disappear.

And given that that's the case, how do we, what do we do to ensure that should such a thing happen, despite all of our efforts, should such a thing happen, we minimize the damage. Not the damage to the audit partners, not the -- but the damage to the system itself.

And I think that that's what we're trying to do here. And as I said, I think your comments are consistent with that undertaking.

MR. GERDTS: They are. And if I could just take one second to respond to that. I think that, you know, your Chapter 7, Chapter 11 analogy is apt. I would say that I don't know of a Chapter 11 that was successful involving a professional services firm.

I think most of the professional services firms have ended up in 7 pretty quickly. And I think they've liquidated because of the adverse selection of people leaving.

The only other thought that I had for your Subcommittee is that you focused on the rehabilitation efforts involving the firm that's in the spotlight. But I do think that it's important for a Committee concerned with sustainability of the profession, to consider what happens at the other three firms when another firm is caught in something that's going to end up in its demise, or potentially.

And don't partners and staff who are very often, have a non-diversified investment in the profession and in that, one of those remaining firms, do they then make a different decision about what they do? Because the only other thing about the recommendation that occurred to me is, did it take into account a domino effect and the adverse selection that could occur at the other firms as some of your leading engagement partners say, I'm done with this.

Because as we all know, the leading engagement partners in the audit practice are the people who are going to be most desirable, and therefore have the most opportunities to go into things like industry. So I do think that one of the things, one of the reasons I assign a low probability of success to that is because of the ripple effect.

The only other thing I would want to debate with you, and I recognize that this is probably not the time and place, is, and I've heard it a couple of times today. With all due respect, we sort of posit the bad conduct, and then presume what the consequence should be of the conduct.

And one of the points I would make to you is that because of the nature of an accounting firm acting as an agent, the event that most often puts the firm into the public light in a negative way is derivative. It is an issue that has arisen at a client. And it's very often very difficult to get out the story of what the accountant did or did not do, particularly in that hysterical moment when people are considering some major corporate problem.

And so I would just -- I think it's, you make the question more difficult, I recognize, when you think about, well, how are we going to actually assess the auditor conduct in that period of time. But I do think you have to do it if you want to actually be intellectually honest about this. I'm not suggesting dishonesty. I'm just suggesting that you can't overlook that issue.

CHAIRMAN NICOLAISEN: Gary.

MR. PREVITS: I guess I would like to make some observations there, legacy observations. I have a very serious hobby in the area of the history of this profession. And just as after 160 years Western Union stopped carrying telegrams, or sending telegrams a few years ago, there's still the money order business, but they're out of the message business.

That doesn't mean that communications are unnecessary, it's just that the technology has changed. I often wonder if we aren't trying to fix a business model for public company auditing that is not subject to being fixed. It might be sustainable, but I'm really wondering if you started with a blank sheet of paper whether we'd be organized the way we are today, if we could start with a blank sheet of paper. It's just an overwhelming thought.

It was kind of instigated by Alan's comments about thinking five or 10 or 15 or 20 or 25 years out as to where we need to be in a position of, if you will, owning the information processes from the world capital markets as opposed to them residing in another environment where it might not be to that national sovereign interest to be so influenced.

I don't think federalization is a good option. I don't think it's a possibility. Right now, I think we have essentially a federally-sanctioned cartel. And that's the reality of it. And we're working out what that means. That's just a personal observation.

But how else in the world can you get 12,000 plus public companies audited within 90 days of year end, and who else would step up to that challenge? And what high standard do we hold them to? What impossible standard do we hold them to to accomplish that feat?

So, you know, those are just some of the observations I have about you know, the difficulty of trying to make the Western Union model work in the 21st Century.

MR. GOLDMANN: Mr. Chairman.

CHAIRMAN NICOLAISEN: Amy.

MS. WOODS BRINKLEY: Thank you Mr. Chairman. I would just like to comment that I think Mr. Gerdts' comments around sort of looking at the other side of the equation as to what would one of the remaining three need to be prepared for in the event of a crisis at the fourth, and it's, given the relative concentration of the industry, it's very, very important and you know, not unlike financial services practicing for counter-party failures, as something that's very fundamental because of the interdependencies. And I think that is an excellent suggestion.

MR. GERDTS: Perhaps if you have thoughts about what those ideas are. I mean, we thought about chaining people to their desks, but we were told there was a Constitutional problem.

(Laughter)

MR. SILVERS: That pesky Thirteenth Amendment, right.

CHAIRMAN NICOLAISEN: Yes. I think

over the years, some people have thought about that question and I think, at least from my standpoint, the reaction as a profession would not look anything like it does today. There would be a more radical overhaul and that there would be more federal intervention and there simply would have to be a mechanism put in place to ensure that investor interest in attesting to the veracity of financial statements is available.

Thinking about those things is one thing. Publicizing those things is something else. And I think for purposes of this, where we are, as interesting as that is, I'm not sure that that's the place that we ought to visit at this juncture. But I'm always happy to hear from Zoe-Vonna and Lynn and anyone else.

MS. PALMROSE: Well, thank you. I just wanted to add the Committee did actually some, Subcommittee did do some thinking about this issue, including reaction of regulators under crisis situations, including the Japan situation where part of it was the notion that you needed time -- you needed some time to work through these issues.

And so, part of the spirit and intent of this recommendation is really to provide for some time here to manage a problem, but having the mechanisms in place in advance to do so.

So, I think all of us have recognized that in a difficult situation, it's sort of hard to manage without any signposts in place. And it's trying to use existing, use history, or recent history, to work with, as well as having some recommendations that would be helpful based upon that.

CHAIRMAN NICOLAISEN: Lynn.

MR. TURNER: I just echo what Gary said. I think we have now created, by allowing all these mergers, a federal cartel. And any time you create a federal cartel, you, in essence, privatize reward and socialize risks to some degree.

And I think when you do that, you need to understand that you're outside of a normal regulatory environment. And things like you've recommended in the Subcommittee with respect to the trustee, while I hope we never have to go there again, because I think another firm would fail if they ever have to implement it, I certainly think you've been thoughtful and got some good ideas on a piece of paper on that.

