

PANEL ON AUDIT EFFECTIVENESS
PUBLIC HEARINGS ON EXPOSURE DRAFT OF
REPORT AND RECOMMENDATIONS

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Reported by:
BETH RADABAUGH

TOBY FELDMAN, INC. (212) 244-3990

P A N E L M E M B E R S

SHAUN O'MALLEY, Chairman

DAVID PEARSON, Chief of Staff

DENNIS CHOOKASZIAN

BEVIS LONGSTRETH

LOUIS LOWENSTEIN

ZOE-VONNA PALMROSE

AULANA PETERS

RALPH SAUL

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P R O C E E D I N G S

MR. O'MALLEY: Good morning, everyone. I'm Shaun O'Malley and I, once again, would like to introduce the Members of the Panel for those of you who may not have been here yesterday. Coming from my left is Bevis Longstreth, Lou Lowenstein, Aulana Peters, and from my right, Dennis Chookaszian, Ralph Saul, Zoe-Vonna Palmrose, and Chief of Staff, Dave Pearson. I think we had a very good meeting yesterday and got a lot of very useful input. The Panel has already begun to discuss some of that input. We have a full slate of presenters this morning.

I would mention one thing. Some of you had asked about Panel Member Paul Kalton, who yesterday had to go to the hospital towards the later stages of the afternoon. He's fine. He's going to be going home. Unfortunately, he won't be

able to join us today, but it looks like he's just fine.

Our first presenters this morning are from the American Institute of Certified Public Accountants, a body of which I've been a member for some 40 years. I just got my dues bill. It's gone up this year, even though I'm retired. We have the distinguished President and CEO here, Barry Melancon, along with Jim Gerson, the Vice Chair of the Auditing Standards Board, and Dan Jones from the SEC Practice Section. We welcome you all and look forward to hearing your presentation.

MR. MELANCON: Thank you, Shaun. I can assure you your dues are a real value proposition for us.

Mr. O'Malley and all Members of the Panel, thank you for the opportunity to be here this morning. As Shaun said, I'm the President and CEO of the AICPA. And

he introduced Jim and Dan, but let me give you a little bit of background on each of them.

Jim is representing the AICPA's Auditing Standards Board. He currently serves as the Vice Chair of the ASB, and assumes the Chairmanship of that body in October of this year. He's a partner with PricewaterhouseCoopers and the National Director of Audit Policy for the firm.

Dan is attending as the AICPA's SEC Practice Section representative. He's a partner with Deloitte & Touche, a senior partner in charge of the Audit and Attest Practice of his firm. During our testimony today I will be asking both of them to speak on certain aspects of the Panel's draft report, especially concerning the recommendations as it relates to auditing standards, governance, and disciplinary matters.

Overall the report has validated our belief that the profession and quality of audits is fundamentally sound. We know you and your staff have worked long and hard to harness just a whole cluster of information over the last year and a half, and we congratulate you and thank you for your contributions. The issues you have struggled with are complex. We acknowledge that, and the profession recognizes and appreciates your dedication to improving the overall quality of audits of publicly held companies.

We also want to thank the profession's eight largest firms for their continued support of this project, especially their cooperation in the Quasi Peer Reviews review and the significant resources that each of these firms have devoted in the past 18 months to your

study. The Panel is to be commended despite the focus on the large firms, and the auditors of SEC registrants that its draft report included many helpful recommendations that were designed specifically to assist and help small firms, and we are appreciative of that because the profession is diverse, as you well know from a firm's honest perspective.

We would be remiss if we did not mention that the investing public is fortunate that our profession, we believe, as we have said to you on many occasions before, is committed to the protection of the public interest. And we also acknowledge that we have a Securities and Exchange Commission that is equally committed in that area.

If there is one overriding message that we want you to understand and take with you today, it is that our value as

the AICPA and its mission statement is a commitment to the self-regulatory program that focuses on the protecting of the public interest, enhances the credibility of financial reporting to the audit, monitors firm performance, and disciplines those who violate the rules.

A profession has unique responsibility in its ability to have an effective self-regulatory program. It has been the auditing profession's commitment and dedication to preserving the integrity of financial reporting that has made our self-regulation program so successful over the years and will continue to make it successful in the future. Without question, our self-regulatory system has greatly contributed to creating the best and strongest financial reporting system and financial markets in the world. The auditing profession would not do anything

to jeopardize this public trust.

The investing public can be reassured by Panel's findings and conclusions, based on your own independent and in-depth review of audits, that audits are being conducted in an effective manner and that the Panel is satisfied that the model underpinning financial statement audits is generally appropriate.

As you recall, when I first appeared before you in October of 1999, I reminded you that the auditor does work in a static environment. With the dynamic markets, globalization of the economy, the rapid changes in technology and a virtually-driven world, to name a few, the auditor must be able to readily adapt to his or her environment. We at the AICPA are committed to assisting our members and the profession with this adaptation process. It is critical. In

our efforts to meet that goal, we will evaluate all the panel's recommendations with that in mind. It is our obligation at the AICPA to be cautious so that we do not anchor the audit so that it becomes static.

In our comments today we'll be addressing three major issues in the report that we view as vitally important to protecting the public interest and enhancing the credibility of financial reporting. Those issues are the ability of audit firms to provide non-audit services in the new economy and the positive effect those services may have on the effectiveness of audit, reliance and sound professional judgment rather than mandating prescriptive approaches to auditing, and an effective due process structure for standard setting. The AICPA will also be submitting a detailed written comment that addresses some of

the specific issues contained in your draft report. We have put a lot of resources and continue to put a lot of resources into that report and you will expect to see a comprehensive written response.

Our commitment to self-regulation is extremely important in today's business environment. We also must look to the future in assisting audit firms to meet these changes. The new economy has caused all of us to re-evaluate long recognized business models on which business success is predicated. The new economy requires new and different skills for those in the audit profession. For example, understanding rapidly evolving information technology, understanding how new businesses are run, and evaluating soft information. We must bring these new and broader skills and strong professional judgment with us to the

audit to enable us to understand these new forms of business, including all aspects of their operation. The profession of today must also interact internationally and not be confined specifically to domestic issues. Our efforts have always focused on continued improvement of the audit process. We are always looking at and re-evaluating what we do in all aspects of the regulatory program that exists as well as the business environment changes.

Our profession welcomes this study, this in-depth independent review of our standard setting and self-regulatory activities. The recommendations you have made will assist us in studying changes helpful to our profession now and, most importantly, in the future. The profession has thrived because of its willingness to have transparency in its standard setting and self-regulatory

activities, subject itself to outside reviews, and to make changes, if required, that enhance protection of the public interest.

This profession has a truly enviably track record on responding to independent reviews of its activities. In 1996 the report of the General Accounting Office entitled "The Accounting Profession: Major Issues, Progress and Concerns" found that the profession has been responsive in making changes to improve financial reporting and auditing of public companies to major issues raised by many different studies from 1972 through 1995. In fact, we are confident that no other profession can compare to our track record as far as being responsive. We shall be equally responsive to your study.

To start our comments, we would like to address the issue of auditor

independence with specific respect to non-audit services. In your report you have identified two opposing views on the various services that an accounting firm may offer to audit clients and whether those services may be perceived as a weakening of the independent auditor's relationship with the client. We are pleased to see that the Panel did not detect any instances of non-audited services having caused or had a negative impact on audit effectiveness. We understand that a majority of the Panel members hold the view that an exclusionary rule is not warranted and would not best serve the public interest, and that audit firms should be allowed to provide these services, if the audit firm has appropriate safeguards in place to assure the independence of the attest function. We agree with this view held by the majority of the Panel members.

Over the years, various studies have been performed regarding non-audit services and no empirical evidence exists to suggest that providing non-audit services impairs or causes ineffective audits to provide a basis for conclusion that an exclusionary rule of non-audit services is necessary. This is consistent with our profession's findings. We believe that with the appropriate safeguards in place, the provision of many non-audit services may enhance the audit by broadening the firm's understanding of a company's business, its operating environment, and other factors that lead to more effective audits. This more effective audit clearly is in the public interest. Another positive factor is the importance of non-audit services that effect our ability to attract and retain qualified specialists.

I know that several of the people who appeared before you yesterday commented on this point. We ask that you in your final report state clearly a majority of the Panel members found that an exclusionary rule is not warranted.

We believe that the Panel's findings lend crucial objective evidence that providing non-audit services to audit clients does not impair the effectiveness of the audit, and if non-audit services are also performed, may result in more effective audits in many situations. We also believe the Panel's majority view opposing an exclusionary ban on non-audit services does not support regulatory action to ban non-audit services to audit clients. We believe that important issues, those important issues should be dealt with by the Independence Standards Board and through effective audit committees.

Our position is best articulated by SEC Chief Accountant himself, Lynn Turner, in a January 19, 2000 memorandum to SEC Chairman Arthur Levitt, I quote, "Taken together, the ISB standard and the Commission's audit committee disclosure requirements should bring independence issues to audit committees' attention and stimulate their participation in identifying and resolving independence issues."

As both the Panel and the profession consider the complex issues of independence, we want to state our support for the ISB and the Independence Issues Committee. We believe that the ISB is the appropriate public forum in which independence issues should be thoroughly considered and debated. The ISB was created jointly by the SEC and the profession. The SEC's support of the ISB is imperative and needed for the ISB

to properly fulfill its mission. At no time since its creation have the public and non-public members in the ISB been divided on a decision. It is our belief that the ISB is the body that should issue independence standards for auditors of publicly-held companies.

Moving on to another subject of great importance for the audit profession, we would like to spend a couple of minutes talking about an issue that is implicit in many of the recommendations that you have made. That issue is one of professional judgment. Throughout your report, especially in Chapters 2 and 3, you have made recommendations that appear to negate or minimize both the importance and ability of auditors to use professional judgment. Numerous recommendations call for more specific and definitive requirements in the auditing standards.

We believe that increasing reliance on specific and definitive requirements in the audit of financial statements can lead to a cookbook audit approach, which is driven by checklists and limits the role of professional judgment by the auditor. We believe that as the role of professional judgment is minimized, the quality and effectiveness of audits will decline. We believe that the most important component of a high quality and effective audit is the professional judgment of the auditor. No amount of specificity in auditing standards will replace good, sound professional judgment.

Sound professional judgment is organic. It's dependent on the competency and skills that the auditor brings to bear. It is capable of assessing and reacting to the infinite number of situations that will be

encountered as an individual performs an audit. A cookbook audit approach could never be as rich and complete as sound professional judgment. An auditor is able to exercise his professional judgment because of an extensive amount of education, years of experience in similar situations, comprehensive professional education requirements, adherence to a professional code of ethics, and of course high quality, comprehensive auditing standards.

Greater professional judgment by an auditor is the key to protecting the public today and in the future as we face ever changing and complex situations. Although we understand that specific and definitive auditing procedures make it easy for a regulator to determine whether the procedures have been followed, we believe that a static checklist will never be able to keep pace with the rapid

changing nature and risk associated with the new economy. Understanding the nature of these risks requires sound professional judgment and it is unlikely that more specificity within auditing standards will create an environment that encourages professional judgment.

This reminds us of a current debate in the medical profession. When a physician makes a diagnosis of an illness, the physician uses his or her professional judgment in making decisions on the best ways to treat that illness. However, in today's environment if the patient is a member of an HMO, then the HMO goes through a checklist-oriented procedure on whether to allow the costs attributable to the treatment. In many cases, as we're sure you are aware, the HMO disallows or refuses to cover many of the treatment costs. This in effect overrides many of the physician's

professional judgments in treating that illness. We fear that prescribing required auditing procedures, like the HMO following a checklist of prescribed treatment procedures of various illnesses, would lead to an eroding of the professional judgment that is needed to conduct a more effective audit.

Auditing is a profession. The fact that we are professionals and can bring our expertise and professional judgment to bear is the reason we have been so successful in protecting the public interest and maintaining public confidence in financial reporting. Its specialized body of knowledge that is applied by all of its members, whether it is the legal, medical or auditing profession, defines profession. Without professional judgment, auditing will cease to be a profession. Those protecting the public interest will cease

to be professionals. We believe that the public interest will be at risk.

In your report you acknowledge an issue that we have long tried to influence. That is the future of the accounting profession is dependent on attracting the best and the brightest students. If professional judgment gives way to checklists of required auditing procedures, the best and the brightest students will choose more challenging and interesting professions. The profession will spiral downward. We also fear that the recent rulemaking proposal by the SEC to restrict audit firms from providing non-audit services to its clients will also contribute to making the profession less attractive to the best and the brightest.

Further, auditing firms have different strengths and competencies, which allow them to specialize in clients

of different industries, types, sizes, and complexities. This specialization is important because one size does not fit all when it comes to auditing. We are concerned that an increased reliance on specific and definitive standards will lead to an auditing process that is contributing to this downward spiral of the profession. To maintain the value of the audit in the eyes of the public and the auditing firms, we believe that it is very important to prevent the perception that audit is a commodity. We believe that allowing the firms to differentiate themselves according to their specialties, their strengths, and competencies will maintain the value of the audit. Auditors will be encouraged to maintain their competencies and clients will be able to choose from auditing firms based on their specialized skills.

You recommend that peer review should -- peer reviewers, I should say, should exercise more professional judgment during the conduct of peer reviews. In certain circumstances we have seen the results of peer reviews that are checklist driven. This method results in an ineffective peer review. Many of your recommendations regarding specificity of audit procedures may lead to that same result in the audit area.

We urge you in your final report to consider the importance that professional judgment has in the performance of audits. We will consider this skill as we review your recommendations. Professional judgment should constantly be nourished, thus protecting the public today, and as I have said many times, most importantly in the future. We ask that you reconsider your recommendations as to whether they inhibit the

attractiveness of the profession to the best and the brightest individuals.

We recognize that meeting the needs of practitioners while establishing minimum standards to the profession to ensure the continuation of high quality audits is not an easy task. We have to wrestle with that on a constant basis. Too many standards can hamper the exercise of professional judgment and can never cover all of the circumstances that an auditor will face. The ASB recognizes the fine line between too little and too much guidance. The ASB's goal in setting standards is not to eliminate professional judgment, but to focus on it.

Over these two days of hearings you're implementing a process that is as important as any recommendation contained in your report. By this statement we mean a due process by which interested

parties can testify or comment on the conclusions and recommendations that you have reached. The AICPA firmly believes in due process. Every standards-setting function at the AICPA is open to public comment.

I am now going to ask Jim Gerson to specifically speak about the ASB'S standards-setting process and give you some insight from an ASB perspective.

MR. GERSON: Thanks, Barry. And I want to thank the Panel for the opportunity to be here. Having observed all of your activities, it's nice to finally get to the front table.

Barry has discussed the importance of due process in any standards-setting environment, and the protection of the public interest is really the foundation of the ASB's standards-setting procedures. We use the same general due process procedures as the Administrative

Procedures Act prescribes for government agencies in enacting regulation.

Protecting the public interest as a standard setter requires maintaining a challenging balance between the needs of the public, preparers of financial statements, auditors of SEC registrants, auditors of private companies, and government regulators. The ASB achieves this balance through its due process. Our due process protects the public and allows us to issue new auditing standards within a reasonable time frame.

The standards-setting processes of the ASB are conducted under true public oversight. That is, our meetings are open to any member of the public, and our standards are subject to public scrutiny and comment before the ASB issues an auditing standard in its final form. We follow the same procedures with respect to the quality control standards.

Within the framework of our due process, the ASB pledges to consider all of the Panel's recommendations. All of our auditing standards are the result of our due process. And just to give you a flavor for the process we generally use, first, the need for a project may be identified in several areas. It can be comments from practitioners, regulatory pressure in some cases, litigation, actions of other groups that affect the profession, and certainly recommendations of such that are coming out from this Panel. Then we go through a research phase to analyze the issues, gather data on current practice, review existing literature, and developing alternative approaches. The AICPA's Audit and Attest Standards Team, which are employed by the AICPA, together with a small task force of the AICPA of volunteers do this activity. Then a proposed pronouncement

developed through the task force is submitted to the ASB, which considers it generally at several meetings before we go final, as I'm sure you're familiar with, and evaluates alternatives.

An important part of this process is that we bring knowledge and experience to the table to develop the auditing standards in a public forum, but it's important to note that this knowledge and experience is not limited to the 15 members of the board. Experts on various topics are invited to sit on the appropriate task forces to contribute to the deliberation of the standards. And even before we would take a proposal to exposure, we seek input from representatives of our constituencies, and it always includes the SEC.

The recommendations resulting from the ASB's public deliberative process will be subject to public scrutiny in the

form of exposure drafts of proposed auditing and attest standards, and exposure drafts are posted on the ASB's website with notices sent electronically to all of the offices of the audit firms with AICPA members, regulators, to other interested parties, and anyone else who requests them. Ordinarily 90 days are allowed for comments from the public. Through our exposure draft process, the ASB will obtain views of interested parties in both the public and the private sector. Finally, we can carefully consider the comments from all parties, especially those comments on issues that had not been previously considered before issuing a new standard or revising an existing standard. We believe that our procedures will result in new or revised standards that address the underlying findings contained in your recommendations in an appropriate and

timely fashion.

It's clear to the ASB that the omission of any one of the steps in our due process is not in the public interest. It's also clear to us that if the ASB were to ignore or override the comments that may be received during the public comment period merely because they may vary from certain of the Panel's recommendations, that this would not be consistent with the due process and would deny due process to some of our constituencies. The ASB needs to consider the opinions of all of our constituencies, including auditors, users, preparers of financial statements, and government regulators.

Having said this, I want to assure the Panel that we do work closely with the SEC. We meet regularly with them and we take their suggestions very seriously. But even with the SEC, we

must consider their views in the context of our overall deliberations and the views of others.

As such, we ask that the Panel acknowledge in its final report that its recommendations and the priority of its recommendations be subject to the ASB's due process procedures, which we believe are in the public interest. Furthermore, we suggest that the Panel make a recommendation to the SEC that the SEC encourage and support the ASB in carrying out our planning and standards-setting mission in the public interest and subject to full due process.

That concludes my comments on due process, and I'll turn it back over to Barry.

MR. MELANCON: Thank you, Jim.

I would like to turn my comments now to the area in your report concerning earnings management and the fraud

chapter. Obviously we as a profession are very concerned about fraud. We recognize the impact that misstated financial statements have not only here in the U.S. and our capital markets, but also on international exchanges and other users of financial statements. The purpose of the audit is the issuance of an opinion on whether the financial statements are free from material misstatements that are caused by error or by fraud. However, we fear that your use of the term zero defects conveys an unreasonable expectation to users of financial statements. Terms or representations such as zero defects contribute to the continued expectation gap between what audits are and what the public believes an audit is.

We suggest that you revise your report to recommend a zero tolerance for unacceptable behavior by auditors. We

believe that this is consistent with your conclusions that reasonable, but not absolute, assurance that financial statements are materially misstated is a sufficiently high standard of responsibility for auditors to protect the public interest, and will not create unrealistic expectations for the audit.

I'm now going to ask Jim to comment more thoroughly on earnings management and fraud.

MR. GERSON: All right. Thanks, Barry.

Many of your findings concerning earnings management and fraud really confirm the ASB's desire to issue additional guidance that helps auditors exercise professional judgment. For example, your recommendations related to non-standard journal entries and the relationship between the risk assessment process and the auditing procedures are

issues where I personally would predict that the ASB is clearly going to consider issuing additional guidance.

Most of Chapter 3 seems to focus on the Panel's desire for stronger and more definitive auditing standards in various areas, including planning and supervision, forensic-type field work phase, and the performance of specific substantive procedures in various areas. The ASB and the Panel share a common goal, the performance of effective audits. We believe that the auditing standards should enable auditors to provide reasonable assurance that financial statements are not materially misstated.

In keeping with that goal, I should note that the ASB Board of Directors issued a policy statement in 1993, in which it stated as one of its five principle goals is the improvement of the

prevention and detection of fraud. In 1997, the ASB issued SAS 82, Consideration of Fraud in a Financial Statement Audit. And importantly, at that time, we immediately developed a strategic plan to commission several academic research projects to study the efficacy of that standard.

