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## PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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## AUDITOR'S REPORTING MODEL

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## PUBLIC MEETING

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WEDNESDAY, APRIL 2, 2014

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The public meeting convened in the National Ballroom in the Westin Hotel, 1400 M Street, N.W., Washington, D.C. at 9:00 a.m., James R. Doty, PCAOB Chairman, presiding.

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

2 9:03 a.m.

3 MR. DOTY: Good morning. This is an open meeting  
4 of the Public Company Accounting Oversight Board. We've  
5 assembled a distinguished set of participants to assist  
6 the Board over the next two days in an in-depth  
7 discussion of the PCAOB's proposed standard on the  
8 auditor's report and the auditor's responsibilities  
9 regarding other information in certain documents  
10 containing audited financial statements.

11 I want to begin by thanking the panelists for  
12 their contributions. All of us have many competing  
13 demands on time, they especially. And many of them have  
14 traveled a long way to be with us. I'm grateful for this  
15 extraordinary effort, and we want to assure all of these  
16 panelists over the next two days that their effort is  
17 appreciated and will be given very deep consideration.

18 I want to also thank the staff of the SEC for  
19 their counsel and support as we've advanced this  
20 standards setting project. In particular, Deputy Chief  
21 Accountant Brian Croteau is present as an observer, and,  
22 Brian, I want to invite you to participate any time as

1 you see fit. Raise the flag, and you'll get the floor.

2           Former Chief Accountant Jim Kroeker is also here  
3 as an observer on behalf of the Financial Accounting  
4 Standards Board, FASB. It's always good to see Jim in  
5 these meetings. And I want to thank you for FASB's  
6 interest in this initiative and invite you to participate  
7 actively over the next two days.

8           Finally, I want to thank my fellow Board members  
9 and the PCAOB staff for being here today and for the  
10 immense preparation that I know they've all engaged in  
11 to analyze the issues before us.

12           The discussions we undertake during these two  
13 days will address important issues for our financial  
14 markets and the protection of investors. Eighty years  
15 ago, the Congress afforded a statutory franchise to the  
16 audit profession to protect the investing public's  
17 interest in accurate financial statements. The Congress'  
18 purpose in doing so was to regain and promote public  
19 confidence in the integrity of our capital markets.

20           The standard form audit report used to deliver on  
21 that mandate has not changed in any significant way in  
22 more than 70 years, although our capital markets,



1 indisputably, have. This audit report continues to serve  
2 a critical purpose, but many call for it to be more  
3 relevant in our capital markets today and to better serve  
4 today's investors and other users.

5           As I said when the Board issued the proposed  
6 standards to enhance the auditor's reporting model, I  
7 believe this marks a watershed moment for auditing in the  
8 United States. But this is a global initiative. We've  
9 benefitted greatly from our cooperation and coordination  
10 with the International Auditing and Assurance Standards  
11 Board.

12           To arrive at an opinion as to whether the  
13 financial statements are fairly presented, the auditor  
14 amasses a great body of evidence and, based on that  
15 evidence, gains unique insights. Investors are calling  
16 for these insights to anear to their benefit: to make the  
17 auditor's report more relevant and useful.

18           Similar calls are coming from other important  
19 users. Earlier this week, the Basel Committee updated  
20 its supervisory guidance on bank audits. The Basel  
21 Committee calls for more robust communication channels  
22 between auditors and banking regulators and banking

1 supervisors. The proposed standards are intended to make  
2 the audit report more relevant to investors by  
3 establishing criteria and a framework for the auditor to  
4 provide deeper insights from the audit based on  
5 information the auditor already knows from the audit.

6 The proposed standards emerged from an unanimous  
7 recommendation of the Treasury Department's Advisory  
8 Committee on the Audit Profession. They are also based  
9 on our own extensive outreach and public comment on both  
10 what would make the auditor's report more useful, as well  
11 as what auditors are in a position to deliver.

12 The hearings today and tomorrow are an important  
13 part and extension of that outreach. By requiring and  
14 providing a framework to report critical audit matters,  
15 the proposed standards would keep the auditor in its area  
16 of expertise: the audit. No one wants to return to the  
17 days before the pass/fail model was instituted when  
18 auditors' free writing could obscure disclaimer of  
19 assurance on misleading financial statements.

20 As many commenters have confirmed, there's real public  
21 interest in retaining the binary pass/fail model of  
22 opinion.

1           The proposed framework is intended to set forth  
2 concrete criteria to consider and apply in light of the  
3 specific audit at issue in order to limit both the  
4 discretion to avoid disclosure, as well as the  
5 opportunity to back into and fall back on boilerplate.  
6 The proposal would also require new elements in the  
7 auditor's report related to auditor independence, auditor  
8 tenure. It would include enhancements to existing  
9 language in the auditor's report related to the auditor's  
10 responsibility for fraud in notes in the financial  
11 statements.

12           The PCAOB's proposal would also require auditors  
13 to evaluate certain other information besides the  
14 financial statements, such as the company's annual report  
15 and management's discussion and analysis. And for the  
16 first time, the audit would describe this evaluation and  
17 its results.

18           Again, thank you for being here. I look forward  
19 to the discussion. And so we should commence with the  
20 first panel, and it's a distinguished panel. Let me  
21 point out a few of their qualifications.

22           Gaylen Hansen is the immediate past chair of the

1 National Association of State Boards of Accountancy,  
2 NASBA. He is an audit partner, EKS&H. He currently  
3 serves on the consultative advisory group to both the  
4 IAASB and the International Ethics Standards Board for  
5 Accountants. He serves on the International Auditing  
6 Standards Task Force for the AICPA. He's been a member  
7 of their Professional Ethics Executive Committee and on  
8 the PCAOB Standing Advisory Group. Gaylen, we appreciate  
9 your being here.

10 Richard Murray is the Chief Executive Officer of  
11 Liability Dynamics Consulting, a chairman emeritus of the  
12 Leadership Board of the Center for Capital Market  
13 Competitiveness. He serves on the board for the National  
14 Chamber Litigation Center. His current directorships  
15 include the Center for the Study of Financial Innovation  
16 and Oxford Analytica, both United Kingdom institutions.  
17 And he is a current member of the PCAOB Standing Advisory  
18 Group.

19 Lynn Turner is a managing director of LitiNomics,  
20 a firm that provides expert research, evaluation,  
21 analyses, and testimony in conflicts and commercial  
22 litigations. He served as the chief accountant in the

1 United States Securities and Exchange Commission from  
2 1998 to 2001. He is a former member of the Technical  
3 Advisory Committee of the FASB, a former member of the  
4 PCAOB Standing Advisory Group, and a current member of  
5 the PCAOB's Investor Advisory Group.

6           Jeff Mahoney is the general counsel of the  
7 Council of Institutional Investors. He is responsible  
8 for developing and communicating the Council's public  
9 response to proposed regulations, rules, standards, and  
10 laws that may impact corporate governance practices of  
11 companies in which council members may invest. Prior to  
12 joining the Council, he was counsel to the chairman of  
13 FASB. He is currently chairman of the Investor Rights  
14 Committee of the Corporation Finance and Securities Law  
15 Section of the District of Columbia Bar Association and  
16 a member of the International Financial Reporting  
17 Standards Advisory Council. He serves on the NASDAQ  
18 Listing Qualifications Hearing Panel. He is also an  
19 adjunct professor at the Washington College of Law at  
20 American University and a current member of the PCAOB  
21 Standing Advisory Group.

22           The first panel takes us back to the Treasury's

1 Advisory Committee on the Audit Profession and its roots.  
2 And with that, I want to turn it over to Gaylen Hansen  
3 for your statement. Thank you.

4 MR. HANSEN: I'd like to thank the Board. Thank  
5 you, Chairman Doty, for the opportunity to express my  
6 views on your initiative today and to I guess go back in  
7 time to reflect on the ACAP recommendation that led to  
8 where we're at today.

9 I'm an audit partner and director of quality  
10 assurance with a Denver-based accounting practice. I've  
11 been an auditor for over, well, nearly 40 years and have  
12 signed many audit reports. I also have a regulatory  
13 background as a former chair and member of the Colorado  
14 State Board of Accountancy and the AICPA's Professional  
15 Executive Committee. I am the immediate past chair of  
16 NASBA, as you pointed out. I've been invited to share,  
17 as mentioned, some insight into ACAP's recommendation  
18 leading to this reporting initiative.

19 ACAP took place in the midst of the 2008 economic  
20 meltdown five years into the PCAOB. Among ACAP's many  
21 objectives was the opportunity to reflect upon the  
22 Sarbanes-Oxley Act and the PCAOB.

1           We met at the Treasury Building next door to the  
2 White House. I saw frenzied late night activity at  
3 Treasury and, as I walked the hallways, noticed an  
4 abundance of looseleaf binders curiously labeled "TARP."  
5 Later, we would all learn much more about TARP and the  
6 economic Armageddon that our country narrowly dodged.

7           So against that backdrop, the handpicked ACAP  
8 members, with very diverse backgrounds, hoped to wrestle  
9 with media issues, find common ground, and, in this city  
10 of grand bargains, come up with creative solutions  
11 designed to ensure the long-term sustainability of the  
12 auditing profession. We were dealing with matters that  
13 had been kicked around for decades, and this was a chance  
14 to do something meaningful, even historic.

15           While auditors were not being blamed for the  
16 economic meltdown, per se, there was a general sentiment  
17 that they could have done more and why didn't they.  
18 There was also serious concern about firm concentration  
19 and over-reliance on the remaining handful of firms  
20 auditing our largest companies.

21           At the same time, firms coveted civil litigation  
22 reform and were willing to consider some compromises.

1 On the table was greater firm transparency and  
2 governance, improvements in audit quality.

3 Our recommendations covered a broad range, from  
4 establishing a national center to combat fraud to  
5 enhancing independence. One led to the subject matter  
6 of this meeting, and I believe it to be among our most  
7 important.

8 ACAP wasn't interested in change for change's  
9 sake or just because the current audit report was 70  
10 years old. We were interested in a substantive fix,  
11 increasing accountability and transparency with real  
12 teeth.

13 In retrospect, ACAP's recommendations remain as  
14 fitting today as it was in 2008. Investors continue to  
15 express dismay over reports offering limited, if any,  
16 value. Specifically, audit reports are noticeably silent  
17 about audit strategy and the overall audit approach, the  
18 extent of evidence obtained, and key audit judgments that  
19 are made.