But I think it also stems over to the issues of governance and transparency. And this isn't just about, simply about audit quality as someone would leave you to believe. This is about regulating a federally-mandated and authorized cartel. And that's a different situation that we now find ourselves in than we were in, you know, 15 years ago.

And I am, I really disdain the notion that we've now got ourselves into a too-big-to-fail notion. And that's where we're at any way you cut it. It is, people say, and you can't argue with them, that if you lose one, that's not a good thing. And that's by definition too-big-to-fail.

And when you're in too-big-to-fail, you've got problems. And you can't, market forces no longer work in that scenario then. Because if you let market forces work, which you hope would be the system, that means when a firm got in trouble, and put out poor quality audits like Andersen did, they should go away because the market moves away from them and moves to someone else.

And you'd like to have a system where that type of market regulation works. That's, from my perspective, by far and away the best. And then you don't have to worry about it. But we no longer have that system. And that's gone by the wayside. And so, we're in the too-big-to-fail federal cartel. I couldn't have said it better, Gary. And that brings on new need for regulation.

CHAIRMAN NICOLAISEN: Kenneth, you wanted to make a comment.

MR. GOLDMANN: Yes. And I apologize for taking the Committee's time as well, as this is probably a lot more mundane than the topic we've been talking about over the last 15 minutes.

But earlier when we talked about some of the key indicators of audit quality, I'd like to caution the Committee that restatements are really a double-edged sword. And to tread very lightly on whether or not that's a key indicator of audit quality. Because, you could have an environment where a successor firm uncovers something that was wrong, requiring a restatement. And the successor firm might get charged with a ding, if you will, on audit quality because one of their registrants had a restatement.

But in addition to that, and that could be controlled, but in addition to that, you could create an atmosphere where firms and individuals are opposed to restatements, vehemently opposed to restatements, to the point where, again, in a successor situation, you could have a firm of our size going up against a Big Four firm. And the Big Four firm simply saying, We're not restating. You don't like it, re-audit the prior year, because of the key indicator of audit quality.

So, I just caution to be careful of that.

CHAIRMAN NICOLAISEN: Other comments. If not, we'll thank our panel. We appreciate it very much, their participation, your input. And we'll permit you to exit. The rest of the Committee, I would ask that you'd stay where you are. We have our final session, which is to consider the Addendum on Firm Structure and Finances. If you want to just stretch for a minute, you should feel free to do that. But if you don't leave the room, I'd appreciate it.

This remains a public meeting.

Anyone who wishes to stay is certainly welcome to do that.

(Whereupon, the above-entitled matter went off the record at 4:28 p.m. and resumed at 4:30 p.m.)

CHAIRMAN NICOLAISEN: All right. We're at that point in the agenda where I think we've covered pretty thoroughly all of the recommendations of the Subcommittee that had been made as recommendations. We now have to deal with those matters that had not reached recommendation status that appeared in the Addendum that all of you are familiar with and which actually occupied, I think, the bulk of today's discussion.

Part of it, Bob will go through with you, and I think will conclude that there are, is in fact some action on some of the things, and then we're left with what is the process going forward with respect to I think the three sticky areas having an engagement partner sign the opinion, which we did not hear a lot of discussion about today, whether there should be federalization of what is essentially some state actions, and then transparency disclosures from the firms.

I would make one comment before I turn this over to Bob, and that is that I think, notwithstanding the commentary that I've heard from the firms and others, I do think there is tremendous value to having audited financial information for the largest firms.

And I say that for a number of reasons. One of which is if they are desirous of some sort of litigation reform, for us to go to Congress and make a recommendation and to say, we don't have any financial information for these firms, but we think this is something that you ought to consider, to me just doesn't have any real appeal.

It may to others, and you know, so I'm simply giving you my expressed view on this. It's similar to Arthur's view. We very, very much feel strongly that for firms that occupy this space, the importance to our market, our capital markets, that are responsible for auditing 95 percent-plus of market capitalization, that to operate without a base line of financial information is to me not acceptable.

That doesn't mean it may not be acceptable to the Committee. But I just wanted to make sure that you understand where I'm coming from. Arthur's in the same place. So, Bob, let me turn this over to you.

MR. GLAUBER: Sure. These recommendations, as you all know, are basically noncontroversial and this presentation will be purely pro forma.

There are four. And my understanding is, we should just present them. Do you plan to have a debate on these this afternoon, Mr. Chairman?

CHAIRMAN NICOLAISEN: No. I don't think we should have a debate on them, unless the Committee has an appetite for a debate today, because there are a number of things that will happen. One is, we will receive more input on each of these. That's good. We should continue to encourage input. I think it's helpful, it's meaningful and you know, that's the correct process.

But what we would like to do is to particularly work through your Subcommittee in the next several weeks, and bring this to a conclusion.   The conclusion could be that there are no further recommendations. That things have been discussed and it would write-up to that effect, but no further recommendations.

Or, the Subcommittee may choose to bring recommendations to the rest of the Committee. The rest of the Committee to the extent that you have strong views, it might be desirable to at least express those through Kristen, or directly to Bob, so that he has at least the benefit of what your thinking might be.

But we're at the point, I believe, where there's not -- we've discussed this for quite a while. We've heard from people who are directly involved. We've had the kind of input that I think is desirable. We don't have everything that we might desire, but we probably never will.

These -- all of these issues have been around for as long as I've been in the profession, and that's a long time. So we can make progress on them, or we choose to leave them to rest as they have been.

MR. GLAUBER: Very well. And I think that's a wise course, because as you know from having read these pro forma recommendations, most of them are in the form of the request for further comment. And they aren't -- having said that, the first of the four actually is a recommendation.

And that is taking account of the ongoing discussion of the expansion of the audit report beyond its current pass/fail character, to call on the PCAOB to undertake a standards-setting initiative to consider various improvements in the auditor's reporting model beyond this pass/fail. So that is in fact the form of a recommendation.

