G. PETER WILSON: Good afternoon and welcome to today’s Deloitte Fireside Chat looking at Regulation in the Audit Profession - Yesterday, Today and Tomorrow, broadcast live on www.sechistorical.org.

I am G. Peter Wilson, Joseph L. Sweeney Chair of Accounting at the Carroll School of Accounting, Boston College and moderator for the program. The Deloitte Fireside Chats are made possible through a partnership between Deloitte LLP and the SEC Historical Society. Deloitte is the brand under which tens of thousands of dedicated professionals in independent firms throughout the world collaborate to provide audit, consulting, financial advisory, risk management and tax services to selected clients.

The SEC Historical Society shares, preserves and advances knowledge of the history of financial regulation through its unique virtual museum and archive at www.sechistorical.org. The museum is free and accessible worldwide at all times and currently welcomes more than 30,000 visitors a month. I serve on the Museum Committee advising on the growth and outreach of the museum. Both the museum and the Society are independent of the U. S. Securities and Exchange Commission and receive no funding from the public sector. The Society is grateful for the generous support of Deloitte LLP in making the Deloitte Fireside Chats possible.

I am delighted to welcome today Roderick M. Hills, Hills, Stern & Morley LLP and a former Chairman of the SEC; and Robert J. Kueppers, Deputy CEO, Deloitte LLP and a Trustee of the SEC Historical Society.

Before we begin our discussion I would like to state that the views of the presenters are their own and do not reflect those of Deloitte LLP or of the SEC Historical Society. The Society is responsible for the selection of the moderator and presenters. We have determined the questions that will guide the content of our discussion.

The last seven years since the formation of the PCAOB is the time frame during which the profession has seen the most significant regulatory change. But let’s set the stage to what got us to that point with a few upfront questions. Bob, can you quickly walk us through how the regulatory model for the profession looked before the creation of the PCAOB?

ROBERT J. KUEPPERS: Pete, thank you and thank you for that disclaimer. My partners will be happy to know that their views are not being expressed today.

Let’s talk a little bit about the history of regulation. I think the best place to go back to is the passage of the Securities Acts in the 1930s. For the first 45 years or so, up to 1977, the franchise or charter of the public accountant was the requirement that our clients have independent audits in order to register and trade their securities. During that time we had what I call the privilege of practice before the SEC, though we had no specific
program to monitor the quality of our work. In other words the profession wasn’t even in the phase of what I call self-regulated. It was literally a firm by firm commitment to maintain quality.

But things changed about 45 years later in the 1970s, a time that Rod Hills was very familiar with, because as a result of a couple of things including some of the scandals at that time, not the least of which was Equity Funding in Penn Central, a lot of questions about the integrity of auditing came forward. There were many proposals and discussions but what ended up coming out of that was a self regulatory structure that was put in place within the American Institute of CPAs, the AICPA. That was the first time when public accounting Firms became members of the AICPA through the SEC Practice Section. That gave us a new regime because, by agreeing to be a member, firms agreed to be subjected to a triennial peer review by a peer firm or a committee of members of peer firms, the formation of the Public Oversight Board, to watch over that process, included prominent members from business and former government officials and the like. And for the first time the SEC, by overseeing the process including the Public Oversight Board, actually took a look at the results of those reviews and had a role in watching over the quality of specific audits that the profession performed.

That was a 25 year run, if you will, and I remember finally that I had the honor of being the last Chairman of the SEC Practice Section Executive Committee because when the scandals of the turn of the century occurred and Sarbanes-Oxley became the reality, the profession ceded all of that authority to the PCAOB, which was born out of the requirements Congress put in place, through Sarbanes-Oxley. Now that’s the shortest run, we have only been at that about seven years. So I think the trend of 45-25-7 and things seemed to be getting in shorter pieces here, but that, the 7-year period, is the first time we have had direct regulation of the profession including registration, inspection on an annual basis for the eight or nine largest firms, public reporting of those inspections, and so forth.

G. PETER WILSON: Rod, you were either SEC Chairman or an audit committee member at the time of some of the key turning points Bob discussed. From your perspective in these roles, how did those turning points affect the audit as well as perhaps audit committees?

RODERICK HILLS: The only turning point that I saw was in 1976, the same year that Bob speaks of. My perspectives of the year are slightly different. It was the year that the SEC persuaded the New York Stock Exchange to adopt the requirement of audit committees and to add in its rules that there must be internal controls. Auditors were to bring anything of a suspicious nature to the attention of somebody independent of the company.