20 During the crisis, there were numerous instances  
21 of clean opinions immediately followed by corporate  
22 collapse. Investors saw their capital vanishing



1 overnight, while those in the know couldn't or wouldn't  
2 share untapped insight.

3 I don't believe that it's realistic that  
4 investors will begin expecting less of auditors any time  
5 soon. Consequently, raising the bar on the audit is  
6 inevitable. And for this reason, I support the PCAOB's  
7 proposal.

8 Generally, auditors don't take kindly to change,  
9 and some have objected to certain aspects of the audit  
10 reporting model, especially related to critical audit  
11 matters, or CAM, which I'll say a bit more about in a  
12 minute. Some objections are legitimate, but others  
13 simply because the ARM will take them out of their  
14 comfort zone, and that are understandable. What we are  
15 talking about won't necessarily be easy, so some  
16 convincing still needs to take place.

17 On the matter of that convincing, here's some  
18 ACAP testimony of Jules Muis, a former VP and controller  
19 of the World Bank, and I quote, (I have, on various  
20 occasions in the past, thrown out a less revolutionary  
21 teaser suggesting that we should ban clean audit opinions  
22 as an audit reporting instrument for at least ten years

1 to come just to wean the audit profession off its  
2 addiction to clean opinions and to make it recognized a  
3 public interest in having the right opinion rather than  
4 a clean opinion.

5 I'm sure that Jules wasn't really serious about  
6 banning clean opinions, but his insight about the lack  
7 of communication and transparency resonates. And he goes  
8 on to say the problem is client confidentiality.  
9 Confidentiality has a long and important place in the  
10 profession. However, it doesn't serve investors when it  
11 prevents auditors from calling things as they see them.

12 The informational wants and needs of investors  
13 supersede all others in an efficient capital market. It  
14 doesn't escape notice that, of the 232 comment letters  
15 that PCAOB received, only nine percent came from  
16 investors. Hopefully, the weight of change will come  
17 down heavily on the side of that nine percent.

18 I'm going to sum up. There's a clarion call for  
19 many corridors today for greater auditor accountability  
20 and transparency. Other major players on the  
21 international scene are moving rapidly to require more  
22 informative audit reports, with or without the U.S. in

1 tow.

2           The audit profession has a long and storied  
3 history of excessive secrecy. At times, this can even  
4 strain the imagination. My first four years in the  
5 profession were with a Big Eight firm in Los Angeles.  
6 The firm's office was a large standalone two-story red  
7 brick building without a single window. I was told this  
8 emphasized confidentiality. Outsiders would never know  
9 what was going on within those brick walls. On the other  
10 hand, we couldn't see out.

11           At the time, my first job, it seemed quite  
12 normal. I knew nothing better. In retrospect, it was  
13 just plain weird.

14           Today's reporting standard is akin to a  
15 windowless building. It just doesn't make sense. The  
16 world has changed, and we need to change the way we are  
17 doing things to stay relevant. We can do better, and  
18 doing it is long overdue. I look forward to it.

19           MR. MURRAY: Chairman Doty, Commissioners, I've  
20 had the fortunate opportunity to spend more than 40 years  
21 watching the process of audit firm performance in the  
22 public company sector, both from inside the firms and

1 from critical positions outside the firms, critical in  
2 terms of having interests adverse to those of the  
3 profession.

4 I've also had the pleasure of participating in  
5 every assessment of audit performance, from Trueblood in  
6 1973 to ACAP, and am very grateful for the opportunity  
7 to participate with you here today. And thank you,  
8 Chairman.

9 The judgments that have shaped my views from  
10 those experiences I think should be identified before I  
11 share them. I consider auditing to be the most  
12 challenging of the learned professions and callings of  
13 our era. I think it is a process that performs  
14 imperfectly at times, occasionally in an embarrassingly  
15 flawed way. But we live in an imperfect world of not  
16 uniformly perfect people, and I believe that the role and  
17 performance of audit generally equals or exceeds the  
18 performance standards of any of the comparable learned  
19 professions and callings that address our public sector  
20 interest.

21 I believe that the role of auditing in financial  
22 reporting, while not yet what it can be, is at the

1 highest level of my period of experience, and much of the  
2 credit for that surely goes to the existence and the  
3 activities of the PCAOB and its commissioners, for which  
4 I thank you.

5           And, finally, I believe that the unfortunately  
6 litigious culture we enjoy here in America needs to be  
7 considered as one addresses all of the issues affecting  
8 auditing, not in terms of what's good for the welfare of  
9 the firms but in terms of what's good for the welfare of  
10 the American economy because litigation, a game that is  
11 played as a means of pursuing a variety of agendas in  
12 America, differs quite significantly from conditions in  
13 the US and the UK. It has impacts on audit quality, on  
14 the financial reporting environment. It impairs  
15 innovation and strains the ties of corporate governance.

16           I will deal with the issues that have been  
17 presented in the Board's proposal individually to save  
18 time. Regarding critical audit matters, I don't think  
19 there can be any question that the current form of the  
20 audit report is the longest-standing, least modified,  
21 most important, least informative, and most expensive and  
22 least understood form of commercial expression that man

1 has ever created, or woman either.

2           The real question is is this like democracy, the  
3 worst choice, except for all others; or is there a better  
4 way? And it is clearly time to explore that better way,  
5 and I commend the Board for having done so in a very  
6 comprehensive and challenging proposal.

7           There were two ACAP recommendations addressed to  
8 what is called critical audit matters. The first was a  
9 strong call, as Gaylen has well expressed, to enhance the  
10 value of the audit report through narrative about the  
11 auditor's views, views that would enlighten on the  
12 understanding the public will have about the company, not  
13 the information that the public will have about the  
14 company, which is the company's privilege and obligation  
15 to disclose.

16           The critical audit matter proposal seems to me  
17 overly prescriptive and overly focused and not properly  
18 stimulative for the kind of narrative that ACAP had in  
19 mind, at least that is, in my personal impression, not  
20 an extension of the views of others on ACAP.

21           I think it also blurs objectives a bit. If the  
22 purpose is to gain insight about the company, there is

1 an overlay of understanding that has grown around the CAM  
2 proposal that suggests that it also ought to enlighten  
3 about the quality of the audit performance, and I think  
4 that potential for confusion is unhelpful. And I would  
5 recommend that the CAM activity, as proposed, if it is  
6 to be pursued, be delivered through the audit committee  
7 rather than directly from auditor to the public. Nothing  
8 need be lost in content, but there would be a greater  
9 preservation of the growing and important role of audit  
10 committees as the nerve center of financial disclosure  
11 and corporate governance in all its aspects. I'm  
12 concerned that the proposal currently undermines much of  
13 the great work the Board has done in enlarging the  
14 responsibilities of the audit committee.

15           But ACAP had a second recommendation that there  
16 ought to be no harm done to the extreme value of the  
17 pass/fail model as the backbone of the capital markets.  
18 And we were concerned, not uniformly concerned but there  
19 was extensive concern about the extent of litigation risk  
20 to undermining the stability and clarity of the pass/fail  
21 model.

22           I do believe that that risk is a significant

1 concern. I note just two respects. I believe the CAM  
2 proposal creates a new and more extensive risk of  
3 exposure to private rights of action. Its architecture  
4 is broader than Sections 10(b) and 11, and, as a process  
5 matter, it puts the auditor in a devilish position in the  
6 way the litigation process moves forward. The auditor  
7 can be questioned, if whatever went wrong happened to  
8 involve something you addressed in the CAM process, why  
9 didn't you carry through and recognize the consequences?  
10 If it did not involve something addressed in the CAM  
11 process, why did you address so many CAMs and not happen  
12 to find the right one? I think that's a dilemma that the  
13 profession and the companies they represent will find  
14 very difficult to deal with.

15 I'll address briefly fraud and independence  
16 together. I think they are aligned and embedded in the  
17 expectation gap, and I think neither is ripe for  
18 attention at this point.

19 ACAP recommended on fraud that the PCAOB  
20 establish a fraud center to study and facilitate  
21 collaboration in fraud detection and to study the subject  
22 in a way that for 50 years had never been fundamentally



1 addressed as systemic risk. The PCAOB, I understand,  
2 does have a fraud project in planning. I am pleased and  
3 commend that. It may not be exactly what ACAP had in  
4 mind, but it surely must be a proper step forward. I  
5 suggest that the fraud proposals be deferred until that  
6 is completed.

7           The similarities of independence. ACAP had two  
8 recommendations here: That the PCAOB lead a compilation  
9 and rationalization of the requirements and standards for  
10 independence. There are multiple authority of guidelines  
11 on the subject that exist currently. They have  
12 conflicting interpretations. They don't even really  
13 agree upon whether independence is a noun, a condition  
14 to be independent, or is a verb, the way action is to be  
15 taken independently.

16           So long as we don't have a road map or even a  
17 common language to address the subject, there is concern,  
18 certainly in my view, that there is no way to get from  
19 here to there and it is time, after all these decades,  
20 to do the fundamental analyses of what qualities of  
21 judgment are really being sought here and what are the  
22 appropriate guidelines to measure those qualities?

1           We seem to have spent all those decades in  
2 rancorous debate based on non-concentric assumptions  
3 about what is the problem. Indeed, I wonder on both the  
4 fraud and the independent issues whether we've become so  
5 embracing of debate and controversy that we have  
6 forgotten that there is an opportunity to create  
7 understanding if we do a careful job of reassessing the  
8 fundamental assumptions on which we operate and put them  
9 at risk of being modified by listening to one another.

10           That is my recommendation as to both the fraud  
11 and independence studies. The acts of regulation follow  
12 on the acts of enlightenment that the Board is in the  
13 ideal position to bring to the profession and to the  
14 regulatory responsibilities. Thank you, Chairman, for  
15 the opportunity.

16           MR. DOTY: Thank you, Mr. Murray. Mr. Turner?

17           MR. TURNER: Thank you, Chairman Doty and all the  
18 Board members, for the invitation here today, as well as  
19 the staff. Thank you, Marty, as well. For the sake of  
20 time, I'll just ask that you include my written statement  
21 in the record, and I'll try to summarize it quickly  
22 before the red light goes on this time.

