

UNITED STATES OF AMERICA
DEPARTMENT OF THE TREASURY

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ADVISORY COMMITTEE ON THE
AUDITING PROFESSION

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MONDAY, FEBRUARY 4, 2008

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

BOARD MEMBERS PRESENT:

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

OBSERVERS:

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

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PANELISTS - PANEL I:

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

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

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

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

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

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

PANELISTS - PANEL II:

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

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

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

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

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

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

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PANELISTS - PANEL III:

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

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

BRAD KOENIG, former Managing Director, Goldman
Sachs

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

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

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

2 (1:30 p.m.)

3 CO-CHAIR NICOLAISEN: All right.

4 It seems like we're at the appointed time --
5 1:30. Good afternoon. I'm Don Nicolaisen,
6 one of the Co-Chairmen of the Committee.
7 Sitting next to me at my right is Mr. Arthur
8 Levitt, who is also co-chairman.

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

18 I say with a little bit of glee,
19 because I have been on the Board of Advisors
20 to the Leventhal Accounting School for almost
21 20 years. So I think it is top rate, and we
22 are delighted to be back on campus.

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

8 MS. PALMROSE: He's teaching.

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

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

19 With that, I think it's now time
20 for us to get started with the agenda for the
21 day. We're going to conduct it in three
22 separate sections, each at 90 minutes. We are

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1 going to hold fast to that 90-minute time
2 commitment in order to ensure that we have an
3 opportunity to deal with all of the things
4 that we want to talk about during the day.

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

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

20 We will have an opportunity for
21 each of the Committee members, if they choose,
22 to do followup questions with the panelists,

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1 and we would appreciate panelists' willingness
2 to be part of that process by responding to us
3 at -- within an appropriate period of time.

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

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

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

21 We have approximately 800 members
22 and are led by a Governing Board that includes

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1 leaders from eight public company auditing
2 firms, the American Institute of CPAs, and
3 three public board members who represent
4 perspectives from the investor, issuer,
5 regulatory, and academic communities.

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

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

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

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

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

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

20 All told, the profession devotes
21 about 50 cents of every dollar in revenue to
22 personnel-related expenses, not including

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1 partner compensation. College and university
2 instruction is an equally important part of
3 the human capital equation.

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

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

22 How might the Advisory Committee

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

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

19 We ask you to encourage
20 accreditation bodies to revise their standards
21 to allow the employment of more audit
22 professionals, either active or retired, as

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1 adjunct professors. And we ask you to
2 consider solutions to liability risk. Some of
3 the best and brightest might be deterred from
4 entering the profession due to that risk.

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

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

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

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

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

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

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

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

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

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

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

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

22 On behalf of myself and Energy

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

6 I must preface my comments by
7 stating that I am not a Certified Public
8 Accountant. I feel somewhat undergunned here.

9 However, I serve as a Chief -- I have served
10 as the Chief Financial Officer for the past
11 six years, including my current position at
12 Energy Transfer, and my previous position as
13 Chief Financial Officer of Devon Energy
14 Corporation. In addition, I'm a member of the
15 Board of Directors of Arch Coal Corporation,
16 where I serve on the Audit Committee.

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

22 The perspectives I will share today

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

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

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

22 I do want to take a moment to

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

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

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

21 In addition to accounting skills
22 and business understanding, we expect our

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1 external auditors to bring to every engagement
2 the highest ethical standards, and they do.

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

9 We provide financial disclosure
10 that is consistent with current accounting
11 policies while remaining useful to investors
12 seeking to understand our financial position.

13 I look to our external auditors, as does our
14 Board and our investors, to ensure the
15 integrity of our financial reporting and
16 disclosure.

17 The depth of experience of an
18 external audit team and what they bring is
19 critical to its ability to provide value-added
20 insight to the audit function. That
21 experience must include familiarity with our
22 company and familiarity with our industry. We

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1 want our external audit team to have the
2 confidence to look behind the financial
3 reports and schedules to the critical
4 accounting policies that we adopt and their
5 impact on our financial report.

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

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

20
21 The challenge for the accounting
22 profession is to meet our experience,

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1 knowledge, and continuity requirements.

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

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

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1 PCAOB lead partner rotation requirements.

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

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

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

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

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

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

18 Many excellent studies and books
19 have been written that explore the consequence
20 of these issues. Most would agree that a new
21 generation entering our workforce and making
22 employment decisions is placing significantly

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1 greater value on the quality of their lives,
2 and the quality measurement often includes
3 where and how they work.

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

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

21 I believe that audit partner
22 rotation will have a greater impact on small

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1 to mid-sized public accounting firms, and,
2 consequently, small to mid-sized publicly-
3 traded companies, as their markets may not
4 support the scale necessary to ensure seamless
5 rotation.

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

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

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

22 Thank you.

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1 CO-CHAIR NICOLAISEN: Thank you
2 very much.

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

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

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

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

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

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

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1 on campuses.

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

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

20 And, again, part of it is we have a
21 diminished reputation. We don't want to hear
22 it, but there are fewer people who want to be

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1 associated with a profession that's in the
2 newspaper and the headlines all the time in a
3 negative way. And they don't like teaching
4 the stuff we're being asked to teach -- rules
5 and code sections, more and more and more
6 vocational.

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

17 Quick fixes -- there are no quick
18 fixes. Somebody who tells me among the quick
19 fixes for the Ph.D. shortage is we'll just
20 bring more practicing professionals into the
21 classroom, full-time or part-time adjuncts,
22 they'll teach more -- people who tell me we're

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1 going to fix education by setting up a
2 government commission who is going to mandate
3 accounting curriculum, what that tells me
4 primarily is they don't understand higher
5 education. These quick fixes, then, are going
6 to do more to exacerbate the problem than they
7 are to help it.

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

16 We have to improve the reputation
17 of the profession, so that people want to be
18 associated with it. And we've got to quit --
19 we've got to reverse the trend of
20 vocationalizing our education and return our
21 schools to institutions of higher education.
22 Hopefully, the movement to our principles-

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1 based accounting, away from rules-based
2 accounting, will facilitate that.

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

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

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

17 MR. SALZBERG: Thank you. Good
18 afternoon. Thank you, Chairman Levitt,
19 Chairman Nicolaisen, and members of the
20 Committee. I really do appreciate this
21 opportunity to be before you and share
22 perspectives about the audit profession and

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1 the talent issues that we face.

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

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

19 A national licensing system -- to
20 create a seamless, flexible, and consistent
21 framework for professionals throughout their
22 careers. Such a system should also provide

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1 relief from duplicative disciplinary
2 proceedings by states that have no nexus to
3 the conduct at issue.

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

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

19 So while each of these items is an
20 important part of the solution to the talent
21 issues facing our profession, they could be
22 overshadowed by another issue that has a much

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1 greater potential to harm the profession's
2 ability to attract and retain the best talent
3 over the long term. That is the unprecedented
4 level of risk and pressure currently faced by
5 our professionals.

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

14 However, the risks and pressures
15 the profession faces greatly impact these
16 individuals, including the risks of a
17 catastrophic civil judgment or regulatory
18 action that can put a firm out of business.
19 Others are more personal, such as the
20 frequency with which a partner must uproot his
21 or her family to comply with partner rotation
22 rules. Add to these the increasing lack of

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1 respect for the professional judgments an
2 auditor must make every day.

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

19 During the Human Capital Panel of
20 your December 3rd hearing, there was a
21 discussion of the need to inspire young people
22 to view public accounting as a profession on

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1 par with law and medicine. I wholeheartedly
2 agree, but this is difficult in an environment
3 where audit firms face catastrophic litigation
4 risk and where professional judgment is not
5 respected as it should be.

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

12 Reforms to the private litigation
13 system, including caps on catastrophic auditor
14 liability and certain reforms to the
15 bankruptcy laws. To develop workable
16 arrangements that would address the impact of
17 regulatory action in the U.S. and globally,
18 that could have cascading effects
19 disproportionate to the conduct at issue. A
20 rule or framework to provide protection for
21 good faith, well documented, professional
22 judgments, and lengthening the partner

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1 rotation rules from five to seven years.

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

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

15 Thank you.

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

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

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

4 CO-CHAIR NICOLAISEN: Right.

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

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

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1 When I began my career in public
2 accounting, minorities were a non-issue. That
3 is to say, there were no hiring opportunities.

4 I remember very well when I graduated from
5 college there were seven of us that went up
6 for interview, and we all have Spanish
7 surnames. Two others had -- were Japanese.
8 None of us got hired. The Japanese guy, he
9 had a -- he was a straight A student. That's
10 the way it was. Obviously, things have
11 changed, but not as much as they need to
12 change.

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

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

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

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

14 Here in Los Angeles County where I
15 live, there's about 10 million people. About
16 4.7 million of those are Latinos. Yet in our
17 accounting profession nationwide there is only
18 three percent Latino, one percent African-
19 American, and four percent Asian. Obviously,
20 that's not a number that any of us like to
21 see.

22 Within the 10 top firms here in Los

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

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

15 I believe that there aren't enough
16 Hispanic mentors and Hispanic role models to
17 do that. Some of the solutions that we need
18 to look at -- try to reach out to Latinos much
19 earlier than when they enter college,
20 providing for financial literacy programs that
21 are directed at them, looking at scholarship
22 opportunities that really focus on Latinos,

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1 especially in the CPA firms that hold stronger
2 internship programs that may be -- reach out
3 in this fashion.

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

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

22 I mentioned ALPFA. Fifty percent

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

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

12 I have -- I'm a small firm. I even
13 use the H-1B program. I have difficulties
14 with Latinos and other minorities. Our firm
15 has a cross-section of people, like we all do.

16 But, again, that effort has got to start with
17 our profession, and hopefully it will continue
18 as it has in the past.

19 Thank you.

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

22 Just a reminder to those of you who

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

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

13 David, are you there?

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

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

19 With 2007 sales and revenues of
20 about \$5 million, Caterpillar is the world's
21 leading manufacturer of construction and
22 mining equipment, diesel and natural gas

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1 engines, and industrial gas turbines. Today,
2 Caterpillar has nearly 500 operations in 50
3 countries, more than 100,000 employees, and
4 there are more than 120,000 dealer employees,
5 and thousands of suppliers doing business on
6 every continent.

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

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

21 In addition to the role of public
22 company auditing, management accountants play

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1 a vital role in high-quality financial
2 reporting. Management accountants perform a
3 range of activities that enable an
4 organization to formulate and implement its
5 strategy, drive business performance, and
6 create stakeholder value. These activities
7 start with demonstrated accounting expertise,
8 including transaction processing and financial
9 reporting.

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

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

21 I can tell you that a certified
22 management accountant certification, or other

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1 professional credentialing, is key for our
2 1,800 accountants. And we have a credential
3 expertise requirement for our senior
4 leadership team to help ensure long-term,
5 transparent financial reporting and FAC
6 compliance.

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

18 We can improve the quality of human
19 capital and related outcome audit and overall
20 financial disclosure quality by broadening the
21 mission and principles of this Committee, and
22 other related committees, to include the

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1 proper education and certification of internal
2 finance function personnel.

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

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

20 At Caterpillar, we are striving to
21 create an inclusive environment that fully
22 engages current and new employees. We are

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1 developing a diverse global leadership team
2 that reflects the markets we serve and the
3 communities where we work. Our goal is to
4 have the right people on our team and to fully
5 recognize, and take advantage of, their unique
6 skills, abilities, experiences, and cultural
7 background.