Before that I had two marvelous corporate train wreck opportunities. Both were with large companies. These companies bought countless other companies simply because they could pay less per share than their stock was trading; of course, they showed marvelous profits because of that. In both cases, anyone looking at it with a halfway decent education in math would see it as a perfectly ridiculous scheme. But neither the auditors nor the SEC nor anybody I could see thought particularly bad about it; there had been no specific auditing rules or accounting rules for this misbehavior. I must say the SEC rules and the audit committees had a substantial improvement upon the quality of corporate behavior, but they obviously didn’t stop Enron or WorldCom. You have to look
back and say, why? To me, the operating factor was the growing change of the business world, from one that came out of bricks and mortar before World War II, to intangible assets and growing need to have present value, both of which required management to use its estimates and its assumptions. That gave management discretion over what the numbers would be. That discretion is one that both the boards of directors and the auditors tried to stay away from. So management, as a practical matter, had this enormous discretion. As litigation began challenging those estimates and assumptions, the auditors, understandably trying to avoid exposure to that litigation, went increasingly to FASB to get new rules, so they would not have to use their judgment as to whether or not management’s judgment was correct.

During the same time, as I saw during those years, management became increasingly tough on accounting fees; sadly, the audit committee seemed to abet that effort. I heard too many stories of audit committees that felt that their highest and noblest cause was to reduce the audit fee by 5%. Their auditors carefully kept the audit fees 5 or 10% higher to avoid that. Now those two facts, I think, caused a change in the nature of the audit. I think you found less experienced people doing audits in the 1980s than I saw in the 1970s. As rules became more imprecise and more complex, you got more rule checkers. In the desire to avoid making judgments, I think both the auditors and the audit committees lost interest in the distinction between a fair presentation as set forth in the audit opinion, and the one that was in accordance with the rules. I think as a result, you had an imprecision and a lack of responsibility. The audit committees did not themselves have the sense that they were in charge of the audit. The auditors certainly didn’t think they were answerable to the audit committees.

G. PETER WILSON: Thank you. Now let’s talk about what defines the regulation of the profession today - the landmark Sarbanes-Oxley Act which had broad ranging implications for market constituents. Bob, can you give us a brief overview of how the act changed the regulatory landscape for the profession and what it meant for the self regulatory mechanisms that were in place before the PCAOB was created?

ROBERT J. KUEPPELS: This is really the most dramatic change that I have experienced in my 35 years in the profession because for the first time, the specific regulation by the PCAOB was embodied with a right to practice requiring a registration. So the authority and the law is pretty clear. The PCAOB could prevent an entire firm as well as individual partnership practitioners in a firm from auditing public companies. So that was a huge change. But in addition, they had the standard setting authority for the auditing standards. Previously the private sector had set audit standards and now it’s firmly in the hands of the PCAOB, for audits of public companies, along with an Enforcement program which, truth be told, we were worried a little bit about -- double jeopardy because we still have enforcement programs at the SEC. So the hard part here is figuring out whether the SEC or the PCAOB is going to investigate professional practice violations and violations of the auditing standards. But in addition to that new regime, which took us a little while to get used to, particularly the annual inspections, the other regimes didn’t go away. We still have state regulations, licensure, we still have peer review. Remember, I described how that was true in the ‘70s, ‘80s and ‘90s? Peer review still exists because of our need to have to practice in various state jurisdictions. So we have annual PCAOB inspections as well as triennial peer reviews. And then the other dimension which I haven’t mentioned is the extraterritorial reach of Sarbanes-Oxley, which is the decision that Congress made, that applied to public accounts outside the United States. That created sort of a wave of laws in Europe and other parts of the
world, sort of as counters to or in reaction to Sarbanes-Oxley. So the complexity of our regulatory scheme is a multiple of what it was just ten years ago.

G. PETER WILSON: The U. S. public company audit regulatory model of regulation by a private sector body, the PCAOB, with oversight by a government body, the SEC is a very interesting model. As a former SEC Chairman you are uniquely positioned to share insights on the strengths and weaknesses, if any, of this model. Can you share your related thoughts?

RODERICK HILLS: I see the PCAOB differently than many. I see it as an academy, one to retrain the profession, one to redefine the audit process. I think that, as a result of that, the audit - which in my view before Sarbanes-Oxley had become a commodity with little intrinsic value - has become one with intrinsic value. I think the change has been invaluable. The quality of people doing that work has become an important factor to management. The PCAOB is a training organization that hopefully will maintain its interests in preventing problems, and not focus on enforcing problems. It does have enforcement authority and responsibility. But to try to preserve the relationship between the training aspects requires a lot of confidence from the audit profession. They have to be partners and share the problems. They have to address when they see something. That relationship is terribly important. I think that the business model, and the fact that the SEC oversees it, protects the world from overzealous activity by the PCAOB.

G. PETER WILSON: Very good. Bob, how has the creation of the PCAOB and its related activities impacted the audit and the audit firms?