The second, which deals with the engagement partner signature, is simply at this point a call for comment. We are considering recommending that the PCAOB revise its auditor report standard to mandate that the engagement partner signature appear on that report. We haven't reached that point yet, and again, we would request comments from any of you, and of course also from the public. I assume this will get published in the Federal Register.

CHAIRMAN NICOLAISEN: Yes. We'll take a vote at day's end, on what we have. And one of the -- the question that will be before you is whether or not to post the Addendum to the Federal Register. It is already in circulation, so it's more of an administrative task, but it's one that we do officially need to deal with.

MR. GLAUBER: To just complete the characterization of that second recommendation on engagement partner signature, in addition to considering recommending the PCAOB revise its standard to mandate the engagement partner signature, the Committee, the Subcommittee has written, the Committee notes the signing partner should face no additional liability than that under the current liability regime. And we're seeking comment on that.

The third recommendation, or, and it is in part a specific recommendation, deals with transparency. And we've discussed it at some length today. It has several parts. What we recommend is that the PCAOB require that, beginning in 2010, the larger audit firms, those with 100 or more public company audit clients, that are subject to PCAOB annual inspection, produce public annual reports incorporating first the information required by Article 40 transparency report, that information deemed by the PCAOB to be appropriate, relevant to the U.S. situation.

Second, such key indicators of audit quality, in effect as determined by the PCAOB in accordance with the recommendation from Damon's Subcommittee. And then finally, and this is where we ask for comment, the preparation of audited financial reports, but two options alternative.

One is, that they would be created and placed with the PCAOB and that body would determine after broad consultation whether it would be relevant and useful to the public interest to make these publically available. Or, alternative two, that these audited financial statements would just be made publically available period. What we have politely called, yellow light and green light.

And then finally, on litigation, we seek commentary on this issue that has been discussed at some length today by the panelists. And that is whether or not in recognition of the increased federal interest in oversight over the audited public companies, that jurisdiction for certain categories of claims be exclusively in the federal courts.

And also if that were the case, what should be the standard of care under which they are adjudicated. This would again not be all claims, but certain categories, and we asked for comments on just what those categories should be.

So that is where we're at. As I say, we have some firm recommendations that we have brought to you, some really are in the form of asking for further comment. And we are going to work industriously to see if we can refine these to the point where they are not recommendations, or determining where they should be, or if they should be buried eight or ten feet under the ground with other nuclear reactive materials.

CHAIRMAN NICOLAISEN: Yes. Questions, comments, suggestions, encouragements, cautions, whatever appropriate, would be good here.

MR. PREVITS: I was going to ask the, if Mark had comments about one, but apparently he's putting his tent up, so he does. The other question I had for Bob is the 100-firm cutoff for the financial disclosures, what other cutoffs did you consider besides the 100?

MR. GLAUBER: Well, we are very well aware that such preparation of such reports and disclosure of them could impose a burden on smaller firms. We had a great discussion. So we felt there ought to be a differentiation. We thought of this one as a convenient one, a natural one, because these firms are treated differently by the PCAOB.

We would certainly be open to other lines of demarcation. And were that the only concern with this, I'm sure we can get a solution.

CHAIRMAN NICOLAISEN: Rick. Oops, Gaylen.

MR. GAYLEN: I'll go then. In drafting this Addendum, the first item on the auditor's report, I was told that I gave some commentary fairly late in the game for it to be seriously considered just because of the time constraints.

But I really believe that it needs to be expanded to address the expectation gap better than what it is. And I provided Kristen some language on that. I hope it does at least get a fair hearing.

And then the other thing that I think is probably more, well, it's more problematic, but -- and I bring it up very briefly. I've circulated to the Committee leadership on several occasions now, and I brought it up in several of the meetings, I think a significant issue to address, you know, involving the profession today is international. And I'm not sure that it shouldn't at least be given some discussion in this Committee in terms of, well, all of the issues surrounding it.

I don't know if we have time for that, or not, Don. But I think it's a serious issue that really should be considered.

CHAIRMAN NICOLAISEN: I think it has been addressed in a few areas. The context, I think, you've heard, Alan's comments are certainly accurate that we have lost the dominance in capital markets around the globe. We are -- there are, Bob can talk about this, but to my knowledge, there's no one in the world who is saying, let's adopt FASB standards.

We, there's a significant risk that we marginalize ourselves more than we already have. And if there's a debate, I mean, you could have a debate, you know, is IFRS better than GAAP, is GAAP better than IFRS. You could have a debate about regulatory processes around global organizations.

But I think if you want to think ahead 20, 30, 40, 50 years, we either are going to still be a player in this, in the global markets, or we're not. We're certainly, the companies that auditors are involved with are global organizations. It's not likely that that's going backwards, that you know, that there's less globalization.

And so you're going to see I think, increasingly, abilities to do financing in other parts of the world to raise capital through different means than what, than even the public markets.

It's an enormously, emotionally laden discussion because it involves nationalistic tendencies and your world views and all kinds of other things. Is it, does it have some relevance? Yes. Does it impact dramatically the recommendations of this Committee, I think, is really the question that I'd ask you to think about. If you think that we're missing the boat with what we are recommending, then we ought to discuss it.

If we think there's some fine tuning that we ought to do, we ought to talk about that too. But I don't think we want to enter into a debate of global versus U.S. accounting standards, or anything like that.

MR. GLAUBER: Don, if I could respond?

CHAIRMAN NICOLAISEN: Sure, Bob.

MR. GLAUBER: I think it properly frames our consideration of a number of these issues. I was part of a group back in 2006, which still exists, a Committee on Capital Market Regulation, that talked about, and concerned itself with the declining dominance of the U.S. capital markets.

And I think it is a reality. Markets around the world are becoming increasingly important and increasingly strong. And while as you said, all of these discussions are difficult because they engage the issue of nationalism and such considerations, markets don't much care about that.

Markets just roll along. And perhaps as good an example of that as any is the one you just made reference to, IFRS versus GAAP. I think it would be very difficult now if anybody in the United States decided they would try and stop this train and say, what we should do is have one standard, it will be GAAP.