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

17 These skills are critical to
18 applying professional judgment on the job and
19 building quality into end-to-end business
20 practices such as financial reporting.
21 Accounting graduates today often are not
22 properly prepared for government, corporate,

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1 or not-for-profit practice.

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

10 Thank you for allowing me to
11 comment.

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

15 MR. BURRITT: Yes, sir.

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

18 Let's turn it over now to questions
19 from our Committee members, as we have a
20 custom of doing. We'll begin with those on
21 the Human Capital Subcommittee. Gary Previts
22 is the Chairman of that Subcommittee, and I

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1 think he is joining us by phone. Gary, are
2 you available?

3 (No response.)

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

7 MR. MELANCON: Thank you, Don.

8 I guess I would start with Dr.
9 Reckers.

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

12 CO-CHAIR NICOLAISEN: You are.
13 Okay.

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

16 (Laughter.)

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

19 MR. PREVITS: Yes.

20 CO-CHAIR NICOLAISEN: Go right
21 ahead.

22 MR. PREVITS: I have a question,

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

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

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

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

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

6 MR. BURRITT: Yes.

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

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

19 And then, the -- I think the
20 indication that accounting curricula are
21 essentially focused on auditing and other
22 matters, I would also like to see the -- you

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1 know, the analysis that supports that, so that
2 we have that to work from perhaps in contrast
3 to some of the other, you know, pre-
4 conceptions that are out there.

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

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

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

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

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

18 (Laughter.)

19 But we would be happy to work with
20 Barry, the other firms that are part of the
21 Center for Audit Quality, the AICPA, to
22 outline what some of those practica and

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1 internships might look like, so that we can
2 share that with the Committee.

3 MR. SALZBERG: The only thing that
4 I would add to that is that there are a number
5 of additional courses or different approaches
6 to education that can be part of the
7 additional 30 semester hours as part of the
8 150 hours of college credit that we're talking
9 about that could be focused on different
10 programs like ethics, like taxation, like
11 valuation, other disciplines that are
12 absolutely critical to the performance of a
13 quality audit as part of that additional 150
14 hours.

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

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

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

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

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

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

22 We can do these practica and these

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

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

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

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

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1 CO-CHAIR NICOLAISEN: All right.

2 Thank you very much.

3 Barry?

4 MR. MELANCON: Thank you, Don.

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

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

20 But my bigger question is -- you
21 talked about a lot of environmental issues --
22 starting pay, what is being taught, what is

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1 being expected or how hires are deployed in an
2 audit environment or audit firm environment.
3 But -- and clearly sort of encapsulating that
4 entire environment is a movement and a lot of
5 discussion about movement to principles-based
6 standards, which is probably a misnomer. But
7 professional judgment -- you heard Barry talk
8 about professional judgment. IFRS clearly
9 will drive some of that.

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

19 MR. RECKERS: This is one of the
20 most problematic areas I think that has
21 emerged in the last 10 years. The disconnect
22 between the practicing profession and the

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1 academic profession is grossly -- is terribly
2 deteriorated. There is almost no members of
3 the AICPA that are educators. There is almost
4 no practitioners in the American Accounting
5 Association anymore.

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

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

22 There are some of them, but then

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

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

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

17 How can you synergistically teach
18 more than one thing, and at that same time
19 also teach critical thinking, analytical
20 skills, teaming skills, you name it -- all the
21 things that have to be put there. There's a
22 great deal that has to be put in a very short

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1 period of time. So there does have to be
2 discussion. Simple answers aren't going to do
3 it. There has got to be some commitment of
4 time and energy and some relatively deep
5 thought about some of these things.

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

22 MR. SALZBERG: I think that there

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

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

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

17 MR. MELANCON: I see that I'm out
18 of time. I do want to just compliment your
19 founding of the ALPFA -- what is today the
20 ALPFA organization. And while we do have a
21 problem in the Latino area, it's at least
22 better than in some of the other minority

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1 categories. So thank you for your leadership
2 in that area.

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

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

17 Sarah Smith, are you on the line?

18 MS. SMITH: I am.

19 CO-CHAIR NICOLAISEN: Terrific.

20 MS. SMITH: I have a question for
21 Cynthia, if I may. On your very first page of
22 your testimony, you just -- it was a very

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1 small part of what you talked about, but it
2 just intrigued me. You said that faculty
3 should be encouraged to take sabbaticals to
4 spend time at firms.

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

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

17 We've talked about having
18 professionals go in and teach as adjuncts at
19 the universities. But is there a way also
20 that we might be able to explore having
21 professors going into the firms? It seems to
22 me that, as we look at that, we need to find

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1 ways to partnership so that it's a two-way
2 street.

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

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

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

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

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

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

22 MR. RECKERS: Without the financial

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1 support, it really becomes almost impossible.

2 If you ask a faculty member for a year to
3 take half pay, you know, they've got
4 obligations and commitments they have to pay,
5 mortgages, etcetera, and kids' tuition. It
6 becomes almost impossible.

7 MS. SMITH: Right.

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

18 MS. SMITH: Okay. And then, one of
19 the things that we had -- along the same lines
20 we've been hearing about is how to get the
21 balance right of the professional experience
22 and doctorates. And what is your current view

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1 of the accreditation standards in terms of
2 mix? Do you think that is the best place it
3 could be at the moment?

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

7 MS. SMITH: Well, that's helpful.

8 (Laughter.)

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

17 And this is really one of the --

18 MS. SMITH: In the event -- I mean,
19 and you gave a very good suggestion for
20 dealing with the upcoming crisis of shortage
21 through asking those who might retire to stay
22 on longer. But in this type of shortage,

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1 might that not be a way that could open up the
2 field and add people to the faculty?

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

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

18 MS. SMITH: Chairman, that is my
19 questioning.

20 CO-CHAIR NICOLAISEN: Thank you,
21 Sarah.

22 We have two other Committee members

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

4 (No response.)

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

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

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

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

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1 CO-CHAIR LEVITT: Yes.

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

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

19 And so that is really the context
20 in which we are talking about the professional
21 judgment rule or framework -- allowing
22 auditors to have that freedom to not be

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1 second-guessed. It's a term that I don't
2 really like, because it implies that one was
3 guessing in the first place, but that they
4 have the freedom that their judgment will be
5 respected as long as there are certain
6 safeguards and frameworks around it. And I
7 think that's what the SEC Advisory Committee
8 is very much working toward.

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

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

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

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

10 CO-CHAIR LEVITT: Yes.

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

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

21 CO-CHAIR NICOLAISEN: Great.

22 Gaylen, you were next, then Ken.

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

15 You know, who should bear the cost
16 of that? Who should regulate that, provide
17 the examination, the monitoring, and so forth?

18 So, you know, I don't know to what extent you
19 could maybe elaborate on -- because it's one
20 thing calling for a national license. It's
21 another, you know, do we have something more
22 specific than that.

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

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

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

21 One would be most recently, a
22 couple of months ago I think, we asked a

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1 partner to relocate from his state of
2 residence to another state in order to provide
3 leadership on a major audit client that we
4 have. That individual has been 25 years in
5 our practice, very significant in experience,
6 and he was unable to get the license in that
7 state, because he was short three credits back
8 in his college days.

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

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

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1 example.

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

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

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

21 MR. HANSEN: If I could just follow
22 up on that, then -- and recognizing that there

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1 are a lot of CPA firms that serve -- and I'm
2 sure yours as well -- serve public as well as
3 private companies, you would cover private
4 practice as well as public company auditing.

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

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

15 MR. GOLDMAN: Barry, I was very
16 struck by some of the recommendations you had,
17 so I have sort of related questions on three
18 areas. First of all, on the issue of
19 professional judgment, could you maybe a
20 little bit there relative to, what influence
21 do you think either the SEC or the way the
22 PCAOB is doing their various views has on the

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1 potential for professional judgment and how
2 you exert your influence in terms of
3 professional judgment?

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

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

18 MR. SALZBERG: Okay. I think the
19 first question of the three was addressed to
20 me specifically with regard to the
21 professional judgment rules that we were
22 talking about. I would not identify anything

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1 specific in terms of SEC or PCAOB.

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

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

16 And so today's graduates are
17 looking for companies that are interested in
18 further -- in corporate responsibility that
19 further community involvement, that are more
20 diverse, that has an environment of
21 flexibility, that are more adapted to the --
22 to their needs as young professionals. And

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1 compensation is one of them.

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

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

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

22 MS. FORNELLI: If I could elaborate

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1 just a bit on that, with what Barry was saying
2 with respect to starting salaries. The firms
3 have all been given a lot of accolades lately.

4 Business Week named the 100 best places to
5 launch a career. The firms placed very
6 prominently in that.

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

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

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

20 MR. GOLDMAN: Correct. The only
21 other point I want to -- I do want to make
22 about the professional judgment -- it's hard

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1 to address that if you say "all of the above."
2 It's not clear to me who is going to -- how to
3 take the next step there when there's an "all
4 of the above" issue.

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

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

18 Other information that we would be
19 disclosing, I think in response to your
20 question in terms of the kinds of things that
21 might be helpful in your view, I think could
22 provide a level of confusion to the

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1 marketplace as a private enterprise. We are
2 not like a public company. We have a lot of
3 expenses that our partners have.

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

6 CO-CHAIR LEVITT: That's a tough
7 problem. I mean, you've put your finger on
8 something that is very difficult to have your
9 cake and eat it. I mean, on the one hand we
10 are talking about certain special protections.

11 On the other hand we are saying that
12 competitive factors make it difficult for us
13 to provide you with the insights and the
14 information that might be useful.

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

18 MR. SALZBERG: From our
19 perspective, Chairman Levitt, our desire to
20 provide financial transparency, I think
21 depends upon the importance of the information
22 to the assessment of our ability to provide

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1 audit quality.

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

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

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

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1 that.

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

8 CO-CHAIR NICOLAISEN: I would agree
9 with that.

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

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

17 MR. HERZ: This gets to the
18 question of the interest and familiarity with
19 the young people in the profession. I think I
20 heard Mr. Vasquez say that one of the issues
21 is -- in the Latino community is that among
22 young people there is not that much awareness

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1 of the profession and what it does. And I
2 think I heard Dr. Reckers say that on campus
3 the image of the profession is not all that it
4 might be.

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

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

17 (Laughter.)

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

21 (Laughter.)

22 But, you know, are there things

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

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

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

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

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

11 (Laughter.)

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

20 And that to me -- we have to start
21 that early, because I think that there's an
22 opportunity to increase the number of

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1 potential accountants in our workforce by
2 doing so. And so whether it's in connection
3 with going to high schools and making programs
4 directly there, or working on not-for-profit
5 activities that support high schools to drive
6 that, I believe that that's one of the -- but
7 it is a longer term. It's not a quick fix.

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

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

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

18 MR. MURRAY: Frequency with which
19 the subject of professional judgment has
20 arisen and the regret that there is -- if
21 there are constraints on its exercise -- is
22 striking here, and that there is alignment of

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1 view that we haven't had on very many issues.

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

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

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

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

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

3 Lynn?

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

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

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

21 MR. TURNER: So I would say he
22 needs to go -- has a long ways to go before he

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1 will ever pass Dr. Reckers' class.

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

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

18 MS. FORNELLI: I cannot provide
19 that to you.

20 MR. TURNER: Thank you.

21 MS. FORNELLI: But I will say,
22 though, that things -- sometimes it's the fear

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1 of being second-guessed or the fear of not
2 having your judgment respected, and --

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

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

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1 that the inspection process is working.

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

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

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

20 The fear of being second-guessed is
21 inherent in the world. We all live with that.

22 The question is: what is it that is really

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1 not functioning today? And if you think --
2 those in the professional community think that
3 it is a subject that needs to be addressed by
4 this Committee, we really need some data.