1           But I would echo everything that Gaylen had to  
2 say. I thought those were excellent comments. I would  
3 echo what Mr. Murray had to say about the profession  
4 being a very, very challenging job.

5           I would differ from Mr. Murray on the views of  
6 the subcommittee on the litigation issue. It was a  
7 fairly split committee as to whether there was an issue  
8 there on litigation or not. Those views were clearly set  
9 forth in the report. In fact, today, I think investors  
10 are very concerned about their ability to hold auditors  
11 accountable when, in fact, there have been failed audits,  
12 and they have suffered significant losses.

13           But the views I have today are based upon my  
14 experiences, almost four decades in this profession. It  
15 includes time as a preparer, as a CFO, audit partner.  
16 I've signed many, many audit reports, large, small,  
17 public, private companies. I've prepared, I can't fathom  
18 how many CAMs during that period of time and very well  
19 understand those. And I've served on the boards and  
20 chaired audit committees of public companies, as well.

21           And through all of that, I think it's clear that  
22 it's time to get something of value in the audit report.

1 The audit report today doesn't have value. That's  
2 something that I consistently hear from my fellow  
3 investors. In fact, in talking to a CIO where I sit on  
4 the board on one of the hundred largest investment funds  
5 in the world, the question was raised as to whether or  
6 not the portfolio managers even read the report because  
7 there's just nothing to be learned or gained from really  
8 reading it today.

9           So I would commend you all for taking on this  
10 project. It was a strong recommendation of ACAP. There  
11 are other recommendations which I wish you would also  
12 take up in short order, as well. But that's for another  
13 day.

14           As far as the approach, I think your approach is  
15 a good approach to tie it to the CAMs. I've sat at SAG  
16 meetings in the past that, if an investor ever saw those  
17 CAMs, if they were ever made transparent, they would  
18 understand that is what an investor really wants. It's  
19 what is critical, it's what significant to the auditor.  
20 That's why we prepared those CAMs. It lays out our  
21 strategy for dealing with them, how we dealt with them,  
22 how we resolved, and that's the type of information that

1 investors are looking for today. That's what I hear time  
2 and time again that they want.

3           There are those that say, well, you should only  
4 disclose information management has. That's nonsensical.  
5 If management has already disclosed it, why does it need  
6 to be disclosed again by the auditor?

7           What the investors are looking for is what was  
8 the auditor's perspective on the audit? And one concern  
9 here is we've seen time and time again where the auditors  
10 were aware of very important information, information  
11 that, most typically, would have shown up in a CAM in a  
12 quality well-done audit report, and that information was  
13 hidden by the auditor from investors. And if investors  
14 had seen that information, it would have made them  
15 change, I think, their investment allocation decisions.  
16 It would have avoided costs and losses for investors and,  
17 I think, in many of those instances, would have avoided  
18 litigation and costs for the auditors, as well.

19           So I commend the CAM approach that you've come up  
20 with. I think, to Mr. Chairman Doty's point, I think  
21 boilerplate can be avoided. I've given some thoughts on  
22 that in my statement. I think you ought to lay out

1 clearly your objectives, and I've given some other  
2 thoughts as to what I require in disclosure, and those  
3 are, in part, based upon what we do with similar type  
4 disclosures on related parties, which haven't worked all  
5 the time but have worked. So I think it's something to  
6 think about.

7           The one thing on the CAM approach that I would  
8 forewarn you about, and that is you can't leave it just  
9 to the discretion of the auditors. We did that when we  
10 did an independent standard in the past. It didn't work.  
11 It was fatally flawed, so leaving it solely to the  
12 discretion of the auditors would not be worth the time  
13 or money then because we'd get the same result. We've  
14 had that lesson once before. We shouldn't repeat it.

15           As far as some of your other recommendations, I  
16 think the recommendation on the auditor signing the  
17 report is very good. It's consistent with what ACAP  
18 recommended. There's no further liability to be had  
19 here. There is going to be the fact that, once you put  
20 your name out there as an audit partner, you're going to  
21 be concerned that have you got the job done right, and  
22 I think that's going to enhance, in the long run, audit

1 quality. It's going to cause you to focus. I sign those  
2 reported, and when you're signing with your own name, you  
3 know if your name shows up in too many problematic  
4 audits, you're probably going to have a problem. And I  
5 think that's what the whole debate is about here as far  
6 as the audit partner signing the report, and so I think  
7 that goes without saying.

8 I think the points you make about tenure,  
9 disclosure of tenure and independence is good. I was  
10 there at the SEC when we went through the fight over the  
11 independence rules, and when those independence rules  
12 were adopted there was positive statements of support  
13 from five or six of the firms at the time in support of  
14 those standards. And the ACAP did not recommend any  
15 changes in those standards. It did suggest codification  
16 somewhat, which would be helpful.

17 Finally, if we've learned anything from China  
18 it's the fact that we really do need some transparency  
19 around who is doing the audit. And if a significant  
20 portion of this audit is not being done by the signing  
21 partner or is not subject to the typical examinations  
22 that you all do that have turned out to be beneficial,

1 then certainly that needs to be disclosed, as well.

2           And I think, as Rich summarized about the audit  
3 report and his description of the current audit report  
4 being old and long in the tooth -- you know, it goes back  
5 now almost to the Model A, and we have had some things  
6 change in the country since the Model A came out, the  
7 assembly lines. So I suggest the time for change is now,  
8 and let's not let this get any longer in the tooth.

9           MR. DOTY: Thank you, Mr. Turner. Jeff Mahoney?

10           MR. MAHONEY: Good morning. Thank you, Chairman  
11 Doty and Board members and staff for hosting today's  
12 public meeting on the PCAOB's proposal to enhance the  
13 auditor's reporting model. The Council of Institutional  
14 Investors appreciate your leadership and willingness to  
15 pursue this important issue that has long been debated  
16 and remains controversial, particularly with some members  
17 of the auditing profession.

18           It was a real honor for me to have had the  
19 opportunity to serve on the Department of Treasury's  
20 Advisory Committee on the Auditing Profession on behalf  
21 of my executive director, Ann Yerger, and to participate  
22 on the Committee's Subcommittee on Firm Structure and



1 Finances with my three distinguished fellow panelists to  
2 my right.

3           As you may know the Subcommittee was ably chaired  
4 by Robert Glauber and, in addition to my fellow  
5 panelists, the Subcommittee included Timothy Flynn, the  
6 then chairman and CEO of KPMG; and William Travis, the  
7 director and former managing partner of McGladrey &  
8 Pullen. Others who devoted countless hours to the  
9 activities of the Subcommittee and, in my view, were  
10 instrumental in assisting in the development of the  
11 Subcommittee's findings and recommendations included Don  
12 Nicolaisen, who was co-chair of the Committee, along with  
13 Arthur Levitt; Alan Beller, the counselor to the  
14 co-chairs, who I understand will provide his perspectives  
15 this afternoon; and, last but not least, Kristen Jaconi,  
16 who was the senior policy advisor to the Undersecretary  
17 for Domestic Finance at the Department of Treasury at the  
18 time.

19           After reviewing extensive amounts of data  
20 provided from many sources, including from the audit  
21 firms, the Center for Audit Quality, and after receiving  
22 testimony and comment letters from a broad range of

1 experts, the Subcommittee focused mainly on seven areas  
2 in need of improvement in the auditing profession and  
3 produced seven recommendations. In my opinion, perhaps  
4 the most compelling of the seven was recommendation  
5 number five, to urge the PCAOB to undertake a  
6 standard-setting initiative to consider improvements to  
7 the auditor's standard reporting model.

8         As the Committee final report indicated, the  
9 auditor's report is the primary means by which the  
10 auditor communicates to the users of financial statements  
11 regarding its audit of those statements. And despite the  
12 numerous instances over the years in which blue ribbon  
13 panels of experts recommended that the standard auditor's  
14 report be improved to provide more relevant information  
15 to users of financial statements, as we all know,  
16 material changes to the auditor's report were never  
17 implemented.

18         I believe it's also significant that the  
19 Committee's final report highlights the testimony of  
20 Richard Fleck, whose a global relationship partner for  
21 Herbert Smith. In that testimony, Mr. Fleck stated that  
22 institutional investors believe an expanded auditor's

1 report would enhance investor confidence in financial  
2 reporting and recommended exploring a more narrative  
3 report in areas such as estimates and judgments,  
4 sufficiency of evidence, and uncertainties.

5           The substance of Mr. Fleck's testimony, in my  
6 view, has since been corroborated by multiple sources,  
7 including surveys at the CFA Institute and the PCAOB's  
8 Investor Advisory Group and the results of the PCAOB's  
9 own extensive outreach to investors and other users in  
10 connection with developing the proposed model.

11           Just a couple examples. Disclosure of the  
12 independent auditor's assessment of management's critical  
13 accounting judgments and estimates was supported by 79  
14 percent of institutional investor respondents to a 2011  
15 IEG survey and 86 percent of respondents to a 2011 CFA  
16 Institute survey. With respect to the latter survey, I  
17 understand Kurt Schacht will be on a panel this  
18 afternoon, and he can certainly provide more details and  
19 discuss other CFA Institute surveys and materials that  
20 may be relevant to the proposed model.

21           Based on those results, related findings and  
22 recommendation of ACAP, as well as the Council's own

1 membership-approved corporate governance policies, we  
2 generally support the PCAOB's proposed audit reporting  
3 model. We would, however, revise the proposed model to  
4 provide that the auditor be required to communicate, at  
5 a minimum, an assessment of management's critical  
6 accounting judgments and estimates based on the audit  
7 procedures that have been performed.

8           In our view, this modest revision to the proposed  
9 model would result in an auditor's report that provides  
10 the kind of independent auditor insights that are  
11 reflected in our policies and, more importantly, are  
12 responsive to investors' information needs. In that  
13 regard, we would not support a proposed model that failed  
14 to provide independent auditor insights and simply  
15 repeated or referenced management disclosures that  
16 already are provided to investors.

17           We believe if our modest revision were adopted,  
18 the proposed model, as revised, would be far more likely  
19 to achieve the Board's worthy goal of increasing the  
20 relevance and the usefulness of the auditor's report to  
21 investors, who ultimately are the key customer of the  
22 auditor's report.

1           Thank you again for inviting me to participate in  
2 this important meeting. And I look forward to learning  
3 from my fellow panelists, the Board, and all of you here  
4 today. Thank you.