ROBERT J. KUEPPERS: Peter, I will answer your question but I actually would modify it a little bit. The PCAOB as envisioned by Sarbanes Oxley, if you take all of its provisions, has had a dramatic impact on the audit profession, and on even how audits are performed. Let me take you back just a little bit. Rod mentioned the ’70s and things were beginning to happen on the commoditization of the audit, there was a lot of economic merger activity in the country, our clients were merging, the firms were merging. Big 8 became Big 4 over time to get the kind of scale that our clients were insisting upon, in terms of serving them on a sort of a global platform. But what happened during that time is that our clients started losing focus on internal controls. Systems weren’t really rationalized, controls were not there, in what I call the post merger part of the merger, due the cost cutting, a lot of finance staffs and accounting expertise in some of the world’s largest companies began to be diminished foolishly, in my view and we grew to a great deal of deferred maintenance existed on internal controls. So Sarbanes with its requirement in 404 that the auditor for the largest companies, at least, have a separate opinion on top of management’s assessment of internal controls really changed the game in terms of how audits were executed. And it also caused our clients, who may not always have been happy about this, to refocus on internal controls and remember we saw that spate of restatements and all kinds of things as you sort of sweep out the dust in the corners, you are going to find things. But if you look at where that’s gone, it’s kind of run its course now, those things are dropping like a rock, restatements that is and we find a renewed discipline in the client organization, on the audit side is the audit team. And I think the quality of audits we perform today are better and I think it’s better directly as a result of the regulatory regime including the PCAOB that Sarbanes Oxley put in place.
Now its easy for me to say that. I could say, "Gee, audits are better, I am an auditor, I have a passion for auditing." But I will tell you that one of the things we did through an organization called the Center for Audit Quality a couple of years ago. We said, "Well, let's talk to the people that are responsible for overseeing audits." In this case, the audit committees, the beginning of which Rod referred to earlier. And we went to 253 audit committee members and asked them, "Now you have five years of Sarbanes Oxley, how's it going? What do you think about the quality of audits?" And 82% said that the quality had increased over that time, either increased somewhat or significantly. 95% of those audit committee members said the overall quality of audits of public companies is either good, very good or excellent and that the risk of materially misstating the financials had actually dropped, 68% said that this was lower post-SOX, so two out of three. My point being that even the people that are saddled with the responsibility were feeling more confident, more comfortable and frankly knew a heck of a lot more about what goes into an audit than they did pre-Sarbanes when you go back to the '80s and '90s.

RODERICK HILLS: The first thing that happened is that the audit committee took charge of the audit. If you ask an audit engagement partner now who is in charge, he will say, inevitably, the audit committee. The audit committee increasingly interviews the audit firm as well as the engagement partner. It has a role in deciding whether or not the fee is correct and whether or not the scope of the audit is correct. I used to say that the audit committee, before before Sarbanes Oxley and even before the requirement of an audit committee, was kind of a confessional. The auditors and the company came before the committee and said what they had done. The audit committee did not really understand what they had seen. The relationship has changed; the substance has changed. One can now say the audit is a management tool, and not a compliance tax as I think it was.

ROBERT J. KUEPPERS: Let me just reinforce a couple of those things because I spend a lot of my time, I am senior enough in the firm, I spend a lot of my time in the audit committee room for some of our largest clients. And where evidence is itself in a really interesting way that I am guessing the people listening don’t realize that we now have a five year partner rotation regime. Now we always had partner rotation ever since the 1970s. It was seven years which I frankly prefer, but the partner rotation responsibility now who has the authority to talk about the attributes of that next partner the firm would want to assign? I have seen companies do it all different ways. But I had one recently where the audit committee chair made it crystal clear that the audit committee would describe the needs and requirements as they saw it for this company as they understood it. They wanted to interview a couple of different people to get a sense for whether they would a good fit with management. And ultimately management was brought into the process to make sure that would work, the audit committee took full charge at determining what resources our firm is going to put inside that client to perform the audit. If you go back, not all that many years ago, maybe they would introduce a new partner to the audit committee as you would obviously have to, Rod, but the involvement of the audit committee, even a process like that which I find to be very important, matching the skills and experiences of a partner to requirements of the company, I have seen a change, it’s just a wholesale change.

RODERICK HILLS: There are a lot of changes there. The selection of directors and the selection of the people to be on the audit committee have changed. Increasingly, management has been kicked out of the process of producing candidates for the
directors. The nominating committee will select candidates, and the candidates will be submitted to the directors, including the CEO, but the CEO is excluded from the nominations. So, you have audit committees and nominating committees that owe nothing to management for their presence. I used to be fond of saying that I knew that the auditors never worked for me, because the chief financial officer got to play golf every year with the auditors, and I was never asked. I made that comment to Paul Sarbanes, and he asked me if I would go if asked. That was life then, you played golf with them and you had fun with them and you had a nice relationship but it was not a substantive relationship.

ROBERT J. KUEPPERS: I am not going to make any golf comments, however.

RODERICK HILLS: Do you play golf?