These research projects are ongoing now and, in fact, they are really coming to fruition this summer. A couple of them are done, and a couple more will be hopefully finished by the end of the summer. These research projects will be considered by the ASB together with the recommendations of the Panel within the context of our due process deliberations concerning possible amendments to the auditing standards. We're committed to that process.

Since SAS 82 was issued, we've also completed several other projects to

assist auditors in this area. First, when SAS 82 was initially issued, it was accompanied by a considerable amount of additional guidance in terms of practice aids. In 1999, the ASB issued guidance on revenue recognition. We're following this project up with the development of an audit guide on auditing revenue. The ASB is also currently working on guidance on auditing reserves, and in addition, the SEC Practice Section has issued practice alerts in both 1998 and 1999 on revenue recognition and non-standard journal entries.

It's our understanding that the Panel's recommendations are based, at least in large measure, not totally, I did hear you yesterday, on conclusions drawn from audits performed before the effective date of SAS 82. And we just caution that you have to take that in context. Not that we're dismissing the

importance of the area, but that the research itself, at least in some cases, particularly the AAPR's, are drawn from an earlier time.

Just to finish up, I would say that we further suggest, keeping with the comments that Barry made, that the Panel's recommendations to the ASB related to earnings management and fraud focus on areas where auditors could use additional guidance in exercising professional judgment. As Barry said, to focus on professional judgment, rather than eliminate it by putting in a set of standard procedures.

MR. MELANCON: I'd like to turn now to your recommendations that you put in your report concerning governance of the auditing profession.

Self-regulation over auditing processes works because of the strong commitment of our profession and the

existence of a strong, independent oversight board. To that end, each party has supported the other individually and collectively to protect the public interest and the public investor.

The AICPA supports a strong oversight board that is independent of both the profession and the SEC. The Public Oversight Board has served the public and the profession well for almost 25 years. The AICPA has always supported the POB's efforts and initiatives monetarily and in the mutuality of interests in protecting the public interest.

We understand that the POB is currently proposing to develop a formal charter to depict explicitly the standard scope of its activities. We are confident that the POB and the AICPA will produce a charter that will support and preserve an independent oversight board.

In your report you also raise several issues and made recommendations regarding the peer review process and other items that enhance the disciplinary process. I'd like to ask Dan Jones now to comment on these aspects.

MR. JONES: Thank you, Barry. And I thank the Panel also for the opportunity to address you and to speak on behalf of the SEC Practice Section.

Barry has asked me to convey a few comments with respect to issues of recommendations contained in your report, and first, I would like to talk about the items related to discipline and, then second, follow up with certain issues around peer review. I do want to thank the Panel for accepting our assistance with respect to certain areas in your report which you have accepted with respect to discipline.

With respect to discipline, we are

pleased to see that you have incorporated in your recommendations many of the suggestions for the profession presented to you earlier this year. You recognize that many aspects of the current disciplinary processes work well, and that the profession should be a driver of suggested reform to our disciplinary processes. What became apparent from your report is that more transparency is required in our current processes so that the investing public fully understands the commitment that the auditing profession has in disciplining our members.

As you have aptly described in your report, the profession's disciplinary procedures center on the AICPA's Professional Ethics Provision and the SECPS Practice Section. Many of the Panel's concerns revolve around timeliness of disciplinary actions by the

profession. You have rightly discerned the reason for the delay in certain disciplinary matters. That is, the lack of protection or the right of privilege over its disciplinary activities.

We are pleased to report to you that the SEC Practice Session is implementing many of the Panel's recommendations. The Practice Section has scheduled to vote on a new membership requirement regarding its disciplinary processes in September of this year. This membership requirement will offer transparency to the current process and provide timelier disposition of disciplinary matters. To ensure that the profession meets its commitment to these enhanced disciplinary requirements, the largest accounting firms have pled significant additional funding. This additional funding is to provide resources to ensure that disciplinary

matters are conducted in a more timely and effective manner.

However, we must advise the Panel they any recommendations that may result in additional or unnecessary litigation risk or actions against auditors are unacceptable to us. Some of the Panel's embellishments to our original proposal are risks upsetting the delicate balance that we have achieved with respect to additional transparency and restrictions imposed on the current process. These embellishments may not be possible to implement or accept and may upset the proposal in its entirety. As we are sure that you are aware, any modifications to the original proposal must be completed in a way that is not prejudicial to the firms or their members or that would in any way add additional unacceptable risk of legal exposure.

Next, I'd like to spend a minute

discussing the Panel's report and recommendations concerning the peer review and the processes thereof. As you know, the SEC Practice Section in March of 1999 began to research and consider methods on how the peer review process could be improved and enhanced. The Practice Section completed and issued a report on its research in January of this year. For example, the report contained recommendations on continuous peer reviews for larger audit firms, and recommended more involvement by the POB staff in those reviews. We're pleased that you have included the SEC's Practice Section report and recommendations as an exhibit to your report, and that you encourage us to implement the recommendations contained in that report.

We're also pleased to inform you that the SEC Practice Section Peer Review

Committee is implementing many of those recommendations as possible as early as the end of this year. The Peer Review Committee is evaluating the effectiveness of the other recommendations that the Panel has made to determine if the recommendations are within its expertise to implement. Several of these recommendations are contained in Chapter 2 of your draft report. As we understand it, the purpose of recommendations to the Practice Section Peer Review Committee was to "close the loop" on new or existing auditing standards to determine if the auditing standards or a firm's audit methodology is effective. At first glance many of the Panel's recommendations appear to be appropriate and fall within the peer review purview. Our written response to the draft report will discuss other issues in more detail.

Thank you for your attention and we'll be pleased to answer questions I'm sure at the conclusion of this testimony.

MR. MELANCON: Thanks, Dan.

Dan reported on several projects that are underway within the Practice Section, and I think there are several projects that you should also be informed of that are underway or on the agenda from the ASB's perspective, and Jim will cover those.

MR. GERSON: All right. One initiative the ASB has already started concerns audit documentation. We have a task force up and running on this, and we're sensitive to the number of comments based on the recommendations of the Panel's staff. We knew this one was coming. And the purpose of this project is really to develop clear, concise, and consistent guidance regarding the objective, the nature, and the extent of

audit documentation required for compliance with Generally Accepted Auditing Standards.

Earlier I discussed the research activities concerning SAS 82. The ASB has already formed a new fraud task force, and that task force is going to be chaired by David Landsittel, who is a past chair of the ASB, and I think many of you would agree a very respected member of the profession. He has agreed to chair that task force. This group will consider the research and other activities of the ASB as well as the Panel's recommendations in preparation for the retrospective review of SAS 82.

Last year the ASB responded very quickly to the Blue Ribbon Panel on Audit Committee Effectiveness report and recommendations by issuing SAS 90 within -- I think it was nine months, which is pretty good for us. Frankly, we

believe that this document addresses many of the recommendations in the Panel's report in the section on Communications with Audit Committees.

The ASB has also begun a project on inherent risk that is seeking to provide strength and guidance to auditors in making inherent risk assessments and determining the nature, the timing, and extent of audit tests because of these assessments. I nailed John Fogarty on his way off the floor yesterday and got him to agree to chair that task force. So we are making progress.

The ASB also has begun a project that will provide a formal GAAS hierarchy that establishes the authoritative status of auditing pronouncements that are below the level of the standards to clarify where that guidance is in the pecking order.

And also I guess finally, in order

to ensure that we have a comprehensive response to all matters affecting audit, attest, and quality control standards, the ASB is going to hold a special two-day meeting in September to fully develop our work plan for the next few years. This is similar to what we did back in 1997 with the Horizon's Project that I think you were acquainted with earlier in your process. And we planned this meeting -- we've actually had to defer it a couple of times unfortunately. But we planned this meeting in anticipation of your report. It's obviously a key input to that process, and a number of constituencies are going to be represented at that meeting, not just board members, including international representatives. We believe that's an important part of the way to go forward.

Barry.

MR. MELANCON: When your Panel was formed in 1998, your mission was to assess whether audits that were being performed today were effective. We have your draft report and the results of that study, and I would like to confirm to you that our mission is not only to ensure that audits are effective today, but also in the future. We are moving forward in the areas of continuous auditing and, as Dan mentioned, continuous peer review to ensure that effectiveness is met in the future.

The advance of the digital economy has created, among other things, a demand for more timely assurance and a broad range of information that was previously only provided in an annual audit report of historical financial statements. I know you heard some testimony yesterday in which people described one-day closes and immediate real time financial

reporting. If decision makers need continuous information in which to base their decisions, which obviously in today's world they have to, it is also highly likely that these decision makers will need independent assurance on the reliability of such information on an equally quick time frame. We believe that the relevance of financial statement information may be significantly enhanced by the provision of timely assurance.

We suggest that the Panel reconsider their recommendations in the light of the possibility of continuous auditing because we believe that continuous auditing will be an integral component of the financial statement audit of the future. Where the walls of an audit begin and end in the future may, in fact, be very difficult to discern. As such, many of the recommendations that you make concerning specific audit

procedures could become quickly outdated or inefficient in the new economy of today or certainly in the future.

We will continue to research and develop new services that provide protection for the public in situations where the public receives information. WebTrust and SysTrust are examples of such services. WebTrust is a comprehensive e-commerce service designed to build trust and confidence among consumers and businesses purchasing goods and services over the Internet. SysTrust is an innovative service that responds to the critical need for assurance and the reliability of computer operations and technology in computer systems. We believe SysTrust is the ground floor for continuous auditing. Both services meet increasing demands in the marketplace for independent third-party verifications of business operations and cover important

aspects of today's economy, such as privacy and confidentiality.

We are also keeping our eyes on the international auditing arena, as mentioned in your report. We are involved in shaping international auditing standards, vigorously involved. The ASB is committed to significantly strengthening its leadership role in developing international auditing standards and quality control processes that meet the need of a global marketplace. The AICPA has a representative on the International Auditing Practices Committee, and the ASB has a subcommittee that monitors the work of IAPC and provides input into all of IAPC's operations.

In May of 2000 a joint working group consisting of representatives of Canada, the U.K., and the United States published a report making recommendations

to the IAPC arising from a study of recent developments in the audit methodologies of the largest accounting firms. Based on this experience, IAPC will begin a project to identify areas where significant changes are necessary in international auditing standards.

We face many complex issues as an economy, as a society, and certainly as a profession. I can assure you that the AICPA will continue to exert significant leadership in the evolution of the audit to set priorities and apply resources to make a difference where priorities and projects can, in fact, improve the effectiveness of audits, and we are also committed to looking in the future.

And I know that there were limitations in the work that you did because of the process of looking at historical work, but I think it's important that terminology and concepts

in your report reflect upon this future environment and the need for guidance and leadership in the profession that will continue to match the changing environment with the needs and expectations of an economy that is changing as we speak before you today.

We look forward to answering any questions that you may have.

MR. O'MALLEY: Well, thank you, gentlemen, for a very comprehensive presentation. I'm sure there are a number of questions that have come up, and in due course I'll ask each of the Panel members to ask whatever questions.

I would like to just bring up a couple of points myself to start us off, and that has to do with the due process issue, first of all. We understand that -- or I'm sure you understand that our recommendations are going to the institute, to the POB, the SEC, the ASB,

and the firms, the ISB, etcetera. All of them have their own due process, which we totally respect and have no interest in suggesting that they run rough shod over them. We're making recommendations. Our recommendations do not have the force of law or the force of regulation or the force of administrative process or anything. They are recommendations, and each of the groups that we're making the recommendations for, we would expect them to consider them and put them through their own due process procedure and go forward. Just so we're clear about that. We're not suggesting any fast road that's going to overcome your due processes.

MR. GERSON: I appreciate that, Shaun. My hope is that all parties to the process going forward will approach the recommendations in the same fashion.

MR. O'MALLEY: Okay. Well, I don't

know that anyone would disagree with that, but perhaps they do.

The second point I would like to make is on the use of pejorative terms and setting straw men in some of these presentations. The use of the word cookbook and the use of the word checklist is used in a pejorative fashion, and it's been used before. Every time a new accounting regulation comes out, that's trotted out. We're talking about the staff that worked on this and the Panel. Let me turn to the staff first.

We're talking about leaders of this profession, people who have done the toughest audits of huge companies that had problems, people who led the ASB, the QCIC, the peer review, were technical leaders within their own firm in this profession. These are not a bunch of rookies that are out there trying to

dream up some checklists. These are seasoned professionals that I would stack against anybody from any firm, and I say that from my own experience of 36 years of auditing.

So having said that, we're not talking about cookbooks and we're not talking about checklists, and I would like to get that terminology out of the debate because it is just a red flag. Obviously it got to me. What we're suggesting be done is that do the diagnosis and cause it to result in professional judgments that are going to lead to the kind of audits that are sound and make sense.

And going to that medical thing, in all of these 31 billion of market cap losses somebody did the diagnosis, but what happened after? The diagnosis was wrong. So we're trying to make sure that the diagnosis is correct and that

professional judgment is infused into that process. Not to do cookbooks and checklists. I feel very strongly about that, and I know I had to restrain some of our Panel staff when they saw that language. And the word cookbook is in there too often in your response, as is the word checklist. Always in a pejorative sense.

MR. GERSON: Shaun, can I just make a slight comment --

MR. O'MALLEY: Sure.

MR. GERSON: -- on that because I -- you know, if it was just one person saying it -- I mean I agree with you, and if you really read the words, in most cases it doesn't come across that way. I would just offer that enough people sort of read it and had that reaction, that it may be less of an issue on the specifics of the recommendation and it may just be an issue in the tone or the way they're

set up. And the use of the term specific and definitive in a number of places in your report I think created maybe a reaction among some that was as strongly felt as your reaction to cookbook and checklist.

MR. O'MALLEY: Okay. I accept that, Jim. We would just ask that you take these recommendations and consider them on their merit and not assign them to the dustbin of checklist or whatever.

MR. GERSON: No, we're not.

MR. MELANCON: Shaun, I think some of the comments you just made, if that could be sort of plugged into the preambles or whatever in the report, that would probably make sure that that track record or that record is established along the lines of what you just said. I don't think anybody would disagree with your passion from that statement.

MR. O'MALLEY: Okay. I don't want

to hog the Panel's time but I do just want to ask one question, and that's on the first point you made, Barry, about independence of non-audit services. Often times in this debate or in this consideration there's two polls. One poll says anything goes and the other poll says nothing goes, you can't do any non-audit, and another poll would be you can do anything you want.

It's unclear to me where the AICPA stands on this because I personally believe, and I think most professionals do, there are a number of services that ought to be prescribed. Some of them already are. And I just wonder where you are in that. Are you on an anything goes? I don't think so, but why don't you tell us where you are.

MR. MELANCON: I think your statement of -- some services certainly should be prescribed and some have

historically been prescribed, and I don't think anybody is debating against that. For instance, if you look at some of the debate that the ISB has had on evaluations, for example, through a due process, through discussion, the profession members and the public members came to I think a pretty sound conclusion on that and that there were certain things that should be prescribed. So I think our problem is it is a middle ground and there may be some things there that have to be looked at.

But it is very difficult today -- and as I said in my comments, you know, where an audit begins and ends in the new world is going to be very difficult. And when you start trying to put very definitive rules in place, I think you're actually going to do some damage to the accountability of our financial reporting systems.

MR. O'MALLEY: Would you be willing then to allow the entirety of this subject to be dealt with by the ISB?

MR. MELANCON: Sure.

MR. O'MALLEY: Okay. Panel members, I've taken too much time already. Zoe-Vonna.

MS. PALMROSE: Well, continuing with the, you know, hot buttons, one of the things that the Panel felt very strongly about is that we were trying to position the profession to go forward, and you did talk about that (inaudible) accomplish that with some of our recommendations. So it would be very helpful if you could provide some guidance on that either here or especially in your written response on those areas where you feel that that is not the case.

MR. MELANCON: Okay. We'll include comments in our written response.

MR. O'MALLEY: Dennis.

MR. CHOOKASZIAN: Again, not to kind of beat a dead horse on the cookbook issue, but if you read our report on page 13 in the summary, I think it says -- I'm having real trouble understanding how you draw that conclusion when you read our recommendations under Comments of Audit because it says exactly what you said. So when I read this -- what would be very helpful to us is if you could take this page particularly, because this is probably the most important summary page in the recommendation, page 13 and 14, and say where it says cookbook. Because it says things like new judgment and we've got to get more definitive work done. So I'm having trouble figuring how we would change one word in this. So if you could come back more specifically and say where does this say cookbook, that would really help me because it doesn't

say it here at all.

MR. MELANCON: Okay. I think we will certainly comment on that in our written response, but I can -- I think we're closer to our meeting of minds that we're dealing with nomenclature. I think it's --

MR. CHOOKASZIAN: Yeah. No, I understand. Nomenclature only.

MR. MELANCON: I think it's words such as definitive and things of that nature that a lot of people in a cold read of this document, not having sat in the room for hours and hours and hours like you have debating these issues, reach those conclusions and that was the feedback that we provided.

MR. CHOOKASZIAN: See, the words were carefully chosen. For example, "Auditors will be required to perform substantive tests directed at the possibility of fraud during this phase."

MR. GERSON: Well, no argument -- that's not an argument.

MR. MELANCON: That's not an argument.

MR. CHOOKASZIAN: Well, the whole thing reads like that. So if you could come through here and point very specifically -- see, it doesn't help us to say something like cookbook.

MR. GERSON: I think that's probably best done in the comment letter.

MR. CHOOKASZIAN: I agree. I agree. So if you could go through here in the comment letter.

The second point is on your -- and, again, this is nomenclature only because I think we're really aligned on what we want to do. But you're making a distinction between zero defects and zero tolerance. I don't get it. I don't get how zero tolerance is different than zero

defects.

MR. GERSON: Well, I think it's a matter of what is the intent of that, zero of what? And I think it's written -- it's in here in a couple of different places. I think actually twice. It's in the fraud chapter.

MR. CHOOKASZIAN: Yes.

MR. GERSON: And you can read it in the context that the goal should be zero defects, meaning the auditor should detect every instance of fraud that there is.

MS. PETERS: No.

MR. GERSON: But I think you could read it that way in the context of which it was written. And we think that sets up a really unreasonable expectation. And I think the construct of zero defect of performance or zero tolerance for non-performance is a more appropriate concept, but that's dealing with the

audit process, not the outcome of the audit reports. And I think that is an important distinction.

MR. CHOOKASZIAN: It is.

MR. GERSON: And I just -- I mean I just ask that you focus on the intent --

MR. O'MALLEY: We'll take a look at that.

MR. GERSON: -- because it can come across that way, and that's really the issue. It's not so much the word. It's what it's aimed at.

MR. CHOOKASZIAN: What we were trying to get at, and a comment from you might help on this, is that we all recognize that the incidence of fraudulent reporting is very, very small. It's down in this -- you know, such a small percentage that what we're trying to do is take a process which is fundamentally good and make it better. But then you're eliminating such a small

number of things, you're really at the zero defect level in what you're trying to target. So how -- if you can help us --

MR. GERSON: Zero defect may be an appropriate goal --

MR. CHOOKASZIAN: Yes.

MR. GERSON: -- but holding out an expectation that it could be achieved --

MR. O'MALLEY: It's a goal.

MR. GERSON: -- is a separate issue.

MR. CHOOKASZIAN: I agree with that. It's a goal. It is a goal.

MR. O'MALLEY: Bevis has a question here.

MR. LONGSTRETH: Well, I have a comment. I have to rise in defense of the checklists and cookbooks. And I want to make a serious point about it because -- I suppose being a little outside of this profession, I don't have

quite the electric reaction to those words that Shaun does, but I have a fundamental reaction which is as strong as his and I'm sure almost as strong as the staff's because I think you've created a straw man here that is not only unnecessary, but counterproductive in terms of encouraging a sensible evaluation and dialogue with respect to the recommendations we've made. I mean on page 10 you go from checklists and cookbooks to suddenly there's no exercise of professional judgment, and that's just absurd on its face.