5 Damon, I believe you were next.

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

9 (Laughter.)

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

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

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

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

21 So most of the H-1B issues that we
22 would have identified is at that level. We do

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1 not -- none are coming to my mind where we
2 actually bring in partners from outside the
3 country on an H-1B.

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

12 MR. FLYNN: I think, Damon, I think
13 it -- it takes 12 to 15 years to create a
14 partner. You can't go out and find partners.

15 It is not something that happens just because
16 we're going to go find a partner and just hire
17 a partner in the audit practice -- be it from
18 law firms, be it from practical experience.

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

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

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

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

20 Thank you very much.

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

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1 p.m. and went back on the record at
2 3:15 p.m.)

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

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

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

16 Before I turn to auditors, I want
17 to say a few words about the most important
18 player in the capital markets -- the investor
19 -- without whose money there would be no
20 capital markets. The institutional investor
21 clients that my firm represents understand
22 from painful recent experience that trust in

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1 the integrity of the capital markets is
2 fragile, and they view the role of a vigilant
3 auditor as crucial to maintain the integrity
4 of the markets in which they invest their
5 beneficiaries' money.

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

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

21 As I'm sure the Committee has
22 thoughtfully considered my written work, I

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1 will just touch on a couple of things here. I
2 will start with the assessment of the actual
3 litigation risk to audit firms. I say
4 "actual" because proponents of the cap often
5 unfairly inflate the threat posed by investor
6 litigation.

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

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

20 It is my experience that these
21 hurdles present significant downward drivers
22 on the settlement value of cases brought

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1 against auditors. These challenges are
2 particularly daunting, given the fault-sharing
3 provisions of the PSLRA. Auditors can almost
4 always point to evidence that management
5 conspired to lie to them, and perhaps even
6 generated false documents in an effort to
7 deceive them.

8 The PSLRA was intended to weed out
9 weak and frivolous cases, and it has done so.

10 The rate of dismissal of these actions has
11 nearly doubled to almost 40 percent, and
12 auditors are less frequently named as
13 defendants. Recent studies show that auditors
14 have been named in just a handful of cases in
15 each of the last three years.

16 Analysis of the settlement payments
17 by audit firms also confirms that claims of
18 catastrophic liability exposure are
19 exaggerated. Despite several recent multi-
20 billion dollar accounting scandals at their
21 client companies, audit firms avoided
22 suffering anything close to a catastrophic

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1 blow. If audit firms paid at all, it was
2 typically a fraction of what other market
3 actors paid.

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

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

19 Even if one were to quantify, able
20 to quantify a realistic litigation threat of
21 significant size, the question that must be
22 answered is: threat to what? In making a

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1 plea for special treatment based on what they
2 claim to be financial peril, it is incumbent
3 on the audit firms to be more forthcoming
4 about their true financial and insurance
5 capacity to withstand a so-called mega
6 judgment.

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

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

19 This, again, is not theory. It is
20 reflective of what happened just a few years
21 ago after the PSLRA was passed, and many in
22 the audit profession apparently got

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1 comfortable with the idea that their
2 litigation exposure was circumscribed.

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

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

16 *Stoneridge* has made the world
17 safer, considerably safer, for those who
18 profit from engaging in deceptive conduct that
19 enables the company to report financial
20 statements that are false. Ironically, while
21 it has made it safer for those bad actors, it
22 has made it decidedly less safer for auditors

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1 in at least two ways.

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

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

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

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

6 Thank you.

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

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

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

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

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1 right.

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

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

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

19 As explained in my submission, I
20 have been involved in developing many of the
21 key discussion papers to the UK, and I would
22 particularly draw attention to those relating

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1 to promoting audit quality, the limitation of
2 liability, and the form and content of the
3 audit report. My comments now are directed at
4 what it would take to ensure the future
5 viability of the profession, and I strongly
6 believe that the audit profession is at a
7 crossroad.

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

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

22 First, the future security of the

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

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

14 Secondly, there needs to be a
15 balanced approach to liability reform that
16 would ensure appropriate financial exposure,
17 which is proportionate to ensure the necessary
18 self-interest in quality on the part of the
19 audit profession, but which on the other hand
20 would remove a level of exposure that is
21 unlimited and wholly unrealistic, but more
22 importantly has the potential to destroy firms

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1 that are critical to the effective operation
2 of our financial and commercial markets.

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

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

17 Thank you so much.

18 CO-CHAIR LEVITT: Thank you very
19 much.

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

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1 Joe Grundfest.

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

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

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

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

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1 the topic.

2 And that proposition very simply is
3 that the "out-of-pocket" measure of damages,
4 as applied to after-market trading cases,
5 which constitute the very large majority of
6 10b-5 cases, there is absolutely no rational
7 relationship to the actual economic harm
8 caused by the fraud, and there is indeed
9 economic harm caused by the fraud.

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

18 Let me share with you a very simple
19 example. In a pure after-market fraud case,
20 we have the following hypothetical situation.

21 A company, its auditors, whatever, make a
22 false statement, which causes the stock price

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1 to be inflated by a certain dollar amount.

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

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

21 In that event, where did the money
22 go? For every dollar that was overpaid by a

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1 shareholder who purchased at an inflated
2 price, that dollar didn't disappear. That
3 dollar went to another shareholder who
4 happened to sell into the inflated price, and
5 thereby actually profited from the fraud.

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

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

22 You add that to the fact that these

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

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

20 If you look at the academic
21 literature in this space, there is essentially
22 not a good word to be heard anywhere in

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1 support of this measure. And that if this
2 Committee wants to do something to address the
3 liability to which these auditors are exposed,
4 which in these after-market cases is a
5 fraction -- all right -- of that number. But,
6 ladies and gentlemen, I will submit to you
7 that a fraction of an irrational number
8 remains an irrational number.

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

13 I yield my two seconds.

14 (Laughter.)

15 CO-CHAIR LEVITT: Thank you very
16 much.

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

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

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1 Corporate Governance, the California Public
2 Employees Retirement System.

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

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

20 Topic number 2 -- public company
21 audit firm structure and ownership. CalPERS
22 is currently reviewing its policy position on

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1 audit firm structure and ownership. How an
2 organization is structured could define its
3 ability to react and fulfill its mission.
4 Structure not only supports the effectiveness,
5 efficiency, and accountability, for how an
6 organization accomplishes its mission, but
7 also influences the culture and ethical
8 practices of an organization.

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

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

22 Third topic -- corporate

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

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

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

20 Fourth topic -- audit
21 responsibility for fraud detection. Of
22 critical importance to investors is the

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1 responsibility of auditors to detect fraud and
2 improve the timely communication of these
3 frauds to the company's share owners. I will
4 refer you to our written testimony, which
5 includes quotes from former SEC Chairman
6 Levitt and former SEC Commissioner Roel Campos
7 about the importance of this issue.

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

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

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

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1 financial reporting.

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

6 CO-CHAIR LEVITT: Thank you very
7 much.

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

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

19 Grant Thornton, LLP is the U.S.
20 member firm of Grant Thornton International, a
21 major global public accounting organization
22 whose members comprise a vast network of more

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1 than 520 offices in more than 110 countries
2 with some 2,200 global partners and 27,000
3 international personnel.

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

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

21 First, I would like to touch upon
22 the detection and deterrence of material

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1 financial fraud. Recent events in France
2 remind us that some wrongdoers can and will
3 always be able to game the system with sunny
4 effect. As a profession, we must continually
5 enhance our own performance by investing in
6 improved processes, human resources, training
7 and technology, to try to stay ahead of
8 wrongdoers as much as possible.

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

17 In addition, the leading audit
18 firms and regulators should be required to
19 share with each other their fraud detection
20 experiences and promote research to educate
21 and empower all audit professionals. We ask
22 this Committee to consider developing a

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1 process to coordinate the improvement of the
2 prevention and detection of fraud.

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

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

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

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

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

16 Fourth, the risk of catastrophic
17 litigation is unhealthy for the profession,
18 investors, and the capital markets. It hurts
19 our ability to be seen as a viable, long-term
20 profession for the best and brightest people
21 entering our firm. It inhibits our economic
22 capacity and our freedom to structure

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1 ourselves to deliver what investors need, and
2 it erodes investor confidence. The companies
3 always will have an adequate choice of
4 auditors.

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

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

18 Fifth, we ask this Committee to
19 consider developing recommendations for
20 revising certain auditor-independent
21 standards, to enable firms to maintain a
22 structure based on a logical approach to

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1 independence that is in the best interest of
2 investors.

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

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

19 I also ask this Committee to build
20 upon the work of the SEC Advisory Committee on
21 Complexity and Financial Reporting, and to
22 encourage global standards on every level. In

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1 addition, we must all work hard to combat
2 misinformation and misperceptions that
3 currently restrict auditor choice.

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

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

14 Thank you.

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

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

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

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

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

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

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

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

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

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1 GAAP and GAAS failures and making
2 determinations of whether there has been a
3 GAAP failure or whether there has been a GAAS
4 failure.

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

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

16 One of the things that I have noted
17 -- and I want to share with you some of the
18 principal thoughts that come as a result of
19 that experience, which tends to mean in many
20 of the cases I just described we spent 10- to
21 20-, 30,000 hours of analysis of work papers,
22 analysis of testimony.

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

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

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

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

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

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

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

22 And to reiterate, one of my

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1 principal conclusions that I'd like you to
2 take away from here is that the auditing
3 procedures that have been developed by the
4 AICPA originally, and now the PCAOB, have been
5 good audit procedures. In the '80s they
6 worked, in the '90s they worked, and in the
7 2000s they work.

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

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

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

18 I have to say parenthetically that,
19 having been through this for some years,
20 personally I think that the profession today
21 is better managed, better structured, than any
22 time in my recollection. So I share your

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1 general view about the direction the
2 profession is going. How we get there is the
3 subject of this setting and these discussions.

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

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

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

20 And on the issue of financial
21 disclosure, I think there's a disagreement.
22 Presumably, the purpose of financial

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1 disclosure would be to serve the public
2 interest. And I'd like to know in particular,
3 since I think that quite definitely Mr. Coffey
4 and Mr. Nusbaum, you believe that there's
5 insufficient financial disclosure.

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

15 MR. COFFEY: Yes, sir. Well, I
16 think you have to start with the premise that
17 auditors are asking for special treatment here
18 by virtue of what's claimed to be a
19 significant financial risk in litigation. I
20 talked at length about what I think the facts
21 are with regard to that risk, but you don't
22 have the second piece of the equation. You

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1 don't have enough information about the
2 ability of these firms to withstand it.

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

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

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

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

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

17 MR. NUSBAUM: Let me answer that
18 question in several aspects. First of all,
19 we've tried -- the profession has tried to
20 provide aggregate information to the Committee
21 to hopefully analyze the profession better and
22 spent a lot of time and effort putting that

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1 together, which will hopefully enable the
2 Committee to reach some conclusions and
3 analyze the profession adequately.

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

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

19 And I might also add, you know,
20 I've heard many people say that the
21 experiences in the UK, we'd all disclose this
22 financial information and the world would not

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1 come to an end, and indeed it didn't.

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

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

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

22 Thank you, Mr. Chairman.

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

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

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

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

20 CO-CHAIR LEVITT: Tim? Tim Flynn?

21 MR. GRUNDFEST: If I may, just
22 briefly from a litigation perspective, I think

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1 we can understand the push and pull, and we
2 just might as well put it all out on the
3 table. Plaintiffs' lawyers obviously would
4 like to get the information, because it gives
5 them an opportunity to calculate a bleeding
6 point. You know, how much can we actually get
7 from this -- how much can we actually get from
8 this particular defendant? How far can we
9 push in these negotiations?