ROBERT J. KUEPPERS: Well, in theory I play golf, but is there ever time, right? The one crossover of regulation of the profession to the audit committee room which I think some people understand, other people might be surprised to hear is that as part of an inspection of an audit and our firm, and other firms who are inspected annually -- maybe anywhere from 50 to 80 audits are inspected in detail by the PCAOB. And they have got a big team of folks who come and do this. But to their credit, one of the things they have done from the beginning is ask for time, ask for an interview or some kind of exchange with the audit committee chair and get the perspective of the audit committee in terms of sort of the, I call it the skills, the attitude, the attributes of the audit team and what the relationship is like between the audit committee and audit partner or partners. And we never did anything like that in the old peer review system and while first it was a little unsettling to the audit committee members to understand, “Why do these folks want to talk to me?” It’s come to be actually mutually beneficial because it helps the audit committee members understand a little bit more about what an inspection’s about. But it also I think gives the audit committee an appreciation of what it’s like sort of walking in our shoes being a regulated profession. So it’s kind of new and different but it’s actually pretty routine these days for that to happen.

RODERICK HILLS: Two years after I left the Commission, it occurred to me that I missed one last speech before I left. That speech would have gone something like this, “We know now that auditors have the responsibility of pointing out any material weakness in the controls of the company. Can you detect a material weakness if you don’t have a well-qualified, independent audit committee?” I think today boards understand that. There still is a weakness that is not the fault of either the auditors or the board but it is a fault of our legal system. There is a great reluctance on the part of both the board and the auditors to delve into the question of whether or not, as the audit opinion says, it’s a fair presentation on the financial position of the company. In the case of Enron, for example, people on the board had a good accounting background. I take it from lawyers that have argued it that there was no obvious violation of GAAP in the Enron statements. But it wasn’t hard to see it wasn’t a terribly fair presentation when you understood the non balance sheet liabilities. It’s a understandable problem; they don’t want to be sued by saying it’s fair.

ROBERT J. KUEPPERS: Yet the audit opinion speaks to both.

RODERICK HILLS: Yes.
ROBERT J. KUEPPERS: Fairly presents in accordance with the generally accepted accounting principles.

RODERICK HILLS: I still have lawyers that tell me that as long as it's GAAP, it's fair.

ROBERT J. KUEPPERS: Well, that’s the point which is in the U.K. I believe, I am getting way out of my element here, we have this true and fair override notion, right? The words in the opinion… everyone pays attention to the “in accordance with GAAP,” there is the possibility that GAAP might not yield a fair presentation which is a whole separate issue.

RODERICK HILLS: Possibility?

ROBERT J. KUEPPERS: I just meant that we all know what we always used to call Rule 203 opinions where you would argue that it was misleading if you did follow GAAP. This maybe two in the history of the SEC, if we could even locate them and they would be pretty old and moldy by now. But the point is the fair presentation part of that, I think has always been a bit unclear.

G. PETER WILSON: Rod, I was wondering if you can elaborate. Something you said that was very interesting to me is that the management now sees the audit as a management tool. Could you elaborate on that with an example?

RODERICK HILLS: I was the audit committee chair on a board before I retired to this life, which is not retirement of course. But I talk to chief financial officers of major companies all the time. I find almost uniformly that the audit is a valuable exercise. In a sense, the external audit has been usurped by 404. I think in most cases - Bob, you know better than I do whether that has been blended - that there is no really separate 404 process. It is the difference between an audit based upon understanding the transaction, and one that is a rule checking transaction. I think that’s the significant difference.

ROBERT J. KUEPPERS: Here’s my view. I think that what happened to the profession in those ‘80s and ‘90s I mentioned earlier, where there are a lot of rationalizations, a lot of mergers, a lot of resources on the client’s side, began to be diminished and controls began to fall apart a little bit. The auditors found it easier not to rely on the controls, but simply to increase the amount of work they were doing. In other words, rather than using a control reliance audit strategy, let’s say we will just increase our sample size and we will pick more selections. I think that that sort of led atrophy of controls. Now, I don’t believe the financial statement audit was subsumed by the control audit, I believe it is served by the control audit. But I also think, it will allow you to do a little less sampling, if controls are effective of course, and focus a little bit more on the bigger issues, the real questions. Every year an active company is going to have a handful of issues that probably require a national office consultation, an application of the principles that aren’t just crystal clear. You look it up in the book and everybody salutes. But the real struggle is how that transaction should be accounted for and maybe it's one that involves a lot of estimates or calculation of a gain loss and the standard we all want to abide by is that it will stand up to scrutiny if the SEC reviews it. If anybody wants to challenge the financial statements, that they will hold up, that they will be solid. And so maybe that’s a… I guess it’s my way of saying that piece by piece the notion of the fair presentation really comes to those bigger issues often. I feel like our auditors are more focused on the risk of
material misstatement, the financial statement assertions, the design of the audit to properly test and there is a much better and deeper understanding of the real purpose and intent of the audit as it was. I must say when I was a youngster a number of years ago having a deeper understanding of the audit. So without conceding it, maybe we did go through the valley of death a little bit. But I think the current system, including inspections, has really been a wake up call in terms of a better designed construction and execution of the audit. And that’s got to be a good thing because we all worry about the next generation of auditors and the people just coming into the profession now.