That train moved forward while many people weren't watching. And when they became aware of it, it was perhaps later than one would want to try to influence it. I think that's informative for many of the issues we're discussing. And we ought to, as we discuss them, consider the impact of globalization on the kinds of issues that we're discussing sometimes from a perspective much narrower.

So, I think your point in calling it to our attention, Gaylen and Don, is very, very important.

MS. BUSH: Don.

CHAIRMAN NICOLAISEN: We've got a couple others who have been up, Mary.

MS. BUSH: All right.

CHAIRMAN NICOLAISEN: Let's get Lynn, Damon, Mary, Ann.

MS. BUSH: Thank you. Just on the comments that the both of you just made. It seems to me that if some of those kinds of comments were in the preamble to the report, that it really internationalizes everything that we are doing. And it puts it in a much broader, global perspective than what might seem like narrowly looking at the audit profession.

It really shows how important it is, you know, to the global capital markets to our position in them. So I would suggest that we consider something like that.

CHAIRMAN NICOLAISEN: Great. Thank you. There will be a background section which is in very, very early stages of drafting. So as soon as we have that, you will see that. Lynn.

MR. TURNER: I actually take great exception with what you say, Don, and agree with Gaylen. And I think he's been getting quite frankly, lip service so far on this issue.

It's to me, it's not an issue where you're going to have global capital markets, we as a country and rightfully so for the last two decades, have been telling other countries, go get really good capital markets. And they've listened. And they've done a much better job.

And as a result, they're going to attract a much higher portion of the capital. And when the capital is there, Goldman doesn't care whether they do the IPO in the United States, or in Hong Kong, or Singapore. You know, it's where the capital is. So, those markets are going to grow.

I personally think we have a better set of standards, more transparent today than what IFRS provide. And I again, wish we'd left the two in place and then the capital markets could work out which one works the best and let the market forces pick and choose. I think that's a much better alternative.

But, this administration has chosen to go in another direction. But it does raise then, a very serious question that Gaylen is trying to get on the table, and that is, we have more than four firms doing audits of public companies in this country.

And it is going to be exceedingly difficult for them to make the switch. And how do we help them, or how do you make that switch other than just say, go do it. I think when you go make that switch, I think we're going to see further concentration rather than further competition. And there is absolutely no discussion of that in this report whatsoever. And I think that's highly unfortunate.

CHAIRMAN NICOLAISEN: Ann.

MS. YERGER: I'll just quickly say, I agree. I think that this is ultimately a competition issue and I don't want to -- I don't know where is everyone on convergence. I will say that we're very, we're strongly supportive of it. I think it needs to be done carefully and on a time line that markets, investors, companies, audit firms, everyone involved can accommodate it.

And I don't think we're there yet. And I am worried that if this convergence moves on a rapid pace, the way it seems to be, that it's going to put the smaller firms at a great disadvantage and we're going to aggravate a problem that already exists.

CHAIRMAN NICOLAISEN: Damon.

MR. SILVERS: I want to make two

comments, one about sort of our process, and then one about the kind of very broad sort of strategic and -- issues that have been raised both just now and by Alan in the prior session.

Just in terms of the Subcommittee's process around this. In our discussions, and I think Zoe-Vonna reflected on this earlier a little bit, in our discussions we spent a fair amount of time looking at the international context of competition.

Looking at it in terms of the Japanese experience with a major firm failure, looking at it in the context of, is it likely that a major firm would emerge from a, globally from another country anytime soon, we -- and that would have both, that would have a variety of implications if that were to happen. Although, I think we concluded that it didn't seem, at least immediately, on the horizon.

The questions that I think Gaylen

has posed, we did not look at directly, and we didn't gather data on. And that question being, what is the interaction of a variety of developments globally in auditing and accounting with our mandate around competition.

And there are a set of sort of obvious questions. And I feel sort of, you know, a little responsible for not having raised them earlier. Unless I'm directed otherwise, I think our intention would be to try in the limited time we have to gather whatever data is available, and particularly, I pose that question to the panel.

I would hope that other firms, particularly smaller firms who have views on this would let us know what those views are. I don't believe, I may be wrong, my committee may have a different point of view, but I don't believe that we are likely to try to wade into and resolve as a subcommittee any of the very contentious issues that are around us.

Some of those issues just, that's not our place. But I think that what we would -- I think what we're, what I'm at least interested in, is seeing if there's, if we can at least make sure our report is thoughtful and nuanced around these issues. That's the, I think that's the approach I'm inclined to take, unless others -- unless that turns out not to be not what people want.

CHAIRMAN NICOLAISEN: I think that's -- I think you'll find that in the background section.

MR. SILVERS: Right. So, but at this point, our Subcommittee just doesn't have enough information about different relevant actors' view and concerns here.

I would like though, to add a thought or two about the larger question this is really about. And I think it's not just the question of -- it is not just the question of exactly what process we take here around the Competition Committee, but it's the large -- it's what Alan kind of put on the table earlier in a much broader way.

We have, and Bob pointed it out. People have been talking about this for a while. We have a world in which the relative importance of the United States as a capital market has been decreasing.

But what that is really about, I think any sort of look at the data will tell you, is not so much our shrinkage or anything wrong with us, but the fact that the world's major economies have developed their own markets, and that not surprisingly, Chinese entrepreneurs are somewhat more comfortable listing their stock in a big liquid market where they speak Chinese, rather than one where they don't. And similarly to varying degrees, although it's a somewhat more complicated story, in Europe.

The idea that the United States was going to be the world's capital market, I think, was a mistaken idea to the extent anyone ever really held it. Whether we were going to do so forever, or anything of that nature.

The challenge that I think it present to the United States, and to those of us, so that those of us -- some people in the room who actually are responsible for this, people thinking about strategic considerations for the United States, is a two-fold one.

On the one hand, there's the question of, if we're going to have global markets or more or less global markets, what will the rules, what will the baseline for those markets be. And how do we act in a way multilaterally to get good rules, to get rules that embody both the -- both make those markets effective and also embody the kind of values that our securities regulation systems embodies. The values that we don't exploit people, and fraud is a bad thing, and that kind of stuff, independence.