What we were trying to do, and we'd like you to consider and evaluate in the light in which it was written and thought about, is to provide checklists, or call them procedures, whatever you want to call them, the due process, which I'm sure you've written down in your due process of procedures, is to provide a

better platform on which professional judgment, sound professional judgment can be exercised. Not to eliminate it, but to encourage it and to enable it to function across the board in very complicated situations.

Even the greatest chefs not only write cookbooks, but use them. Why? Because they may forget the baking soda. And all the kind of culinary judgment and professional skill to make something that doesn't have baking soda because it's too pedestrian to remember, falls flat.

So it is useful to have lists and it is useful to have cookbooks, and it doesn't in any way subtract from professional judgement. And our effort was to really provide a better platform to ensure that the judgments are professionally rendered across the board and the \$31 billion or 61, or whatever it is, might be avoided the next time.

MR. O'MALLEY: That is our hope.
Absolutely. Thank you, Bevis.

Aulana.

MS. PETERS: Yeah, I have a few questions, but first, my one comment is that I subscribe to and endorse and embrace the comments of my Panel members. So I'm going to swallow my own and ask specific questions first of Bob. Right?

MR. JONES: Dan.

MS. PETERS: Dan. I'm sorry.

MR. JONES: I've been called a lot worse.

MS. PETERS: First of all, I would comment that I read your materials, your 28-page statement, and I was disappointed that there were no specifics about what troubled you in our report. The presentations today -- the most helpful presentations are the ones that help us focus on what we need to do to be

responsive, if we feel that that is appropriate, and in a specific way. So I hope that you get your comment letter that has such specific recommendations and pointed comments in to us as soon as possible because this train is leaving the station and we want to enjoy the rest of our summer. So the final report is coming out really soon. So let's hear from you on the specifics.

Dan, you indicated on the governance recommendations that we made that certain of the changes, which you characterized as embellishments -- which I promise not to come out over the table at you. I won't comment. I won't say what I thought about your use of the word embellishments. But you were concerned that some of our changes to your recommendations would increase litigation exposure, for example.

MR. JONES: Okay. Good question

and I knew it was coming.

MS. PETERS: My reputation precedes me.

MR. JONES: I saw your eyes.

MS. PETERS: You saw the eyes.

Okay.

MR. JONES: It was really with respect to some of the comments on the disciplinary process, especially where you make the three choices. You can take persons involved in a -- we'll call it an audit failure in connection with a public company, and you have three choices that you make. It may go to an ethics' determination to defer that, and you say, okay, we're going to either take this person and we'll retire them or we'll terminate them. Two, is we will ask them not to participate in public company audits, or three, we will allow them to participate but we will have an additional partner that performs a lot of

oversight in the process there.

Let me give you a couple that I was concerned about with respect to that oversight. One is that that oversighting partner would have to participate in all planning activities. When you consider an audit, planning activity is not just the first week of the audit. It literally transcends A to Z on an audit practice. So the ability to actually participate in all planning activities may be beyond the scope of anybody to really fill that bill. And I'm thinking from the perspective of six months into the audit they decide, gee, this isn't working. We've got to redo something or we've got to try a new approach because we're not feeling like we're getting the traction we need. So I just look at it and I parse the statement and I say that could be pretty broad in terms of what that person is required to do.

And the other thing is to participate in all consultations during an audit. Well, when you think about consultation, that can be between a senior and a manager, a manager and a partner. It could be any number of consultations. We would agree that they need to participate in every significant consultation. All consultations may be broader than we would like to have to tell them that they have to participate in. It's not really a disagreement with the process that you've identified, but maybe some of those would be harder for us to meet if someone wanted to hold us to a standard that we don't think is quite what you had in mind.

MS. PETERS: Okay. So we're talking about some tweaking. Maybe some tweaking.

MR. JONES: That's exactly right.

MS. PETERS: Okay. That is

helpful.

Barry, when you suggest that we reconsider our recommendations in light of the fact that we're in a constantly changing and evolving economic business environment, frankly it sounds to me like you're suggesting that the status quo needs to remain the status quo or static and -- you're not? Okay. Then you get on this train and you make changes and if and when the recommendations, if you find that they're appropriate, become outdated, then you change them again. Isn't that what we all do in life?

MR. MELANCON: Certainly.

MS. PETERS: Okay.

MR. MELANCON: But I think at the same time there are issues of we live in a -- your title of your report is to deal with audit effectiveness, and I think the report taken as a whole does not convey a look to that future in a lot of different

places, and I think that some comments along those lines would be appropriate.

I think also we live in a situation today where we have, you know, a financial reporting system that's based on the 1933 and the '34 Acts, and, you know, we think that modernization throughout, from the government regulatory perspective as well as some of the actions of the profession, have to be included in that process.

MS. PETERS: Well, there is a chapter on the future. But when people appointed the Panel, they didn't hand out crystal balls to enable us to see exactly what that future holds in store for the profession and for the industry, and we can only take one step at a time. So I think that it would be really appropriate to analyze whether or not the steps that we recommend are good, indifferent or bad first steps, and then deal with whether

or not they work for a second step or a third step --

MR. MELANCON: Sure.

MS. PETERS: -- once you take that first step.

MR. SAUL: Could I piggyback on what Aulana is saying? You know, I would pick up the same point because you -- our report is almost portrayed as static, looking backward, dealing with a historical model and all of those words. And I think it would be very -- we thought hard and long about the future of auditing and where we would be going. It would be very helpful I think to this Panel if the AICPA has some specifics on future directions and objectives and what we ought to be looking at in terms of the future. In your written response I hope you'll include some of those.

MR. MELANCON: Duly noted. I think that the -- what we are saying is that as

we look at the various recommendations and pass them through, as Shaun said, legitimate due process and things of that nature, that we're going to spend a considerable amount of time, as we always do, trying to be as predictive as possible about the future because change is a difficult process. And we support change and modernization, but we ought to be making those changes that we do today with an eye towards that and be as smart as we can about that future, and that's what we're talking about.

MS. PETERS: As long as you don't wait too long to get going.

MR. MELANCON: We're not going to wait too long.

MS. PETERS: The future passes you by.

MR. O'MALLEY: Zoe-Vonna.

MS. PALMROSE: Changing directions slightly, and I think this is for Jim

again, one of the things that concerns me is that, and we heard it yesterday, is that fraud is obviously a major centerpiece of our area of concern as well as our recommendations. And several times yesterday, and you also mentioned today, that the research we did was outdated because it was pre-SAS 82.

MR. GERSON: Some of it.

MS. PALMROSE: And I would like to say that that is not the case on average, especially for the persuasive evidence.

MR. GERSON: Okay.

MS. PALMROSE: So that would be a mistake to assume that you would dismiss our recommendations because of that?

MR. PEARSON: I would like to add a little bit to what Zoe-Vonna said there, and that is that specifically I think the most important factors in our -- in helping us come up with those recommendations were, number one, what we

heard in the focus groups and on the engagements we reviewed in the Quasi Peer Reviews, and every one of those engagements was after the effective date of SAS 82.

And in addition, and I'm certainly speaking personally, I was very much swayed by the fact that many of the most prominent and high-profile litigation matters that we are aware of, that were not in these studies, but we were otherwise aware of were post-SAS 82. So I think that while we believe that SAS 82 is a good document, we don't think that it goes far enough. But, frankly, speaking personally, I was not persuaded in any way with these recommendations based on the pre-SAS 82. It was the after SAS 82.

MS. PALMROSE: And that includes fraud and restatements -- from the context of restatements in the current

environment.

MR. GERSON: Right. Well, I think that -- I mean, you know, we're going on the written record, and some of the research should be based on, at least as it's presented here, the (inaudible) QPR's, and giving the detail on when those things happened.

MR. O'MALLEY: And COSO.

MR. GERSON: And COSO was also primarily pre-82. And in no way should those comments be taken as a rejuvenation of the recommendations because we would be crazy to do that. But it also says -- well, for a lot of reasons.

MS. PETERS: Right, right.

MR. GERSON: But it also says that there's another opportunity, and I'll speak to Dave Landsittel about this, because we do have an opportunity, I think a fairly short window of opportunity from the ASB's point of view,

to get more knowledge out of the process that you went through beyond what's maybe in the written report.

MR. O'MALLEY: Yeah, and I would encourage taking advantage of that quickly because there's more than just what's written here that would be helpful to us as we go forward in our work.

I know we're just about out of time here, but I'd like to just -- on the governance issue and the POB charter. We had comments on the draft such as it now exists yesterday from at least five or six presenters. Our recommendations have been in this current draft somewhat watered down or reduced. We'll put it that way. And two of the firms said they endorsed the present draft. One of the firms said they were this close and they wanted to be a yes shortly. One of them had a few concerns about it. But the SEC Chairman made the point that this -- you

know, he thought this should be adopted like forthwith, and I think he was feeling that it was up to the institute and the SEC Practice Section and so on to get off the dime and approve this sooner rather than later. I think it's fair to say the Panel agrees with that, although we would have taken it further as our recommendations outline. But I would like to have your view, Barry, whether your pen is out or ready to sign off or exactly where you are on this issue because we think it's an important one.

MR. MELANCON: We think it's an important one as well. Just a couple of comments. You talked about the use of pejorative terms. I think saying that it's watered down, we would -- as passionately as you talked about checklists, I would passionately come back to you on that point.

Also you talked about appropriate

due processes and the ability to look at things. And we had this on our board agenda in April. We have that on our board agenda in July. And words mean things. And, you know, how things are written and what the intent is is important. We've only had that document for about a little bit over a week, a couple of weeks now. It was given to us in various iterations and then taken back after five minutes or ten minutes of review. And just to say, as you responded to Jim on the due process, we certainly -- as I say in my testimony, we anticipate coming to a conclusion and a resolution on that, but it's important to have people be able to air their concerns and to deal with certain issues.

MR. O'MALLEY: Okay. Well, you're not in the stage where you think it's got serious flaws then; this is -- from your standpoint you need to go through the due

process, you've got to look at the thing, consider it and so on. But you don't see any significant roadblock within that document now? I don't want to put you on the spot, but I mean is there some fatal flaw in there?

MR. MELANCON: We support a strong independent Public Oversight Board, and to the extent that those words support independence and oversight and not management, I don't think we're going to have any problems. To the extent that they cross the line from oversight, then there will be problems.

MR. O'MALLEY: Well, I think they would agree with that. The POB doesn't want to manage either. They want oversight.

Any other comments or questions?

(No response.)

MR. O'MALLEY: Well, I thank you all for a good discussion and a good

presentation. It was very helpful.

MS. PETERS: And get your comment letter in.

MR. MELANCON: We are.

MS. PETERS: Well, I have an enormous respect for your organization and we want to get it in.

MR. O'MALLEY: All right. We'll break and be back at 10:35.

(Recess taken.)

MR. O'MALLEY: All right. If we could take our seats, we have another distinguished member of the profession here this morning to present, Mike Conway, who has appeared before this group before wearing the SECPS Practice Section hat and today he's representing his firm, KPMG. So Mike, once again we welcome you and look forward to your presentation.

MR. CONWAY: Thank you, Shaun. I appreciate that. As you said, I am

representing KPMG, not the Practice Section. I hope to be brief. I did not provide you with a submission beforehand because I think my messages are fairly simple.

First, let me thank the Panel for all your efforts and for a -- after a very, very long and difficult task, I'm sure, providing us with your report. I think that it is, at least to my knowledge, probably the most comprehensive examination of audit effectiveness and audit quality, as I say, I'm aware of. So, again, I thank you for that.

I looked at the report and I see what I consider to be three primary findings. One is that audits are, in fact, effective. Perhaps not perfect but nonetheless effective. Secondly, that the audit risk model is also effective. Perhaps not perfect but, again,

effective. And thirdly, particularly in today's environment, the important finding that there was no evidence that non-audit services impacted the quality of audits. In fact, in a number of cases, I recall 25 percent of the cases, you felt that, in fact, providing those services improved the quality of audits.

In terms of perhaps a criticism of the report, one has to search for those findings. They don't exactly come shouting from the rooftops, and, again, in today's environment it would be awfully nice for the profession if we did shout those things out. So don't be embarrassed if you want to emphasize nice things just a little bit more. This is not a congressional committee where you have to find \$10,000 toilet seats and \$5,000 hammers. You know, you can find some good news, too.

Let me touch just for a moment on

the risk model. I found it interesting that when you referred to it, you suggested that it needed updating. Of course the negative of needing updating is that it's outdated. I'm not sure you really meant that. I would suggest that perhaps you meant that it needs to be continuously updated with additional tools and perhaps standards. I don't think that it's outdated. So just a suggestion in terms of how it's mentioned.

Let me now move to cost benefits. I was disappointed that you really didn't cover that very well. You make reference to cost benefits and it's sort of well, it's assumed that, you know, the benefits are going to be wonderful. If we can just prevent, you know, one fraud, that will pay for just about anything that we recommend. But I would suggest to you that even when we deal with human life,

when we decide if we're going to put a traffic light someplace or change an entry ramp or exit ramp, somehow or another we always have to look at cost benefits. The only place I don't do that is negotiating with my wife because I always lose that one.

But seriously, I think that it is important that we address that more fully. And I would suggest perhaps addressing the cost side of it as fully as you can. I've gone through this exercise before and searching out for the value of benefits is not an easy task. So I don't envy you in that respect. But I think on the cost side you could do a better job, and I think it's important for a couple of reasons.

One is that you do, in fact, have to, if you will, convince the profession to take these up and do something about them, and costs are going to be a factor

in that respect. But, as importantly, the marketplace has to accept the cost factor. You know, the marketplace is out there and it's a cost benefit relationship. So if you don't give as much ammunition as possible for the profession to be able to deal with it and, quite candidly, pass on the cost, then it's going to be a much more difficult thing for the profession to accept some of the recommendations. So a suggestion that you look at that a little more carefully.

I do want to tip toe a bit into this forbidden land of cookbooks and checklists, appreciating that it is a mine field, but I want to deal with it a little more conceptually I suppose. One of the things that I am concerned about with so-called specificity and detail in standards is I've seen how that has gone over a number of years. Coincidentally,

an equal number of years to Shaun in terms of being in the business. But over a number of years that -- on the accounting side. And I must tell you I personally believe that it is a mistake because I will tell you there are a lot of people out there that make an awful lot of money figuring out ways to get around detailed rules. They find it much more difficult to get around rules and standards that are, in fact, principle based.

So I just -- I put that on the table for you. This is not a criticism, a checklist, cookbooks or anything like that. In point of fact, I agree with the comments that were made that once you reach the engagement level, checklists, cookbooks, whatever you want to call them, are very important. But at the standard levels I think you have to be very, very cautious about asking for, you

know, a substantial level of detail because it is also very difficult, I might say, to modify those that are embedded in a lot of detail as conditions change. So I think it's worthy of another look.

Aulana, you referred to the future a moment ago. I must say that that is a disappointment that I have of the report. I think you barely touched on the future, and I think that -- I think that there's a lot of wisdom represented not only by this Panel, but by the staff and I had hoped for perhaps a bit more emphasis. That is important. And I think that related to audit is, of course, the -- if you want to call it the financial model that we have today. I say related to it because, you know, we're auditing historical financial statements that may not represent reality today in a number of cases, and I think

that -- I think it would be worthy of this Panel considering some recommendations with respect to that.

Another area that you cover is auditor independence. I mentioned at the outset that one of your primary findings is that there is no evidence that it impairs audit quality. I think that you would do well -- let me back up just a moment.

One of the things that struck me is this is a unique chapter, a unique chapter in that it presents, quote, pros and cons, unlike all the other chapters that come up with a recommendation. I am confident that not everyone on this Panel agreed with every one of the recommendations that are in this report. I might be wrong, but my guess is that not each and every one of them were agreed to by each and every one of you sitting there. So I would suggest it

would be well if you expressed what the view of the Panel really is with respect to non-audit services, and I suspect that there is a view of the Panel, at least the majority of the Panel.

Let me close with governance, and, you know, the translation of that is the POB and POB charter. It turns out as I reflected on the charter, my initial reaction, and I think I might have expressed it to you all in one of my sessions of testimony, is it's probably no big deal. I mean it sort of says what they do right now.

As I reflected on it, and I have seen at least a few reiterations of the charter and certainly your recommendations in here, it struck me that -- well, I go all the way back, as it turns out, to the beginning of the POB in one fashion or another. Starting with the first wave of peer reviews, I was an

engagement partner and team captain on one of the -- at that time, big eight firms and did that review. And it was one of the, as I say, the first wave that POB had oversight, and since then either with the Peer Review Committee or the SEC Practice Section Executives where I had an awful lot of interface with the POB. I probably actually go back interfacing with the POB even before Mel Laird, but that has to go back a long ways.

MS. PETERS: That's impossible.

MR. CONWAY: Are you back there, Mel?

MR. LAIRD: Only 18 years.

MR. CONWAY: Having said that, then I started to reflect and say, well, you know, the POB is very, very influential. I said, well, why are they so influential? You know, the charter was -- the existing charter is pretty broad, and it -- I guess it was two

things. One is that they certainly gained the respect of the profession, and I suppose that all depends upon who the members are of the POB, but I think it's been typified by excellent leadership. And I thought to myself, you know, you can't legislate those two things. You can't legislate respect and you can't legislate leadership ability.

And as I looked at the charter, I thought, well, you know, the blank check bothers me but I could probably live with that. I looked at the appointment -- the veto power over the appointment of certain committee members, and I said, I find that to be particularly offensive because they have the capability of objecting right now. Quite frankly, because they are a respected body, if they did object, we would be sort of suicidal to go against their objections.

So I had to wonder why we want to

put that in the charter. And I said, well, if I drew the analogy to an auditor who also ought to be independent and have a lot of the attributes that you say the public oversight ought to be, that I would be sitting with a client and saying, client, let me tell you what the understanding here is. Number one, we'll talk about fees. This is the last time we're going to talk about it. I send you a bill, you pay it. That's the arrangement. That's number one. And number two, let's start talking about the CEO, CFO, controller, and the head of internal audit. Before you reappoint them, let's pass that by me because I may want to veto that. And I said, well, that -- you know, I'm not quite sure that that's the position -- well, first of all, you wouldn't think I would be very independent I suppose if I had that power over a client situation.

So what I fear, I suppose, is that you get what you ask for with respect to the POB. And if, in fact, they get all the things that you ask for, I think they'll just be another regulator and I think that would be a sad thing for the POB. I think that would be the end of POB as we know it today.

Let me thank you again for all of your efforts. Thank you for letting me be before you, and I'll open myself up for any questions that you have.

MR. O'MALLEY: Well, thank you, Mike. Do I understand on the charter issue that you guys are pretty close then? You still need to negotiate some and absorb it a little and put it through your process, but that you don't see any giant rock there?

MR. CONWAY: Well, I do believe that a big issue is, in fact, the veto power over appointments. I think that

needs to be worked out.

MR. O'MALLEY: You could live with consulting on appointments or something like that?

MR. CONWAY: I could live with that, sure.

MR. O'MALLEY: Okay. I don't want to inject myself into this process, but I just --

MR. CONWAY: But you would like to see it brought to an end, huh?

MR. O'MALLEY: Well, yeah. I mean I think for the good of the profession I would like to see them come together and say, we're going to go forward with this, we've got a good, strong POB, the profession is together on this, and let's do what needs to be done. I think that public perception would be well served by that happening rather than having the Chairman of the SEC saying, you know, quit dragging and using terms like that.

It just doesn't do the profession any good. But I agree that it's not an easy decision. It's not -- but I think it's one that has to move along the sooner the better.

The cost benefit is a tough one. You know, we've got this quick down and dirty number. You know, the 30 billion is what the firms were paid to audit, and the 31 billion -- I forget which is 30 and which is 31.

MS. PETERS: 32 is the market cap.

MR. O'MALLEY: Is the market cap loss. So you say, okay, so the total cost we're looking at here -- this, as I say, is down and dirty. So don't -- I didn't audit this. All right?