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

20 CO-CHAIR LEVITT: Tim Flynn?

21 MR. FLYNN: Thank you. Mr.
22 Johnson, you talked about independent board

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1 members, and I think it's something very much
2 worth pursuing. We've got the liability
3 issues, how you actually track them, but
4 setting aside that we could attract
5 independent outside board members, what do you
6 see the role of that board member? Is it just
7 the same type of role that a public company
8 board member would have in a public
9 corporation, or is it a public interest role?

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

18 MR. FLYNN: But doesn't that
19 oversight role possibly create some kind of
20 conflict? If their role is to look at the
21 safety and soundness of the institution in
22 response to the shareholders, how do they

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1 balance that, then, with looking at -- you
2 know, that they have then -- also have the
3 public interest, the investors, that are not
4 part of the ownership or part of the structure
5 of the organization?

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

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

19 MR. JOHNSON: That is correct.

20 MR. FLYNN: Mr. Coffey, if you
21 could look at, just for a second -- and, you
22 know, there's lots of stuff in the litigation

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1 issue and debate about litigation,
2 catastrophic, and other things. One of the
3 things that -- in our system today is
4 ultimately the decision is to take a case to
5 trial and have a jury look at the case.

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

15 MR. COFFEY: Well, I guess let me
16 give you a little bit of my personal
17 experience. I have taken two -- I've gone to
18 trial twice against auditors, both were Arthur
19 Andersen -- for the *Baptist Foundation of*
20 *Arizona* trial in 2002, which was the largest
21 nonprofit bankruptcy in history, and that was
22 an audit malpractice case brought on behalf of

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1 the estate, and, of course, WorldCom, where we
2 went to -- against Andersen for five weeks
3 until just before we closed and they settled.

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

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

18 I don't think -- I think the point
19 of your question was: do you bring a case
20 even though you won't try it? No, I wouldn't
21 do that. One of the things that has filtered
22 through this discussion here and in other

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1 forums is the idea that the cases that really
2 put an audit firm and other defendants at risk
3 are somehow non-meritorious.

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

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

19 And so -- but generally speaking,
20 cases settle. The reason the two cases I
21 mentioned that I took to trial went to trial
22 -- one, *Baptist Foundation of Arizona*, each

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1 side had a very strongly held but dramatically
2 different view of the value of the case.

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

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

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

19 MR. FLYNN: If you look at our
20 litigation environment in the U.S., and you
21 superimpose upon that a more principles-based
22 IFRS accounting world, how do those two things

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1 come together, and how do you think that
2 really works? Will it just drive us right
3 back into a rules-based world, because the
4 system won't allow the principles-based in our
5 litigation system to work in concert?

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

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

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

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

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

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

14 Yes, quickly.

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

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

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

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

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1 damage theories were accepted.

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

12 CO-CHAIR LEVITT: Gaylen?

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

17 CO-CHAIR LEVITT: Gaylen?

18 MR. HANSEN: Thank you.

19 CO-CHAIR LEVITT: Gaylen Hansen?

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

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

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

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

18 I think that, you know, this --
19 talking about the trial bar, and I read these
20 editorials about the trial bar. And in my
21 experience -- and it just may be me, but in
22 almost every case where I've been in the

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1 courtroom there has been a defense lawyer
2 there as well, and usually more of them, and
3 they are better paid and better funded,
4 etcetera. They are working pretty hard.

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

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

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1 MR. HANSEN: Thank you.

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

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

12 (Laughter.)

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

18 MR. GRUNDFEST: I was afraid
19 someone in the room would ask the obvious
20 question. You'll notice my written submission
21 doesn't go there, because I just sort of
22 figured that I could take the high ground and

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1 say that everybody agrees that this piece of
2 the system is broken.

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

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

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

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1 consequences.

2 At one extreme -- one group
3 suggests that there be a schedule of
4 penalties, payments, damages where you would
5 look at the magnitude of the pricing
6 distortion, the period of time, the amount of
7 capital that was actually distorted, and come
8 up with a formula that came to the formulas
9 that already exist in the Securities Act of
10 '33 and the Exchange Act of 1934.

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

22 There you would take evidence about

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

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

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

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1 WorldCom.

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

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

11 Rick?

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

18 And then, with appreciated candor,
19 I think you said the sustainability of the
20 audit firms capable of delivering that
21 essential product really lies in the prudent
22 judgment of the savvy investors who bring

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1 claims which could destroy those firms and the
2 willingness of those investors to settle at
3 prudent levels.

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

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

16 And, secondly, with respect to the
17 very different world of foreign investors,
18 private equity, and now sovereign wealth
19 funds, particularly sovereign wealth funds who
20 come from parts of the world where respect for
21 the importance of audit is not as well
22 developed as in other communities, can we

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1 responsibly rely as an act of faith on those
2 prudent self-controls to preserve the
3 availability of quality audits for the capital
4 markets?

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

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

20 Then, you have to come up with the
21 fraudulent intent. You have to have cogent
22 and compelling evidence of this. And then,

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1 you have a very significant point which is the
2 proportion at fault. And as someone who has
3 debriefed yours, after the *BFA* trial and after
4 *WorldCom*, and tried each of those cases many
5 times to mock juries, I can tell you -- I'm
6 not happy to say this in front of Mr. Nusbaum,
7 because he may repeat it back to me in the
8 *Refco* case at some point, or his lawyers may.

9 (Laughter.)

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

21 Now, when it comes to non-
22 securities cases, the private equity cases, I

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1 think, again, that is more where you get to --
2 you know, I am less comfortable opining on
3 that, because I am not involved in those cases
4 as much. But it is hard to imagine -- again,
5 in the absence of knowledge about what the
6 threat is to, what is the financial
7 wherewithal of the firm, it's hard to imagine
8 any of those cases being of such magnitude to
9 put a firm at risk.

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

18 Again, the point I make is that
19 after a whole series of wickets, you get down
20 to that last circuit breaker, which I believe
21 was demonstrated in *WorldCom* and would be in
22 any mega case, an institutional investor, that

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1 understands the importance of each and every
2 accounting firm we have left, and would not
3 want to see that number reduced.

4 CO-CHAIR LEVITT: Rick, is that --

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

8 MR. MURRAY: I take the Fifth on
9 that.

10 (Laughter.)

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

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

17 MR. GRUNDFEST: With regard to the
18 last-ditch circuit breaker argument, if the
19 circuit breaker doesn't kick in at the level
20 of actually getting a settlement, then in my
21 experience when you take it to trial, you
22 basically put the pedal to the metal, and you

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1 ask for damages and the like that would
2 bankrupt everybody. Exhibit A, the JDS
3 UniPhase trial.

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

8 CO-CHAIR LEVITT: Bill Travis?

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

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

20 MR. FLECK: Very briefly. Thank
21 you for that. I think that -- that there is
22 computational authority certainly on my side

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1 of the Atlantic. On a number of occasions, it
2 has probably not helped the future of the
3 profession -- one by encouraging competition
4 in a way which has not put an equivalent
5 amount of protection on the values of the
6 important components of professionalism and
7 integrity. And, secondly, obviously through
8 the concentration in the marketplace.

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

18 And the result, as I said earlier,
19 nowadays I very rarely go to a board meeting
20 and have a senior partner from an accounting
21 firm present when they make a serious decision
22 about whether to proceed with a transaction or

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1 make a judgment about the future of the
2 business.

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

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

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

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

22 And in the UK, we produced a

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

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

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

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

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1 Advisory Committee as opposed to being
2 considered in the CAQ.

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

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

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

22 But we want to encourage this

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

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

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

22 So we think that the auditors,

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

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

10 MR. TRAVIS: Okay. Thank you.

11 CO-CHAIR LEVITT: Thank you very
12 much.

13 Lynn Turner?

14 MR. TURNER: Thank you, Mr.
15 Chairman.

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

20 CO-CHAIR NICOLAISEN: Lynne, get
21 closer to the mic. The reason why I'm asking
22 people to get closer to the mic is this is

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1 webcast and it's -- for those not in the room,
2 it's hard to hear.

3 MR. TURNER: Sorry, Don.

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

15 Let me ask everyone the question.

16 Richard, in your testimony you had
17 some very good remarks about the audit report
18 and audit quality. Question for you is: are
19 there specific things we should think about in
20 terms of expanding or changing the audit
21 report? I was intrigued by some of the
22 comments you had. And what are you looking or

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1 thinking about in that respect over in the UK?

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

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

22 And last but not least, for Ed, the

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

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

17 And this is something that, to the
18 extent possible, we would encourage this panel
19 to look very closely at, to strengthen the
20 rulemaking in this regard so that companies
21 are able to provide a very detailed story, if
22 you will, about why there is a change in

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1 auditors, so that the share owners in the
2 company can be well informed and not operate
3 with the perception of either something
4 positive or negative potentially driving that
5 change.

6 MR. FLECK: I'm frantically
7 writing.

8 (Laughter.)

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

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

18 Second is that I think it would be
19 much clearer about the message that is being
20 given. One of the great worries I have is
21 that most people don't actually read a written
22 report at all. As soon as they know it's an

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1 audit report, they turn to the next page.
2 That seems to me to be rather unsatisfactory,
3 and I think there are two elements to be
4 addressed there.

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

17 And the third thing, which is in
18 relation to that, is that I hoped the -- much
19 better sections of an opinion that address
20 areas where people believe that they should be
21 drawing shareholders' reports -- attention to
22 matters. And I actually don't believe it is

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1 adequate just to do that by saying, "See note
2 33-1/2."

3 (Laughter.)

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

8 MR. TURNER: Joe and John?

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

11 (Laughter.)

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

14 (Laughter.)

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

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

19 (Laughter.)

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

22 MR. COFFEY: The recent cases

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

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

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1 income of that company.

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

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

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

22 So when the jury is asked to say,

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

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

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

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1 are too big.

2 Second, you have institutions that
3 are keeping -- are controlling the lawyers.
4 You have fewer law firms on these cases. They
5 are driving attorney's fees down. Joe, the
6 next time you write an editorial for *The Wall*
7 *Street Journal*, please write it as if it's
8 2008, not 1994, when it comes to attorney's
9 fees.

10 And so -- and they are also getting
11 corporate governance in a lot of these cases,
12 which is making the capital markets safer
13 tomorrow than they were yesterday as a result.

14 So the institutional lead plaintiff, I have
15 my issues with the PSLRA, but that was a
16 stroke of genius. And it really has made a
17 very, very important difference.

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

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1 Circuit that was out of step with every other
2 circuit.

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

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

16 Second, with regard to the
17 *Stoneridge* decision, here, you know, with all
18 due respect to John, I think many people in
19 the plaintiff's bar consciously mistake the
20 holding in *Stoneridge*. There is no other way
21 to put it. *Stoneridge* does not allow anybody
22 to commit a fraud. It does not vindicate any

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1 action. It doesn't give anybody a safe harbor
2 from any action.

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

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

17 Now, Mr. Coffey's additional
18 complaint may well be that he cannot also
19 bring a private claim and recover money for
20 his clients and get a percentage of that
21 claim, but that is a very, very different
22 proposition of law, and I do wish that the

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1 plaintiff's bar would be a little bit more
2 accurate in this area.