5           MR. DOTY: Thank you. The intention in these  
6 discussions is always to attempt to give everybody a  
7 chance and to have some structure but to preserve some  
8 spontaneity. And we now have about 15, a little more  
9 than 15 minutes to get in to that. My colleagues have  
10 permitted me to call on each of them for one question.  
11 If we have time, we'll go around again, and I want to be  
12 sure that both staff and observers have a chance to get  
13 on this.

14           But we'll begin. Mr. Harris, one question.  
15 Multiple parts not allowed.

16           MR. HARRIS: Well, you just took my multiple  
17 parts off the table. Under common guidance on economic  
18 analysis, when the Board undertakes a standard-setting  
19 project, it should identify the need and the problem.  
20 And while it may be self evident and obvious, because  
21 we're creating a record I'd like each of you to  
22 articulate the need and the problem with as much

1 specificity as you can and why now?

2 MR. DOTY: Address to whom, Steve?

3 MR. HARRIS: The panel.

4 MR. DOTY: Gentlemen, should we just move down  
5 the line?

6 MR. HANSEN: That's fine. That's a great  
7 question. You know, I've heard over the course of my  
8 career every time there's a new standard that comes out,  
9 it layers on top of the others and that it's not going  
10 to take any significant additional time and nothing to  
11 worry about. I don't believe that. And I believe that,  
12 when it comes to the majority of the proposal, it will  
13 be pretty straightforward. It gets to the CAMs. You're  
14 talking about custom writing, custom thinking, and really  
15 thinking through the issues at the highest level of the  
16 talent within the audit organization, and I think it will  
17 take some additional time and it will involve some  
18 discussion with the audit committee. That shouldn't be  
19 overlooked.

20 Does that mean that it's going to be an  
21 overwhelming cost? No, because, as Lynn pointed out, I  
22 mean, those CAMs are part of the audit documentation

1 already. It needs to be polished up. It needs to be  
2 articulated better, but I think the economic analysis is  
3 going to show that, while there's going to some increase  
4 in the cost, it's not going to be overwhelming.

5 MR. DOTY: Richard?

6 MR. MURRAY: The problem, to look at it from too  
7 high a height, is that we do not understand each other.  
8 We have continued to not understand each other on various  
9 aspects and perspectives on these issues for too many  
10 years. We've been focusing on sharpening the ability to  
11 dispute, rather than considering the possibility of  
12 agreement. And I believe why now is because we have the  
13 benefit and advantage of the established and growing  
14 importance of the PCAOB to take the leadership in  
15 exploring what can be accomplished by a search for  
16 agreement and a search conducted in a collaborative  
17 manner in which the regulator and the regulated operate  
18 in partnership, as well as in a regulatory relationship.

19 MR. DOTY: Lynn?

20 MR. TURNER: Chairman Doty, I think the crux of  
21 the issue is not one of understanding. I think the  
22 auditors understand it very well, and I think investors

1 understand very well what they want. It's a difference  
2 over what product is going to be produced. Are you going  
3 to produce a product that the investors want, or are you  
4 going to produce a product that the auditors want?

5           As your own enforcement action on Medicis show  
6 and as I know full well from my time at the SEC in cases  
7 like Xerox, the auditors were fully informed about a  
8 fraud or a problem with the financial reporting, yet  
9 rolled out clean reports and remained silent and said  
10 nothing. And in those circumstances, silence is not  
11 golden. It's devastating.

12           And so that needs to change. The product needs  
13 to reflect what the customer wants. In this case, the  
14 customer is the consumer.

15           And to the question of why now, after 80 years  
16 that this report doesn't work, why not now?

17           MR. DOTY: Mr. Mahoney?

18           MR. MAHONEY: Similar to what Lynn said, we have  
19 a product that the major customers of that product are  
20 dissatisfied with it. And I think their dissatisfaction  
21 summarized in the PCAOB's staff's conclusions from their  
22 outreach, just reading from the concept release, the



1 PCAOB staff "observed that there was consensus among  
2 investors that the auditor has significant insight in the  
3 company and that the auditor's report should provide  
4 additional information based on that insight to make it  
5 more relevant and useful." I think that's where we need  
6 to head.

7 MR. DOTY: Mr. Ferguson?

8 MR. FERGUSON: Yes, I have a question for Jeff  
9 Mahoney on his suggestion that we have the auditor  
10 assess, that management's judgments on critical  
11 accounting estimates -- I can't exactly remember what you  
12 suggested. But if we were to do that, how would we do  
13 it? And would it be through a grading system, A to F,  
14 or like an honor's degree or magna cum laude or summa cum  
15 laude or, you know, they were conservative or they were  
16 aggressive? What would the criteria be, and how would  
17 we achieve comparability among audit reports so people  
18 looking at these judgments would be able to have a sense  
19 that there was a uniform standard being applied by the  
20 auditor?

21 MR. MAHONEY: With respect to the requirements,  
22 I think investors are not looking for anything new here.

1 The type of information, as Lynn has said earlier, is  
2 information that's already being provided to the audit  
3 committee. I think investors are just looking for some  
4 of that information to be provided in the main piece of  
5 communication with the auditor in the auditor's report.

6 As far as comparability, I don't think investors  
7 believe that this additional information needs to be  
8 comparable across all companies. I think, as I  
9 referenced earlier, what they're looking for is insights  
10 from the auditor. And if you look at the studies and  
11 surveys, a reoccurring theme is they want some insights  
12 with respect to significant estimates and judgments.

13 MR. DOTY: Mr. Hanson?

14 MR. HANSON: Thank you all for coming and your  
15 insightful comments. Just one question related to what  
16 investors think about our proposal that's on the table,  
17 and I'd ask you to each maybe comment about it to the  
18 extent you've had direct discussions with individuals  
19 responsible for making the investment decisions about  
20 what they think in the value of what we put on the table  
21 and any feedback you've gotten around that.

22 MR. DOTY: Is that a question for the panel or

1 for --

2 MR. HANSON: A question for each of you on the  
3 panel.

4 MR. DOTY: Jeff, do you want to take it and then  
5 move left, right for you?

6 MR. MAHONEY: Sure. As I said in my prepared  
7 statement, it's very clear that investors are  
8 dissatisfied with the product and they want more  
9 information. And as I indicated, I believe and our  
10 policies reflect that what they want is some more  
11 insights from the auditor, so then it's a question of  
12 insights about what? And as I said earlier, if you look  
13 at the many studies and surveys, a common theme is that  
14 they want more insights about the key estimates and  
15 judgments.

16 MR. DOTY: Lynn?

17 MR. TURNER: Jay, as I was doing my remarks,  
18 drafting them, I did share them with a number of  
19 investors and I did get responses back I think from five  
20 investors, and these are people who are making investment  
21 decisions. And, universally, they came back, with one  
22 exception, and said they are exactly where those remarks

1 were that I submitted in the written statement.

2           The one exception was one of the investors said  
3 he wanted further information, to Jeff's point, about  
4 changes in estimates, key estimates that the auditor had  
5 audited and changes in that estimate. So the feedback  
6 that I got from actual investors were my comments are  
7 exactly where they thought you should end up.

8           MR. DOTY: Mr. Murray, Mr. Murray, Richard?

9           MR. MURRAY: My perspective on the investment  
10 viewpoint comes primarily from involvement in the  
11 insurance industry, which is a major force. Insurers  
12 worldwide own 20 percent, 22 percent of global equities  
13 currently and remain a bastion of the investment  
14 stabilization of commerce.

15           To be overly quick and simplistic, my sense is  
16 the insurance industry is not opposed to things requested  
17 by groups of retail investors and some of the views that  
18 have made their way into active attention in the outreach  
19 reports of the PCAOB, but they don't consider them  
20 representative of their views and interests, as fixed  
21 long-term value-oriented investors. Their view, again  
22 simplistically put, is that there is a vast industry of

1 intermediating advisors that can and do provide much of  
2 the insight and analysis that seems to be requested at  
3 the retail investor viewpoint. And the question that  
4 insurers would have is how can that value then be best  
5 aligned with anything that might additionally be done in  
6 the audit reporting process to produce a better net  
7 outcome?

8 MR. DOTY: Mr. Hansen?

9 MR. HANSEN: I must say that my interactions with  
10 actual investors is somewhat limited. I'm an investor  
11 myself. I don't see the critical audit matters as being  
12 a magic bullet. I don't see that it's going to solve all  
13 of the uncertainty that investors might like it to  
14 resolve. But I think it's going to contribute to them  
15 being able to make their own evaluations better.

16 That said, you know, there was a lot of  
17 discussion about who signs the audit report. Sometimes,  
18 I wonder whether we didn't spend enough time talking  
19 about who it's addressed to. You know, it's sort of  
20 legalistic, this addressing it to the board of directors  
21 and the stockholders. Maybe it should be addressed to  
22 the public interest or investors themselves. But those

1 are just a couple of thoughts.

2 MR. DOTY: Ms. Franzel?

3 MS. FRANZEL: Thank you for being here today and  
4 sharing your insights. Going back to the recommendations  
5 of the ACAP and for expanding the information provided  
6 by auditors for the benefit of investors, in your view,  
7 does the CAM proposal meet those objectives based on the  
8 need that you all identified and the recommendation you  
9 made, along with everything we've learned since then?  
10 Does the current CAM proposal, as written, get us there?  
11 And if further refinements need to be made, in your view  
12 what would be the most important changes or revisions to  
13 the current proposal in order to meet the needs of  
14 investors?

15 MR. DOTY: To the panel, Jeanette?

16 MS. FRANZEL: It's to the whole panel, yes.

17 MR. DOTY: Gaylen, do you want to take it first?

18 MR. HANSEN: Sure. I believe they do meet the  
19 basic objectives of what we're trying to accomplish here.  
20 I think if the focus can be on, as it says, those few  
21 things that keep the auditor awake at night, those few  
22 things, not many things. That may be a different signal

1 of a different problem, or, if there's no things that  
2 keep the auditor awake at night, maybe that's a  
3 completely different issue. But I think the objectives  
4 are met.

5           MR. MURRAY: I would go back to my brief and  
6 poorly-illustrated remarks earlier. I believe that,  
7 while Lynn and I may not have exactly the same  
8 recollections of the ACAP discussions, that the  
9 objectives we were identifying had to do with getting  
10 more insight about the company and not necessarily  
11 additional or different information about the company,  
12 and I think that is a distinction that isn't entirely  
13 well articulated in the current CAM proposal and creates  
14 some of the confusion of what is intended and how should  
15 it be performed.