61 or 62 billion. So if we can jigger one of them up a little and bring the other one down, we've got tremendous leverage on benefit. I don't know if we'll ever be able to -- it's not like

we're going to get an internal rate of return here to show that it's really a pay-off, but I think -- I think there's a need to bring down that big number. If we didn't have those headline jobs, the 30 some billion, you know, maybe this Panel would not be here. Would not have been here.

So I think I view it as vitally important, and I pushed hard on Chapter 3, part of it, to get after the huge frauds. And I think -- I do believe if we're talking, you know, one percent, two percent, whatever the additional cost might be, I think it would be well worth it. But I don't know how we can expect -- I mean I'll ask the staff if they think there's any way we could estimate the additional cost, but every company is different. Every company will have to have a different approach. I think it's very hard to have anything

solid left. I would be interested in hearing any opinion of yours.

MR. CONWAY: Well, one of the things that is important that we cannot let have happen is that it simply just becomes a cost. And by that I mean -- because it will take away from, you know, the ability to spend money on people and -- it's got to come from someplace.

MR. O'MALLEY: Yeah.

MR. CONWAY: So the more persuasive we can be in the process as to why it's valuable, the better off we're all going to be.

MR. O'MALLEY: Absolutely true.

MR. SAUL: It would be helpful if you and your firm could think about that to demonstrate some of the costs.

MR. O'MALLEY: Dennis.

MR. CHOOKASZIAN: Mike, one of the things that we discussed on the Panel on the cost issue was whether we could look

at this from an absolute or relative point of view. And more specifically, if you take forensic audits, for example, we're recommending that there be some proportion of the audit that should be forensic. So we're in the cost side suggesting an allocation shift so that some of the audit dollars would be forensic. And in the report it didn't necessarily say that the cost of the audit should go up. The report in that specific section was kind of consciously a little soft on that point because we weren't saying drop everything else -- you know, drop everything else and add ten percent forensic audit. We were a little soft on that point. Could you react to that?

MR. CONWAY: Well, yeah, and it would be purely a reaction. It's a little hard for me to sort of imagine that with 200 recommendations -- and I

don't know how many of them are applying to the profession, but well over 100 that somehow that's not going to cost something along the way. So while there may be clearly shifts, if you will, in some of the activity, I suspect that at the end of the day it will add cost to the process. I can't imagine there's a zero sum to gain here.

MR. CHOOKASZIAN: And we weren't saying a zero sum, but we're saying some of this is allocation and some of it is sufficient and clearly the cost will probably be higher.

MR. O'MALLEY: Lou.

MR. LOWENSTEIN: Cost benefit and the issue of independence, Mike, and non-audit services. You and all of the other -- I think every one of the big five that spoke yesterday and Barry pointed out that in our Quasi Peer Reviews we found no evidence of a corrupt

audit because of non-audit services, which is certainly true. And I think whether you take either of the two views that are expressed in Chapter 5, one is the blanket exclusion or rather taking them -- evaluation of other services, the cost benefit analysis there becomes extremely hazardous. There are some costs clearly because there would be an efficiency gained from keeping the service within the firm that's already there and knows the client and the like.

The difficulty I suggest comes in weighing the benefit and the benefit is one not of avoiding corrupt audits, because that's not really what we're dealing with I think is corruption. The goal is not anti-corruption but rather maintaining the independence that is vital to the credibility and the integrity of the profession. And the same values -- I'm puzzled by it. I

don't know how to measure the value.
It's intangible. It's the same
intangible, however, that was reflected
in the recommendations of the Blue Ribbon
Committee in dealing with non-audit
committees.

We don't say to the directors of
publicly-owned corporations, well, I
don't see any reason why you can't render
services to the corporation. There's no
evidence that members of audit committees
have been corrupt or that their work in
the like has been tainted by it. But the
sense of independence is a benefit, the
measurement of which it seems to me is
extreme, but nonetheless important to the
credibility of our system. And I'm
puzzled why -- I guess having now made it
a lecture, but I'm puzzled why that
benefit isn't equally applicable,
whichever of the two methods you apply
that we discussed within Chapter 5,

doesn't also apply to the accounting profession, as difficult as it is to measure the gain.

MR. CONWAY: Well, when you say the gain, at the end of the day I think what you all were looking at and all of us are looking at is to have the most effective audits that you can possibly have. Now, independence when you -- it becomes pretty abstract in that it's -- you can be as independent as anybody possibly can be. You can be a monk living in a cave someplace and, you know, having nothing and be totally incapable of doing a proper audit. So independence and doing a proper audit are not necessarily the same thing.

I would say that when you start talking about some of these services and the capability that you need to have within the firm, and particularly when someone might suggest that in the

technology area that -- you know, this is something that you ought to avoid because it's -- you know, it's going to be bad for you if you provide that service to the clients. I have a difficult time with that because certainly in the last century and the century we're in now, I think -- depending on how you characterize the year 2000. But putting that aside for the moment, the one we're in now --

MS. PETERS: It's the end, not the beginning.

MR. CONWAY: I think it's very clear that whatever capabilities you can accumulate in that area are going to be beneficial to you in conducting audits. So I don't think that providing some other service other than audit jeopardizes independence.

It would also be in the legal profession, and maybe this is a bad

analogy, to say, well, if you have a criminal practice or if you have a, you know, a divorce practice, then by golly that's what you should have, period. You should not practice in any of these other areas because, you know, that's -- you ought to be restricted to that. Well, why? I don't know. It seems like the right thing to do. I feel that divorce lawyers ought to just do divorce.

Is it a matter of perception? No. I just find it difficult -- it bothers me a lot to say that no one has found any evidence at all that it corrupts an audit. And, in fact, to the extent that there's any evidence, it is that providing those services benefit the audit. And then for someone to come along and say, ahhh, but under this umbrella of independence you ought not to provide those kinds of services to your audit clients, I just have a very

difficult time with that. I guess maybe I've been an auditor too long where I do need some evidence before I have an opinion.

MR. LOWENSTEIN: How about the number -- the SECPS data showed that 75 percent of audit clients receive no consulting services.

MR. CONWAY: Right.

MR. LOWENSTEIN: Good audits? Are they doing good audits?

MR. CONWAY: Yeah. I would hope so. Yeah. I'm not suggesting that those are bad audits. I think you found that at least in 25 percent of the cases based on what you looked at, you thought maybe they could have done a better job because of that. Maybe the rule ought to be just the opposite. Mandate other services.

MR. O'MALLEY: I think we're getting into dangerous territory here.

MR. LOWENSTEIN: Mike, we'll leave

that for another panel. That's the next panel.

MR. O'MALLEY: That's right.

Aulana has some questions.

MS. PETERS: First a comment, Mike. One of the benefits of these hearings is to put a little sunlight on our process and how we came up with these 271 pages. And to answer your hypothetical question of did we agree on all of the hundreds of recommendations that we actually did make, the answer is yes. And did we debate them? The answer is yes. And it was important we thought for the value and the force of this report for us all to be able to stand behind those recommendations that we would come -- that we came up with. So take that for what it means.

MR. CONWAY: Good.

MS. PETERS: Because they're very unanimous recommendations. And where we

couldn't have a unanimous recommendation, under the guidance of our leader we decided not to have any at all, which I think is also very, very significant. You and everybody else keeps saying put in there what the majority thinks. I don't think it's going to happen. Sorry about that.

But by the same token, because our methodology was also to have findings to support our recommendations, we really struggled and had a difficult problem with the future, and we did try to address those. We did address it, and I'm sorry that you were disappointed, but maybe next time. Yesterday I suggested that maybe another panel could deal with that.

Now, my question after that deals with the POB. Do you view -- and I'm pleased that you think that the POB is an influential and very important body

because I agree with you. But now do you consider the POB the profession's client? The analogy that you used was I as an auditor would not attempt to dictate or veto the selection of a CEO or CFO.

MR. CONWAY: I sort of flipped it around that --

MS. PETERS: You did.

MR. CONWAY: -- we I guess would be the client of the POB, if you use that analogy. If I used that same analogy --

MS. PETERS: Well, that's the analogy you used. You said you would not dictate to a client. So you don't think, do you, that the POB is the client or the servant of the industry?

MR. CONWAY: Oh, no, absolutely not.

MS. PETERS: Good. All right. That's the only question I have.

MR. CONWAY: But I don't know of

very many of my clients that think that they're my servant either. So...

MS. PETERS: Well, precisely.

MR. O'MALLEY: Zoe-Vonna.

MS. PALMROSE: I just want to extend something that Aulana said and make it slightly different than the way that you responded before. We really felt that our recommendations were positioning the profession to go forward into the future. So again, if you have any suggestions where that isn't the case, it would be most helpful to have them in your written comments. So if there are any impediments that you see because of our recommendations to go forward, we would like to know about them.

MS. PETERS: And by the way, you're the one presenter that made a comment to which -- that resonates with me in terms of the complaint of our call for more

specificity and definition in the standards. I'll take that home and think about your concern about where this specificity and the definition needs to be, at what level.

MR. CONWAY: Thank you.

MR. O'MALLEY: Any other questions for Mike?

(No response.)

MR. O'MALLEY: Well, Mike, again, thank you very much.

MR. CONWAY: You're quite welcome.

MR. O'MALLEY: We appreciate your input.

Our next presenters come from north of the border, and they are Andrew Wingate and Diana Hillier from the Canadian Institute of Chartered Accountants. And we very much appreciate their presence here and their willingness to sit down with us and give us their views on our report or on other subjects

touching on the professions, which I think the profession in America and in Canada are very close and have spent considerable time together over the years. So we welcome you both and we look forward to hearing your comments.

MR. WINGATE: Thank you, Mr. O'Malley. We're very pleased to be here today to offer comments from the Canadian Assurance Standards Board on the Panel's draft report. I sincerely hope that our remarks contain no references to cookbooks.

I am Andrew Wingate, Chief Inspector of Alberta Treasury Branches, a Canadian Financial Institution with assets of about \$10 billion and net income last year of \$230 million. That's of course Canadian dollars, not American. I'm Chair of the Canadian Assurance Standards Board, the body responsible for generally accepted

auditing and assurance standards in Canada. With me today is Diana Hillier, Director of Assurance Standards at the Canadian Institute of Chartered Accountants.

The CICA will be submitting a written response on the full scope of the Panel's draft report. Today, however, we would like to focus on the Panel's recommendations related to auditing standards.

The Canadian Assurance Standards Board has followed the Panel's work with great interest. We share the Panel's view that auditors play a vital role in the efficient and effective function of the capital markets.

The profession's ability to fulfill that role depends on the trust that investors and stakeholders have in the audit process. Threats to that trust, whether rooted in fact or perception,

cannot be taken lightly. For that reason, we believe that the Panel's thorough investigation into audit practices is important, and its findings very significant. We commend you on your work and all that you've done.

It's reassuring that your research demonstrates that both the profession and the quality of audits are fundamentally sound. That is not to say that the profession can rest on its laurels. It must always seek improvements in its standards, and in its governance structures, and processes. Nevertheless, the results of the research should serve to bolster the trust and credibility in financial reporting that has been challenged in recent months.

This morning we would like to address six issues. First, Diana will discuss the international context and the international initiative to revisit core

standards. I will then discuss the Panel's recommendations in terms of cost benefit, our concerns about the thrust towards more detailed standards, concerns about the proposed forensic phase, and finally, a comment regarding the auditor's responsibilities with respect to going concern.

Diana.

MS. HILLIER: In its May 1998 report, the CICA's task force on standard setting concluded that in the long term the internationalization of standard setting for both accounting and auditing is inevitable. The globalization of business activities and the need for standards accepted in the world's capital markets will simply demand it.

The Canadian Assurance Standards Board is committed to international harmonization and is working with the IAPA, the International Auditing

Practices Committee, and other national standard setters towards that goal.

While the Panel Report offers advice on effective global self-regulation for the auditing profession, it doesn't directly address the importance and significance of international auditing standard setting.

(The lights have gone out.)

MR. LONGSTRETH: We're in the dark. How about you?

MR. CHOOKASZIAN: It's just on a timer. That's all.

MS. PETERS: He's our technical wiz kid.

MR. O'MALLEY: Sorry.

MS. HILLIER: The report doesn't directly address the importance and significance of international auditing standard setting. We recognize that it was directly not part of your mandate. Nevertheless, we believe that the

profession needs to support and strive for global solutions.

There are a number of current international initiatives that the Panel could endorse and encourage the U.S. profession's participation in them. In the absence of such recognition, the Panel's final report might focus the U.S. profession's attention away from those international initiatives at a time when it is crucial that the profession internationally find effective ways of working together. One such international initiative is the recently initiated IACP project to revisit its core standards embodying the audit risk model.

In this connection, we note that the Panel Report expresses the view that the auditing profession has failed to keep pace with the rapidly changing environment. We're not convinced that's so.

Our research on audit methodologies, which we conducted jointly with the U.K. and U.S., and you've heard the others speak to it as well, suggests that one of the driving forces behind the redesign of new audit methodologies was the need to respond to the changing environment. Just as General Motors could not compete today if it continued to build its cars the way it did 20 years ago, auditing today cannot and should not be performed the same way it was in the past.

The report expresses a concern that the redesign of methodologies has reduced the scope of audits and the level of testing. But the question shouldn't be whether or not the extent of testing is reduced, but whether the nature of the evidence obtained from the procedures performed supports the level of assurance being provided.

Advances in technology, strengthened corporate governance, changing organization structures, new ways of thinking about control within organizations, and the introduction into financial statements of more relevant but arguably softer information, all mean that auditors have had to seek new ways to obtain evidence. By necessity, the traditional hierarchies of the sources of evidence and the techniques to obtain it are being challenged.

One of the key conclusions of the Canadian/U.S./U.K. Joint Working Group on Audit Methodologies, the JWG, is that if properly implemented, a business risk approach is likely to provide an improved basis for the auditor to understand issues associated with accounting estimates, going concern, and management fraud. All issues that are of utmost importance and interest to you as well.

A number of the Panel's recommendations resonate with the JWG's findings, including the need for auditors to better understand the entity's business processes and risks, the need for more rigorous inherent risk assessments, and the need to better address technology. Other recommendations appear to differ. For example, the report does not address the role of strong governance and management controls over business processes. Debate on how such issues -- or debate on such issues will be important as the international community considers if and how standards ought to be updated.

The Canadian Assurance Standards Board fully supports the JWG's recommendation that the major national standard setters should work with the IAPC to reach international agreement on the changes necessary to update core

standards. We believe it's at the international standard-setting table at which these issues should be debated and revised. We hope that the Panel's final report will arrive at the same conclusion.

MR. WINGATE: We share the Panel's view that in the final analysis the most important determinants of audit effectiveness are personal attributes and skills of individual auditors. The public interest must be their highest priority. We also recognize that auditing standards, quality control, the leadership within audit firms, and the governance of the profession are fundamental to effective auditing. All help ensure that individual auditors are fulfilling their responsibility.

We strongly support the recommendations in the report that professional bodies and firm leaders need

to emphasize the importance of performing high quality audit services. The tone at the top is vital and must be supported by appropriate policies within the firms governing compensation, training, and clear expectations regarding such things as the management of time.

We also support the recommendations encouraging stronger relationships between the auditor and the audit committee. Audit committees provide a formal channel of communication between the auditor and the Board of Directors, and also strengthen the auditor's independence.

On the other hand, we have some concerns about the recommendations regarding auditing standards. The findings of the Quasi Peer Reviews support the view that audits are not ineffective. I think I got that quote right.

MR. O'MALLEY: The old double negative.

MR. WINGATE: The Panel accepts that reasonable, not absolute, assurance that financial statements are not materially misstated is sufficient to protect the public's interest. While the Quasi peer reviewers identified areas where auditors could improve, it did not identify significant systematic problems.

Based on these results, we are somewhat surprised by the large number of recommendations in the report. Implementing the recommendations will be costly. We encourage the Panel to consider the priority of the many recommendations in the draft report. In your final report it may be more effective for the Panel to focus on those recommendations that you believe are most important and will have the biggest

impact on audit effectiveness.

The report's recommendations favor more detailed standards as a resolution to drive auditor performance. In our view there is a very real risk of the opposite result. Rather than improve performance, auditors may focus on applying the rules rather than use judgment to achieve the desired objective. In our experience it is not a lack of knowledge of the issues, but the auditor's lack of appropriate judgment in the circumstances that is most often the cause of audit failure. Clarity in objective and responsibility is paramount. Copious rules can cloud the auditor's prime objective and responsibility. Standards need to encourage the auditor to stand back, consider the facts and the fundamental principles, and apply appropriate judgment.

The auditing profession needs to attract people who can apply fundamental concepts to new situations. It does not need people who search the rules to find ways to approve aggressive accounting. A thrust towards more detailed standards may risk encouraging the latter approach and discourage conceptual thinkers from joining the profession. We believe that the standards should guide judgment rather than replace it with detailed procedures.

We accept that it's necessary for standards to require certain minimum procedures to assure stakeholders that auditors have kicked the tires and lifted the hood. But we challenge the panel to be satisfied that each new recommendation is supported by the results of the Quasi Peer Reviews.

One of the Panel's key recommendations is to create a

forensic-type phase in all auditing. We share the Panel's concern about fraud. The Canadian Assurance Standards Board urged the IAPC to reconsider its guidance on fraud three years ago. In our view the profession needed to seek international consensus on the appropriate level of responsibility for auditors with respect to fraud. Canada provided the staff resources for this IAPC project, and the IAPC is currently considering responses to its exposure draft.

The Panel's recommendations for a forensic phase to the audit comes at a time when the effectiveness of SAS 82 is just being assessed. We understand that the AICPA has commissioned research on the implementation of SAS 82, but that the results have not yet been finalized. In our view this research, when completed, should be considered before

initiating a new approach to fraud.

We agree entirely with the need for appropriate professional skepticism. We agree that auditors need to seriously consider the possibility of fraud and how it might be perpetrated. In part, that is what SAS 82 and the IACP's fraud exposure draft set out to do.

In advance of the research findings, our preliminary reaction to the recommendation for a forensic phase is concern that it may serve to increase the expectation gap. It may also be difficult to scope within reasonable parameters. Further, its cost might exceed the benefits.

The reference to forensic phase heightens expectations all by itself. A forensic auditor investigates problems that have been identified, challenges all information for authenticity, and gathers evidence in contemplation of possible

litigation.

Can an auditor put a fraud hat on for only a part of an audit? How much forensic audit work is enough? In our view by introducing a forensic phase to every audit, any fraud not uncovered could be considered an audit failure. In fact, the report itself suggests that the profession should aim for zero defects. The only way to meet that expectation would be to abandon the concepts of reasonable assurance and materiality.

That's not to say that the profession should not strengthen existing standards, but we believe the solution rests in addressing the issue within the conceptual framework of audit.

Chapter 2 offers a number of needed recommendations aimed at strengthening the auditor's ability to detect earnings management. They include the recommendations on inherent risk

assessments, and on auditing revenues, estimates, and reserves. The guidance in Chapter 3 on non-standard journal entries and looking back with hindsight at how certain issues involving accounting estimates and judgments were resolved have merit, but we would argue that they should be integrated into the audit itself, rather than seen as something straight.

We also believe that new tools can be effective in detecting fraud. Technology is enabling new data analysis tools and sophisticated analytical procedures that can provide much greater assurance about a population than statistical tests of detail.

In addition, we echo again the value of the business risk methodologies that encourage the auditor to better understand the business as a whole and the objectives and motivations of

management.

The importance of bringing the necessary skills and expertise to bear in integrated audit teams is vital and could better be supported in the standards. Supportive firm policies and practices, including quality control practices that encourage auditors to seek second opinions where appropriate, have a key role to play. And appropriate training in fundamental skills, such as inquiry techniques and training aimed at heightening professional skepticism are critical.

There's no doubt that behavior that fails to put the public interest first and foremost or that subjugates professional skepticism to client need cannot be tolerated. But we urge the Panel to reconsider its recommendations for a distinct forensic phase audit.