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

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

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

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

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

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

22 MR. GRUNDFEST: Very simply, I

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

7 MR. TURNER: Paul?

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

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

22 I think there are no more rules

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

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

18 I think audit rotation has done
19 that on occasion -- audit partners' rotation,
20 excuse me. But I've seen too many instances
21 where that has not worked, that has not
22 stopped the fraud. Firm rotation has done

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1 that, and that happens in other countries in
2 the world.

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

5 (Laughter.)

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

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

22 And so the basis for that was

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

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

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

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

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

14 MR. TURNER: No specific examples.

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

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

20 CO-CHAIR LEVITT: Thank you.

21 Jeff Mahoney?

22 MR. MAHONEY: Thank you, Mr.

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1 Chairman.

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

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

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

18 MR. NUSBAUM: Well, first of all,
19 you know, Grant Thornton, and I think
20 hopefully the entire profession, embraces more
21 transparency around a variety of things. And
22 we think that the 8-K requirements should be

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1 expanded, and that companies should disclose
2 the reasons for changing auditors. We think
3 that is in the best interest of investors.

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

14 MR. REGAN: Mr. Mahoney, I'd like
15 to make a comment on that. One of the things
16 that I think you folks ought to give some
17 thought to is that if there -- you keep audit
18 partner rotation, if an audit partner is early
19 rotated off of an issuer, there ought to be a
20 disclosure, and there ought to be
21 communication from the partner who was rotated
22 off early as to why he was -- he or she was

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1 rotated off early, because in many instances
2 that -- there's controversy there.

3 CO-CHAIR LEVITT: That's it?

4 MR. MAHONEY: Thank you.

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

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

9 MR. NUSBAUM: Yes.

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

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

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1 country.

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

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

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

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

22 MR. NUSBAUM: Well, any capital,

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

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

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

19 MS. BUSH: Thank you.

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

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

5 Thank you so much.

6 CO-CHAIR NICOLAISEN: Could you
7 indulge one --

8 CO-CHAIR LEVITT: Yes.

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

11 CO-CHAIR LEVITT: Okay. One last
12 question.

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

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

22 I would appreciate if your folks,

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

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

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

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

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

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

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

15 I think both of your testimony has
16 touched on that a little bit, and particularly
17 Mr. Regan's testimony about the intensity of
18 the pressures in the other direction on audit
19 -- on engagement partners. And I hope that
20 each of you could comment a bit about
21 deterrence, its value, whether you think our
22 current litigation system, combined with

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1 regulation and oversight, provides sufficient
2 deterrence, and what the down side on
3 deterrence might be of weakening that system.

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

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

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

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1 doing that.

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

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

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

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

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

21 CO-CHAIR LEVITT: Okay. Thank you
22 very much. We will be back promptly at 10

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1 minutes after 5:00.

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

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

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

13 Annalisa?

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

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

20 MS. BARRETT: Okay. Yes, we thank
21 you very much for the opportunity to speak
22 with you today, and we actively promote the

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1 importance of transparency of information
2 presented by U.S. companies, because we
3 believe that better transparency permits
4 better oversight and decisionmaking by
5 investors.

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

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

20 The audit process and the audit
21 should contribute to the transparency of
22 financial reporting for preparers and

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1 investors. We hope that the information
2 provided by The Corporate Library here today
3 and in the packet submitted to you would help
4 the Advisory Committee to know the goals based
5 on these important principles.

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

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

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

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1 1,293 companies for which we have data between
2 2001 and 2006. And, therefore, it provides a
3 very accurate picture of the changing market
4 share of the audit firms included in the
5 study.

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

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

22 All of the data in this report

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

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

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

18 When we evaluate -- we at The
19 Corporate Library evaluate the effectiveness
20 of boards of directors, we take into
21 consideration the level to which management
22 and/or the boards of directors are entrenched

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1 and potentially holding too much power or not
2 considering new ways of approaching their
3 business or serving shareholders.

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

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

19 We also suggest that all companies
20 provide comprehensive disclosure regarding
21 their policy on rotation of audit firms or
22 partners and their procedures for ensuring

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1 auditor independence. Additionally, we
2 support the harmonization of global accounting
3 standards, as long as such standards continue
4 to require a high level of transparency.

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

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

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

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1 CO-CHAIR LEVITT: Thank you very
2 much.

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

8 Paul?

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

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

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

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

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

21 If you only hear one thing from me
22 today, hear this, please. And that is that

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1 it's critically important that investors be
2 engaged in all aspects of the consideration of
3 improvements, not just in accounting standards
4 but also in the accounting practice, dealing
5 with conflicts and other matters, litigation
6 issues relating to accountants. We are
7 critically important consumers.

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

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

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1 standard.

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

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

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

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

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

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

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

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

11 Thank you.

12 CO-CHAIR LEVITT: Thanks a lot.

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

17 MR. KOENIG: Thank you. I was at
18 Goldman Sachs, and, as was mentioned, was head
19 of the investment banking technology global
20 effort for over 15 years, and as such I worked
21 with many venture capital-backed companies,
22 all the way through billion dollar companies

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1 at various stages of development, and also
2 represented hundreds of companies in
3 underwritings, whether it was initial public
4 offerings or IPOs or follow-on offerings of
5 equity debt convertible.

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

17 We are also concerned very much
18 about our liability management as an
19 underwriter, and also very importantly with
20 our reputation. In terms of the data, as the
21 General Accounting report -- the GAO report
22 shows, that for much larger companies there is

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1 very heavy concentration. For companies over
2 \$500 million in revenue, about 95 percent of
3 those companies used Big Four accounting
4 firms. And then, at less than \$100 million,
5 about 22 percent use non-Big Four public
6 accounting firms.

7 The data that I presented and was
8 sent out to the Committee previously reviewed
9 companies that were undertaking initial public
10 offerings. So that is the new population of
11 companies that is entering the field of public
12 companies. And the time period reviewed as
13 2002 through 2007, so it was from the period
14 of the adoption of Sarbanes-Oxley and the
15 Enron fallout until the present.

16 And over that time period, there
17 have been 817 initial public offerings in the
18 U.S. over \$20 million in size. And of those,
19 713, or 87 percent, had Big Four accounting
20 firms that presented the audit, and 104, or 13
21 percent, were audited by non-Big Four.

22 And of the non-Big Four, of the

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

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

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

21 We did recommend -- make
22 recommendations, clients were considering

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1 retaining various auditing firms, and they
2 employ their own criteria in terms of price,
3 service, expectation, relationships, and so
4 forth.

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

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

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

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

18 An interesting note is that now in
19 Silicon Valley, whereas 10 or 15 years ago
20 almost nobody outside of the Big Four at the
21 time, whether it was the Big Six or the Big
22 Eight, was retained by venture capital startup

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1 companies. Now it is estimated to be about
2 three or four in 10.

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

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

20 Thank you.

21 CO-CHAIR LEVITT: Thank you very
22 much.

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

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

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

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

18 While competition and concentration
19 in the audits of small public companies has
20 improved, there is still significant
21 concentration among the large and mid-sized
22 public companies. The impact to the capital

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1 markets of the departure of another large
2 accounting firm would be significant.

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

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

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

20 Audits of public companies,
21 especially large public companies, carry much
22 greater liability exposure than those of

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1 smaller non-public companies. Catastrophic
2 risk or risk that a single failure could bring
3 down an accounting firm is also exponentially
4 higher in audits of public companies.

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

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

19 In the current litigation
20 environment, many firms may decide that the
21 risk-reward equation is simply out of balance,
22 and decide that they are not willing to expand

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1 this practice. We believe that many regional
2 firms like B.K.D. and other local firms are
3 interested in expanding their public audit
4 practice, but generally, for smaller, lower
5 risk type clients.

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

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

22 This fundamental change is

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

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

16 Some might argue that eliminating
17 the risk of catastrophic loss potentially
18 lessens an auditor's rigor in performing
19 consistent quality audits. However, there are
20 several other factors in place to ensure that
21 auditors are conscientious and focused on
22 audit quality. These include -- the cost of

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1 litigation is still high, our professional
2 reputation, the PCAOB oversight and
3 enforcement, the possibility of SEC sanctions,
4 the ability to obtain ongoing professional
5 liability insurance, and our firm's governance
6 and culture.

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

11 CO-CHAIR LEVITT: Thank you very
12 much.

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

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

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1 profession.

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

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

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

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1 -- 2,600 at last count -- as well as those
2 companies that list overseas with our Euronext
3 affiliate.

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

12 More recently, pursuant to the
13 Sarbanes-Oxley Act, all listed companies have
14 been required to have independent audit
15 committees with respective responsibilities.
16 At the same time as the Sarbanes-Oxley
17 legislation was focusing on the audit process,
18 the NYSE was adopting a set of enhanced
19 corporate governance standards, requirements
20 for its listed companies. These requirements
21 focused mainly on independent directors and
22 board processes, but also contained

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1 significant requirements focusing on the Audit
2 Committee, generally its purpose, use, and
3 responsibilities.

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

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

22 After reviewing this report, and

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

7 It seems clear that there has been
8 a perception in the market for many years that
9 a certain group of auditing firms, amongst
10 which it is appropriate for a substantial
11 public company to choose from -- the Big Four.

12 This is not a dictate.

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

20 We do think that the expectation
21 that a company must use a big auditing firm is
22 beginning to erode, as one would expect given

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1 the very constrained number of big firms. At
2 the NYSE, we have noted an increase in the
3 number of next tier national and regional
4 firms beginning to do public company work.

5 While it is true that approximately
6 94 percent of the NYSE's operating companies
7 are still done -- audited by the Big Four,
8 that is down from about 98 percent from a few
9 years ago.

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

21 Companies may, of course, initiate
22 a change in audit firms on a voluntary basis

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1 for many good reasons. And certainly, on the
2 flip side, audit firms are taking those risk
3 policies also on the opposite side as they
4 look at their list.

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

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

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

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

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

19 MR. KOENIG: Well, I think that
20 they have been forced to embrace the
21 practices. And even though the provisions are
22 very costly and potentially onerous,

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1 especially for small and medium-sized
2 companies, I think having some relief would be
3 very strongly welcomed, although I think there
4 is also a strong recognition that many of the
5 provisions of the Act are in the public
6 interest.

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

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

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

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1 bit lower.

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

4 MR. SILVERS: Thank you, Arthur.

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

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

20 Ms. Barrett, you said -- and I
21 think a number of other investor
22 representatives have said so -- that it would

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1 be better should there be -- that there should
2 be more competition, that the smaller firms
3 should have more business effectively.

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

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

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

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1 Let me suggest to you the following
2 example, and you tell me why it doesn't apply.

3 I am an architect, and I'm a really kind of
4 simple architect, and I build things that have
5 no more than five pieces. So they kind --
6 it's easy to see them. It's easy to see
7 whether they fall down or not.

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

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

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

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

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

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1 And, if so, where?

2 MS. BARRETT: Can I start?

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

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

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

20 And so I think that that would be
21 the ideal structure is where you get to a
22 large group of companies of similar size, of

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1 similar capability, of similar resources, and
2 similar willingness to take on liability
3 necessary to be in this business, and that
4 would give companies the opportunity to choose
5 from a larger pool of large to medium-sized
6 firms with the capabilities to audit them
7 appropriately and to share appropriate
8 information with investors.

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

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1 and experienced firms.

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

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

15 MR. KOENIG: I think it's a very
16 competitive process. When companies are
17 selecting auditors, I think that the firms get
18 geared up. It's generally a fairly
19 comprehensive evaluation. There are criteria
20 that are drawn up. The Board gets involved.
21 The Auditing Committee gets involved, and my
22 experience is that it's a very thoughtful and

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1 competitive process when the selection is
2 actually made.