16           And I also think that we had a focus on what can  
17 be learned through this process about the company, rather  
18 than a further standard and way to evaluate the  
19 performance of the audit. And I think that, too, could  
20 be clarified in the way this is articulated and  
21 presented.

22           MR. DOTY: Lynn?

1           MR. TURNER: The discussion at ACAP started out  
2 with the discussion, I think it might have even been Tim  
3 Flynn who brought up the issue with the pass/fail model  
4 and the shortcomings that some expressed with respect to  
5 the shortfalls in that model. And then it expanded to  
6 what about making sure that we tell investors exactly  
7 what the auditor is going to do to detect fraud and  
8 clarify that responsibility, which was an important part  
9 of the recommendation to be addressed.

10           And then, as we got into public hearings, then we  
11 started hearing from investors. Jeff has mentioned some.  
12 There was Tony Sondhi testifying on behalf of the CFA  
13 Institute and others. I'd urge you to go back and look  
14 through that testimony. There's binders of records of  
15 it -- I've still got them if you don't -- that lay out  
16 exactly what investors were looking for. And investors  
17 were looking not just for information about the company,  
18 if you look at that testimony, but, in fact, looking for  
19 an auditor's perspective of it.

20           When you look at the actual recommendation, the  
21 recommendation doesn't get to that detail. The  
22 recommendation says: Undertake a standard-setting



1 process. This is your job, not our job at ACAP. It's  
2 your job to decide what should be done, so go through a  
3 thoughtful standard-setting process and go do it. And  
4 I think that's what was intended.

5 As far as does approach tied to disclosure of  
6 CAMs meet that? Based on my experience, having written  
7 many of those CAMs, done audits and, yet, been on the  
8 investment side, I actually think that's a good approach.  
9 It requires disclosure of all CAMs, though, and it  
10 requires that it not be discretionary. And there's been  
11 some question, as we've talked about at other meetings,  
12 about is there too much discretion or not and are the  
13 objectives around the CAMs clearly laid out?

14 But I think, in general, the CAM type approach is  
15 a good start and would respond, assuming you also deal  
16 with the fraud piece of that recommendation.

17 MR. DOTY: Mr. Mahoney?

18 MR. MAHONEY: Thank you. I, as well, agree the  
19 proposal can meet the objective. And as indicated in my  
20 comment letter and in my statement today, I believe it  
21 can be revised in such a way that it will get the auditor  
22 insights that our policies reflect and that investors

1 have been asking for for many years.

2           And, again, we don't need to, we already have  
3 that information. We also already have rules related to  
4 that information in connection with communication. It's  
5 through the audit committee. So I think it's just a  
6 matter of refashioning those requirements to get that  
7 information into the auditor's report.

8           MR. DOTY: I want to ask a question back to  
9 Richard Murray because, as lawyers, we both share an  
10 interest in liability and litigation. And noting  
11 parenthetically that our re-proposal on transparency does  
12 not call for signature of the audit partner but naming  
13 of the audit partner, one of the issues that pervades all  
14 these discussions is a concern that, where we provide  
15 more disclosure, we think about the litigation and the  
16 liability issues.

17           And you made an arresting statement. You say  
18 that critical audit matters will lead to a new wave of  
19 litigation. If the disclosure of the CAMs appears in the  
20 context of the audit report and the audit report is good,  
21 it's a good audit, the auditor has his defenses even if  
22 the financial reporting is not good but the audit is

1 good. That would seem to be not a problem for the CAMs  
2 in terms of what results from it.

3 But if the audit is not good or if there is, if  
4 there's frivolous litigation, I'm interested in getting  
5 to what you clearly see is a need for a constructive  
6 change. I'm wondering if, in fact, if we consider  
7 language both in the adopting release and in the standard  
8 to clarify the informational value of the CAMs, to  
9 clarify what I referred to in passing in my opening  
10 statement which is our intention that this be limited to  
11 what the auditor knows. Richard, you've also made a  
12 point as to communication of the audit committee and not  
13 the public, and I think that's a different issue. But  
14 do you think that by clarifying the value, the  
15 informational value of what the CAM is, that, at the same  
16 time, we diminish and really address the risk of  
17 litigation, of meritless litigation, frivolous  
18 litigation, with which we're all concerned?

19 MR. MURRAY: Chairman, first, I have to recognize  
20 that one of the things that's common to most lawyers is  
21 hyperbole, particularly in time pressure. My point was  
22 --

1 MR. DOTY: We've all done it.

2 MR. MURRAY: -- not to declare that this is  
3 clearly an unequivocally a problem to be accommodated but  
4 to urge the Board to pay more focused attention to  
5 explore whether the Board concludes that it is. Then at  
6 least it's apparent in the publically-disclosed  
7 materials.

8 In terms of what would help assist with the  
9 problem, if there is some degree of problem here, it  
10 seems to me there is a positive direction and it was  
11 explored by ACAP, not too agreement but it was explored,  
12 sometimes loudly. And that is whether or not there is  
13 some opportunity to create, by regulation or otherwise,  
14 a judgment privilege that surrounds the most sensitive  
15 and difficult judgment and expression forms.

16 We have a business judgment rule for the  
17 corporate sector that recognizes that you get into some  
18 gray zone issues that expose one to a double bind you're  
19 wrong if you do this, you're wrong if you do that. That  
20 doesn't exist in the audit environment in liability  
21 today. And with every more granular disclosure, whether  
22 it's the CAMs or any other formulation, that gray zone

1 expands and deepens. And it seems to me the most  
2 promising solution would be to demand more of the  
3 auditors. But for the sake of the financial reporting  
4 process, not just the auditors, to allow that innovation  
5 to be addressed constructively and with enthusiasm,  
6 provide a degree, not full protection but a degree of  
7 accommodation to the judgment periphery on the edge of  
8 responsibility.

9 MR. DOTY: But do we at all, by speaking to the  
10 issue of what the CAM is and the value of it, do we, in  
11 any sense, ameliorate the risk of meritless litigation  
12 since the CAM is in the opinion and the opinion, as a  
13 whole, is what it is?

14 MR. MURRAY: You could, and you would,  
15 undoubtedly, have some influence. But if one considers  
16 the extent to which federal government agencies are  
17 having, generally speaking, are having their agendas  
18 rewritten and their interpretations ignored by judicial  
19 and private sector litigation, I think there's a real  
20 risk that your very best intentions, articulately  
21 expressed, would not survive the hassle of litigation.

22 MR. DOTY: You're not giving in on this point,

1 and I respect it. One of the points of being chairman  
2 is I get to ask one more question before I go back to  
3 Jeanette Franzel, and it goes to Lynn Turner where you  
4 point out that neither the audit committee, nor  
5 management, knows what the auditor knows from the audit.  
6 How do you respond to Richard Murray's and others'  
7 comment that the appropriate place for what the auditor  
8 would otherwise say in a CAM is either in the proxy  
9 statement, as to which we have no real jurisdiction, or  
10 by more privileged communications directly with the audit  
11 committee, as Richard suggests.

12           Lynn, Jeff, do you all want to do a crisp  
13 one-minute? Isn't he right? Can't you do this by -- if  
14 the audit committee doesn't know this and this is such  
15 important information, don't you reduce the expectation  
16 gap by giving it to the audit committee and having rules  
17 expanding on the disclosures in the proxy statement and  
18 other documents?

19           MR. TURNER: The short answer is no. If you look  
20 at, again, the cases I mentioned, there's others that are  
21 out there, as well. In the WR Grace case that we have,  
22 the information didn't ever go from either the auditor

1 to the audit committee. Now, assuming it goes from the  
2 auditor to the audit committee, you still haven't  
3 delivered the product that the investor wants. I've run  
4 a company, I've run a manufacturing company. The key  
5 thing is to give a product to the customer that the  
6 customer wants, values, and pays for. If you stop it at  
7 the audit committee, it doesn't go out to the investor.

8           This is simply a matter of are you going to give  
9 the customer what they're looking for, what they need to  
10 make sound capital allocations? If that information  
11 doesn't get to the people making those investment  
12 decisions, and that's not the audit committee, it's not  
13 management, then you aren't giving them the information.  
14 And right now that information doesn't flow.

15           As to where you put it in the proxy or wherever,  
16 I really don't care, as I say in my statement, where the  
17 information is put out. What I care about is the  
18 information investors want gets put in their hands in a  
19 timely and complete fashion and reflects the perspective  
20 of the auditors.

21           MR. DOTY: Jeanette, you want to take one last  
22 shot?

1 MS. FRANZEL: Sure. I want to drill down a  
2 little bit on Mr. Mahoney's suggestion of a modest change  
3 to the proposal, and I think some might take issue with  
4 the characterization of that as modest. So I just want  
5 to drill down --

6 MR. MAHONEY: It is a little optimistic.

7 MS. FRANZEL: I just want to drill down a little  
8 bit. You are calling for an adjustment where a CAM would  
9 include an assessment of management's critical accounting  
10 judgments and estimates. What do you think that would  
11 look like and how would that be achieved under this  
12 current model? And then I'd be interested in the  
13 reaction of the other panel members, as well.

14 MR. MAHONEY: Here again, I'm looking at the  
15 communications that are currently being provided to the  
16 audit committee today. And looking at those  
17 communications related to significant estimates and  
18 judgments, I think those that the auditor thinks are most  
19 important in the CAM should be disclosed in the report.

20 Going back to the Chairman's last question, as  
21 Lynn said, the information is what's important. But  
22 right now the auditor's report is the main piece of



1 communication between the auditor and investors. And  
2 investors want more communication from the independent  
3 expert. The audit report seems to be a logical place to  
4 put it since that's the only communication that we have  
5 between the two today.

6 MR. TURNER: Jeanette, I've served as chair of  
7 three public audit, chaired the audit committee of three  
8 public companies. In each of those three instances, each  
9 a different one of the Big Four, so three of the Big  
10 Four, came in and, consistent with the blue ribbon panel  
11 recommendations, had a discussion with us about not just  
12 the acceptability but the appropriateness of the  
13 judgments and estimates made by management. That's part  
14 of that report recommendation. It's not the first time  
15 it's come up. Jeff's recommendation is totally  
16 consistent with what's been recommended in the past.