Given the Panel's strong position

on the auditor's responsibility for fraud, we were somewhat surprised that the report did not adopt an equally strong position on going concern. The report accepts that the auditor's responsibility is limited to responding to matters that come to the auditor's attention in the course of performing other audit procedures.

Recently, the IAPC approved a new International Standard on Auditing that is more proactive. Such an approach is also entirely consistent with the firms' new methodologies that encourage auditors to look forward and think about business risks that might affect the entity's ability to meet its objectives beyond the current financial reporting period.

The recommendations to FASB to get the necessary accounting framework in place are welcomed, and we accept that it may be necessary to have that framework

in place before revising the audit guidance. However, we would encourage the Panel to discuss this in your report.

In closing, I'd like to thank you for the opportunity of appearing before you today. We would like to reiterate our support for the importance of the Panel's work. The lessons learned from the Panel's Quasi Peer Reviews and other research is invaluable. There are many recommendations on which we believe the profession can and should act.

That being said, we encourage the Panel to reconsider certain recommendations. In particular, the proposed forensic audit phase to the audit, and the overall thrust towards detailed, specific standards. We also encourage the panel to support the debate at the international level regarding the extent to which standards can be

strengthened by incorporating a business risk orientation. We hope the U.S. will be at the table.

Thank you very much.

MR. O'MALLEY: Well, thank you very much. It's clear that you did a thorough analysis of our report and we thank you for that and for your input today. And I would ask the Panel -- Lou has a question to start us off.

MR. LOWENSTEIN: You and others have raised the question whether implementing -- recommending forensic-type procedures would enlarge the expectation gap. And it seems to me you're putting us in -- obviously we're not an administrative rulemaking body. These are recommendations.

But it's sort of a catch 22 because within the framework of reasonable assurance we're recommending procedures that will enhance the effectiveness of

audits, but by -- and while we're enhancing the effectiveness, recommending enhancement of audits, if we do that, then it's said that we're creating larger expectations on the part of the investing community and such. Perhaps, therefore, we shouldn't recommend these new and hopefully enhanced procedures. I don't know where we -- what to do with that.

MR. WINGATE: I think my reaction would be that you've heightened expectation by talking about a forensic phase. The word forensic carries with it some meaning which the general public I think would be entitled to believe involves investigative work rather than auditing work. So that's the first thing.

You're also saying that this is within a phase of the audit. We have a forensic phase of the audit. Whereas, if we introduced the procedures, a number of

the procedures that you talk about in your report throughout the process of the audit, this wouldn't draw the same attention to a forensic phase of the audit. That would be my take on it, that you're giving great emphasis on the importance of the forensic phase and that will in itself heighten expectations.

But really the job to be done is to perform a number of the procedures that you've identified as being necessary. I mean that's what's going to produce the results. Not the high profile forensic phase of the audit. So I mean that would be my take on it. I'm not entirely sure that Diana is in full agreement with me.

MS. HILLIER: No, I think I would agree. I know in some of the discussions we had around our board table at our meeting at the end of last week where we were discussing the draft report, and we were discussing forensic phase and what

that would mean, the various people around the table -- it was interesting in terms of their interpretation of what would be involved because it ranged from those who perhaps were reflecting that it's part of the audit or a minimal increase to the audit to those who saw that this was clearly adding 50 percent to the audit to those who thought it was actually a quantum leap because to really meet the expectations you would, in fact, need to be virtually into a full forensic audit. So very different reactions to the same chapter and the same recommendations.

And I think in part that was when we were discussing and, as Andrew said, came to the conclusion that there are a number of very good recommendations in that chapter. And perhaps what we need to do is integrate that with the recommendations in Chapter 2 that also

address some of the similar issues and integrate it within the scope of the audit itself rather than talk about a separate phase where you put your audit hat on and put your fraud hat on and change it into something quite different.

MR. O'MALLEY: Zoe-Vonna.

MS. PALMROSE: I think I have a comment and a question. And the first is yesterday and today we've heard a fair bit about wait for the results of research, and some of this research is being conducting. For example, the fraud research by academics. So this is very gratifying as an academic and perhaps one of our finest moments. This is going to sound like a strange comment, but you must recognize the limitations as well as the usefulness of research. So to delay the process waiting the outcome of research that may not be definitive is

one that may be problematic. And I just add that as a comment, and I'll probably pay for that for the rest of my life.

Then my question though is on the going concern.

MR. WINGATE: Can I just respond to that?

MS. PALMROSE: Oh, sure.

MR. WINGATE: I'm not personally very clear on the state of the research and how far it has progressed. I think in drafting these comments, our thought was if it's just beyond the horizon, expected very shortly, then wouldn't it be prudent to gather up that research and see whether it's pointing in a different direction to --

MS. PALMROSE: Yes, and of course that's what we always would emphasize, what we can learn from it undoubtedly. So I don't want to undermine the value of it in any way, shape or form.

MR. WINGATE: Okay.

MS. PALMROSE: But on going concern you talk about that you were surprised that we didn't go further in this area. One, our recommendations are truly based on our findings, but I'm not as familiar with the standard as it's apparently been recently promulgated, and it sounds like it's really an extension of the auditor's responsibility that you're asking us to consider here, and I'd like to just understand that briefly a little bit better.

MS. HILLIER: I think the view of the International Auditing Standard that's dealing with going concern does take a more proactive stance. But in some ways in comparing the two we refer to them as the stumble over, that you look for things in the course of performing the audit versus an approach where you would be thinking about it,

consciously thinking about it early on in the engagement. And, therefore, in the international standard it talks about consciously thinking about the issues that could be related to going concern when planning the audit, revisiting those planning decisions throughout the audit, looking at management assessment, because first and foremost it is management's responsibility to assess the entity's ability to continue as a going concern and have appropriate financial statement disclosures for that.

But looking at management assessment, looking slightly beyond management assessment to see if they've missed anything. It's just a slightly more proactive look than simply thinking about going concern in the course of doing other audit procedures, and if something comes to your attention, then follow up. It's just thinking about it a

little bit earlier on in the process.

MS. PALMROSE: Would you describe the bar as higher in this area for this standard than the U.S. standard?

MS. HILLIER: I think arguably it could be argued that it is slightly higher. It's at least more proactive.

MR. O'MALLEY: And you don't believe that's going to raise the expectation gap?

MS. HILLIER: I think the expectation is there. I think if the Panel was doing its work 15 years ago when we had a number of audit failures, going concern would be a major issue together with fraud. So the timing in the economy, when things are going well, going concern is perhaps not as heightened an issue as it was. But I think the expectations do exist.

MR. O'MALLEY: Aulana.

MS. PETERS: I have a question I

guess for both presenters. Mr. Wingate made a comment when you commented on the guidance that the report gives in Chapter 3 with respect to non-standard entries, and you indicated that it should be integrated into the rest of the audit. I didn't understand that or I didn't follow the point. But it may be that Miss Hillier gave the answer in discussing or commenting on the forensic phase of the audit and I thought that perhaps her distinction may have created confusion. I'm not sure. Could you help me understand what you mean by integrated into the rest of the audit?

MR. WINGATE: Yes. I think there were two procedures that we were talking about there. They make a lot of sense. They're going to likely produce some interesting findings. So it's a sensible idea, but I don't see that it's necessary to put it in the forensic phase of the

audit. I think --

MS. PETERS: I see. Okay.

MR. WINGATE: All I'm trying to do I think is downplay this forensic phase and incorporate it into the standard body of work that constitutes the audit because I don't want to see expectations heightened to a level that is unreasonable. It's just that simple.

MR. O'MALLEY: Well, thank you both very much. We appreciate the effort that went into this and we also thank you for traveling across the border.

MR. WINGATE: It was a pleasure. Thank you very much.

MR. O'MALLEY: Our final presenter before lunch will be Bill Bishop from the Institute of Internal Auditors, and he is accompanied today by Bill Duane. Is that right?

MR. DUANE: Yes.

MR. O'MALLEY: Can you spell that

for --

MR. DUANE: D-u-a-n-e.

MR. O'MALLEY: Thank you. We welcome both of you and we thank you for coming and we look forward to hearing your comments.

MR. BISHOP: Well, thank you. We appreciate the opportunity of being here. As you said, I'm Bill Bishop. I'm the President of the Institute of Internal Auditors, which is a Chief Staff Executive. Our Chairman of the Board this year, Jackie Wagner, who's the general auditor at General Motors and could not be with us sends both her respects and her regrets, and sent her mentor on, Bill Duane. Bill is a past chairman of our organization and presently heads the committee that deals with professional and emerging issues. He also is the retired general auditor of Chemical Bank, and prior to that

Manufacturer's Hanover. So he's our resident expert.

I thought it might be useful to give you just a few moments about the Institute of Internal Auditors and the profession of internal auditing since I think we are the only non-practitioners appearing before your Panel in the last two days.

Internal auditing is a self-regulating profession. By that, I mean we don't have requirements to exist, but we also, through the Institute of Internal Auditors, do provide the necessary tools for regulation. We promulgate standards. We have a set of standards that have been translated into 20 languages and are recognized around the world. We have a rigorous certification program. They certify internal auditors. That is a four-part two-day exam that has been translated

into ten languages and is given in over 50 countries. We do research. I brought along -- not just for show and tell, but because I think there may be some research projects that I'm remiss in not getting to the staff to use in your deliberations. So maybe if it's not too late, I can present those into the record.

We have 70,000 members. 35,000 of those are in North America and the other 35,000 are in some 70 affiliates around the world. We have a staff based in Orlando, Florida of some 100 people who do all these things, plus create professional development. We do seminars, conferences, and put out a lot of literature. So in essence it's a profession that while self-regulating, does have all the elements of a profession and, therefore, we think we would very much like to give you some of

our views today.

I did give you a paper on July the 7th. Tom Stemlar tells me the quality of the paper, but I hope he meant reproduction, was not high.

(Inaudible). I didn't intend to read that paper to you today. Instead, I wanted to just concentrate with particular emphasis on a couple of issues, and particularly on the importance of the assessment of the system of internal control and how that will help improve the quality of financial reporting and audit effectiveness.

Now, I have to say I arrived yesterday about the time the Arthur Andersen people were here just in time to hear someone, I think it was Zoe-Vonna, say if you think this Panel did not consider control, you're wrong. So I thought maybe I should just leave.

Because that's my message today I think is to put things in the context of internal control.

We greatly admire your report. As a non-practitioner, I can say that's a compendium of audit practice that is very useful, and it certainly demonstrates the complexity of the external auditing process. I think some of us maybe don't have a full recognition unless we stop and think about how complex the entire audit process is. So I commend you on that as well as the recommendations concerning audit committees, internal auditing, external auditing, and reviews of internal control.

We believe that the Panel's recommendations could be slightly enhanced by further recognition of the importance or the positive impact of internal control on financial reporting. We believe that the audit process can be

improved with additional emphasis on a comprehensive assessment of the system of internal control. And by that I mean an assessment that perhaps goes beyond financial reporting and also includes input from a variety of sources; external auditors, internal auditors and regulators as well so that it is a comprehensive report.

So today I'll focus on three key points. One is, and it relates to Chapter 2, that the analysis of control risk and in turn the audit process will be more effective if there are highly collaborative efforts between internal and external auditors. And I think what I'll try to say later on is perhaps supportive of what both Ian Plaistowe said yesterday and Barry this morning, that there's a need -- there's an area for professional judgment. And regardless of getting involved in

auditing standards and how you use the work of the internal auditor, I think the input to a professional judgment exercise would be useful if there were greater collaboration between internal and external auditors.

My second point would be that we do think greater recognition should be given to a broad concept of control, and to the fact that continuous monitoring of controls is required in today's technologically-dependent environment. Therefore, a management report to the audit committee, as recommended by the Panel, should be comprehensive and based on input from multiple sources.

And finally, I would like to offer a few comments about non-audit services. Over the years because of the events such as those leading to Chairman Levitt's call for action, there's been a greater demand on corporate management for

increased responsibility and accountability. And we believe that a cooperative effort is required within the corporate structure from the Board of Directors to senior management to internal and external auditors and to all others involved in financial reporting. In particular, we believe that the ability of the internal and external auditor to work well together on risk and internal control issues significantly impacts the financial reporting as well as the effectiveness of the audit committee.

What I say to you today may seem as somewhat self-serving on the special interest of our members, but in reality I really believe that my comments are more nearly related to our long-term objective of the IIA to improve corporate governance and control, and to operate in the public interest. In fact, we've

recently modified the definition of internal auditing to recognize a much broader scope of internal auditing, and to provide an enhanced framework for issuing standards and guidance. And I would just like to mention this definition to you because I think it emphasizes the broad scope of contemporary internal auditing.

"Internal auditing is an independent, objective, assurance, and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management, and control."

So it's a fairly broad definition of what we're doing, but it's based on quite a bit of research that recognizes

what internal auditors are doing in today's environment. And I think that leads to a key point, and that's the one I mentioned earlier, we think that the conduct of audits can be improved by more effective collaboration between external and internal auditors. We fully support an effective, comprehensive auditing process, and we fully believe the information gained in an audit benefits all stakeholders, not just financial reporting.

And contrary to the findings of the Panel, our research indicates that most organizations where internal auditing provides or exists, internal and external auditors do work together in partnership to provide an efficient and effective process. The work of one complements the work of the other.

Therefore, we were a bit concerned about the reference in the Exposure Draft

of the use of internal auditors. One of our members said that sort of reverts to pre-SAS 65 days. It doesn't really emphasize a collaborative effort between internal and external auditors. It really reverts to language that refers to testing the internal auditing function, are we independent, are we competent in documenting how you rely on the work. I mean it's just sort of an extension of SAS 65, but it doesn't really encourage more open communication or relationship.

MS. PETERS: Just so I understand the point, the criticism is with the phrase or the title of the section, "Use of Internal Auditors," or with the content?

MR. BISHOP: No, it's the content. I think when you review it, the content basically suggests that the firms should do more to understand whether the internal auditing department is competent

or whether or not it's independent. Which is all good. It's an extension of SAS 65. But I don't think there's any need to imply that internal auditing is not competent. I just thought the language was such that it doesn't say, let's go out and review the work of the internal auditor, let's put it into a context that might help us make professional judgments. It rather says let's go in and study a little further, you know, how good these guys are before we rely on their work. I don't think those are wrong things to do. I just think that the report could go further when it talks about being aware of what internal auditors do and what the use is.

I think we have always considered that internal control is a real safeguard in effecting financial reporting. As you've heard here, continuous auditing or

continuous monitoring of the control system is paramount today. You can't just take a point in time and review controls because our systems are so dependent upon technology and moving so fast, that there needs to be a continuous audit. And yet your findings talk about instances of auditors, and they're very few, where auditors have come up with reportable conditions or have come up with any material weaknesses. Your statement says it's uncommon. And conversely, we think internal auditors have as their primary focus internal control.

So there's sort of a contrast. Your findings didn't show any material conditions or reportable weaknesses on control in internal auditing, and it says it's perhaps because of the limited amount, the controller. And we're saying conversely that internal auditors do

control work. So we're encouraging a greater understanding of that. And what concerned us is the Exposure Draft found that independent auditors made significant use of internal auditors during only 16 percent of the engagements that you evaluated, and yet we have benchmarking and research, fairly good research by Professor Felix, who demonstrated that internal auditing work is coordinated in 84 percent of the instances in the research, and that 75 percent of these internal auditing activities performed completed partial audits of locations, products or processes. Similar evidence in the research from Professor Felix. So our suggestion basically is that the Exposure Draft and perhaps SAS 65 be modified to provide a stronger basis or incentive for collaborative effort between internal and external auditing.

There are a couple of other areas that we've written into our testimony that we gave you Friday that I would just touch on. You talked about forensic auditing. There is one statement that indicates in a fairly negative way that internal audit work should not be used in tests that are aimed at the possibility of fraud. And I would say just in the same cases in 65 where the work of the internal auditor may be used, that the work of the internal auditor should be considered in the forensic phase, if you get to it, and I would say that today the work of the internal auditor encompasses a great number of the steps that you talked about in forensic auditing.

And internal auditors bring in new concepts. We have something called control self-assessment, which would never stand your test of independence, but which evolved from internal auditing

facilitating open discussion among people involved in the process to explore the control system and to look for improvements in control. And I think, again, in the external audit process if that type of work were considered in order to render say a professional judgment on how far the audit needs to go, then it might be something that would enhance the process.

I think in a similar vein, internal auditors today are very involved at the highest level in assessing risk and working with management on identifying risk. And I think in the audit risk model if external auditors were preparing risk assessments, it would also behoove them to look at the work of the internal auditor and encompass that into their risk assessment. So just some enhancement there that we think would help the report.

My second major point is an elaboration upon the panel's recommendation for communicating with audit committees on internal control. You state that audit committees should obtain a written report from management on the effectiveness of internal control, and we certainly agree with that. We've advocated it for a number of years, and of course many other people have going all the way back to Treadway (ph). The FEI I know has recommended to the SEC that there be a management report on internal control, or an expansion I guess of what some firms do today, and we would support that.

As I mentioned earlier, we think that it should be an assessment that is broader than just financial control. We encourage the use of the COSO or the COCO model, both of which have been implemented to a great extent. We have,

again, some study of some 12 best practices of a number of companies now that provide a high (inaudible) or an enterprise-wide assessment of the system of control using one of the control models and using some of the criteria that's been established within our profession. So I think we want to encourage your commentary on the idea of a comprehensive report on control.

We think that we're continuously -- or contemporary auditing is continuously driven by risk. And when you relate to Chapter 3 and earnings management, and when we look at risk, a good risk assessment should encompass a number of the things that drive the quality of earnings issues, whether it's new businesses, mergers and acquisitions, new products or systems, joint ventures, partnerships, restructuring. All of those things that Chairman Levitt raised

ought to touch the processes or events that drive risk. And so in a comprehensive risk study those should be identified, and they should lead to, among other things, reviewing the underpinning or the accounting activity that supports those. So we see a comprehensive risk assessment combined with an assessment of the controls over those risks being put into a report to the audit committee as an amplification of what you have said.

My third area is to highlight non-audit services. We recognize that in Chapter 5 of the Exposure Draft, the Panel re-emphasized the paramount importance of auditor independence. And we think that through your statements on the pros and cons of an exclusionary ban on non-audit services, that there's a valuable analysis that should help others in reaching a conclusion. There's no

doubt that the provision of some non-audit services has affected the external auditor's appearance of independence in the minds of some, and I think this is demonstrated by the fact that not only the Exposure Draft, but the SEC has now come out with a proposed rule.

It's been debated for a long time. I think it needs some remedy. Our position on that is that we do not believe there should be a total ban on non-audit services. We think relief can be obtained without having to go through a total ban. And we will be providing our more detailed commentary to the SEC since I think they're the ones who are addressing this at the moment.

I would point out that in the letter to you, we -- following the Blue Ribbon Panel and audit committees, there was buried in the back under the

principles the idea that the audit committee should help preserve the objectivity of the external auditor. So we did a survey of a number of our members to determine what is the real practice out there in terms of audit committees and management helping to preserve that objectivity. So we have a list in that letter of about 12 practices that we found that practitioners or clients are using to help preserve independence. Some of those are mentioned in your report. Some are covered by ISB. But I thought you might find them informative and maybe something you would want to consider in your report.

I think those are the key points we wanted to make. We certainly applaud what you've done. Just to re-emphasize, we look for something that would ask for a more collaborative effort. We would

re-emphasize the reporting on internal control in a broad way, maybe beyond financial reporting. And I will say too, we would be pleased to work with any group to help in the process. The Auditing Standards Board is starting a review of fraud and perhaps other things that are germane, and we would be happy to contribute to the task force if the POB is going to do any studies. And to the extent we can contribute, we would be happy to.

MR. O'MALLEY: Well, you're fortunate that Mr. Gerson, the next chairman of the ASB is here, and Mr. Sullivan of the POB. So during the break I think you can make your volunteer efforts known.

MR. BISHOP: Well, the ASB has been very open with us. We meet with them annually and we have had members participate in some of their task forces

in the past.

MR. O'MALLEY: Well, we thank you for this very interesting and informative input, Bill. It's clear that you've done a thorough job of reviewing our report.