RODERICK HILLS: How often do you think that auditors, who go through the process of approving the accounting after a major acquisition, how often do they explore with the audit committee the alternative ways that the management could have presented the accounting? In other words, the assumptions and estimates made in allocating the purchase price of a company, and then saying to the management or to the board or to the audit committee, “Now this is the process and you should know that there is another way of doing it.” Do you think that happens?

ROBERT J. KUEPPERS: I have seen it happen. I think that each acquisition you have to look at what are the drivers of the valuation because what you are trying to do is say, “Okay, we paid a billion dollars for this company, what did we get? We need to value that on our balance sheet on day one. And it is not only the obvious assets but it’s intangibles and other things that certainly the regulators are going to ask us about, if we are not really diligent to make sure we… if you will hold our client’s feet to the fire to be complete with that.” I have been in a number of conversations over the last three or four years where what I call the trade offs on valuation have been discussed and some of them are quite complex even to the point where maybe more than one outside valuation firm has been employed to keep each other honest. I will say in terms of what are the range of possibilities, I think less evident today are some of the tax driven motivations for valuing in a certain way. In the old days we couldn’t amortize intangibles and what that fight was all about was trying to get more value to the tax benefits that will come out of the purchase accounting allocation.

RODERICK HILLS: Sometimes it affects the earning per share.

ROBERT J. KUEPPERS: There’s no question, it could. But I think that the thing that drives those conversations most, I mean in my own view is the sophistication of certain audit committee members in certain situations. And the worry, is that the purchase accounting right because if it’s not we are going to find ourselves… we don’t amortize goodwill. We are going to find ourselves with impairment problems 18 months down the road or even less. So a lot of the challenges are trying to be certain that if it’s a big transaction that management, auditors, outside experts such as valuation firms are all on the same page and the discussions I have been involved with are sort of comparing the views of those parties to see if everybody’s kind of aligned or are there differences of opinion? Needless to say, it’s more often than not that you try and get aligned before you are subjected to those questions. But I have seen some pretty healthy discussions, more so than I would have ten years ago, for example.

RODERICK HILLS: If Sarbanes Oxley had been in place at the time the Arthur Andersen auditors presented the alternatives to the audit committee of Enron, would they have been required to say to the audit committee, “Here is a presentation in
accordance with GAAP. By the way, here’s a whole lot of potential liabilities off the balance sheet. We think this is a fair presentation, do you?"

ROBERT J. KUEPPERS: If you take that one apart a little bit, the thing that immediately comes to mind for me are the… I call it the structures, the finance structures that were sort of part of that set… actually not part of that set of financials, they were off balance sheet. That’s a pretty big threshold question. I don’t know what would have happened even with Sarbanes because once you have decided that it qualifies under GAAP even it’s not a technical… I know it’s your question.

G. PETER WILSON: I think that we are true and fair, are we not?

ROBERT J. KUEPPERS: I mean having had some involvement post mortem on that, pulling that all apart in doing the tough work that eventually became the Powers Report in the Enron situation, I didn’t personally do all that work but had some involvement. The complexity of that particular case is one that I have a hard time looking back and saying, “Oh well, here’s exactly how that should have gone.” I really did it. I really struggled with it. There was more disclosure there than you shake a stick at, if you will, and yet some people would say it was very difficult to sort through it, even they could point to some words that someone would say, “There it was. It was right there in front of your eyes.”

G. PETER WILSON: Well, that was very good. We have talked about where we have been and where we are now. So let’s turn our sights to the future. One of the biggest factors affecting financial reporting and auditing today is globalization. Bob, how do you see this impacting the future of the profession’s oversight model?

ROBERT J. KUEPPERS: You are right. The sort of the next wave of change is in the global arena. And what’s really happening is a sort of a confluence of a couple… I will just call them regulatory regimes but it’s not… I will talk about the auditing model in a minute, but first and foremost is the accounting standards and the questions about adoption of IFRS in the United States. In fact, outside the United States it’s sort of a fait accompli in many ways. It may not be final, but almost every major economy is either on IFRS or has plans to adopt it between now in the next two or three years. If you did a little math and you colored the countries red and blue or whatever, the only red one left is pretty much going to be United States, if you project it out just a couple of years. That has a huge impact on financial statements first and foremost. The SEC is expected next year to make a decision on completion of the work plan, it’s a little unclear when next year but…

RODERICK HILLS: Or when next year really is.