So, how do you get to the right global, set of global rules. That that's a tactical question in a lot of ways. And there are differences in point of view about tactics. I think Ann expressed sort of kind of the place I'm at personally. And that might be in variance with what some of our regulatory bodies are thinking about right now.

But then there's a second question. And the second question, I think, was embodied by Bob Herz's comments a few minutes ago. Which is, what is the United States as a kind of actor, to the extent we're still going to have, still going to have national markets, and this statement of well, the U.S. is this percentage and so on, and that percentage, is a statement that we're going to still have national markets.

To the extent we still have national markets, what is the United States' strategy in relationship to our national markets? What are we going to be in a world where we're not going to be everything.

And I think that most investors both, by the way, in the United States and outside the United States, are interested in the United States being the high-road player, being the country whose markets, whose capital market representatives can go to a place like Moscow and say that if you're good enough to come here, you're going to get a 20 percent premium. That should be our strategy.

Now, what does that have to do with all of the, with what we're talking about? A lot. Because what we are talking about is a key, is the, is how we maintain audit quality in our system as it moves in a larger, global system, when audit quality is -- it will be a key driver of our strategy.

And in my view, that's what we ought to be doing here. And that the, and then question I think that Gaylen has posed to us is relevant to that, the reality, the political reality that there are different points of view about exactly, for example, how to pursue setting the global standard, is a political reality we live in.

And I'm not sure that this Committee is structured, or has time, or mandate to resolve that issue. I will just point out one thing about it and then I'll stop.

There is a perception, and I think that perception has some merit, there is a perception among investors, certainly among the press, among some in Congress, that the tactical approach to these issues on the part of some of the agencies and bodies charged with them, is fundamentally, has a de-regulatory content to it.

I'm not going to, whether we argue that out or not, it has two, that perception has two consequences. One is, if that's true, it's completely contrary to the kind of strategy I'm advocating.

Secondly, it constrains the ability to get agreement on anything. And it constrains our ability to engage with the very process we need to be engaging in, which is to build that global standard, because there's a lack of trust about the participants in the dialogues in the closed rooms.

And that lack of trust, I think, is, that lack of trust and that perception that a de-regulatory agenda is underway, is actually hurting our ability to engage just when we need to. And so, again, it may be beyond this Committee, but I couldn't resist saying it.

CHAIRMAN NICOLAISEN: Great. Thank you. Zoe-Vonna.

MS. PALMROSE. Thanks, Don. I wanted to ask a question about the litigation proposal to help reconcile it with what Don was saying in terms of the audited financial statements would be a quid pro quo, I think, for some kind of litigation relief or litigation reform. Well, can I just --

MR. GLAUBER: I -- the Committee has -- I apologize for interrupting, but the Committee has not presented this as a quid pro quo. It may be the view of some people, but these are offered as free standing proposals.

MS. PALMROSE: Well, in that regard, do you see this as a proposal that really gets at catastrophic risk? Because it seemed to me that this is one where it might have some possible catastrophic elements to it, but it looks like, from the testimony that we had today, that very little of this proposal would really touch on catastrophic.

MR. GLAUBER: This proposal is offered in the framework that is presented in the paper before you, which is, that there is an argument that, as we have federalized the oversight of audits of public companies, there is an argument that we should federalize more of the litigation of claims arising out of those audits, much as we have done when we federalized the oversight of the securities industry in the `33 and `34 Acts, and at that time federalized much of the litigation arising out of those claims.

That's the spirit in which it is proposed, not as a solution to the catastrophic risk issue and not as a quid pro quo for anything.

MS. PALMROSE: Okay. So it doesn't really necessarily encompass catastrophic risk.

MR. GLAUBER: It's presented --

MS. PALMROSE: It may, but the intent is not necessarily to do so.

MR. GLAUBER: This is presented on the basis and in the terms that are written on the paper.

MS. PALMROSE: I'm just trying to clarify what that basis and those terms are. But thank you very much.

CHAIRMAN NICOLAISEN: Zoe-Vonna, I don't think this gets at the catastrophic risk issue, at the heart of it, because you still got the large federal securities cases, which is where many of these large cases have been. So, it doesn't address it at all.

MR. GLAUBER: Absolutely.

MR. TURNER: It may limit investors' rights to the state courts where the pleading standards may be lower. I think this is more an issue about trying to move the pleading standard up to a higher level, something I certainly don't support. But I think that's what this is all designed to do. The firms have been trying to get this action taken for over two decades now. And so in that respect, though, it's not really driven at the catastrophic issue, which is more the liability cap-type issue.

MR. GLAUBER: Let me make this very clear. That this proposal does not suggest changing the legal standards that govern federal cases.

MR. TURNER: I think that's way off

base when you start asking and teeing up the pleading standard on a federal level. I think this begs the question. I think that's misleading to the public to say that.

MR. GLAUBER: It certainly, I don't think, is the intent of it. To change the standard under which --

MR. TURNER: You know, we went through a discussion over whether or not the pleading standards should be built around something like 102(e) and the firms absolutely said no, because of the negligent piece. So you're talking about whether you're giving --

CHAIRMAN NICOLAISEN: I think you could see some of the dialogue that's occurred in the subcommittee. And it probably is not beneficial to continue that here.

MS. PALMROSE: Let me try the other prong of my question. Would that be okay?

CHAIRMAN NICOLAISEN: Sure.

MS. PALMROSE: I'll move off the litigation one and into the financial reporting one and the transparency issue. So, I assume that that's not primarily for assessing audit quality. It's the objective there is primarily to, for solvency, liquidity issues? Is that audited financial?

MR. GLAUBER: A large amount of testimony on that issue, some people have said it would enhance audit quality, some have spoken to its effect on information for audit committees in regards to sustainability.

MS. PALMROSE: Okay. Then, maybe just for a second then, I'll put on an academic hat. And just let you know that as part of my dissertation, where I was searching for how to measure audit quality from a market perspective, back in my Ph.D. days, I actually had the financial statements that were available from Arthur Andersen, from KPMG, then it was Peat Marwick, and Touche Ross. And I really struggled to find that there was any connection between audit quality and the audited financial statements provided by

Arthur Andersen, and the unaudited ones provided by the other firms.