I'll turn to the Panel. Are there any questions? Dennis.

MR. CHOOKASZIAN: Yeah, two questions. I think that in your comments here, in the written report, you comment on your concern about the -- on the auditor independence issue, about the outsource of internal audit, which has become a bigger idea. In your report you comment that you think it may impair the independence, the independence issue. Could you go a little bit further in that? I'm sure that obviously your organization more than any other is impacted by this. So could you give us --

MR. BISHOP: Sure. If I may give

you a little background, obviously this issue of internal outsourcing is something that goes back almost ten years, and it became an emotional issue in the early '90s when it looked like it was costing jobs. But I have to say that our institute over the past years five I think has taken a very balanced view on the idea of third-party provision. And our statements include things like, well, we think whoever is doing internal auditing should do it in accordance with our standards, and we think whoever is doing internal auditing should demonstrate their competence by being certified internal auditors. We think it's a best practice to have a fully resourced, competent internal auditing group in-house. And we do think that independence is impaired in that case where there's full outsourcing of the internal audit function to the same firm

doing the attest engagement. And I should emphasize full. I'll come back to that in a moment.

We recognize the need for outsourcing or for third-party provision. I think internal auditors have always collaborated to use some third-party assistance, including from its external auditors. I did that in 1980 with the Board of Europe, and we called it reverse reliance in those days. We thought we were clever. We were using the work of the external audit.

My colleague, Mr. Duane, when he was at Chemical Bank, I heard him say on a panel once, I have a budget of \$25 million that I have to use judiciously and with great responsibility, and if I don't have an audit resource on my staff, then I'm going somewhere else to get it. So the use of a third-party provider is

something that we're not opposed to at all. In fact, endorse. I think it helps effectiveness.

But we do think that when an audit firm that has to do the attest engagement is also doing the full scope of internal auditing, that is impaired. And I say that -- we testified before the AICPA Ethics Committee in 1995 or '96 and made our views known. We thought the provisions of Ruling 101-13 were not bad. They recognized that internal auditing is a management function, and they put into place some safeguards that said management should plan the scope, should review the results, should report the results.

In practicality and certainly antidotally without any attribution, I'm told that sometimes that prophylactic setup is not one that works in reality, that the engagement of the audit partner

is truly acting as the chief internal auditor, and if the CFO or the controller who's in charge is nominally in charge, it's more or less (inaudible). So there's the practicality of that.

But you can say that if you're asked to work with management on risk management, to work with management in a very detailed way to recommend improvements and to put in improvements of control, then as an outside set of eyes coming in to review, that you can be objective if you help management make the recommendations and decisions to put a control in process. So, you know, I think what the SEC has said in its exposure draft is something that elaborates a bit on that, but we need to look at it with the proper --

MR. O'MALLEY: So it's the idea that internal audit is part of management. That's your independence

issue.

MR. BISHOP: Sure.

MR. SAUL: Couldn't outsourcing be viewed as just an extension really of the external audit, a larger --

MR. BISHOP: I think it could be if you had well defined where the line into management is crossed. And as I tried to emphasize earlier, the breadth of internal auditing in some organizations today is so broad that crossing that line is something that could occur. We claim to be independent of those we're auditing by organizational structure, but we recognize that we're part of the organization. Objectivity is something that's more important to us I think than independence. So there's a fine line that is judgemental.

And perhaps it's more perception than fact. When you think of the Morrison Knudsen case where I think they

did terminate the external auditor and bring in another outside party -- I don't know the details of that, but I've always looked back on that. Is that a case in point or was it just perception.

MS. PETERS: You've made some very interesting points and I happen to think that the internal audit function is a critical one, and a very, very important one. The points that you make about the limitation perhaps on an external auditor providing those services also probably illustrates the limitations that an external auditor has in collaborating, to use your word, or relying upon the work of the internal auditor because you are management. That is not to say -- if you get my drift.

MR. BISHOP: Well, that's why --

MS. PETERS: But that is not to say that there shouldn't be greater collaboration.

MR. BISHOP: That's why I draw a distinction and use that term that I've heard here, professional judgment. So it is not necessarily total reliance. It's understanding the environment, and understanding where the risks are, that there might be something occurring.

MS. PETERS: Absolutely key. And I think that if our report doesn't emphasize that aspect of relationship, shall we say, that it should, and that we ought to take a look at that.

MR. DUANE: If I might, one of the things Bill asked me to just chat about was from a practicable experience in the banking industry. We didn't look at it so much as outsourcing. We looked at it -- we had a certain amount of resources available, whether it's the external auditee or the internal auditee -- and by the way, unfortunately my fee was double what you said. At the

high point of the merger I had 525 people in the internal auditing department with an annual budget of \$62 million.

And when we looked at that with the public accountants, between the two of us, we should offer a seamless approach to the firm out there that the auditee, the audit committee, and between us, the public accountant and ourselves, we just had to agree who was going to do what. And it came down frequently as to who had the competence. When it came to some of the issues in terms of industry experience, meaning non-bank, when it came to certain technology, the outside firm had the experience that I would need five years to build up to.

So we looked at things in terms of mutual cooperation so that the bank got the best benefit of that money we were spending. And that's the collaboration. And I think the term that you and I may

have used in the early '90s was seamless auditing as to -- you had to be aware of who was doing it. Even of your own constituencies you have to do things --

MS. PETERS: Separately. I agree 100 percent and the audit committee is an important part of that process.

MR. O'MALLEY: Dave has a question.

MR. PEARSON: Have you ever done a study of the major audit failures or the alleged audit failures where there have been major frauds or, say, the cases that have been dealt with by the SEC and Accounting and Auditing Enforcement releases of whether those companies had internal auditors or at least whether those companies had people who were members of your organization?

MR. BISHOP: Well, we've attempted to and, in fact, the -- well, of course we're a member of COSO, and the COSO research that was commissioned was

designed to also try to pull out those types of facts. But as a practical matter, very few of the enforcement releases comment on internal auditing. So yes, we've tried to backtrack to see if the internals were there or not, and it's been difficult to do.

But when you look at those 200 cases in the COSO research, you see there was an absence of internal auditing there either physically -- I mean there was no internal auditing function or there was very little oversight by an audit committee, and the audit committees were not particularly well qualified.

So, you know, I think as we deliberate on the use of internal auditing, obviously the question is how many organizations have internal auditors? And that's difficult to answer. We know that the Fortune 1,000 through either internal auditing work or

participation through some third-party provision all have something similar to the internal audit, but when you get beyond into the smaller, midsize companies, it's tough to know.

MS. PETERS: Which may account for the difference in our --

MR. BISHOP: Auditing standards?

MS. PETERS: -- our figures and your research.

MR. DUANE: The registrar would have it.

MR. PEARSON: We would be most interested to look at --

MR. DUANE: Well, in fact, that's our (inaudible). I suspect that's the answer.

MR. BISHOP: Well, I want to ask the staff too how many of those 128 had internal auditing functions at all? When you say 16 percent made use of it, maybe there wasn't a high percentage.

MR. PEARSON: And I think that's exactly what we found because we did -- because of the fact that an awful lot of the fraudulent financial reporting is in smaller type companies, we weighted our sample heavily towards those types of companies. But maybe one of the findings could be, should be maybe a combination of some more work by you plus our finding is the need for those companies, the absolute need for those companies to have internal auditors. That it is cost beneficial, much as they might not think so.

MR. BISHOP: Well, of course, we're not regulated, as I said. We're self-regulating, but we've always encouraged audit committees to be supportive of internal auditing. And I will say also, thanks to Tom Stemlar, I appreciate that you had a focus group of internal auditors in the process.

MR. O'MALLEY: Dennis.

MR. CHOOKASZIAN: In your comments here you also comment about the survey that you did, and the issues that you touch on here could be very valuable to us. Did you actually tabulate responses and do like, you know, X percent this, X percent this, things like (inaudible)?

MR. BISHOP: It was mainly antidotal, discussing with audit executives how their audit committees and management are addressing these issues.

MR. CHOOKASZIAN: Do you have that in writing? Do you have a summary of that or is that in writing?

MR. BISHOP: Yes.

MR. CHOOKASZIAN: If we could get that, I think that could be of value to us.

MR. O'MALLEY: Well, again, we thank you very much for your interest in the project and for your input today.

MR. BISHOP: Thank you.

MR. O'MALLEY: And now we'll break
until 1:15?

MS. PETERS: No, one.

MR. O'MALLEY: Oh, sorry. 1:00,
1:00.

(Luncheon recess taken.)

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

MR. O'MALLEY: We're going to start this afternoon. We have three presenters, and the first is Larry Gelfond from the Colorado State Board of Accountancy. Larry, we welcome you here. We appreciate your interest and we look forward to hearing your remarks.

MR. GELFOND: Thank you. Good afternoon. Chairman O'Malley and the Distinguished Members of the Panel Committee, it my pleasure to address you on your Exposure Draft on Audit Effectiveness.

My name is Larry Gelfond, a senior director of the local accounting firm, Gelfond Hochstadt Pangburn & Company from Denver, Colorado. In addition to my CPA license, I'm a certified fraud examiner, a certified valuation analyst, a former audit partner of the firm, who now spends a great deal of my time in the forensic

arena. I have served 12 years on the Colorado State Board of Accountants. I am the immediate past president of the Colorado Board. During my 12-year tenure, I have served as president three times.

My comments today are personal to me, although I am a member of the Colorado Board. They are not to be confused as the official position of our entire board. The board has the Exposure Draft under review and will comment either individually or in conjunction with NASBA comments. The Colorado Board has seven members, four of which are CPAs in public practice, and three are public members, non-CPA members. The board meets once a month, and due to the short notice, was not able to formerly respond. I am also a former partner in the failed accounting firm of Laventhol & Horwath. And although that's not an

issue here today, I can tell you when an accounting firm fails for whatever reasons, it not only impacts the firm members, their families, clients, the public, but sends repercussions through the entire profession.

I apologize for any duplication of my remarks. Fortunately, I have had the benefit of sitting here for the past two days and listening to the well-thought out and ably presented comments by other distinguished speakers. I will limit my remarks to Chapters 5 and 6, and take appropriate notice -- and I have taken appropriate notice of all the chapters and highly respect all the recommendations contained in those chapters.

In reading Chapter 6, Governance of the Auditing Profession, it seems to me to emphasize the unique relationship the profession has with the SEC. While the

draft correctly points out that state boards have regulatory licensing and discipline authority over CPAs, the SEC has certain discipline authority but only as it impacts CPAs practicing before the SEC.

My remarks are not intended to reflect negatively on the current self-regulation by the AICPA, the SEC Practice Section, the Independence Standards Board or the Public Oversight Board, although I found it interesting that this morning at no time during the AICPA presentation neither the CEO or the two gentlemen representing senior audit committees mentioned the unique position of the state boards. I will assume that this was not intentional but merely an oversight.

My concern is that the AICPA is at the end of the day still a trade organization of CPAs and CPA firms which

gets its funding from its members. How the public views that relationship is not for me to judge. I have been an AICPA member for almost 40 years, and have a great deal of respect for their work and leadership given to the profession.

My experience while serving on the state board is that the SEC and other self-regulating agencies investigating firms or its members have been slow and in some cases uncooperative in providing information about cases. This has resulted in our state board having to duplicate investigation resources. I state this system of lack of cooperation should end. I have recently seen a change in the SEC and I am personally encouraged by this change and hope it continues. I would like to suggest that all agencies embrace the state boards early on and keep them informed about cases under review as they progress.

This is not to suggest that I want to prejudice civil litigation or the rights of any individuals or audit firms.

I want to commend the Panel for its proposed system of governance and its recommendations. It is clear that a lot of thought and understanding have gone into the Exposure Draft. I wholeheartedly support giving the POB increased authority and making it independent in all aspects and demonstrate its responsibility to the public.

I caution the Panel not to exclude the state boards' from the influence given to the POB. The 54 jurisdictions come together through NASBA. I support the comments of other state board members who have testified before you as well as those of the NASBA representatives. For the Exposure Draft to have real effect when it's finally issued, it is

imperative that a partnership be established with state boards who are responsible and have ultimate licensing authority in their local jurisdictions.

In closing, I would like to comment briefly on Chapter 5, Auditor Independence. I have a strong concern that audits are looked upon as commodities. I know my concern is not apparently shared by my brethren in the larger firms, or for that fact by the AICPA, but I respectfully disagree. Many of the audit failures I see are either caused by unqualified firms or individuals within those firms taking on work and not possessing the necessary technical skills required to do the audits, be it SEC, governmental, not for profit, or private company audits. Usually this occurs in smaller firms with less resources.

The other area that causes failures

is budget constraints. Auditors low ball big audits on the hope to get more lucrative consulting work. When audit tasks exceed a lot of time, errors or failures occur. Needless to say, many of these are unintentional. I will take the liberty of suggesting that firms are reluctant to reward or promote auditors that do not bring engagements in on budget. Many of these budgets are even unrealistic from the get go. Therein lies a dramatic problem within the profession. Firms have to assess clients on the merits of the audit engagement and not on what other fees might be associated with the client.

If the POB were to examine billing practices within the firm and the pressures that the audit staff are under, they would see why good, qualified staff want to do other less stressful and rewarding work. Clearly the emphasis on

non-audit work is complex and is under significant study and evaluation.

I have a concern that we continue to establish one set of rules of independence for SEC audits and another for private non-SEC audits. This I believe creates confusion and should be avoided. The audit of Cargo, a large private company, should not have a set of independence rules that is different from the smallest of audits performed for a public company under SEC rules of independence. Auditors should be independent irrespective of other considerations and the same rules should apply.

I want to thank the Panel for their hard work, deliberation, and giving me the opportunity to share my personal views with you today. I wish you well as you complete this very important task before you. I've kept my remarks short

in case there were any questions I might answer for the Panel. Again, thank you.

And let me also say that I am not a radical person who is trying to be against the flow of any previous testimony or thoughts of other people. These are just my personal thoughts having been in the profession obviously, as I indicated, almost 40 years.

Thank you.

MR. O'MALLEY: Well, thank you very much, Larry, and I'm sure the panel and myself included do not view you as any kind of radical whatsoever. We appreciate your insights.

I would just caution you about the budget failures and lowballing eventually leading to audit failures. The current information that we have in terms of audit fees and the like is that the audit practices are, in fact, profitable, highly profitable. So we haven't heard

much in recent years about lowballing. And in SEC clients, I think it was pointed out earlier in one of the studies that only 70 or some 70 or so percent of SEC clients don't have other audit and non-audit services performed by their independent auditors. So I'm sure that lowballing happens from time to time, sometimes just to gain a wedge in the market or whatever it is, but I have not heard -- perhaps you have other insight or evidence that that is as serious a problem today as it might have been in years back.

MR. GELFOND: Again, my remarks are personal to me and my experience, and there clearly can be profitable auditing when you take high risk in your engagements and basically -- and I don't want to suggest that firms are short-cutting. But in looking at the work that they do, many of the firms in

some of the work papers that I've clearly examined either as a member of the state board or in connection with some forensic work that I've done over the years, there are ways to make things profitable.

Clearly the suggestions in your Exposure Draft about having the firms indicate the importance of the audit process and the audit engagements I think is very important for the continued survival of this profession.

MR. O'MALLEY: Okay. Other Panel members. Aulana.

MS. PETERS: I'm not sure which of the views you expressed you fear may be viewed as radical, but many of them sounded very sensible to me, and I happen to agree wholeheartedly with the view that we shouldn't have a double standard with regard to auditing of SEC clients as opposed to non-SEC clients. So radical or not, that happens to be a good opinion

in my view.

You said when you introduced yourself that you spent quite a bit of time doing forensic auditing. Did I get that straight?

MR. GELFOND: Expert testifying.

MS. PETERS: Oh, okay. Well, I'm still going to ask you this question. Do you have any idea of the extent to which auditing for fraud in the manner of which we recommend in our report would cost more than say a traditional approach to examining systems and financial statements say under SAS 82, compliance with SAS 82?

MR. GELFOND: I think any time you add additional steps in the audit --

MS. PETERS: I know that, but do you think from your -- based on your experience, can you quantify it? Anytime you do more it's going to cost more.

MR. GELFOND: Right.

MS. PETERS: Is it going to cost one percent more or five percent more or -- if you don't know, I don't mean to --

MR. GELFOND: I heard Chairman O'Malley suggest maybe one percent. I would think that that might be on the low side personally, but I have no way of assessing it, no.

MS. PETERS: I thought I had a fountain of information here.

MR. O'MALLEY: Bevis.

MR. LONGSTRETH: Yeah. You said that you hoped that in the new governance system there would be a -- that the voices of the State Boards of Accountancy would be heard. Could you spell out how that might most effectively be accomplished?

MR. GELFOND: Whether it be on an ad hoc basis or representation on one of the POB committees that you suggested,

clearly NASBA should have some either representation or input into your committees. Again -- and maybe I can just share with you my own view, too. Over the past 12 years, having been associated somewhat tangentially and personally with NASBA, I have seen them step to the table and take a more active role in bringing these 54 jurisdictions together, and hopefully that they can be of some assistance to the POB in their exercise of responsibilities that you set forth in your Exposure Draft.

MR. O'MALLEY: Dave.

MR. PEARSON: Does the Colorado Board have its own set of ethics rules or have you adopted those of the AICPA or what exactly is the situation in Colorado?

MR. GELFOND: Colorado has rules that are similar in many respects to the Uniform Accountants Act. Fortunately or

unfortunately, we have some things that deviate from those rules. And one of the requirements for relicensing is a two-hour continuing education course every two years in the rules and regulations of the Colorado State Board of Accountancy.

MR. PEARSON: And those rules and regulations, do they include specific independence rules?

MR. GELFOND: Yes.

MR. PEARSON: My question then becomes -- this is something I hadn't really focused on until yesterday when hearing some of the state boards. That is, in the SEC's proposed rulemaking they propose to induce the burden of some of the independence rules as they relate to family relationships and investments. So let's suppose that those rules are adopted. If a Colorado CPA were to do an SEC audit and let's say comply with the

new SEC independence rules, might they be in violation of the Colorado Board's independence rules, and do you have any idea what state boards that have independence rules that are say comparable to current AICPA or SEC independence rules are going to do in that situation? Are we going to get ourselves into a horrendous mess of having conflicting rules where it's not that SEC's rules are higher but the SEC rules are lower, and I would assume that a CPA would be held to the higher standard? I think, and maybe somebody can correct me, I think the AICPA Professional Ethics Committee has taken steps to deal with this problem just recently, but I'm wondering about the state boards.

MR. GELFOND: Well, many of the states, including Colorado, are attempting to adopt the uniform rules.

And in that, in the uniform rules, I think there would be adoption of the changes that the SEC is proposing. They would be accepted in uniform rules.

The problem is that many times in states you have to go through legislative review and pass laws and go through rulemaking, and it can be very cumbersome. I'm not advocating that state boards are necessarily the right place to make these rules, clearly. But what I am advocating is that they do have the responsibility of governance of licensees, and the only thing that we license is the CPA to do audit work. At least in Colorado. So I don't know if I answered your question.

MR. PEARSON: No, you have answered my question and it confirms what I was concerned about, is that there could well be a problem that is going to need to be dealt with by a whole bunch of groups.

MR. O'MALLEY: And possibly legislatures. Yes, Ralph.

MR. SAUL: Since we have a practitioner in front of us -- you didn't comment at all on Chapters 2 and 3, and you heard the testimony over the last couple of days. Basically one criticism, or two, is it's a cookbook approach and rule based as opposed to broad principles and standards, and then in Chapter 3 you heard the Canadians talking about the forensic type of audit. I just wondered, do you have any comments on either of those chapters in our report?

MR. GELFOND: Prior to my coming to New York, I had the good fortune of sitting down with our audit partner, who I respect his judgment, and discussing both Chapters 2 and 3. He wholeheartedly supported the recommendations and the comments in there and felt very strong that in some instances they were needed,

and he did not perceive them as being cookbook or how it's been referred to here. But beyond that, I don't think it would be appropriate for me to be discussing the technical side.