ROBERT J. KUEPPERS: When next year. A point, I have a feeling it won’t be in the first quarter, just a guess on my part. But there are elements of IFRS that are sort of appealing if you stand back at least academically, I mean the amount of judgment required. As we went through this exercise that the SEC sponsored, the Committee for Improvements to Financial Reporting, we had some very smart folks involved with that and this importance of the role of professional judgment for both the accounting decisions the preparers make and the auditing decisions coming behind it that the auditors have to make really cannot be ignored. We had a whole Fireside Chat on that last year. But it’s not just accounting. At the same time, the PCAOB has colleagues, counterparts, other national regulators that have very similar responsibilities. And so we
have the risk of having the PCAOB with sort of one set of requirements and across Europe and in Asia and up and down the Americas, regulators with different approaches. So for example, my firm has clients that are global in scale. They are listed securities all over the world. So the US audit firm, in my parlance here is registered, not just with the PCAOB but with the Canadians and the Japanese and half of Europe and so forth. So what I see happening, and this is actually very good news in my mind, is that the regulators are starting to collaborate with one another. There’s a new organization called the IFIAR which is just an acronym for the International Forum of Independent Audit Regulators that has some 30 or 35 regulators that meet regularly now. There are a lot of common agendas. How are we going to do this? How are going to do that? And anything that can lead to some form of international cooperation is going to be a good thing, because I am sure in my lifetime there will be no true global regulator, just as the securities exchanges and the security commissions collaborate with one another but there is no global authority truly. So I am starting to see signs of people being more open and that’s got to be a good thing for the markets and because inspections are good for investor confidence, getting some consistency over time has got to be even better.

G. PETER WILSON: Rod, you have seen significant evolution in financial reporting in your career, not only due to globalization but also to a broad range of other factors. In today’s world of “information now,” ever increasing technology and increased investor engagement with companies, how do you see the future financial reporting model evolving and affecting auditing?

RODERICK HILLS: As you ask that question, I am tempted to say, “apart from that, how did you like the play, Mrs. Lincoln?” Going back to bricks and mortar, I would like to assert that the current financial statement is obsolete. As The Economist put it, that statement preserves the illusion of accounting exactitude which tends to collapse in periods of economic strain. That is still so. That is not anywhere near the precision in the financial statement that people pretend there is. People believe, although it’s not strictly true, that auditors are attesting to the numbers in a financial statement and they get sued for that. I think they ignore what they really should be doing, that is, attesting to the process by which the numbers are secured.

Until we get there, all this talk of consolidation to me seems premature. We won’t have the same accounting rules as Europe if we merge. We will still have a litigation requirement that our auditors will be sued for making the judgments that are casually made in Europe. FASB will create all kinds of rules to go with the principles, just as we have now; there won’t be any change. We will continue to have scandals because we will consider to have had uncertainty as to the financial statements no matter how good the directors are.

You won’t get judgments until you give the auditing profession some kind of safe harbor. With the PCAOB and with all the access the SEC has to the PCAOB information, it seems to me quite clear that the SEC could give a safe harbor. We had an assembly with Columbia University a few years ago, I think Bob was there, and we had three former General Counsels of the SEC and four former SEC Chairmen. We all agreed that SEC could give a safe harbor, and that it was necessary it do so. Protected by the PCAOB and the SEC, why should plaintiffs have the right to challenge the judgment made by the auditors if the SEC and the PCAOB are happy with it?
G. PETER WILSON: Would you extend that to the auditor’s clients? If they had a process which could be defended, as opposed to outcomes - would you take the same position? Do they would need a type of safe harbor?

RODERICK HILLS: One has to be artful about it. It wouldn’t be the same; there will be more responsibility on their part. But if you refocus the auditors on the process, you refocus the directors, and we focus the SEC and the PCAOB and the investing world on the imprecision of what they are dealing with. It is not purely cynical to say the only value of the financial statement is to the plaintiff’s lawyers.

ROBERT J. KUEPERS: If you don’t mind, Pete, just a couple of thoughts. One of the things that Rod Hills just touched on which is sort of near and dear to my heart. This is why that disclaimer at the beginning is so important because these are my views.

RODERICK HILLS: You have got my disclaimer. I have got six partners; I have no disclaimers.

ROBERT J. KUEPERS: I actually believe that you are really hitting on something. I think that… someone said to me once, “You know, do you really want to give an opinion on $2.37 cents a share?” And the answer is, well, by the way it really isn’t 2.37, it’s probably somewhere between about a buck 90 and two and a half, I don’t know which. Because of the estimates involved that lead to very precise calculation. As we know markets move notwithstanding the fact the lack of precision. See, that’s why I am such a staunch defender of 404 because that at least gets to the process. And if you look at COSO, if you look at all the work that’s been done since the Treadway Commission, all the years going forward. If someone said to me, “In terms of the value, you only have one opinion, which one would you keep?” I think it would be the one on the process because the argument then would be, “The numbers are what they are. They fall out of a process.” Certainly we get management certifications, we got all kinds of things around that. I mean others have said we should show ranges. ‘The loan loss allowance for this bank is between A and B or X and Y’. The problem with ranges is they don’t add up nicely in those columns that we all like to… the footings on the balance sheet.

RODERICK HILLS: You will need a range and you need a judgment by management as to what the number is.