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

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

13 MR. SILVERS: With changing. Thank
14 you.

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

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1 how you meet the needs of the clients that we
2 serve.

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

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

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

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

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

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

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

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

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

15 MR. SPENCER: Very important.

16 MR. SILVERS: That that incremental
17 process -- that firms are actually succeeding
18 at that incremental process. I think this
19 Subcommittee is very interested in how do we
20 foster that, how do we encourage that without
21 doing things that are dangerous in
22 relationship to investors in the markets. If

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1 there was a paradigm here, I think we're
2 trying to get our arms around it.

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

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

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

22 (Laughter.)

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1 So I think that's part of the issue
2 is name recognition, and for us it's really
3 for already existing public companies who have
4 seen a lot of the regional and national firms
5 picking up the work from New York City. So
6 when we look at -- when you're going public,
7 when most of Silicon Alley and West 17th
8 Street was going public three or four years
9 ago, much like what the West Coast experienced
10 -- not necessarily any revenues and a whole
11 lot of seasoning -- did they really need a Big
12 Four firm to do that work? And say, yes, I
13 order you that you have zero revenue. You
14 probably could argue no, but that goes back to
15 who is making the decision.

16 MR. HAAGA: Okay. Thanks. Quite
17 frankly, I've been here all afternoon waiting
18 for a concrete suggestion and coming back with
19 the Pricewaterhouse --

20 (Laughter.)

21 We're not going home empty-handed.

22 You asked about investors being

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1 heard. I have long implied that investors are
2 not being heard. We are being heard -- I
3 think I'd like to suggest a little more formal
4 representation on things like the boards of
5 the -- of FASB.

6 Number two, I think we may be
7 defining "investors" too broadly to include
8 anybody who sort of represents the public
9 interest. Those people are wonderful and can
10 certainly speak on many of the issues. But in
11 the case of public interest groups and even
12 institutional investors who are indexed, they
13 are not picking stocks based on what they read
14 in a financial statement.

15 And so I think if you sort of -- if
16 you cut through the group of shareholders and
17 found some that are really using the financial
18 statements to -- for something as important as
19 choosing investments on behalf of their
20 shareholders, you might get a little richer
21 quality of analysis.

22 CO-CHAIR LEVITT: Thank you.

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1 Mr. Cohen?

2 MR. COHEN: Thank you, Mr.
3 Chairman.

4 One question I would like to
5 address stems from actually an earlier panel
6 where Chairman Levitt remarked there was a
7 passionate plea dealing with the pressures
8 which accountants are confronted every day --
9 pressures from their clients, pressures from
10 within the firms themselves.

11 I would open this up to any of the
12 panelists as to what could be done to reduce
13 those pressures? And I will throw out one
14 specific issue. I mean, it's fortunate having
15 Cap Research, which has a very strong
16 reputation as a long-term investor.

17 One question -- one partial answer
18 may be that the quarterly earnings pressures
19 are such that penny a share makes such a
20 difference that perhaps something can be done
21 in that area.

22 MR. HAAGA: Everybody is thinking

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1 but me, so I think I'll start at least with
2 the answer. We would love to do something
3 about quarterly earnings pressure. I think
4 one of the things that could be done about it,
5 and one of the things we try to focus on in --
6 both in investing and in voting proxies is the
7 compensation drivers of that excessive focus.

8 We like to look at what -- you
9 know, I think management have become obsessed
10 with their stock price, in part because their
11 compensation is so leveraged to it. So we
12 look very hard at what are the incentives to
13 management, and I wish other people would do
14 so, too.

15 Encouraging long-term investing,
16 encouraging the payment of dividends, will
17 create a little bit of a longer-term focus.
18 But to get back a little bit to the quality of
19 life for the auditors, I don't mean this
20 critically of the PCAOB but -- or, frankly, of
21 the SEC and NASD, but we in the mutual fund
22 business have gone through a difficult time

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1 following up on some regulatory problems that
2 we had. So have the accountants following up
3 on some problems that they had in Enron and
4 WorldCom.

5 There is a natural tendency for
6 regulators to become hostile in those
7 situations, and to look to punish wrongdoing.
8 And I think there is often -- being its human
9 nature -- an assumption that comes out of that
10 that the -- whether they be the accountants or
11 the mutual fund advisors or others who are on
12 the receiving end of those enforcement
13 matters, are bad people who are intent on
14 wrongdoing and that the regulatory
15 environment, instead of being a quality
16 control environment, becomes a hostile
17 environment in which we are looking for people
18 to make mistakes.

19 I think both the accounting and the
20 mutual fund professions are coming out of
21 that. I think it's natural, so I don't want
22 to lay a lot of blame, certainly not personal

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1 blame, on anybody. But I think if people
2 could simply recognize that, then I think the
3 accountants would have a more enjoyable time
4 being accountants if their regulators were --
5 made sure that they emphasized quality control
6 more than finding bad guys.

7 MR. TYRANSKI: I would -- on the
8 quarterly side, I think that's a fair point.
9 I was at the FEI's New York meeting a couple
10 of years back, and when the then-Chairman
11 McDonough of the PCAOB gave the keynote
12 address, at one point he actually appealed to
13 the audience to stop putting so much emphasis
14 on quarterly reporting and really look at it
15 over the course of the four quarters in the
16 entire year.

17 So that is one point I think from a
18 pressure standpoint. The other piece is
19 complexity, and Bob Herz, from the FASB, had
20 his paper I guess two years ago on just how
21 complicated it has gotten for not only inside
22 accountants but obviously the outside

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1 accountants.

2 And I think the new guidance that
3 has come out on restatements, kind of
4 codifying the age-old adage that there are
5 good restatements and bad restatements, will
6 hopefully ease some of the pressure of some of
7 those restating. So there's going to be
8 mystic fallout not only to us but to the
9 customer.

10 And the other piece I think from a
11 pressure standpoint is, again, the continued
12 emphasis on always hitting the time limits
13 and, you know, the existing SEC reporting
14 timetable now, at least from what we hear from
15 CFOs, it's not so much the annual that proves
16 to be difficult. It's the quarters and
17 getting that done and out as quick as they
18 have to know.

19 CO-CHAIR LEVITT: Mr. Goldman?

20 MR. GOLDMAN: I've got a couple of
21 questions and comments. Paul, I think you
22 said, if I heard correctly, that per se you

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1 wouldn't feel there's a problem if it went
2 down from four to three firms, and that we
3 shouldn't be worried about too big to fail.
4 And so I'm not sure if I heard that correctly
5 or not.

6 Then, my next question would be, if
7 that's true, when is too few? Is two too few?
8 One too few? So that's one question.

9 Brad, I was wondering in terms of
10 your firm and other firms, is there a
11 perception -- yes, you mentioned there's a
12 perception of a Big Four, non-Big Four, red
13 flag, not a red flag. Is that shared with --
14 I'm not sure if you call it an Investment
15 Committee or a Credit Committee, is that
16 shared sort of high up in firms like the firm
17 you are with, so it isn't just on the people
18 on the street, but it gets back in the firm
19 itself?

20 Neal, I thought one of the comments
21 you made was actually to me enlightening, and
22 I will maybe add a little different

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1 perspective on it. But it is the catastrophic
2 issue. And I'm not going to use the example
3 that he used, but I do worry that in -- you
4 know, in the real scheme of things, you do
5 look at the risk-reward, because it makes
6 sense to take on public companies.

7 And that leads me to the other sort
8 of question or comment. My sense is one of
9 the reasons why some of the concentration is
10 not quite as extreme is some of the Big Four
11 are dropping what they perceive to be high-
12 risk accounts.

13 And by dropping those accounts, the
14 other Big Four aren't picking them up, and so
15 part of the reason why there's a lot of
16 unintended consequences, part of the reason
17 why you're seeing a little less concentration
18 today is because you see some of the non-Big
19 Four picking up clinical accounts being
20 dropped by some of the Big Four.

21 And also, another question is: do
22 you sense -- Brad, do you sense there is a

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1 difference in rigor of the non-Big Four versus
2 Big Four, either in terms of the audit itself
3 or the type of people you hire?

4 And one last question I meant to
5 ask -- Paul, when you look at, from Cap
6 Research's point of view, the companies that
7 you invest in, Big Four/non-Big Four, does
8 that create a red flag for you or your firm in
9 terms of at least asking the question: why
10 would a company that could have a Big Four
11 doesn't have a Big Four?

12 MR. HAAGA: Let me clarify. I
13 think it would be a very bad thing if one of
14 the large firms, current large Big Four
15 auditing firms were put out of business or
16 went out of business. That would be a bad
17 thing.

18 I think the only worse thing would
19 be if we now told them that we would guarantee
20 them that no matter what they did, or what
21 happened, or what their finances looked like,
22 or anything else, that there was no way we

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1 would allow them to go out of business.

2 So it's -- really, it's balancing
3 the two disasters, but I -- but make no
4 mistake, I think it would be a very bad thing
5 if we had fewer than four.

6 I do trust the marketplace, though,
7 to be -- have some resilience. I think the
8 profession and the clients showed a lot of
9 resilience in picking up after the Arthur
10 Andersen thing. That's not to minimize that
11 and/or to suggest that I think it was a good
12 idea that they were put out of business. I
13 don't think it was. I think it should have
14 been handled another way. But I think things
15 would be resilient. I just wanted to get to
16 that balance.

17 In terms of the -- just sort of the
18 Good Housekeeping Seal of Approval, I guess we
19 would look at if someone did not have a Big
20 Four, I'd want to know what kind of a company
21 it was. If it were a major multi-national
22 firm with multi-national operations that were

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1 relying on a specialized, more localized
2 accounting firm, you would wonder how they
3 were getting an audit of all of their
4 businesses.

5 On the other hand, if it were a
6 specialized firm that could deal with -- or
7 could be adequately dealt with -- many of our
8 smaller cap companies in which we invest are
9 audited by non-Big Four firms and do quite
10 well. I'd also want to know sort of how they
11 got there.

12 If they started like with that firm
13 and grew to become a small public company with
14 that firm, that would be different from if
15 they got rid of their Big Four firm and went
16 to it. So there is more to it, but I don't
17 think that we would automatically worry about
18 a non-Big Four audited public company unless
19 they were huge and multi-national and it was
20 just impossible to imagine them being audited
21 by somebody smaller.

22 MR. KOENIG: Maybe I can follow up

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1 to the question about what our internal
2 Commitments Committee process was. The
3 dynamic of our business selection practice was
4 that the team and the department or group, the
5 industry group that was running the client
6 relationship, would go out and do very, very
7 significant due diligence on all aspects of
8 the business including having audited
9 statements.

10 And we would then prepare a
11 comprehensive memo, which would go to the
12 Commitments Committee, which was comprised of
13 about a dozen very senior partners from around
14 the firm, around the world. And in the memo
15 there were required to be a section about the
16 audit and the financials.

17 And being responsible if there was
18 a non-Big Four, we would always highlight the
19 fact that there was a non-Big Four that was
20 presenting the audit, and that would result in
21 a very extensive focus and question on the
22 part of the Commitments Committee which was

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1 precluded by the team actually doing a very,
2 very substantial amount of work directly with
3 the auditors, with the Auditing Committee,
4 understand what the history of the engagement
5 was, why it -- if they could have selected Big
6 Four, didn't they select, what was the basis
7 of the relationship, and so forth.

8 And so, again, I am not aware of
9 any situation that we actually put down a
10 piece of business because there was a non-Big
11 Four, but the level of scrutiny and focus was
12 greatly elevated.