Like I said, in my review of it, I thought it was very thorough and I thought in some instances it was called for, particularly on the forensic side, too. And I know that some people take exception to that, but I wholeheartedly support your recommendations. I understand some of the issues and the problems that you had to deal with in satisfying a lot of constituents in your Exposure Draft.

MS. PETERS: How large is your firm?

MR. GELFOND: We have 70 professionals.

I will also tell you that we deal with the problems related to the issue of

independence because we have two subsidiary companies that clearly create independence questions. We have an investment advisory division, which is a separate company that does financial planning for clients and effectively manages money. In addition, we have another entity where we provide -- or they provide staffing, either temporary or permanent staffing, for either accountants or controllers and do placement. Clearly our audit partner is in constant conflict with that -- some of the issues because we know that we cannot place people in positions of responsibility on a contingency basis in our staff recruiting company.

So, you know, I can respect all of the problems that the firms have to deal with, the larger firms. And again, I consider myself a small fish in this vast pond.

MR. O'MALLEY: Well, I thank you very much for your insights, which I think were most helpful, and I also would extend that thanks to your partner.

MS. PETERS: Right.

MR. O'MALLEY: We would like to hear from him. But thank you very much for taking the time to be here and giving us your thoughts.

MR. GELFOND: Thank you.

MS. PETERS: Thank you very much.

MR. O'MALLEY: Our next presenter is Professor Rick Antle from the Yale School of Management.

MR. ANTLE: I have a power point presentation. Is that possible?

MR. O'MALLEY: Is that possible?

STAFF MEMBER: It's supposed to be.

(Discussion held off the record.)

MR. ANTLE: Well, while we're waiting on the technology, I'll get started. I want to thank the Panel for

conducting the session and for Chairman O'Malley agreeing that I can come.

A little bit of personal background. I'm a Professor of Accounting and Associate Dean at the Yale School of Management. I've also been retained at various times by the big five or six to do various types of economic analyses for them. So when I guess the Independence Standards Board was kicked off, as I recall, the SEC Practice Section of the AICPA, I presented a White Paper before the Independence Standards Board to try to at least put their view of what the Independence Standards Board's agenda should be, and I conducted some economic analyses for that. More recently, I was retained by the big five to conduct some economic analyses in response to some questions directed to the big five by the ISB about profitability and so forth and various

services. So that's just where I get my information, both sort of the scholarly background and then some consulting work that I've done for the big five.

I wanted to be up front about that, the fact that I have been a consultant, but also to underscore the fact that today I'm no one's consultant. I'm not being compensated for my presentation, nor did anyone contact me to hire me. I'm here on my own nickel, so to speak, as a -- hopefully to inform, but certainly as a concerned citizen and also as a scholar of auditor independence issues.

I want to make just a few points I think today. Unfortunately, I did not have the privilege of sitting in on the previous couple of days so I don't know what, if anything, that you might have already seen. But I can give you some information that's public information

from some of the studies that I've done about audit profitability and sort of more recent maybe hard facts and figures. I know from reading the Exposure Draft that various things have been kicked around, is auditing profitable, is it not. I think I can help settle some of that, but then also I want to talk most exclusively about the scope of services. I didn't -- nor do I have much expertise in some of the other aspects of the Exposure Draft and I didn't study it, but I have a lot of expertise in independence and the scope of services. So that's what I want to address.

Maybe I'll come back to the facts and figures a little later since we're not ready for it yet.

I actually wrote my Ph.D. dissertation on auditor independence about 20 years ago, and I've been

struggling with the idea ever since. And I've come to actually the following conclusion that -- let's just back up and look at it from the most basic perspective.

What we really want is we want auditors to have good incentives. You know, period, end of sentence. We want them to have good incentives to go do good audits and report their findings and all that stuff. Auditors' incentives, however, originate from a lot of different sources. There's the reputation in the market. There's pressure from clients. There's pressure from competition. There's regulation. There's professional discipline. We were just discussing the role of State Boards of Accountancy and the AICPA. There's also civil litigation and criminal laws. And so all these things come together to give auditors their incentives.

It's very difficult, if not impossible, to carve out one aspect of that complicated incentive structure and call it independence. In terms of what accountants might understand, you know, incentives are a joint product of all of the kinds of pressures and so forth that accountants face, and where we often get trapped a lot of times in independence discussions is basically trying to cost out, if you will, the cost of a joint product where we would never do that in a product costing sense. You know, we would never try to carve out one piece of a joint product and say, well, now I've figured out the cost of this product, when in fact it's a joint product. But in independence we do it all the time.

You know, we often talk about independence and isolation in our discussion of liability, for example. Literally, you know, from a logical

point of view it really makes no sense. So it's very, very difficult to define independence in part because it's a joint -- it's part of what we think of as a joint product of -- as some aspect of auditors' incentives, which are themselves joint products.

I'll just give you an example of one of the latest attempts to define independence by the Blue Ribbon Commission. And I have to, I guess, apologize to Ira Milstein, who's a sometimes colleague of mine, because I know Ira is about as smart as they come. But this is their definition of independence of an audit committee member, and I'll quote on this.

"Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management in the

corporation." And I always trip on that. Now, wait a minute, I'm independent if I don't do anything to interfere with my independence. I didn't -- you know, I didn't get anything out of that.

You know, the problem is that -- you know, independence, as I said, is part of auditors' incentives and auditors' incentives are the joint product of all the other -- of all the forces faced with it -- facing auditors. And then our attempts to define independence sort of very quickly devolve into a list of thou shalt nots. And if you look at the Blue Ribbon Commission, you'll find out that that's sort of exactly what -- and then immediately after an attempt to define independence, the next thing is and you should have known your client's -- you know, interest in your clients and you shouldn't -- and

you shouldn't do this and you shouldn't do that.

You know, I worry that sometimes our attempt to define independence and isolate it gets us into a state of mind where we sort of reject evidence in favor of moralizing, and we have concerns, broadly speaking, instead of evidence. And I think that's a very dangerous situation to be in.

(Overhead presentation is being set up.)

MR. ANTLE: So independence is a really tough matter and if you're not careful, you sort of end up kind of being concerned about things and guessing about things when you don't have much evidence. This is especially problematic when it comes to the scope of services.

I want to make several sort of basic points about scope of services. First of all, there's a prima facie case

that accounting firms have added a lot of value in providing non-audit services. And to get to that prima facia case, let me go back to some of the facts and figures that I skipped.

This is the market -- the U.S. assurance fees, assurance fees in the United States in 1996 (inaudible) dollars, from 1990 to 1998. Now, you can just eyeball that and you'll see \$6 billion is the answer. Okay. In 1998 -- there's a little bit of growth in '97 and '98 as firms -- as the firms created new types of assurance services. The core attest function in 1998, according to the firms' own estimates, is about 80 percent of that number that's up there, which is about 8 billion. And if you take 80 percent of that 8, you get back to 6.

Okay. So the audit market in the U.S., the core attest market in the U.S. has been stable, at least since 1990, at

about 6 billion U.S. -- \$6 billion in
1996 terms.

MR. CHOOKASZIAN: Rick, excuse me.

MR. ANTLE: Yeah.

MR. CHOOKASZIAN: The SEC gave us a
number that said nine and a half billion
for that same period, for '98. They told
us it was nine and a half billion.

MR. ANTLE: Well, they might have
not adjusted that for -- this is the 1996
dollars, and --

MR. CHOOKASZIAN: So would that be
'96 dollars?

MR. ANTLE: -- that's the big
five. Okay. So are they taking
everybody?

MR. CHOOKASZIAN: Yeah.

MR. ANTLE: Okay. So that's just
the big five firms.

MR. CHOOKASZIAN: This is the big
five only?

MR. ANTLE: Right, right.

MR. LONGSTRETH: I remember that number. Was that limited to assurance fees?

MR. CHOOKASZIAN: That's what I took them to say. I took them to say nine and a half billion was spent on audit only work.

MR. ANTLE: Wow. That really surprises me.

MR. CHOOKASZIAN: It surprises you?

MR. ANTLE: That seems like it's way too high based on just the big five.

MR. CHOOKASZIAN: No, that's all firms.

MR. LONGSTRETH: The top seven firms.

MR. ANTLE: The top seven?

MR. LONGSTRETH: Yeah, the top seven firms.

MR. ANTLE: That could be about right. If you took that in nominal 1998

terms and added another few firms, you know, that seems okay. But I would really have to look at it.

MR. CHOOKASZIAN: Okay. Thank you.

MR. ANTLE: Consulting revenues you can also sort of back into. And these are on the same scale. So they were, you know, around two, two and a half billion from '90 to '93, and then they started growing. I should say this all excludes Andersen Consulting. Okay. So these are -- a lot of these are data from the first White Paper before the Independence Standards Board that was I guess presented in '94, and even at that time Andersen Consulting -- all the data that I saw, Andersen Consulting was out of it. So whether -- you know, how much of this growth is really growth if we would add Andersen Consulting, you know, I don't know. But it's pretty apparent that if we project the '98 number going

forward, if you thought the consulting businesses of these firms just added up to somewhere in the neighborhood of \$10 billion, I would say that that wouldn't be too far off.

You know, I talk about the numbers that way because, you know, exactly the way the firms classify things and exactly what constitutes assurance and consulting, you know, it's a mess. I think the best thing you can do is just get a sense of the order of magnitude involved.

Now, this is some data that's also publicly available from an analysis that Mark Gittenstein (ph) and I did for the big five firms for the Independence Standards Board. This is the gross margin before partner compensation. Okay. So if you take a dollar in assurance fees, that generates about 25 cents in gross margin before partner

compensation for the big five. This is kind of an average, and again, you know, you don't -- you think about it in terms of order of magnitude.

Consulting generates about 20 cents. Now, again, this is before partner compensation. So if there's different leverage, if it takes more audit effort to generate a dollar of audit revenue, then, you know, we would sort of expect this kind of relationship. So if we translate that into gross profits per partner before partner compensation, you know, you see assurance around, you know, 450 or 475. Again, these are '98 numbers. And consulting around seven something.

By the way, the top -- to compare this to the top law firms, the top five law firms by revenue have gross profit per lawyer at about maybe 800,000. The top five -- I'm sorry, that's the top

five law firms by number of partners.
Top five law firms by revenue have gross
profits per partner of about one and a
half million.

So, you know, I look at this and
say, look, assurance is profitable. You
know, there was some discussion about
that. It's clearly a profitable
business. Maybe consulting was like
maybe a little more profitable, but it's
not exactly a horse race. You know, I'll
take both of those.

MR. CHOOKASZIAN: Consulting would
generally have more partners per dollar
of revenue because it's more -- you can
leverage an audit partner more than you
can a consulting partner generally.

MR. ANTLE: The reverse. You can
leverage a consulting partner more than
an audit partner.

MR. CHOOKASZIAN: When you say
leverage, I would --

MR. ANTLE: So I mean fewer consulting partners -- one consulting partner maybe, you know, can supervise 15, 20, 25 people. In audits it's about 10 or less.

MR. CHOOKASZIAN: I think that's true in assistance projects, but everything else it's the opposite. When you go into the other work, it's the opposite.

MR. ANTLE: Well, if you look at the number of personnel and sort of add up the number of personnel, in the U.S. there's sort of more partners per assurance personnel than there are consulting partners for consulting personnel.

MS. PETERS: But these numbers are gross numbers, aren't they? You're not talking about project by project?

MR. ANTLE: No, these are all just sort of gross overall.

MS. PETERS: So it's partner --

MR. ANTLE: So there's a lot of variation, which is another thing that I --

MS. PETERS: Okay.

MR. ANTLE: Yeah, the economics of this is sort of what I want to kind of get back to.

MR. LONGSTRETH: Can I ask you --

MR. ANTLE: Absolutely.

MR. LONGSTRETH: The gross margin for audit was 25 cents --

MR. ANTLE: Yeah.

MR. O'MALLEY: Before partner.

MR. LONGSTRETH: Before partner.

So why this --

MR. O'MALLEY: They need more partners.

MR. ANTLE: They need more partner involvement.

MR. LONGSTRETH: But this is before partner, too.

MS. PETERS: No.

MR. ANTLE: Yeah, that's right. That's right. No, no, I'm sorry. But it's also the case that a consulting partner could generate more dollars of revenue than an audit partner.

MR. LONGSTRETH: Okay.

MR. ANTLE: So the two things -- you have to sort of combine the two things to figure out what's going on, which is why we actually generated this chart because just this based on this one -- whoops.

MR. LONGSTRETH: Well, this shows you the leverage is greater for the consultant.

MR. ANTLE: Right.

MR. LONGSTRETH: Substantially greater.

MR. ANTLE: Right, right.

MR. LONGSTRETH: Okay.

MR. ANTLE: Now, the other factor

is that in assurance, of course, the jobs are much longer than consulting jobs. So, you know, we did a little back of the envelope calculation and figured out that actually assurance ends up, if you take present values, to be more profitable than consulting, although both are profitable businesses if you capitalize things.

So it's really -- you know, when you look at the profitability of these businesses, you know, these three factors, the duration, the differences in leverage, and the difference in maybe the scale of the job, you know, you could -- there are probably a lot more \$75 million consulting jobs than there are \$75 million audits, so picture about zero. You know, the ways these factors combine is fairly complicated.

Okay. So those are some of the background facts.

MS. PALMROSE: Can I just ask you something?

MR. ANTLE: Yes.

MS. PALMROSE: Your bottom line is, I know, that audits are profitable. Can you just bring this all together and give us relative magnitude or -- you know, when you sort through all of this on the back of an envelope, some working number here?

MR. ANTLE: Well, you know, we did a calculation that runs as follows, that a big consulting job is about three and three quarters times the audit fee in a given year. So if you define -- let's just define what a big consulting job would be. A big consulting job would be one that had fees about three and three-fourths or say four times the audit fees in a given year. Okay.

If we assume that the audit is going to last, I think it's in the

neighborhood of 14 years, there's some old evidence on duration, whereas the consulting is a one shot -- or I think we thought -- we gave it two years, let's say.

MR. LONGSTRETH: Gave what two years?

MR. ANTLE: The consulting job. Suppose the consulting job lasted two years.

MR. LONGSTRETH: I see. And it's a big one.

MR. ANTLE: And it's a big one, right.

MR. LONGSTRETH: So it's three to four times the audit.

MR. ANTLE: Three to four times the audit -- three to four times the fees. But then when you make the gross profit translation, that right away narrows the gap because auditing has a higher gross profit. Okay. So that narrows the gap.

Then by the time you take account of the fact that the average audit relationship might last, you know, I think it's in the neighborhood of 14 years, then what happens is the assurance business is like one and a half or two times as profitable as the consulting business.

Now, there's a lot of stuff wrong with that calculation. One is there's no building in of the fact that one consulting job might lead to another consulting job. So you might have a consulting relationship that lasts a long time. The fact is we have some studies of the duration of audit relationships. We don't have any studies that I know of about the duration of consulting relationships. We don't have any studies that really give us insight into how one consulting job might lead into another and might lead into another so that we can actually value the consulting

relationship the same way we can value an assurance relationship.

MR. LONGSTRETH: Is that a well-known statistic, I hadn't heard that, the 14 year average?

MR. ANTLE: There's a paper by Leventhal and Fitchman in like 1988 Administrative Science Quarterly where they study auditor/client attachments and how they go through time. And that number, and I can actually give you that more precisely later if you want, is, from their calculations, about the average length of time an audit relationship lasts. That desperately needs to be updated since we're making rules in 2000 based on it. That's probably also an underestimate --

MS. PALMROSE: In its time.

MR. ANTLE: -- of the duration because some of them last, you know --

MS. PETERS: Twenty years, 25

years.

MR. O'MALLEY: I would ask the Panel's forbearance to let Rick finish his presentation and then we'll ask question.

MR. ANTLE: But, you know, we need to update that. But we also need some serious study on the dynamics, if I can say, of the consulting relationships, you know, how one job might or might not lead to another, what kinds of jobs follow on, so that we can really make some decisions about the scope of services on an informed basis.

I just want to say a couple of things about the economies of scope. One -- well, the key issue here it seems to me is the synergies that might exist between audit and non-audit services. You know, it's not just that non-audit services add value. The question is how much extra value is added by letting --

by bottling that with audit services.
There's no systematic evidence on this
that I know of.

I just want to make two
observations. One is that these firms
have been very, very successful in
growing their consulting businesses. You
know, let's go back to the previous
chart. They've really been successful at
doing that.

And number two is a case study -- I
find Arthur Andersen very intriguing.
You know, when Andersen Consulting split,
they basically had zero consulting left
in Arthur Andersen. I think now if you
look at SEC Practice Section data, you'll
find that they have non-assurance fees
about equal to the assurance fees. So
within what, five or six years -- I sort
of look at it like a starfish, you know.
I mean it regrew -- this arm regrew.
Now, how could that happen unless there

was some powerful economies that drove it. You know, how could that happen unless -- and there were some forces there that enabled them to take advantage -- there was opportunities presented to them I think -- my guess is because of the economies of scope with their audit services.

I have a couple of requests that I want to end on. First, you know, the whole way I've been talking about this, the issue of scope of services, is from a perspective of the overall value added by the accounting firms, and not just the effect on financial reporting. You know, that's part of the effect, but it's not the whole effect. Now, I think one of the problems we have in the regulatory scheme is that this is not the SEC's mandate. I mean the SEC's mandate is to protect the financial reporting system, not necessarily to look at -- as I

understand it, not to look at the overall value added of accounting firms, and yet from an economic efficiency standpoint that's how we want to regulate the firms, the overall value added to the economy. That's my first request, is to think of it that way.

My second request is more specific. I really believe we need a thorough, systematic attempt to understand and try to estimate the magnitude of the economies of scope. We need somebody to study the dynamics of consulting services to try to put a number on the synergy between audit and non-audit services so that if we make some rule that auditors can or cannot engage in a certain scope of services, we'll know -- we'll have some estimate in hand anyway of what magnitudes we're dealing with. Right now we don't know whether -- if we implement an

exclusionary rule, we don't know whether we're going to be destroying \$100,000 in value to the economy because competitors would come in and take all the surplus, or whether we would be destroying \$10 billion in value in the economy. We don't know. And so I have in mind that what we'd really like -- what I would really like to see is an econometric study done by some economist that specializes in investor organizations to try to estimate the economies of scope.

I'll quit. I'm sorry.

MR. O'MALLEY: Well, thank you very much for that provocative --

MS. PETERS: Interesting.

MR. O'MALLEY: -- presentation, Rick. Unfortunately, we will have to issue our report before that economic study is done.

MR. ANTLE: Absolutely. Oh, you operate in the real world? Back to the

ivory tower.

MR. O'MALLEY: No, that's very thought-provoking and we appreciate your bringing it to us.

Any questions from the Panel members?

(No response.)

MR. O'MALLEY: All right. Thanks very much. That's very interesting.

MR. ANTLE: Thank you.

MR. O'MALLEY: Our final presenter today will be Gerald Sokolski from the New York State Society of CPAs. Gerald, welcome aboard.

MS. PETERS: Could we have a copy of your slides for our library or bibliography?

MR. ANTLE: Yeah. Can I e-mail them to the board?

MR. O'MALLEY: Yes.

MS. PETERS: Yes.

MR. O'MALLEY: Welcome. We are

very much interested in your comments.
And if you would introduce your team for
the benefit of our reporter, we would
appreciate it. Thank you.

MR. SOKOLSKI: On my immediate
right is Bill Stocker. Julian Jacoby is
on my left. We also have with us in the
audience Robert Waxman. These are the
various leaders of the New York State
Society's committees that have put
together the remarks that we're going to
be bringing up today.

Good afternoon, Mr. Chairman and
Members of the Panel. I'm P. Gerard
Sokolski, President of the New York State
Society of Certified Public Accountants,
whose 33,000 members will be affected
variously and perhaps unpredictably by
the chain of events put into motion by
your final report and recommendations.
Thank you for the opportunity to comment
on the Exposure Draft.