So, it was difficult to make any connection to audit quality. In particular, if you look at, and I don't know if this would be what they would represent now, but the balance sheet, for example, 75 percent of it is current assets.

The assets that really generate the value, the people, the clients, the networks, aren't recorded on the balance sheet. And these are really current operating service organizations. And essentially, it really depends upon generating the current cash flow, essentially, and keeping that going, and measuring, being able to measure reputation effects, which frankly, weren't captured, again, in the financial statements.

For example, Arthur Andersen's financial statements as they were publishing them, there was a partner signing a audit report for a fee of $14,000 that, you know, resulted in costing the firm $62 million. So, you couldn't measure reputation effects. You couldn't really measure solvence of liquidity by those financial statements.

MR. GLAUBER: I think your points are --

MS. PALMROSE: And it wasn't a particularly useful way to measure audit quality, either. So, I guess, I'm just struggling here to understand, I mean, transparency on average is good, and disclosure is good, but what's the objective and what is the thought that the financial statements that are audited would provide.

MR. GLAUBER: I think your points are very well taken. As best as I understand, GAAP is not particularly well equipped to, or less well equipped to deal with the issues of intellectual capital and reputational capital. And I'm sure your points are well-taken.

The people's support for this, you've heard it around the room. It varies very much. Although, those who support it are very, very strong of mind that this would be a step forward for investors and for audit committees.

MR. PALMROSE: Yes. I just wonder if people have a reasonable expectation for what they're going to find, and also whether they're -- it's worthwhile thinking about the consequences both maybe positive as well as potential --

CHAIRMAN NICOLAISEN: I mean, I'll just express a view. I think Harvey Goldschmid tried to articulate it as well. That these are major players in the capital markets. They're not particularly transparent. There's no way to objectively determine much about the firms, because it's -- they have their own literature, they have their own information out there.

But in terms of being able to say, is -- has this been tested, is it verifiable, is it, have they been subjected to rigor that other public market participants have been subjected to, is really the piece that's lacking, so.

I think where I approach it from is there is a great deal of -- at least that I've heard, maybe other people have different views -- that the profession itself is not believed to be transparent or open in its dealings with the public, that it basically has information that it would say to any other entity, you ought to disclose. It doesn't disclose that themselves.

And so there's this feeling there of a lack of willingness to participate as a public participant. And I think for a lot of people, it's basically that. It's not an audit quality thing. I don't know that you're going to find audit quality.

You could find some indicators. You could find some comparability. You know, your testimony about how much auditing is actually done within a firm versus other activities. What does that tell you? I don't know. Because we haven't seen the statements. But you know, there is presumably some informational value to it as well.

MS. PALMROSE: I guess my only point would be, I think it would be helpful to know what objective, what the objectives are. And what, then, information could be brought to the table to meet those objectives.

CHAIRMAN NICOLAISEN: Sure.

MS. PALMROSE: And that's my only point.

CHAIRMAN NICOLAISEN: It may not be as hard as what you're looking for, as objective as what you're looking for. Mark.

MR. OLSON: Just two quick comments. First of all, because the PCAOB is generously and regularly mentioned, I want to point out that these are not the recommendations of the PCAOB in a specific sense. We are not engaged in mission creep.

The -- but as each of these

proposals have developed, we have stuck, I think, appropriately to our role as advisors. And where the PCAOB has been included, and I think Bob and Don, we have responded to them by saying what we think the issues are that you are raising. And in many cases, we have provided wording that I think would avoid any inadvertent problems or lack of clarity. And the Committee, and Kristen, where are you -- has been wonderfully accommodating to the suggestions that we've made.

The only additional point that I would make, and on the transparency question. There is a lot of appeal of the direction of the Article 40 disclosures. We have -- under our annual inspection reporting, proposed guidelines, something that's been underway for several years -- are having a meeting on this, I think we just sent a memo out yesterday that you probably got as well, that incorporates the direction that we had gotten up to, that preceded the establishment of this Committee.

But fortunately, the direction that we're going, what is being included directionally is all consistent with Article 40, but not entirely inclusive. And the Committee will be taking that up. And I just think with that, no other comments, unless people have specific questions with respect to the PCAOB.

MR. GLAUBER: Just to amplify what you've said, Mark. Actually in the draft of the Committee's recommendation, Subcommittee's recommendation, it says, explicitly, these disclosure requirements should supplement any rules adopted as a result of the PCAOB's 2006 reporting.

MR. OLSON: Exactly. That's consistent, right, thank you.

CHAIRMAN NICOLAISEN: We appreciate it. Bob.

MR. HERZ: Just to weigh in a little bit on the international point. We, our country, our capital markets are clearly in a period of transition. And it's a little bit like riding two horses. You've got to figure out how to ride both of them. But I can tell you, because we experience that every day at our place, and I will tell you that just points of philosophy about that in dealing with that, it's pretty similar to what Damon said, I think.

I think first, you got to recognize that while we're not the masters of our own capital market's future anymore, we're certainly going to be influencers, not only of that, but of also of the global architecture. People still do listen to us and care about us as a single dominant player.

And taking what's good in our system and even could be better, and trying to inject that into a global architecture, I think is real important on the one hand.

But on the other hand, we've also got to be cognizant of not trying to do things here that are particularly -- might be inconsistent or objectionable to a global future. And that it's good having Sophie and Michel here, because I think they can give you a little bit of cross-check on those kinds of things.

The other thing is, you know, while we're going through this transition, I mean in effect, there's going to be multiple markets. There's going to be the market for the biggest players and the biggest auditors doing things, and there's going to be more of a national, regional, local markets. And you're dealing with all of these kinds of things.

And it's a very difficult situation as to how to manage that transition. I'll tell you that from the accounting point of view, but it kind of gets into all these systems issues, we've done some thinking. We're holding a public forum on June 16th. A number of you are going to participate in it, or your organizations, to start getting at all of these issues.