17 In all three of those audit committees, the  
18 auditor would come in and, in part of their communication  
19 to us, they presented us a slide or two each time, giving  
20 us their estimate, their view, perspective on those  
21 estimates, and they would typically do it in a graph that  
22 had aggressive on one side and conservative on the other

1 side, and they defined that in their graphs to us and  
2 said here's where we think it lays. So the information  
3 is there. It's being communicated. It's being  
4 communicated consistent with recommendations of very well  
5 known panels in the past. It's not new information.

6 MR. DOTY: Reluctant as I am, we're going to  
7 leave it at that. I'm going to make sure that we start  
8 with the next panel's question with Jeanette, run through  
9 Jay, and move up and end with Steve. And I will cede my  
10 time on the next question. So we're going to do justice.

11 I'm going to wait for flags to go up from the  
12 wings here. But when they go up, I'll call on them.

13 Thank you for taking us back to ACAP, for  
14 refreshing our recollection of what all this is about,  
15 and for some very meaty insights, trenchant insights on  
16 the current issues we face. Thank you all.

17 Well, where to begin? We next have one of the  
18 giants of the auditing profession with us, and Sir David  
19 Tweedie will be here until 10:40. He's making a special  
20 effort to do this.

21 He serves as the chairman of the International  
22 Evaluation Standards Council, which is looking into many

1 of the key issues that come up in this audit reporting  
2 model question. From 2001 to '11, he was the first  
3 chairman of the International Accounting Standards Board,  
4 as well as the chief executive officer of the  
5 International Financial Reporting Standards Foundation.

6 It goes on. A fellow at the Judge Business  
7 School at the University of Cambridge; visiting professor  
8 of accounting in the University of Edinburgh Management  
9 School; honorary degrees from nine British universities;  
10 various honors and awards, in addition to knighthood, for  
11 his dedication and service to the accounting profession;  
12 president of the Institute for Chartered Accountants of  
13 Scotland from 2012 to 2013; chairs the Royal Household  
14 Audit Committee for the Sovereign Grant which funds the  
15 work of the British monarchy.

16 He's a current member of the PCAOB Standing  
17 Advisory Group. Mr. David, we're grateful for your  
18 presence. Please enlighten us.

19 MR. TWEEDIE: Well, thank you, Jim. And can I  
20 say what a pleasure it is to be here and see so many of  
21 my old friends. As several people in the room will know,  
22 as I've said before, it's always a privilege to come out

1 here to the colonies and to continue my missionary work.

2 But this is a particularly interesting project.

3 Everybody knows about a bad audit. It's splattered all

4 over the press. Very good audits you actually don't hear

5 anything about. They're hidden.

6 And audit, I think, is seen as a necessary

7 commodity. It's what you have to pay for to get access

8 to the capital markets, and the opinion, as we've

9 discussed already, is an on/off switch. And when I first

10 qualified as an accountant over 40 years ago, I could

11 look at an audit report and know instantly if it was

12 qualified because it was only three lines long. If it

13 was more than that, it was something I ought to read.

14 Otherwise, I just knew it was okay.

15 Since then, with the expectation gap, we've lost

16 the crispness of the audit report in a whole lot of what

17 now has become boilerplate language. And one of the

18 things I'm slightly concerned about in the new proposals

19 is a lot of that is still going to be in the audit

20 report. Personally, I'd like to see that on a website

21 or in an appendix. You might like to ask my UK

22 colleagues about how they deal with it.

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1           But the investor, quite clearly, as signaled from  
2 your own papers that they would like, is they would like  
3 additional audit reporting because they don't have access  
4 to or aware of many of the issues that the auditor has  
5 raised.    And Lynn mentioned that a lot in the last  
6 session.

7           The audit report really, in my view, should be  
8 adding value.    At the moment, it's more one of  
9 limitation.    You know, how many auditors does it take to  
10 change a light bulb?   None because they've formed a  
11 committee to say it's not their responsibility.   And  
12 that's the sort of thing that we end up getting in the  
13 audit report.

14          But I think you've given the auditor a wonderful  
15 opportunity to start ending the notion of the audit being  
16 just a necessity and make it a vital part of investment  
17 analysis.    Developments have already taken place  
18 elsewhere, notably the UK and Europe.   And if you can get  
19 Europe to agree on these things, surely it can't be  
20 difficult to get the U.S. to agree on it.

21          But it would be a real help, too, I think, if  
22 PCAOB and the IAASB could get together and make sure the

1 terminology was the same so audit reports throughout the  
2 world said the same sort of thing and we knew exactly  
3 what they all meant.

4 I would actually have liked the PCAOB to have  
5 gone further than it did. I would like to see the audit  
6 report based on the notion that investors want auditors  
7 to ask themselves what would they like to know if they  
8 were investing in the company and make sure that's what  
9 was in the report.

10 The critical audit matters I think is a real step  
11 forward. But that, again, I don't think goes far enough  
12 because it asks, you know, what are the matters and what  
13 did you do about it? What I feel it also has to do is  
14 and what were your findings?

15 I will draw your attention to the Rolls Royce  
16 audit report in the United Kingdom, which I'm sure my UK  
17 colleagues will talk about and certainly Tony Cates of  
18 KPMG because I found it quite excellent. It talks about  
19 the problems. The findings are that the company was  
20 slightly cautious in some areas, overly optimistic in  
21 others. But you get the picture that, on balance, this  
22 was actually a fair presentation, even though in certain

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1 areas there may be slight movements one way or the other.

2           And when you start looking at things such as  
3 valuations, Level 3 valuations, how do we know how far  
4 the auditor has gone in the range? Is this an aggressive  
5 company? It is it a pessimistic company? I think that's  
6 information that really should be out there in the public  
7 domain.

8           The genesis of this change, as we heard from the  
9 last panel, has been the financial crisis. And if anyone  
10 wants to argue that the audit report was fine in that  
11 crisis, they just have to look at some of the figures  
12 that you've got in your own papers about two or three  
13 years ago where it was pointed out that the 2008 and 2009  
14 audits of a company receiving the TARP funding was  
15 actually, word-for-word, the same. And, yet, in 2008,  
16 the audit report costs \$119 million, and in 2009 it cost  
17 \$193 million. So what if you learned, as an investor,  
18 for your extra \$74 million, nothing. It was still the  
19 switch was on, and that's all you heard.

20           And, yet, as we've seen when Enron and WorldCom  
21 blew up, if there's concern about the audit, then the  
22 markets start to tumble and confidence is lost. Going

1 concern is always difficult for auditors. It can be a  
2 self-fulfilling prophecy if they give a growing concern  
3 qualification.

4           And when you look, though, at what happened,  
5 certainly in the UK -- let's take our biggest casualty  
6 or the first casualty, Northern Rock. It bought it from  
7 the wholesale markets in a very major way. Three months  
8 loans from the wholesale markets. It lent out 20 or 25  
9 years, so it was all predicated, its business model, on  
10 that market staying open. Well, it didn't. It closed,  
11 and so did Northern Rock.

12           It was in the notes and, in a sense, you could  
13 see for yourself, looking at the liabilities, where they  
14 were coming from. But that was a key assumption. That  
15 company could only exist if the wholesale markets stayed  
16 open, and I think the auditor should draw attention to  
17 something like that.

18           What are the assumptions laying behind your view  
19 that this is a going concern? It may be that investors  
20 will look at that and think this is a bit risky and I  
21 want to get out, and that's the sort of thing I think  
22 they should do it.



1           And you can see from your own papers that eight  
2 of the top ten bankruptcies, there was no going concern  
3 qualification during the crisis. And the TARP, major  
4 TARP receivers also had no qualifications in there.

5 I think giving some form of assumption why you've agreed  
6 that it is a going concern would be extremely helpful.

7           If you want to change the audit paradigm, I think  
8 what you've done at present is a necessary but not  
9 sufficient condition. I would like to see far more being  
10 done with the audit and making it far more helpful to  
11 users. And you can see the complaints and the pressures,  
12 certainly in Europe for mandatory rotation or at  
13 re-tendering. It's coming from the view that perhaps  
14 fresher eyes are needed, and that's the good reason. The  
15 bad reason is perhaps they're too cozy. And I think it  
16 is in the auditor's interest to make it far more obvious  
17 that he is reporting to the investor and not simply to  
18 the audit committee. So a repositioning I think would  
19 be very helpful for the audit and also for the investor.

20           I think there's things that can be done to assist  
21 the audit. I think the auditor is under too much  
22 pressure from companies these days. I would like to see

1 the removal of the annual appointment and the company  
2 talk about re-tendering and then appoint the auditor  
3 until that re-tendering date and only allow them to be  
4 removed by a vote by the investors, if necessary.

5           And if tendering does take place, I would ban the  
6 companies, the audit firms, from putting a price in  
7 there. Let the audit committee choose on quality and  
8 then ask for a price. And if it shocks, let us tell the  
9 investors how much it saved by taking the second best  
10 audit and let's see if they agree that was a worthwhile  
11 investment.

12           And I think there's other things starting to  
13 happen in there that, after re-tendering, as your own  
14 figures have shown, audit fees are fallen. Well, there's  
15 limits to how far that can go. I think if audit  
16 committees think one of their major proposals or major  
17 jobs is to cut the audit fee, you're really starting to  
18 get into the question of are you starting seriously to  
19 damage the audit because, if the fees are driven down and  
20 if audit partners are not of the caliber of the people  
21 they're auditing, then we're going to have a major  
22 problem.

1           And how do the audit firms deal with that? You  
2 can probably ask some of them as they go through this,  
3 but are they taking part in a time out of the audit to  
4 try to make it pay? And I think that is a serious  
5 problem we're having. One disclosure I'd like to see in  
6 an audit report is how much partner time has been spent  
7 on it compared to those of managers and juniors.

8           As I've said before, I firmly believe the auditor  
9 should sign his own name on behalf of his firm. I think  
10 that concentrates the mind. In my own firm, when I was  
11 there as a national technical partner, I remember twice  
12 an audit partner getting away with something by signing  
13 the firm's name. We ended up in court. He was  
14 protected, and we weren't. I don't think he'd had had  
15 a second chance if his name had been on the first one.