My comments will be organized into four categories: General comments related to the scope and direction of the Exposure Draft; comments regarding Chapter 2, Improving the Conduct of the Audit, which addresses concerns of the members of Society's Auditing Standards and Procedures Committee chaired by William Stocker; comments regarding the economics of the auditing profession and the ability to attract qualified entrants, which reiterates key concerns of our response to your original questionnaire; and comments related to the organization and governance of the auditing profession, which reflect discussions held by members of three of the Society's technical committees, the Auditing Standards and Procedures Committee, the SEC Practice Committee, and the Financial Accounting Standards Committee. Leaders from these

committees, as I mentioned, are here with me today.

As far as scope and direction goes, the extensive scope of the Exposure Draft reflects the complexity of issues surrounding audits of public companies. We agree with the Panel that audits are generally conducted in an effective manner and that the audit risk model underpinning financial statement audits generally is appropriate, although in need of updating and enhancing.

Many of the recommendations in the Exposure Draft will prompt positive discussion in the coming months by the various groups to whom they are addressed. Many will also result in improving the specific conduct of audits and enhancing the professionalism of the auditors. It will probably require considerable time for the Panel's report and recommendations to be synthesized

throughout the auditing profession. We commend you for your effort and thoroughness.

We understand that the Panel's report is focused on the audit of SEC registrants. We hope you will remain mindful that your final recommendations will have an inevitable spill-over effect on the auditors of all other entities.

The Society's Auditing Standards and Procedures Committee, currently chaired by Bill Stocker, responded to your questionnaire during the evidence-gathering phase of the Panel's work. Members of that committee who reviewed the Exposure Draft have expressed their satisfaction that you adequately considered the most important concerns they expressed, with some exceptions noted in the following sections.

Turning my comments to improving

the conduct of audits, the Society's Auditing Standards and Procedures Committee concur with many of the recommendations made regarding improving the conduct of audits. However, they request that you consider the following points as you deliberate the content of your final report.

There are many inconsistencies both in the literature and in the application concerning the identification and definition of various types of risk. These inconsistencies not only lead to confusion in applying the audit risk model, but also undermine confidence that a consistent, learned, professional body of knowledge guides auditors. For example, fraud risk is treated as a separate risk component in some audit guides, while SAS 82 subsumes fraud risk variously in either control risk or inherent risk or both. Consensus within

the profession about the identification and definition of various types of risk, as well as where they are brought into the audit risk model, would be helpful in promoting audit effectiveness.

The work of the Panel has correctly identified the complicated nature of the linkage between inherent risk, control risk, and detection risk. We would like to make two suggestions.

First, when inherent risk at the assertion level is very high, the audit risk equation becomes difficult to apply in practice. In addition, the acceptable level of audit risk becomes an issue when an engagement with a low risk profile changes as a result of unanticipated significant business transactions. The codification and dissemination of best practices related to these two practice issues would enhance audit effectiveness.

Second, we agree with the Panel's evaluation to require documentation of the reasons for both inherent and control risk assessments, and specifically to relate their effects on the audit program.

We applaud the Panel's position on its rejection of the arguments equating failed audit engagements with the provision of non-audit services by an audit firm. Audits fail primarily for two reasons; auditors do not understand the risks or they do not understand the significance of their findings.

The introduction of forensic-type procedures for every audit anticipates a qualitatively different state of mind than currently held by auditors, which focuses on professional skepticism, neutrality, objectivity, and integrity. The substance of the Exposure Draft related to this area describes approaches

and procedures most auditors already agree on and perform. However, auditors do not think of them as forensic, which implies the search for evidence of known or suspected wrongdoing to be used in legal proceedings rather than the professional skepticism that should be held with respect to financial statement audits. The current fraud standard has not been in effect long enough to assess its effectiveness. Delaying any significant change to the approach to fraud detection until a reasonable time period has passed would be prudent.

Moreover, even the most skeptical auditor will be unable to guarantee detection of material financial statement fraud committed by collusive management.

Now on to the economics of auditing and the ability to attract entrants into the profession. The Exposure Draft identifies the critical importance of the

independent audit to the functioning of the financial and capital markets and recommends that auditors receive higher priorities in their firms with respect to visibility, importance, promotions, and salaries. We encourage the Panel to include, and even emphasize, ways of providing financial resources to fund the professional development required to fulfill this recommendation in a world where audits are priced competitively.

I would like to reiterate previous comments submitted to the Panel by the Society's Auditing Standards and Procedures Committee regarding the attractiveness of the audit profession to prospective entrants and encourage the Panel to craft its recommendations so as to create the means for providing the source of funds for competitive entry-level salaries.

The opportunities and rewards

currently are not sufficient to attract and retain auditing professionals qualified to effectively implement a risk-base model of auditing. Even though the current demand for jobs in accounting is high, starting salaries remain close to the bottom of the scale for professionals. Moreover, too many CPAs, their firms, and their professional organizations espouse the concept that audit is a low-value or non-value added service whose purpose is to provide a foothold in the client's door for other value-added services with higher profit margins. Bright young people who otherwise might be attracted to work as auditors will opt for the larger financial rewards of businesses when they discover that auditing, like other products they might sell, is a commodity to be sold as a loss leader rather than the socially desirable fundamental

service of a respected profession.

When a service is valuable, a market economy will provide the appropriate compensation levels to attract the necessary individuals. The essential problem is that there is often a disconnection between those who gain the most value from quality audits and those making the decisions about the engagement of auditors. Many of the Panel's recommendations support the impetus to make the independent audit committee the auditor's client rather than management, a change that could be helpful in creating the appropriate economic environment. We encourage the Panel to consider other recommendations that would enable the market process to express an appropriate valuation of audit services.

Comments relating to the organization and governance of the

auditing profession. Perceptions of auditor independence and the scope of services of audit firms have been at issue for many years. The Panel's Exposure Draft has provided a helpful and balanced commentary about auditor independence and their provision of various consulting services. We hope that the final report and recommendations retain this balance and that the discussion and debate over the next few months will not focus solely on the appearance of independence. For the purpose of improving the conduct of audits and their effectiveness, it will continue to be necessary that those entering the auditing profession have means for forming and developing the independence of mind and objectivity required of certified public accountants. We also recommend that prior to issuing the final report and

recommendations, that the Panel consider how a rotation of auditors might be a viable means of satisfying both the fact and appearance of independence.

We disagree with the Panel's recommendation regarding the placement of the power to ratify the nominations of senior committee members with the POB because it is an inappropriate exercise of a management function with an oversight body.

The Exposure Draft recommends the creation of a GAAS hierarchy, a concept that has significant merit if such a hierarchy would serve the purpose of unifying the audit profession under a set of standards applicable to all audits supplemented by a set of procedures unique to the regulatory environment in which an auditor is working.

My concluding remarks. The U.S. has the strongest market system in the

world, made possible in part by the strength of our auditing profession, one that has been a model for the world. We are confident that the Panel's final report and recommendations will be instrumental in maintaining this leadership position.

I would like to point out that we are planning to issue a more complete written report. Our committees are still in the process of putting facts together. One committee is meeting tomorrow morning. It's been a fairly short period of time since being notified of this and being able to pull our thoughts together and we still have a little more work to do.

I would like to thank you for the opportunity to address this Panel. My fellow members of the New York State Society of CPAs join me in wishing you success as you finalize your report

recommendations.

MR. O'MALLEY: Well, thank you very much and we'll look forward to receiving your written comments.

Questions from the Panel? Aulana.

MS. PETERS: I have two. We specifically tried to get evidence on the profession's view and people who work with the profession of how they viewed the appeal and the allure of auditing and whether it had become a commodity, whether people thought that it was an unattractive field. And our evidence suggested that -- let's see, what did you say. That auditors did value what they did professionally and did think that the audit process or providing the audit service was an interesting and a good profession to be in and that it provided value. Your remarks suggest that you have evidence to the contrary and I wondered the source of that evidence,

what you base your conclusion that auditors don't value auditing.

MR. SOKOLSKI: You want to address that?

MR. STOCKER: I don't think we're -- auditors as individuals. I think we were addressing what is often stated in various materials, which we tried to put together, but from the AICPA and (inaudible) process and the Elliott Report, particularly in the early years, drafts of it.

MS. PETERS: Are you finished?

MR. STOCKER: No. As well as some various marketing materials or marketing guides that are not necessarily produced by the profession, but are often sold by professional organizations that emphasize the fact that -- that often refer to the audit process or auditing as a commodity or non-value added service.

MS. PETERS: Well, these third

parties who -- or these marketers or third parties who express that view, do you think that their conclusions are mythical or do you think that they're well grounded? I mean are they expressing their view as an advertising executive or a PR person that an audit doesn't bring value and that an auditor as -- the professional stature of an auditor is something less than it should be?

MR. STOCKER: From the standpoint of third parties, I think it does. And I'm not -- that's necessarily as much of a concern. I think it gets right to the question of -- they may be reflecting client perception, which -- or certain market perceptions, which over time certainly would have an impact on auditors, or what may be more important on younger people deciding whether to become auditors. I think once you get to

people who have chosen to become auditors, you already have certainly a different group. You've already gotten to the people who have decided to go into auditing in any case, no matter what the overall environment is.

MS. PETERS: But you think clients have that view?

MR. STOCKER: I think there's a perception that clients do, and I think there's -- I think many do. I think there's, as we've said in the comment, a disconnect between those who engage the auditors and the value of the audits. It's useful to the client to have a viable -- to have strong audits in society, but the specific -- in general, but the specific value of the client of that audit is the signature on the page, which has value because all of the other audits done in society are done very well. But as far as whether they don't

think of an audit as done well, is not --
is often not of great concern.

MR. O'MALLEY: Lou.

MR. LOWENSTEIN: I think the
evidence is a little more mixed from our
focus group. And none of this is
material data, but the focus groups that
I sat in on I heard, and they were
different than the one that Aulana sat
on. I heard a good deal of what you were
suggesting about the self image of people
going in on the audit side versus the --
I'm not sure of the exact quote of a
particular young auditor, but the more
glamorous work on the consulting side and
the like. So I think I saw a more mixed
picture.

MS. PETERS: Oh, I don't -- I think
that the perception is out there. I find
that interesting that the word perception
is used. But I suppose that a young 25
to 30 year old who is bombarded with the

opinions of marketers and PR people that it's less jazzy to be A and more attractive to be working as B might express those views. That's why I'm looking for the evidence.

MR. LOWENSTEIN: Well, we might have stimulated discussion between the two of us but --

MS. PETERS: But we're not going to do that.

MR. LOWENSTEIN: Right. In (inaudible) letter of comment to the Panel, he mentioned -- again antidotally, but numbers have had this experience, of the young auditor fresh out of college and on his very first assignment, and I can think of some examples personally, kids tell me this, as they walk in pea green being told by the audit partner to look around for consulting opportunities, you know, that's where the interesting stuff is. But I won't pursue it.

MS. PETERS: That's my signal not to either.

MR. JACOBY: I have a comment, which is just a personal opinion. One of the things that I do is provide staff with training services, educational services, and I've noticed in the last several years that the quality of entry level accountants is not the same as it was. I'm just following with -- you know, that's truism.

MS. PETERS: Well, that's interesting.

MR. O'MALLEY: Any other questions?

Dave.

MR. PEARSON: I'm not sure I understood one comment, but if I did understand it correctly, it was a very interesting comment. Did I understand you to say that firms cannot afford to pay enough to get the high caliber people

needed to effectively implement a risk-based audit approach?

MS. PETERS: I heard it, too.

MR. SOKOLSKI: We're saying that -- the first thing is that right now that competitive salaries entry-level for the accounting profession -- and we look around the whole country, not just the financial scene in the large metropolitan cities. That the salary level out there is one of the lowest going. And trying to get qualified people coming into the profession, people that are going to have the ability and the intelligence to grow into those positions as auditors is more difficult.

MS. PETERS: So it's not tied to the methodology, is it?

MR. SOKOLSKI: No.

MR. STOCKER: No, no.

MR. LONGSTRETH: But, Dave, that isn't quite an answer to your question.

MR. PEARSON: No.

MR. LONGSTRETH: We thought you said they cannot afford to pay, and that's different from what the going rate actually is. I mean in other words --

MR. STOCKER: I think what we're getting at was tying this into the commodity viewpoint, that there's a --

MR. PEARSON: It was in that part of the remarks.

MR. STOCKER: Yeah. In order to be able to afford whatever salary levels are necessary to attract the appropriate people, it has to be possible to earn the audit fees to pay that, which would only be possible if the competitive environment is such that firms can command such fees. And that would be -- the market process would take care of that assuming that the market is allowed -- that the consumers of audit services, if you will, who get the

benefit, are allowed to express that through the purchase of audit services. And that's where we get into the disconnection problem that I was discussing with Ms. Peters before, that the value to -- in many cases to whomever is engaging the auditor is in the signature and that the engagement would tend to go -- if someone could provide that, an auditor, they will provide that signature with -- and use it and bid low because -- by using people who are not really qualified to employ the appropriate auditing procedures, and that need would go to there without the -- so it would have a race to the bottom, if you will.

MR. O'MALLEY: Right.

MR. STOCKER: What we're concerned with is that that ought to be kept in mind in whatever the -- in creating an environment whereby we have those who

have more of a stake in quality audits, have more of an input on the engagement of auditors, such as the audit committees, rather than management.

And also we think the peer review process comes into play to the extent that it is -- that if you have good peer reviews, such that it is less possible -- more difficult to -- it's more difficult for everyone in the profession to perform substandard auditing or to perform less than the best audit practices. And if everyone could be confident that their competitors really can't or are not able to perform less than quality audits, that that would -- such things would enable the market process to express the appropriate fees which would be necessary to get the appropriate people.

MR. O'MALLEY: Bevis.

MR. LONGSTRETH: Your comment about the entry-level stock, if you will, the

work in process, is not in any way surprising if you link it with your statement that this profession pays its entry-level people far lower on average than other competing areas of professional activity to which the graduates can go. If the data supported it, something we could say, and I just don't know, but is hey, pay a higher level to the entry -- and that's critical to the future of the profession. And you can -- it may start -- I mean we just saw you got a 25 percent gross margin. Well, I don't know if that's right or not, but assuming it is, well, maybe you take 20 percent for a little while but you try to pass it on. I mean with a big five, is it conceivable that you can't pass on price increases? I mean it's inconceivable to me that you can't pass on price increases.

MR. O'MALLEY: Spoken by a lawyer

from a major firm.

MR. LONGSTRETH: Well, wait a minute. If a perfectly good CEO can be hired with a \$45 million signing bonus, I think that the top accounting firms in the world, and there are five of them, can pass on an increase if they're paying subprofessional levels. Now, Shaun, I don't know, maybe we ought to be a little more impressive in saying something.

MR. O'MALLEY: I don't think if you had -- if you had the big five representatives here, I don't think they would say they're having trouble. They say there's a smaller stock entering the profession, but they would still maintain that they are getting the best and the brightest and paying an appropriate level. But too it's a bigger profession than just the big five.

MR. LONGSTRETH: I prefaced it all by saying if the data supported it. But

I mean the data that you're talking about is -- I mean there's sort of a disconnect here, Shaun, somewhere. I know we heard that. We heard that statement. But then we hear these statements more than once. I don't understand it.

MS. PETERS: Well, we haven't asked -- I think the concern is a real one and a valid one and it needs to be articulated, and it has been, but I am -- I would be more concerned if there was a disconnect between what entrants into the profession are paid and those who are partners in whatever firm, than to hear that there's a disconnect between what entry-level lawyers or investment bankers are paid because they are different professions. They do generate different revenue streams.

And so the question is are the partners sitting on a whole bunch of money? I know that generally the

partners in the big five firms earn less than partners in major law firms. That is a fact. And we pay our entry-level lawyers -- it hurts, but more, a lot more. But, you know, the disconnect is still not there. So there's a different scale in the accounting profession than one encounters in our profession, Bevis, and heaven only knows it's different in banking.

MR. O'MALLEY: I'm not so sure that's totally borne out. I mean the huge law firms that are paying hundred plus thousand to beginning lawyers, that's not throughout the legal profession. There's a lot of law firms that are paying one hell of a lot less than that. And I think you have the same situation in the accounting profession where the major firms are paying probably at the highest level and medium size and smaller firms necessarily are paying

less.

Now, that doesn't mean there isn't a problem. We all acknowledge the problem that the total stock of entrants throughout the profession is lower than it was, and we've seen evidence of that in presentations on that and it's a matter of concern. And it's one of the reasons why we are trying to promote auditing as an important, necessary, interesting career for people, and I think the AICPA is attempting to do the same thing, and I think your society is trying to do the same thing. And we all want that to happen and it needs to be a continuing concern if that stock continues to reduce itself each year.

MS. PALMROSE: Can I ask a question?

MR. O'MALLEY: Yes.

MS. PALMROSE: I had a slightly different maybe comment on this, too.

One of the things that we generally think about when we -- one of the reasons we're having audit standards is it imposes the same criteria on everyone. So you would think it doesn't put any firm at a competitive disadvantage if everyone is required to do the same thing.

I guess I just wanted to say that I think you've probably sensitized us a little bit to the fact that there might be segments of the market that you can't pass on certain kinds of prices. In generally looking at the cost and benefit of additional requirements, the cost might be priced out and passed on. But what you've done, and I appreciate you saying this, is that you also on the output side may not be able to pass on all of the costs of additional requirements in this segment of the market, and that's something that's probably, at least to me,

important to be sensitive to. Now, I mean one expects to hear from clients that these will be additional costs that, you know, they might have to bear. But I do appreciate you sensitizing us to that issue.

MR. SOKOLSKI: I think one of the concerns of the audit committees, at least coming forward to me, is that obviously this whole thing is looking ahead at the SEC engagement. But if auditing standard bodies come out with standards for audits, they've got to be -- they've got to be --

MR. O'MALLEY: Across the board.

MR. SOKOLSKI: -- across the board.

MS. PALMROSE: Right.

MR. SOKOLSKI: And when you get down to the level of the non-SEC client and the small firm, there's going to be a lot of spill-over effect, and we're

concerned about how that might effect
(inaudible).

MR. O'MALLEY: As well you should
be. We appreciate that.

So, again, I thank you all for
coming and for your very thoughtful input
and your interest in this project.

MR. SOKOLSKI: Thank you.

MR. STOCKER: Thank you.

MR. O'MALLEY: It's good to see
Julian and Bill again. I presented at
your mid-year conference so...

MS. PETERS: Thank you.

MR. O'MALLEY: Well, we've reached
the end of our presentations. I want to
thank all of the presenters. I want to
thank the Panel members. I want to thank
the staff and our administrative support
team, and I want to thank the audiences
that were here for both days and sat with
us and heard these very interesting and
thoughtful presentations. I think they

will constitute really useful input to us in bringing this enormous project to conclusion, which I'm happy to say will be finished up we hope fairly soon.

Also I want to thank TIAA-CREF for kindly giving us their facilities and making them available to us these two days, as they did before in our October hearing. They've been a very kind host.

I think we got lots of support for the work of the Panel in these two days, and encouragement to go ahead with the final phase. I would think probably the most controversial issue that we've heard about has been that of non-audit services and the independence debate, and I think a number of the presenters brought that up. I just want to emphasize that the Panel concluded in its report that both views should be put forward. We believe that was the right choice. We believe that the SEC process should go forward

with all of the views weighed carefully
with significant due process and
consideration to all such views before
any final decision is reached.

Again, I want to thank all of you
for being here and for working with us.
Meeting adjourned.

(The proceedings are adjourned at
2:30 p.m.)

C E R T I F I C A T E

STATE OF NEW YORK)

: ss.

COUNTY OF NEW YORK)

I, BETH RADABAUGH, a Shorthand Reporter and Notary Public within and for the State of New York, do hereby certify that the within is a true and accurate transcript, to the best of my ability, of the proceedings taken on July 11, 2000.

I further certify that I am not related to any of the parties to this action by blood or marriage; and that I am in no way interested in the outcome of this matter.

IN WITNESS WHEREOF, I have hereunto set my hand this 20th day of July, 2000

BETH RADABAUGH