Not specifically the audit issues, although some of those will be on the table, too as to the issues of private company readiness. Would we even go for private companies to, you know, IFRS, if public companies went there? What about smaller public companies? What about the whole training, those kinds of issues?

There's a million other issues in there. And so I think that you know, the best I can offer you is to kind of those, keep the objectives high. Make sure that what, but what you propose is, not only makes sense kind in terms of our historical thinking but also in terms of a more global future.

CHAIRMAN NICOLAISEN: Pick your fights. Barry.

MR. MATHEWS: Just a couple of comments. On the international, I think the way some of the discussion was going prior to Bob's comments just now is that, you know, there was this assumption that tomorrow, we were going to have this -- need to have this IFRS readiness.

I think it will be a process over time. I don't think anyone is anticipating a switch being flipped that has an immediate effective date. There is no one in this room more concerned about the smaller firm perspective on this than I am.

And I will tell you, that while there are clearly differences, they aren't so substantial that it is impossible to overcome. And given a transition period of time, which will undoubtably be there, I think that there will be ample opportunity for that to occur.

As to the international competitiveness from a small firm standpoint, what is in reality happening today, is that we have a whole host of networks and associations that are growing rapidly from an international perspective. All of the 100 largest firms, and many of the top 500 firms, are included in those international networks.

That is exactly how seven of the big eight grew international in its previous, you know, previous decades. And those things from a marketplace standpoint will get addressed.

As it relates to the other recommendations in this report, you know, when Secretary Paulson and Under Secretary Steel appointed this Committee, it was on the notion of sustainability of the auditing profession. It would seem incomprehensible to me, given the amount of testimony that we've had, albeit argued on both points, that we wouldn't have a substantive part of this that focuses on liability concerns.

It is clearly an element of the discussion, no matter how you come down on the side of that particular issue. And so it's sort of hard to believe that we would issue a report and not get to some sort of recommendations in that particular area.

CHAIRMAN NICOLAISEN: Barry, can I

interrupt you for just a second. I want to hold our members here, because we do need to take a vote for the, to have this published to the Federal Register. Bob Steel, do you want to do that for us now? And then, we will continue the dialogue. I apologize for cutting you off.

MR. STEEL: Sure. Mr. Chairman, a Committee decision based on a vote requires a simple majority of the votes cast at a meeting. It's the responsibility of Treasury staff to provide the vote and then deliver the total.

So we need now a motion on the vote to make a Draft Report available to the public for a 30-day comment period. Is there such a motion?

MR. GLAUBER: I'll move it.

MR. STEEL: Second. All in favor. Now I'll call the roll.

MR. MELANCON: Before we, I'm sorry, before we vote. Can I just understand clearly what we're voting here. Are we voting on any of the substantiative points in this document to be -- all we're doing is for an exposure period for comment, is that correct?

MR. STEEL: Yes, sir.

MR. MELANCON: Thank you. I didn't mean to interrupt. But I just wanted to be clear.

MR. STEEL: No, please. So now I'll call the roll. Mr. Beller, absent. Ms. Brinkley.

MS. BRINKLEY: In favor.

MR. STEEL: Ms. Bush.

MS. BUSH: In favor.

MR. STEEL: Mr. Cohen, absent. Mr. Flynn absent. Mr. Glauber.

MR. GLAUBER: Yes.

MR. STEEL: Mr. Goldmann.

MR. GOLDMANN: Yes, I vote for.

MR. STEEL: Thank you. Mr. Hansen.

MR. HANSEN: Yes.

MR. STEEL: Mr. Levitt, not here.

Mr. Melancon.

MR. MELANCON: Yes.

MR. STEEL: Ms. Mulcahy.

MS. MULCAHY: Yes.

MR. STEEL: Mr. Murray.

MR. MURRAY: Yes.

MR. STEEL: Mr. Nicolaisen.

CHAIRMAN NICOLAISEN: Yes.

MR. STEEL: Mr. Previts.

MR. PREVITS: Yes.

MR. STEEL: Mr. Silvers.

MR. SILVERS: Yes.

MR. STEEL: Mr. Simonson. Ms. Smith. Mr. Travis. Mr. Turner. MR. TURNER: I abstain.

MR. STEEL: Mr. Volcker. Ms. Yerger.

MS. YERGER: Yes.

MR. STEEL: I don't have the exact count, sir, Mr. Chairman, but I report that the ayes do carry, 14 in favor, it is the vote.

CHAIRMAN NICOLAISEN: Carry, very good. Thank you very much. Let's continue our dialogue. I'll stay as long as anybody wants to stay. But those of you who do need to go, feel free to go.

MR. MURRAY: Mr. Chairman, may I request a privilege. I'm glad that I deferred an hour and a quarter ago to Gaylen, because he did provoke a very profound discussion. But I didn't wish to withdraw from the Committee at that point. And if I could have a moment or two, I would appreciate it and I appreciate that's out of the order of cards that have been put out since.

CHAIRMAN NICOLAISEN: Sure. It's all right.

MR. MURRAY: I think most of us committed our time to this exercise in the belief and the desire that we could produce a robust analysis of the problems faced today and some substantial recommendations for solving those problems, recognizing that several prior commissions had wrestled with many of the same things, declared success, achieved little, found the circumstances changing, and basically became dusty pretty quickly.

And I don't think any of us expected that we would do that. It seems to me we have, the where do we go from here as we stand today, we basically have three choices. I don't think it's any longer possible for us to all to go home saying we've done a profound analysis of the problem and provided truly substantive solutions.

I agree with Barry's last comment and others that there are some missing elements here. That leaves us two other choices. One would be to reduce our analysis of the problem so that it seems no bigger than the relatively modest recommendations we're able to agree upon, so that it has symmetry, but it will not have impact.

I certainly hope that's not the

solution. Or, we can work on a product where much of the value lies in the profoundness of our analysis, which includes a look backwards at how we've gotten here. Because no one would have arrived at this point by plan. And no one would try to move forward from here if we could start someplace else.