ROBERT J. KUEPERS: Which is presumably within the range but you pick a point. And so I think the education of the fact that... and more so today than ever with fair value, because with fair value, we are dealing with this kind of cash flow, we are dealing with different valuation methods and techniques, some are more precise than others. But every one of them has an underpinning, a set of assumptions, key drivers and our responsibility now is to audit management estimates through the valuation process. And we have got to take and challenge each of the pillars that support the major assumptions to do the testing around that. It’s very complex. But yet fair value is here to stay in some form or fashion and some are wanting to take it even further. It just makes the auditability of the numbers even more challenging. But I think the biggest issue is I don’t know that the readers of the financial statements understand the imprecision that define it in the first instance.

G. PETER WILSON: That would seem to be a major issue all round what we are talking about and that falls into my bailiwick, education, something we are all responsible for.
We serve the public interest but if the public isn’t aware of the imprecision and if we can’t figure out how to educate all the players in the public domain then we are not going to get around this problem. Anyway, that gives us a great segue into education. Many of our listeners today are like me from the academic community. We have not only professors listening today but more importantly there are students and they are going to be the future of the profession. As they look ahead to their careers in accounting either as preparers or auditors, what advice can the two of you offer them to keep in mind about the value of the audit and financial reporting as well as maximizing the quality of both?

ROBERT J. KUEPPERS: It's kind of a hard question. I guess I have to answer it though, right? Okay.

G. PETER WILSON: No, you don't have to… you have the choice… Rod’s way.

ROBERT J. KUEPPERS: It all comes down to the same fundamentals. As I was thinking about your question, Peter, I was thinking about when you go recruiting on campus, what are you looking for? What kind of young people do you want to bring into your organization? What do you expect of them as they mature and take on more responsibility? And some of the things that... it really doesn't matter whether you are a preparer or an auditor, the point is you are part of this the system we have designed to prepare meaningful financial information that people can rely on and have trust in. And the SEC’s system, which by all measures has been a great success, I mean the bedrock of all of that is in financial statements or financial information with integrity. So the things that make up the best outcome in an imperfect system perhaps are folks that are all trying to do it right, that are not afraid to sort of collaborate to get to the best answer. I mean if you look back on some of the problems we all have encountered over the years with frauds or difficulties, it's been people that haven't followed the basic fundamental code of doing the right thing and realizing that you are not the smartest guy in the room. You need help from others who understand the nuance of certain of these things to get it right. From an auditor's standpoint, I will take bright young people that have a good basic education, are willing to learn and are willing to work hard. And we usually pick up where the colleges and the universities leave off and it's a life long process of learning and experience that I think the biggest challenge is matching that experience with the right client situation. You can’t take somebody whose just out of school and expect him to... using your example, audit Enron, without having the kind of depth of experience you would need to do that. So no matter what level, accountants or auditors really have to follow their gut instincts, challenge things when they don’t feel right and critical thinking is the single biggest skill that I will take as opposed to technical knowledge.

RODERICK HILLS: I think you start with the proposition that this globalized world of ours desperately needs an auditing and accounting profession that is better educated and comes with a stronger background than it does now. I don't mean any disrespect for what it is now. But when I was a kid coming out of college, my colleagues went to business school, law school or followed an accounting profession, and there wasn’t much difference. Some became management consultants, some MBA, some in law, some became advisors to CEOs. When I became a young lawyer going to companies, I saw the engagement partner of an auditing firm traditionally at a much higher level, influencing the course of affairs in my company, than I see now.
The legal profession is a profession of advocacy. The worldwide firms of advocates are not really set up to provide the independent judgment that the world needs. Audit firms need to be universal. I think they need to be a single partnership or corporation. I think accountants and auditors need to have a much broader education. I think that we need to compete with the big law firms and the big consulting firms; we need people of that caliber. They have got to give a risk analysis. Why did the financial world collapse? Not merely because of incompetence. The risk analysts and the auditors didn’t make a risk analysis. Well, that’s good for them but it’s not good for us; we need a risk analysis. Something as simple as climate control today - we have something called cap and trade and the clearing development mechanisms, CDMs. It’s billions of dollars of trades. It is as imprecise as anything can be. The auditors are looking at it but they have no desire to give opinions about that because there is liability.