13 MR. SPENCER: Let me address the
14 comments you made about the Big Four dropping
15 high-risk accounts. That's really not what we
16 saw. When Sarbanes-Oxley came along, there
17 were tremendous opportunities for all of the
18 firms under the Big Four. But what we saw, at
19 least in our market, which understand is in
20 the heartland of America, the Midwest, was not
21 the dropping of high-risk public audits.

22 It was privately held companies,

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1 quite frankly, those that fit in our footprint
2 very well, those type of clients that were
3 looking for superior service that they were
4 not getting from the Big Four, because the Big
5 Four's attention was clearly going to be
6 focused on the public environment.

7 So we didn't see that in our
8 marketplace.

9 CO-CHAIR LEVITT: Thank you. Mary
10 Bush on the phone.

11 MS. BUSH: Yes. This question is
12 --

13 CO-CHAIR LEVITT: Can you speak up,
14 please?

15 MS. BUSH: Yes. Can you hear me
16 now?

17 CO-CHAIR LEVITT: Yes.

18 MS. BUSH: This question is for
19 Paul Haaga and for Brad Koenig. Let's assume
20 for a moment that we were to lose another one
21 of the Big Four. What I would like the two of
22 you to do, if you would, is to sort of project

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1 forward with me as to what would be the
2 fallout for the markets of losing another
3 firm.

4 In doing so, you might sort of
5 reflect back on what happened when Andersen
6 went out of business. But kind of the focus
7 of my question is: what should we be thinking
8 about in order to avoid disruption in the
9 capital markets, maintaining investor
10 confidence? What were some of the things that
11 you saw last time in terms of -- I mean, just
12 simple things like the production of financial
13 statements that created problems for your
14 business that we, as the Committee, the
15 Treasury, and regulators need to be thinking
16 about.

17 MR. HAAGA: Thanks, Mary. Losing
18 another big firm, you know, my main concern,
19 what I would focus on the most is how we lost
20 the member of the Big Four whom we lost. If
21 they just all decided to retire at once, that
22 would be one thing. But that's unlikely.

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1 I think it would -- to make it
2 happen now, given the Arthur Andersen
3 experience, it likely would have been caused
4 by a massive failure and a very significant
5 either internal fraud or failure to observe
6 fraud. And I think that -- the cause, rather
7 than the outcome, would be the -- what would
8 be most disruptive to our markets. So I would
9 -- and our investment -- our investment
10 practice.

11 So I'd focus more on that than on
12 the actual how do you deal with the outcome of
13 having only three.

14 MS. BUSH: And because it was --
15 sort of destroyed trust in terms of other
16 financial statements that had been produced
17 for a wide range of other companies, is that
18 what you --

19 MR. HAAGA: Yes, correct. And
20 Arthur Andersen had -- I'm probably being too
21 generous, but they had a rogue office.

22 MS. BUSH: Right.

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1 MR. HAAGA: And they were indicted,
2 my understanding is, without a lot of
3 consultation with other regulators and public
4 bodies. I don't think that would happen again
5 absent some massive, almost unimaginable,
6 circumstances. And I would hope we would
7 catch it before they needed to go out of
8 business.

9 So I'm -- maybe I'm going too far
10 in questioning your premise, but --

11 MS. BUSH: No, no, no. No.
12 Listen, I hope we would catch it, too. I
13 agree. Is this Paul talking?

14 MR. HAAGA: Yes.

15 MS. BUSH: Okay, Paul. Hi. I
16 agree with what you said earlier. I also do
17 not think they should have been put out of
18 business. I think the rogue offices and rogue
19 people should have been put out of the
20 company. Losing the firm is not what I
21 personally think should have happened.

22 What I am really more interested in

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1 is when something like that happens suddenly,
2 and they are working on -- a firm is working
3 on the audits for a number of companies and
4 working on other kinds of businesses, other
5 kinds of business, and they are not able to
6 complete those audits, somebody else has to be
7 found to do it, that takes time. They might
8 be in the middle of IPOs or just equity
9 issuances in general.

10 What kinds of problems does it
11 present for your analysts or investors and for
12 the capital markets in general? And that last
13 part is directed to Mr. Koenig.

14 MR. KOENIG: Okay. Well, first of
15 all, with the proviso that I'm not an expert
16 on the structure, competitive structure of the
17 accounting profession, there are 5,000 NASDAQ
18 and New York Stock Exchange listed companies I
19 think where the market value is over \$100
20 million.

21 So at some point, maybe when you
22 went from eight to six to five, at some point

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1 it didn't really threaten overall competition.
2 But my feeling is that at much below a level
3 of four that would begin to severely threaten
4 public competition.

5 I think the experience that we had
6 in the wake of Enron was that -- near
7 paralysis at many companies who were involved
8 in transactions where Arthur Andersen was the
9 auditing firm. And so luckily that proved
10 only temporary. Many of the professionals who
11 had had long relationships and knowledge of
12 the company ended up going to other firms.

13 And so the disruption was
14 minimized, but there was paralysis and then of
15 course the entire -- the rest of the
16 professionals, the accounting professionals,
17 became very, very conservative, and also,
18 again, to this point of responsiveness, the
19 risk aversion when an event like that happened
20 just really increased very significantly.

21 And the inability to take local
22 action without very extensive consultation

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1 with the headquarters really made things very,
2 very difficult and time-consuming.

3 CO-CHAIR LEVITT: Mary, Alan Beller
4 has some thoughts on your question.

5 MS. BUSH: Thank you.

6 MR. BELLER: Mary, in addition to
7 what was just said -- and I agree with it in
8 terms of disruption -- when the first rumors
9 of Andersen's indictment -- possible
10 indictment surfaced, the SEC basically in
11 complete secrecy drafted a set of emergency
12 temporary rules that would be available if
13 Andersen was in fact indicted, and what people
14 expected would happen would happen.

15 Obviously, there could be no
16 publicity about that, because it would have an
17 effect -- produce the results that --

18 MS. BUSH: Right.

19 MR. BELLER: -- was a problem.

20 MS. BUSH: Right.

21 MR. BELLER: When the indictment
22 was announced, those rules were announced

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1 within about 48 or 72 hours. What they
2 basically did -- and they did not solve the
3 problem that Mr. Koenig is talking about about
4 freezing the capital markets, because nobody
5 was going to go to the markets without audited
6 financial statements.

7 There were several thousand
8 companies that Andersen audited. The market,
9 in fact, caught a break, because Andersen --
10 if the indictment of Andersen had taken place
11 six weeks earlier than it had, you would have
12 been in the middle of the audit season for the
13 year-end companies. As it turned out,
14 Andersen was indicted after most of the audit
15 work for most of the year-end companies had
16 been done, and audits could be produced by
17 Andersen as it was in effect winding down.

18 The temporary rules really provided
19 two things very basically. One, they gave
20 companies the ability to file unaudited
21 financial statements for a period of time
22 which would allow them to replace Andersen if

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1 they either had to do that or chose to do that
2 without violating the reporting requirements.
3 Again, as was said earlier, I don't think
4 anybody was going to get to the market on that
5 basis, but at least they weren't violating the
6 rules when they filed their quarterly and
7 annual reports.

8 Secondly, companies and Andersen
9 were put -- were -- an obligation was added
10 that they in effect had to disclose, in
11 connection with their filings, whether
12 Andersen had fallen so far away that it was
13 unable to complete the audit or the review
14 work that was ongoing.

15 Those emergency temporary rules are
16 probably expired but still on the books
17 somewhere.

18 MS. BUSH: Thank you very much.

19 CO-CHAIR LEVITT: Bob?

20 MR. HERZ: Yes. This question is
21 for Annalisa. I think in your written
22 submission you suggested that going to global

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1 standards might actually foster increased
2 competition in the audit market, and I'm just
3 interested in you elaborating a little bit
4 further on those thoughts.

5 MS. BARRETT: Well, I think that as
6 the U.S.-focused firms and the U.S.-focused
7 concentration is expanded to include companies
8 that can audit IFRS financial statements, then
9 there will be more competition, more firms,
10 and they will be more available to do those
11 financial audits.

12 MR. HERZ: I've heard kind of the
13 reverse argument to a certain extent, that if
14 we did it too quickly in this country, that
15 the only people that might be able to service
16 those companies would -- companies would be
17 the Big Four, or the Big Six as they now call
18 them, the people who have people that are
19 based abroad that are already experienced in
20 IFRS, whereas U.S. regional or even national
21 firms might not have that expertise at hand
22 yet.

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1 MS. BARRETT: What I'm referring to
2 is other companies in other countries who are
3 able to do auditing here in the United States
4 as well.

5 CO-CHAIR LEVITT: Ken? Gaylen?
6 I'm sorry.

7 MR. HANSEN: Yes. If I could -- I
8 have a couple of quick questions. I want to
9 direct this to, Brad, you talked about the
10 Good Housekeeping Seal of Approval. It has
11 been discussed a lot, and I was intrigued by
12 your rating scale. And certainly you are
13 entitled -- you know, everybody is entitled to
14 have their own way that they rate people.

15 But it would seem to me that that
16 would be, as I believe, Neal, you indicated,
17 an institutional or a market bias. And I just
18 wondered, in terms of following up with that,
19 I have often been told one of the reasons why
20 smaller firms are not selected is because they
21 don't have a sufficient amount of insurance
22 available. And I don't know if that is any of

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1 your criteria.

2 And then, another question that I
3 would have, which is probably more significant
4 than that, is, do you or have you ever used
5 the PCAOB inspection reports in really
6 analyzing and screening firms? And if not,
7 why not?

8 And then, I had a question for you,
9 Paul. You talked about the concept of a
10 centralized national standard-setter, and
11 indicated there was a number of different
12 entities that are involved in independent
13 standard-setting.

14 It seems to me that most of the
15 underlying principles of independence are very
16 similar. But I was just sort of wondering
17 what you think a national standard-setter of
18 independence, what would that look like? And
19 would it handle private companies and public
20 companies, both, or what did you really have
21 in mind?

22 MR. HAAGA: Should I go with that

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1 one? I think a national standard-setter -- my
2 sense is that we are moving in that direction,
3 that you are right, there are not greatly
4 different standards in -- by the different
5 bodies and by the states versus the federal.

6 I guess what I'd like to say is
7 that we need to get the rest of the way there,
8 because there are still a few areas in which,
9 particularly relating to the scope of an
10 audit, there are some different rules in
11 conducting an audit -- but the actual conduct
12 of an audit, that there are different rules in
13 different states, as I'm told by my
14 colleagues.

15 So I think the more important part
16 of our -- the uniformity comment really
17 related to the license and making it easier
18 particularly in a national industry like
19 mutual funds to make it easier for people to
20 -- partners and others to practice in
21 different states.

22 MR. HANSEN: Mr. Koenig? Brad was

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1 going to answer a question.

2 MR. KOENIG: Okay. I was just
3 going to respond to the question. First of
4 all, the scores I indicated, 10 of 10 for a
5 Big Four, seven of 10 for a non-Big Four, and
6 then three of 10 if there was a complication
7 or an issue involved -- those are not audited.
8 Those were --

9 (Laughter.)

10 -- really meant just to give you a
11 qualitative feel, not relating to the quality
12 of the work or the team or the firm, but
13 merely as a brand and rating on the Good
14 Housekeeping Seal when we would do our
15 business due diligence and go to our
16 Commitments Committee process.

17 It was simply indicative of having
18 the highest standard of auditing review and
19 practice. So it really was not in any way
20 meant to reflect a difference in quality.