And I think the comments that Alan Beller and that Gaylen and others have made about where we stand in the process of commercial, technological and geographic change mean that whatever we recommend now will itself be out of focus within five years' time with the challenges then.

So, I would hope that we can escalate our attention to the profoundness of our analysis of where we are, and where it is we expect the issues to lie in the foreseeable future, make the recommendations that we -- the most significant recommendations we're able to agree upon, and acknowledge that those recommendations do not carry us very far from where we are toward a sense of resolution.

That seems to me the highest achievable point, and it will require us to get over what I continue to believe our biggest obstacle which is the fault line between those of use who see the audit profession as legitimate and dedicated as any other public service utility, enterprise, private sector or professional organization, and those of us who see auditors as uniquely adolescent in their approach to their responsibilities unless they are under the control of both regulation in the public sector and the threat of litigation as an additional motivator to do their job well.

That's a big challenge. And in some respects, I'm exactly where Damon Silvers is. If we can find one or two fairly fundamental points of agreement, we ought to be able to build something quite respectable around them. I thank you. And I apologize for interjecting.

CHAIRMAN NICOLAISEN: Barry, I interrupted you. I'm sorry.

MR. MATHEWS: I'll just be brief. I think that, I understand the desire on transparency and I'm respectful of that. And I think what we heard today, which was I thought a very good panel, was clearly a disagreement as to whether it helped, or it whether it hurt or not, from a liability perspective.

And in the context of what this Committee was formed about, and what Zoe-Vonna's points, which I think were very well stated as to really what's the tie between audited financial statements and quality, I would just challenge the Committee as we wrestle with this over the next 30 days, if it is increasing liability exposure, which clearly some people believe passionately it is, then isn't that contrary to the sustainability point that this whole Committee was set up to be addressing. And we clearly have a Subcommittee addressing.

And, you know, it seems like we have these two moving parts. And I understand they are not, as Bob said, you know a tie together. But legitimately, if we're going to make a recommendation as to the potential to increase the risk of loss of sustainability, we need to at least look at some of the issues in a more deep fashion that could be used to minimize some of that risk.

And I know that we've been all around those issues in some fashion. But it seems like we're taking contrary positions in almost the worst of both outcomes if you look at the objective of the Committee, which is to make sure that we had a viable, private sector, auditing function in the long term.

And so I think we have to figure out a way how to balance that constructively and with respect of each other's points of views. But we've got to be able to find a way to balance that.

CHAIRMAN NICOLAISEN: I think that' great. And I'm still hopeful that that will happen. I think part of the challenge is, while you can do that at a fairly high level, the question is, is there enough support amongst the committee without putting meat on it, to be able to sustain it.

We're going to lose everybody in the next few minutes. So, let me just define process going forward.

We have a meeting scheduled for July 10th. It's a telephonic meeting followed by a July 22nd in-person meeting here in Washington. I'm going to suggest that we drop the July 10th telephonic meeting, the purpose of which was to review the final draft that would go out for comment.

And instead, let's focus on making real progress in this period of time that we have available. So, next meeting would be July 22nd. At that meeting, we would hope that we would have a Draft Report that encompasses everything that we're looking for.

We would encourage comments from the public on anything that we've done, between now and the end of June, and even if it trickles into the first few days of July, that's understandable too. But the more input that we can get, the sooner we can get it, I think it's helpful to the Committee.

Those who have recommendations as to how to move forward with a solution that provides either transparency combined with liability matters, or that ends up with a position of saying pros and cons were discussed and there was no resolution, I think we, where at some point, we're not going to fruitfully continue the dialogue.

So, either there is a solution that's reasonably obvious, or there's not. I would hope that there is one. I would hope that we can make some meaningful recommendations.

Zoe-Vonna, the recommendations do

not address catastrophic risk other than the recommendation of your Subcommittee. And if litigation catastrophic risk by itself is an important topic to the Committee, then the Committee members should speak up to that.

Because at the Subcommittee level, there has not been an ability to identify it at Bob Glauber's Subcommittee level, there's not been an ability to identify what that solution would be. And quite frankly, in discussions with the firms, it's very difficult to understand what their consensus proposal would be.

We've heard caps. We've had no specificity around that. We've heard others, other recommended solutions, but in order to go to Congress with something meaningful, there would have to be strong support for it, and they would have to have underlying support. At this point, the subcommittee is not there. It's a question of whether the full Committee wants to undertake that on their own. Rick.

MR. MURRAY: Just one clarification. The, Bob Glauber's subcommittee should not in my view, be understood to have abandoned the issue of mega-claim and viability concerns. What we have been unable to do is reach a unanimous view as to what to put forward, and have put forward those things about which there has been unanimity.

But it's my impression that that issue, Bob would speak for himself much better if he were here, is still an issue in front of us.

CHAIRMAN NICOLAISEN: Yes. Well, I think it's fine if Committee members wish to express views. I think we've heard a lot of testimony. We've had a lot of discussion around this. We have a proposal that's semi on the table from the Subcommittee of federalizing some of the state actions. The question is, where do we go with that. And if others feel that we've missed the mark and that there's something else that definitely should be looked at, then please, cards, letters, emails, whatever it is that you want to send in, please send in. Would appreciate that from the Committee members.

But specificity is important. And at this point, we don't have much. Yes, Ann.

MS. YERGER: The document that we just approved to release for comment.

CHAIRMAN NICOLAISEN: Yes.

MS. YERGER: Is the subcommittee still charged with making or trying to make final recommendations on those issues? Okay, thank you.

CHAIRMAN NICOLAISEN: They're going to try. They're very desirous of input. So whatever you have, please provide. It's been a long day. We are adjourning exactly on schedule.

MS. WOODS BRINKLEY: I understand that the tenth is canceled. We'll have a full discussion on the 22nd. Then is there a required follow-up meeting?

CHAIRMAN NICOLAISEN: Yes, there will be. And that will be the week of September 8th. We'll get to you with possible dates during that week. So thank you very much. Meeting is adjourned.

(Whereupon, at 5:31 p.m., the proceedings in the foregoing matter were concluded.)