16           It's not what you're dealing with at the moment,  
17 but I think there's also societal duty on the auditor to  
18 act as a whistleblower in certain situations. Lynn  
19 talked about various cases where the auditor knew things.  
20 I think it would have been very helpful if the securities  
21 regulator or the prudential regulator had been informed.  
22 So I would see the audit repositioning to be much more

1 focused away from the company and onto the investor and  
2 also onto the regulator, where necessary.

3           Well, maybe that was a little bit like a sermon.  
4 I was in the church not so long ago listening to the  
5 minister banging on, and the old lady in front of me  
6 turned to her neighbor and said, (Is the minister not  
7 finished yet? and back in answer, (She just can't stop.  
8 Well, let me show you I can.

9           Advice. I'm always reluctant to give advice.  
10 When I moved into my present home near Edinburgh, there  
11 was a rather architecturally-unusual plant in the front  
12 garden, which looked like overgrown parsley. But the  
13 neighbors who didn't like the lifestyle of the previous  
14 occupants thought it was marijuana.

15           So I was a bit concerned, so I got a  
16 horticulturist in, and he gave me advice I never forgot.  
17 He said, (Look, if you're worried about this plant, he  
18 said, (pick it, dry it, and then smoke it. And if you're  
19 still worried about it, then it's parsley.

20           Well, the advice that I would like to give to the  
21 PCAOB is I would like to see audits in the U.S. the same  
22 as audits everywhere else. I'm delighted you've had the

1 foresight and generosity to invite international  
2 observers to these panels, and I do hope it ends up with  
3 both the IAASB and the PCAOB putting out something  
4 extremely similar.

5           Audit, I think, is at a tipping point. Its worth  
6 to investors in society has been questioned, certainly  
7 by the crisis. Jay, in his recent speech, made it very  
8 clear that the auditor has a unique and indispensable  
9 position in the capital markets to help investor  
10 confidence, and I think that's something that you can  
11 really assist by the audit report.

12           And I'd like to see you go further. I remember  
13 when I left the IASB, the London Sunday Times talked  
14 about my time there and said, (When Tweedie came to the  
15 International Accounting Standards Board, financial  
16 reporting internationally stood at the age of a precipice  
17 looking into a chasm. Since he arrived, it's taken a big  
18 step forward. And I think you have taken a big step  
19 forward, so I'd like you to lengthen your stride a bit  
20 and do a bit more. Thank you.

21           MR. DOTY: Thank you. Jeanette?

22           MS. FRANZEL: Well, thanks for venturing out to

1 the colonies for this important meeting. I appreciate  
2 your comments about not wanting large differences between  
3 the audit reports and the audit approaches between the  
4 U.S. and internationally. And I'm also intrigued by the  
5 UK approach in the audit report describing assessed risks  
6 of material misstatements that had the biggest impact on  
7 the audit. How far apart do you think our approaches are  
8 at this point, our proposal and the approach? And how  
9 do you think that they could come together?

10 MR. TWEEDIE: I think they're very similar. I  
11 would like to see a bit more about the findings. I don't  
12 necessarily think that is part of the UK approach, but  
13 I'm not an expert and you'd best ask Nick and his  
14 colleagues. But they are close. I think the Rolls Royce  
15 one went further and was an experiment, but I thought it  
16 was a highly successful experiment. I know you can ask  
17 about that later on.

18 But I think really we want to try and take the  
19 best. At the IASB, the idea was can we just take the  
20 best of whatever is out there? It doesn't have to be the  
21 international one. If the New Zealanders or even the  
22 Americans on rare occasions have the best accounting

1 policy, we should have it. And that's what I think  
2 exactly PCAOB's line should be.

3 MR. DOTY: Jay Hanson?

4 MR. HANSON: I just wanted to thank you for being  
5 here and coming across the pond. Just a follow up to  
6 Jeanette's question relative to the IAASB proposal that's  
7 still on the table. If you think that a worthy goal is  
8 to have our ultimate standard align with their ultimate  
9 standard, if you think there are particular things in our  
10 proposal that theirs might be missing or particular  
11 things in their proposal that you think we should steer  
12 towards in our thinking, I'd appreciate to hear your  
13 thoughts on that.

14 One tongue-in-cheek follow on, have you concluded  
15 whether the plane you flew here on is on the balance  
16 sheet of the airline that you flew?

17 MR. TWEEDIE: Well, the one I was on yesterday  
18 has probably been written off by British Airways a long  
19 time ago, I think. But, certainly, on the issue of the  
20 IAASB, I think the main point is you move along with  
21 interaction, and it's really a question can we just get  
22 the terminology the same so that people know this is the

1 same and it's not something that's got a variant on it.

2           There may be jurisdictional issues which you'd  
3 have to deal with in the U.S., and that is obviously up  
4 to yourselves. But I think the more you can get even the  
5 words the same, the happier people are going to be that  
6 this U.S. report is the same as a UK report and so on.

7           MR. FERGUSON: Yes, I just want to thank you for  
8 coming across the ocean to see us. But the question that  
9 I have and one of the things I've been very concerned  
10 about the CAM proposal we have is that it will  
11 deteriorate into boilerplate disclosures. I think that's  
12 happened in France where they already have certain kinds  
13 of disclosures like that, and they're not particularly  
14 meaningful.

15           And I'm particularly curious about your view of  
16 the KPMG opinion in the Rolls Royce matter because I read  
17 that, too, and it's really quite extraordinary. It  
18 appears to me, in many ways, to go further than the way  
19 I read what would be required under the British  
20 standards. And is this, in your view, is that simply an  
21 example of an auditor showing unusual courage, or do you  
22 think that's sort of a lamp into the future that, under

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1 these standards, that there will be auditors who actually  
2 feel comfortable in writing opinions like that?

3 MR. TWEEDIE: That's an interesting question,  
4 Lewis. I think, from what I gather, there was an  
5 arrangement with Rolls Royce that the firm would actually  
6 go further and experiment on that.

7 And I think the reaction from the investors in  
8 the UK has been highly positive, and I certainly would  
9 like to see that be made more mandatory because I think  
10 it does reflect, when you actually have to state that,  
11 okay, here's the problem, you've got a lot of Level 3  
12 valuations, which wasn't the case in Rolls Royce, but  
13 you've got a lot of Level 3 valuations, how have they  
14 tackled it, we've tested it in the following manner, and,  
15 on balance, we feel that this is where they're  
16 positioned. And I think that is extremely helpful. It  
17 certainly gives the investor a view is this an aggressive  
18 management or it's within the bounds of acceptability but  
19 always at one end or are they somewhere down the middle?  
20 And Rolls Royce comes out I think pretty well down the  
21 middle. This little bit could be the liabilities perhaps  
22 understated. On the other hand, they're slightly

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1 overstated on balance. And I thought it was an excellent  
2 report. It taught me a lot more than I've ever learned  
3 from an audit report.

4 MR. HARRIS: How do you respond to those who  
5 would say that what you are recommending in your written  
6 statement would require the auditor to be the source of  
7 a significant amount of additional original information  
8 about an issuer and that is simply not the role of the  
9 auditor? We're going to hear that throughout the day.

10 MR. TWEEDIE: Well, you know, I was listening to  
11 the comments that this is the role of the audit  
12 committee. I really don't agree with that. I would like  
13 to see the auditor moving away from the company. He's  
14 representing the investor. He's going into the company.  
15 He's reporting to the investor in my book, and that's  
16 where he should be.

17 So the information that goes out there, that's  
18 what the auditor feels that the investor should know.  
19 And I feel very strongly that we should not have the  
20 audit committee giving that information and the auditor  
21 remaining quiet saying, yes, I agree. I would rather he  
22 did it, and I think that increases the value of the

1 audit.

2           It's certainly interesting, listening to a few of  
3 the audit partners who have been involved in the audit  
4 report. I think it's energized the firms, and it's made  
5 those involved in the audit much more interested in it.  
6 They can see it's far more than just a tick. It's  
7 actually helping the markets. I think there's a lot more  
8 we can do. A lot more you can do. I'm out of this now.

9           MR. HARRIS: Well, I think that goes directly to  
10 the role and the future relevance of the profession, but  
11 you're cutting against the grain of significant amount  
12 of the testimony we're going to hear throughout today  
13 with respect to original information.

14           MR. TWEEDIE: Well, I'm quite used to doing that,  
15 I think. One beauty I found after 25 years of standard  
16 setting, I don't have to be polite anymore. I can just  
17 say what I think. You'll enjoy it, too.

18           MR. DOTY: Oh, the chief auditor.

19           MR. BAUMANN: Thanks very much. And, David,  
20 thanks very much for joining us today. I know you had  
21 a difficult trip over, so thanks again for doing that.

22           Similar to the question that Steve Harris asked,

1 many of the objections that we've received in the comment  
2 letters are that, if additional information is needed by  
3 investors, then accounting standard setters should  
4 require new, different disclosures. If the information  
5 that investors are looking for is, well, what was, as  
6 Lynn Turner was talking about, where was the management  
7 on the range of reasonableness with respect to the  
8 estimates? Could accounting standard setters require  
9 management to disclose their ranges, their high and their  
10 low and where they came out on that?

11           So I guess the question is is this a, as an  
12 accounting standard setter in your great career, do you  
13 think this is something that can be solved through an  
14 accounting standard setting, as opposed to auditor  
15 reporting?

16           MR. TWEEDIE: You know, this is a great country,  
17 but I really despair of it at times. When you look at  
18 the quantum of accounting standards you have in the U.S.,  
19 and this is no criticism of FASB who have been trying to  
20 cut it back, but it's almost you've got to get everything  
21 written down. Judgment disappears in that sense. And  
22 they're always worried. I heard at the last panel the

1 concern about the lawyers. Well, if you had a panel of  
2 lawyers writing the Declaration of Independence, I'd  
3 suspect you'd still be paying homage to Her Majesty at  
4 the moment and trying to define liberty and happiness and  
5 things like that.

6           But I really would like just -- the auditor has  
7 actually got a range of experience, which, quite frankly,  
8 the company hasn't got. So if we want to find out, you  
9 know, where does this company stand, the auditor is in  
10 a much better position, having audited the industry or  
11 various companies in the industry, to be able to say,  
12 well, these guys are aggressive. I don't think the  
13 company itself could say or even would want to say that.  
14 So I suspect they might get boilerplate disclosure.