G. PETER WILSON: Do either of you have any parting thoughts? I would certainly like to hear them.

ROBERT J. KUEPPERS: My colleague here is more articulate so I will start. Chairman Hills has the last word. I have this… I can’t get it out of my head. I have a real passion for auditing. I have been doing it my whole career with two exceptions. I was a CFO for four years and I was at the SEC for a couple of years. So I have seen it from different sides. My own experience is that the biggest change in the 35 years of practice from external focus has been the changes in Sarbanes Oxley and the fact that financial statements are better, controls are better and it’s improved the quality of audits and I think all of that is good for investors. There is big part of me though, just picking up from what Rod said earlier, I too agree that at one time, and I can’t place this in the timeline perfectly, discussing with the audit partner that something was okay or right or he could live with it or accept it played a much bigger role. And that was typically before we had all the rules and the specifics in the accounting standards. And I am not at all sure that was a worse system. It may have been a little powerless from a legal standpoint but there is a big part of me that… and I have tremendous respect for our firm’s capital and certainly for my partners - but I am sort of ready to get back and take on the question of judgment and if that leads to a system where my experts deal with your experts, so be it. But I find that the quality of thought and care comes with figuring out ‘which footnote applies so you must be okay’ does not lead to good financial reporting. The substance, the economic substance of what needs to be accounted for and even more importantly disclosed so people understand it is the main thing. Rod might not agree that I welcome a new regime and a new set of standards without the FASB putting all the rules behind the principles because I actually think the outcomes were better when the systems were simpler, when I came into the profession in the 1970s. We didn’t have a rule for everything. So I guess my point is that as I look forward, I actually feel good about the profession. I am very proud to do what I do. I feel like we have gotten some value back where it’s belonged and the world is different. I think that we all share responsibility to make it even better.

G. PETER WILSON: Rod?

RODERICK HILLS: I gave my closing words a few minutes ago.

G. PETER WILSON: You did, I know.
RODERICK HILLS: All I would do is go back to that wonderful quote from The Economist that the financial statement is preserved in the brittle illusion of accounting exactitude. The United States will always be the odd person out. If it gets sued for making a judgment, the rest of the world can make it with impunity. That needs to be rationalized.

G. PETER WILSON: To what extent is that a joint project between lawyers and accountants? Can the legal profession and the accounting profession come to an understanding as to how one would go about litigating judgments in a true and fair way?

RODERICK HILLS: Everybody who wants to hear the Bible on this subject can access what we did at the assembly at Columbia University about five or six years ago. You can find it on the website of our organization, hillsgovernments.org or Americanassembly.org and you can spend some time on that issue. They were not only SEC Chairmen and General Counsels but they were academics - people like Sir David Tweedie, Bob Herz, Bill McDonough, Bill Donaldson - giving views that are comparable to one we are expressing now. This is not hard. It requires a resolve. It requires more than anything else an understanding that the combination of the PCAOB and the SEC has protected the American investor better than the American investor has been protected before. To weave a fair, safe harbor around those facts is not impossible.

ROBERT J. KUEPPERS: And let me tell you, Pete, one of the things that is sort of in play and this is starting to be a very big topic in Europe and it goes back about your point about risk analysis is, in the EC just a few days ago this sort of green paper on the role of the auditor began circulating as what they call a consultation paper. It’s out for comment. And the question on the table is, what should the role of the auditor be? I mean I have often felt that beyond the financial statements and related footnotes, the circumscribed piece, why couldn’t we have some kind of association with... there is MD&A or risk disclosures, other elements are critical to the view and safe harbor or no safe harbor everything doesn’t necessarily have to be an opinion. I mean there are procedures we could perform or levels of association that might not be as strong as an opinion. It was the opinion language we were talking about before but right now, we have to read the rest of the document and if something is inconsistent, we have to wave our hands and perhaps get changes but it’s not a very strong standard. My point is I think that auditors could bring more value if the financial statements, and that’s core and key, don’t tell the whole story. I think there are other things that we could give assurance around or have some role around that would actually improve the process for investors. I think audit committees might get some comfort from that. I am not trying to be commercial here. The point is, I think we could actually add some value but investors would have to want it for it to make sense. If investors don’t want it, its sort of a fool’s errand, you can think about it. But I think our profession is going to be deciding in the next little while exactly what our role should be, should we reaffirm what we do today? Or should we think about other elements or pieces of the disclosure package that we could provide some association with that would improve the character and nature of information that investors receive? So I don’t know where that’s going, I am just saying we are on a threshold of yet another debate on what the role of the auditors should be.

RODERICK HILLS: I will only add that Bob’s comment about investors. At this American Assembly we had some of the best sell-side and buy-side analysts we could find. Six of them were in agreement as to how much more valuable the financial statement we were proposing would be, than the one we have now.
G. PETER WILSON: Rod and Bob, thank you for this insightful discussion. Today’s program will be an important addition to the collection of materials on accounting in the virtual museum and archive collection. The audio of today’s broadcast is now available on www.sechistorical.org and a transcript will be ready soon.

I invite you to return to tune in again on Tuesday October 26th at 2pm Eastern Standard Time for Deloitte Fireside Chat 4, looking at Responsibility for Preventing and Detecting Financial Reporting Fraud. Professor Ira Solomon of the University of Illinois at Urbana-Champaign will be the moderator. The presenters will include Joseph Carcello, University of Tennessee at Knoxville; Cynthia Fornelli, Center for Audit Quality; and Bob Kueppers. The broadcast will be free and available worldwide without prior registration.

On behalf of the SEC Historical Society I would like to thank Deloitte LLP for its generous support and assistance in making today’s program possible. Thank you for being with us today. Good afternoon.