21 And on the question of the PCAOB,
22 no, we did not utilize that.

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1 MR. HANSEN: Any particular reason?

2 MR. KOENIG: No.

3 CO-CHAIR LEVITT: Mark?

4 MR. OLSON: Thank you. Two
5 questions. First, to Mr. Haaga, in your -- in
6 the written submission, you refer to FAS 157,
7 and you said that the implementation was --
8 made it significantly harder on audit firms by
9 suggested audit approaches by the PCAOB.

10 Could you elaborate on our -- on
11 our suggested audit approaches?

12 MR. HAAGA: Yes. I think what
13 happened on that -- as my colleagues who were
14 involved in it relayed to me -- was that there
15 was a specific audit approach, bulletin I
16 guess it was, that came out from the PCAOB
17 that talked -- and this particularly affected
18 mutual funds, that said something to the
19 effect that if a firm is relying on a service,
20 evaluation service as almost all mutual funds
21 do, particularly in the fixed income area,
22 then the auditors have to look behind the --

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1 what the service does and how it gets its
2 prices, how it determines its prices, and I
3 think that was -- both the timing of that and
4 the seeming breadth of the requirement were
5 disruptive to the accounting firms.

6 MR. OLSON: So you're interpreting
7 that as new guidance.

8 MR. HAAGA: Well, it was certainly
9 a new -- it was perceived as a new gloss on
10 what their responsibilities were.

11 MR. OLSON: We have gone to some
12 effort to make sure that we were summarizing
13 existing audit standards. So I am interested
14 here if that's the result of your analysis or
15 if you're repeating what clients might have
16 told you.

17 MR. HAAGA: Well, I'm not an
18 accountant, so -- but I am a client, because
19 we are a -- we are managed mutual funds, and
20 the mutual funds have had to -- this standard
21 applies to us, just as -- it applies to mutual
22 funds just as it applies to an operating

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1 company.

2 And I'm sure that there was an
3 effort on the PCAOB's part to -- not to
4 surprise people, but it did, and it -- maybe
5 they weren't listening, but I know that when
6 that standard came on they were surprised and
7 they had to go look -- that they had to go
8 look beyond what the services were providing.

9 MR. TURNER: Paul, let me just say
10 -- and I sit on the Board of the Mutual Fund
11 as an ICA member, and we had the same issue.
12 But I must say where markets are coming out I
13 think it is absolutely true.

14 You may want to go back to your
15 people, because there was nothing really new
16 in that whatsoever, and it was just repeating
17 what was already, and had been for a long,
18 long time, existing GAAP with those reports.
19 So you may want to go check on that one.

20 MR. OLSON: One more question of
21 Mr. Spencer. Let's assume that you -- that a
22 firm smaller than the Big Four decided, for

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1 strategic reasons, to address all of the
2 litigation and other issues that are
3 problematic. If you were to make a strategic
4 decision that you wanted to be at the end of a
5 time certain at a size similar to a Big Four,
6 what would be the strategic issues that you
7 would be addressing?

8 And let me tell you why I'm asking
9 it. There is a question as to whether or not
10 it is possible to generically grow into the
11 company of the current Big Four. And so I'm
12 asking the question: what are the strategic
13 issues that it would take in order to do so?

14 MR. SPENCER: Well, there's a
15 couple, but let me first comment that it is
16 almost impossible for a firm the size of
17 B.K.D. to grow into the Big Four. The gap
18 between Number 4 and B.K.D. is in the
19 billions.

20 MR. OLSON: But that's --

21 MR. SPENCER: Right.

22 MR. OLSON: But what are the -- but

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1 can you just enumerate what the critical
2 barriers are to keep that from happening?

3 MR. SPENCER: Well, clearly, I
4 think number one is your international reach.
5 We are part of an international association of
6 accounting firms. We don't -- that
7 international group is not representative of
8 all of the countries across the globe. So,
9 clearly, that would be one huge barrier.

10 The complexity of the rules is
11 clearly another. We would have to invest in
12 many more resources in our home office to
13 support and monitor the ongoing activities of
14 the SEC, and so forth. Those would be two of
15 the biggest reasons.

16 MR. OLSON: Okay. Then, to follow
17 up, do you anticipate seeing a new -- the
18 marketplace helping a non-Big Four firm become
19 a Big Four in size any time in the near
20 future?

21 MR. SPENCER: I think there's a
22 couple of firms that are positioning

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1 themselves to be the next Big Four.

2 MR. OLSON: So you --

3 MR. SPENCER: Yes.

4 MR. OLSON: -- it's within the
5 realm of possibility that in the marketplace
6 that could happen.

7 MR. SPENCER: Sure.

8 CO-CHAIR LEVITT: Thank you.

9 MR. TRAVIS: I might add, Mark,
10 that I think one of the other key strategic
11 issues would be industry expertise, as
12 outlined in the GAO report. I think that's a
13 significant strategic issue that would have to
14 be addressed. And not just acquiring it, but
15 training and developing and all of the tools
16 and things.

17 Neal, a quick question for you,
18 just to shift gears a bit. We've heard --
19 we've talked a lot today about transparency.
20 And you have an excellent audit firm. As part
21 of your practice, the SEC practice has 85 or
22 so clients, so it's a relatively small

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1 percentage of your firm's practice.

2 Can you share your views about
3 transparency and what would make sense from
4 your perspective?

5 MR. SPENCER: Yes, sure. It's not
6 that we're opposed to transparency. I think
7 the question is: what do you want to know?
8 Clearly, when you look at B.K.D., as you just
9 mentioned, less than five percent of our
10 revenue is generated from public company
11 audits.

12 So when we look at transparency,
13 the question of: what is a firm's insurance
14 ability? How much insurance does a firm
15 carry? That would probably be something that
16 we would be willing to share. How much
17 capital we maintain in our firm is probably
18 something that we would be willing to share.

19 But how important is it to share
20 partner compensation? There are so many
21 factors that range when you talk about partner
22 compensation to leverage of a firm, to

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1 structure of a firm, that those numbers vary
2 all over the board. And for a firm like
3 B.K.D. that spends 95 percent of its time
4 outside the public company audit arena, that
5 would cause some competitive disadvantages to
6 a firm like us.

7 MR. OLSON: Thank you.

8 CO-CHAIR LEVITT: Barry?

9 MR. MELANCON: Just real quick to
10 Neal. You mentioned the global association
11 twice, one earlier and once in response to
12 Mark's strategic question on growing. And I'm
13 conscious of the time, so let me preface this
14 and just see if you would agree with this.

15 There is a theory that says that
16 how the Big Eight grew in the '60s, etcetera,
17 the environment in which they grew, through
18 global activities, etcetera, that the
19 difficulties for a next tier -- if you want to
20 focus on a larger firm than yours today -- is
21 much different, and, therefore, is sort of a
22 built-in impediment to that actually

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1 occurring. Would that be a fair statement in
2 your mind?

3 MR. SPENCER: That would be a fair
4 statement.

5 MR. MELANCON: And could you just
6 describe, very briefly, some of difficulties
7 through your association that you are facing
8 today, and what that might look like, just to
9 give the Committee a taste of what a global
10 association of a firm your size might be like.

11 MR. SPENCER: Well, the challenges
12 that we face is -- even though all of the
13 members of PRAXITY, that's our international
14 affiliation, we have member firms in countries
15 and they go through a rigorous membership
16 application.

17 But you still don't know the type
18 of quality work they do until you actually ask
19 them to do some work. And even in our
20 association that has some very good firms in
21 it, we have had issues, as we've gone across
22 the U.S. border, to deal with some of those

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1 accounting issues that our companies are
2 dealing with in Mexico and Europe and other
3 places. So it is clearly a challenge.

4 CO-CHAIR LEVITT: Last two
5 questions.

6 MR. BELLER: Thank you.

7 CO-CHAIR LEVITT: We are wearing
8 down. I don't see --

9 (Laughter.)

10 MR. BELLER: I have a question for
11 Mr. Spencer, and I guess also Ms. Barrett. I
12 want to tease out a different transparency
13 thought that you shared, and this is the
14 transparency of the auditing and accounting,
15 or especially the accounting literature.

16 There has been a lot said recently
17 about the issues of GAAP hierarchy, and the
18 different, somewhat disorganized way in which
19 GAAP is expressed by the FASB, by the
20 Commission in the context of simplicity of
21 accounting standards and reporting.

22 I guess I want to get at it a

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1 little bit from the competition side, and that
2 is, is the profession and/or investors better
3 off -- beyond the GAAP hierarchy, you've got a
4 variety of sort of non-authoritative
5 pronouncements that take on the aspect of
6 authoritative pronouncements, all the way down
7 to, you know, speeches by professional fellows
8 at AICPA conferences.

9 You also have, frankly, greater
10 access by the Big Four to the FASB and to the
11 SEC than the rest of the profession. Are
12 investors and the profession better off with
13 that status quo? There is, after all, more
14 information somewhere, and it may ultimately
15 trickle down from the high priest and
16 priestesses to the rest of the world.

17 Or, as a pure competition matter,
18 is that something this Committee should be
19 thinking about? Does transparency help from a
20 competition point of view in ways that
21 outweigh perhaps the fact that there would be
22 less information out there somewhere?

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1 MR. SPENCER: Yes. I think from a
2 competition standpoint, I think transparency,
3 simplification of all of the accounting
4 standards that we are trying to deal with,
5 would certainly help from a competition
6 standpoint. I think all of the firms spend an
7 enormous amount of resources trying to
8 understand what comes out in terms of rules
9 and regulations.

10 And, quite frankly, look at the
11 differences between firms, they interpret them
12 differently. And so the more simplified you
13 can make the rulemaking, I think the better
14 off we are all going to be, and more
15 consistent we'll be in reporting to the
16 public.

17 CO-CHAIR LEVITT: Lynn?

18 MR. TURNER: Just real quick for
19 Paul. When reading through your testimony --

20 CO-CHAIR LEVITT: Can't hear you.

21 MR. TURNER: Sorry. For Paul --
22 when reading through your testimony on auditor

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1 independence, I wasn't sure exactly what you
2 were getting at. And I wasn't sure whether
3 you were saying we should water down the
4 auditor independence rules in some areas or
5 not. Could you just quickly --

6 MR. HAAGA: Yes. It was more of a
7 cautionary note I think. I wouldn't water
8 down the independence rules. I think that
9 over the years there have been -- and I think
10 the SEC has addressed some of these -- there
11 have been some Draconian consequences.

12 The one -- just thinking of one
13 anecdotally in which we were involved and
14 which the -- one of the Big Four firms was
15 auditing our mutual funds, and somebody in the
16 Cincinnati office married someone who had a
17 401(K) plan in our funds, and we had to go --
18 I was embarrassed to go before our Audit
19 Committees to get permission to deal with
20 that.

21 I think that has been dealt with in
22 rules, but I just -- what I really wanted to

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1 get was sort of constant vigilance about not
2 letting these things -- particularly in the
3 mutual fund area where an audit can't have
4 much impact on the price of the shares,
5 because it is really the underlying securities
6 that cause that, that we not go overboard on
7 independence.

8 CO-CHAIR LEVITT: I want to thank
9 the panel and the members of the Committees
10 and the -- I can't break this up without
11 thanking Treasury and its staff, particularly
12 Kristen Jaconi, for orchestrating a difficult,
13 complex, but I think hugely effective,
14 informative, open, and fair-minded hearing.
15 So thank you all.

16 (Applause.)

17 (Whereupon, at 6:40 p.m., the proceedings in
18 the foregoing matter were
19 concluded.)

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