15           MR. HARRIS: If we've got five minutes to go --

16           MR. DOTY: We have five minutes, but Sir David  
17 has a 1:00 plane. So we do him a courtesy by springing  
18 him and by convincing our next panel on time. So, Sir  
19 David, with copious thanks from this board and from all  
20 of your many friends and associates here, God speed, safe  
21 travels, and we'll see you soon. Thank you.

22           We should commence the next panel as promptly as

1 we can. If we could take a ten-minute break, ten minutes  
2 strict, that would get us started at 10:45, and it would  
3 be a good idea.

4 (Whereupon, the foregoing matter  
5 went off the record at 10:33 a.m.  
6 and went back on the record at  
7 10:47 a.m.)

8 MR. DOTY: If we can resume. This of course, is  
9 the -- this is the international panel that will take us  
10 into the noon hour. This is truly a blue ribbon and  
11 distinguished panel of commenters from Europe. Sven  
12 Gentner is the counselor for Economic and Financial  
13 Affairs Section for the delegation of the European Union  
14 to the United States.

15 He's responsible for the coordination of the  
16 financial markets regulatory dialogue between the  
17 European Commission and the United States. Before  
18 joining the Commission, he has been working for Allianz  
19 Insurance, PLC, the Institute of Public Finance at the  
20 University of Muenster, Germany. He has a private sector  
21 and academic background, as well as his distinguished  
22 service in the EU.

1           Nick Land is the Chairman, Audit and Assurance  
2 Council of the UK Financial Reporting Council. He  
3 retired as chairman of Ernst & Young in 2006. He's a  
4 non-executive director and chairs the Audit and Risk  
5 Committees of Vodafone Group, Alliance Boots, BBA  
6 Aviation, and the Ashmore Group.

7           Nick is a director of the FRC. He's a member of  
8 the FRC's Codes and Standards Committee, and we're  
9 privileged to have him here for these proceedings.

10           Professor Arnold Schilder became chairman of the  
11 International Auditing and Assurance Standards Board, the  
12 IAASB in January 2009. Previously, he was a member of  
13 the managing board of the Dutch Central Bank, responsible  
14 in particular for banking regulation and supervision.

15           In addition, he served as the chair of the Basel  
16 Committee on Banking Supervision Accounting Task Force,  
17 and he's a member of the Public Interest Oversight Board.  
18 Arnold is also a frequent observer at meetings of the  
19 SAG, and we always benefit from his presence. Thank you  
20 all and please begin, Sven.

21           MR. GENTNER: Thank you. Good morning and thank  
22 you for inviting me to speak here on behalf of the

1 European Commission. I think this is another sign of the  
2 very good cooperation we've got between the PCAOB and the  
3 Commission, and we're very grateful for that, and we also  
4 fully support your process.

5 I've been invited to talk about audit reform in  
6 the European Union. I was actually looking forward to  
7 telling you that the European Parliament had just voted  
8 the reform in the EU, but unfortunately the vote has been  
9 postponed until tomorrow. It will nevertheless take  
10 place and I'm sure it will go well.

11 Let me just say a few words about the reform in  
12 the EU. As you know, our main objective, of course, was  
13 to increase the quality of statutory audit. The reform  
14 we are undertaking has got two pillars in EU law. We've  
15 got various legal instruments, one of which is a  
16 directive, which will be -- contain horizontal measures  
17 applicable to every audit unit and their regulation,  
18 which will contain stricter requirements for the audits  
19 of public interest entities, PIEs.

20 For example, credit institution, listed  
21 companies, insurance undertakings or other entities  
22 designated as such by member states, member states of the



1 European Union. Of course, the reasons behind that are  
2 that the consequences of misstatements for PIEs are much  
3 greater than for other types of companies.

4           Concerning the auditors' report, the new legal  
5 framework will only define a minimum. The EU member  
6 states have the right to impose further requirements,  
7 which is a tool for us to accommodate the specific needs  
8 of each concrete legal environment, which as you are  
9 aware, these environments differ across our 28 member  
10 states.

11           We don't impose a template or a model requirement  
12 in the new frameworks. It is up to the member states to  
13 define these models or templates.

14           Let me say a few words about what is new in our  
15 reform. All the initiatives we're taking are mostly  
16 motivated by the objective of achieving greater  
17 transparency. So we've introduced a requirement that the  
18 place of where the statutory auditor or audit firm is  
19 established be indicated.

20           We want a statement that indicates by whom or by  
21 which body the auditor was appointed. Typically, these  
22 are the shareholders at the annual meeting, but there are

1 also other modalities possible in European law, as long  
2 as the independence is assured. But we want this to be  
3 made public.

4           We want a statement indicating the date of the  
5 appointment and the period of total uninterrupted  
6 engagement, including previous renewals and  
7 reappointments of the auditor. Again, this is to provide  
8 more information to the investors, and to allow investors  
9 to better assess the relationship between the auditor and  
10 the audited entity.

11           We also introduced an obligation to report on any  
12 material uncertainty related to events or conditions that  
13 may cause significant doubt about the entity's ability  
14 to continue as a going concern.

15           As you are aware and has been mentioned before,  
16 this is in particular a reaction to what happened during  
17 the financial crisis, where we've seen many cases where  
18 financial firms revealed huge losses just after they had  
19 received a clean audit report.

20           We think that the introduction of these  
21 requirements will help address these issues.

22           We are also introducing obligation to describe

1 the most significant assessed risks of material  
2 misstatements, as well as a summary of the auditor's  
3 response to those risks, and finally and where relevant,  
4 key observations arising with respect to those risks.  
5 As you are aware, typical examples are the use of off  
6 balance sheet finance, changes in IT environment, et  
7 cetera.

8           Important is that there really is a description  
9 of the most significant risks of material misstatement  
10 in the new report, which again we hope will improve  
11 transparency in that respect.

12           Finally, we want that the audit report explains  
13 to what extent it was capable of detecting irregularities  
14 including fraud. This addresses the issue which has been  
15 there before, the expectation gap.

16           We're not proposing a model template. We're  
17 expecting the profession to develop a structure here, but  
18 we think this will be an important element to  
19 counterbalance the impression that auditors sometimes  
20 rely too heavily on management statements, and to make  
21 sure that auditors can show how they've checked the  
22 validity of these statements.

1           As you are probably aware, we are requiring in  
2 addition to the auditor's report, now also a more  
3 detailed additional report, which is to be made available  
4 to the audit committee of the audited entity. We expect  
5 that this additional report will enhance the flow of  
6 information between the auditor and the audit committee.

7           The report will not be public, but member states  
8 can allow the report to be made available to third  
9 parties when necessary, for example, courts.

10           Finally, we think that there is a lot of  
11 convergence and congruence between what has been proposed  
12 by the PCAOB and what is in the EU audit reform. I think  
13 we share the general principle of making the auditor's  
14 report more informative, and we share a concrete approach  
15 how to establish that.

16           In particular when it comes to including critical  
17 audit matters in the audit report, and also in relation  
18 to the reference to the year when the auditor began  
19 serving as the company's auditor, where you are aware  
20 that we've introduced mandatory rotation requirements.

21           Again, I would like to thank you for inviting me  
22 and the European Commission today, and we look forward

1 to cooperating with the PCAOB. Thank you.

2 MR. DOTY: Thank you, and your work on this panel  
3 has just begun. Chairman Land, please proceed.

4 MR. LAND: Well good morning, and it really is  
5 a great pleasure to be here. It's actually a surprise  
6 to be here; it wasn't part of my career plan to find  
7 myself at a public hearing with such an august body. But  
8 it's a pleasure to be here.

9 Can I briefly start by describing the role of the  
10 UK's Financial Reporting Council, because I think it will  
11 help put into context some of the changes that have been  
12 made. The FRC is an independent regulation whose mission  
13 is to promote high quality corporate governance and  
14 reporting to foster investment, and in essence it has two  
15 legs.

16 The first is codes and standards. It sets the  
17 corporate governance code for publicly listed companies.  
18 It sets audit and ethical standards, and it sets  
19 accounting standards. It obviously sets those standards  
20 under the sort of general auspices of the international  
21 standard setters.

22 The second leg is conduct. It reviews companies'

1 financial statements, inspects audits, oversees  
2 professional bodies and disciplines auditors and  
3 accountants. It's more or less a regulatory one-stop  
4 shop.

5           So what drove us to want to enhance the audit  
6 report in the UK? Well, a number of your speakers have  
7 already talked about the wider impact of the financial  
8 crisis in 2008, and of course we suffered from it very,  
9 very significantly. But just sort of narrow down one of  
10 the repercussions from that crisis.

11           We did see a significant increase in the  
12 intensity of focus on the effectiveness of company  
13 stewardship, and the adequacy of the communications to  
14 the market of both audit committees and auditors, and in  
15 that, I'm sure we weren't unique.

16           As part of this, we also detected that investors  
17 were becoming increasingly frustrated that the audit and  
18 auditors operated in a black box. They felt they had no  
19 visibility over the audit and no -- and very importantly,  
20 no hooks on which to ask questions about the audit.

21           As an aside, and as a number of your guests have  
22 said, it's always seemed strange to me that the audit

1 report, which is the only truly independent voice in a  
2 set of accounts, is the one part of the financial  
3 statements that there's normally no point in reading, and  
4 you've referred to the fact that your audit report over  
5 here hasn't fundamentally changed for 80 years.

6 Well, you think you've got problems; it hasn't  
7 changed in the UK for about 150 years. So against this  
8 background, in the first half of 2013 the FRC, after very  
9 extensive consultations, made two significant  
10 interlinked changes.

11 First, it revised the UK corporate governance  
12 code to increase the disclosure in a company's annual  
13 report, about the work of the audit committee, including  
14 the significant issues that the committee considered in  
15 relation to financial statements, and how these issues  
16 were addressed.

17 It also required that the board should make a  
18 statement in the annual report that they consider the  
19 annual report and accounts, taken as a whole, is fair,  
20 balanced and understandable, and provides the information  
21 necessary for shareholders to assess the company's  
22 performance, business model and strategy.

1           Second, the FRC revised the audit standards  
2 governing audit reports in a number of areas. First, the  
3 auditor is now required to report by exception, if the  
4 board's fair, balanced, and understandable statement is  
5 inconsistent with the auditors' knowledge, or if the  
6 matters disclosed by the audit committee describing its  
7 work do not appropriately communicate the matters that  
8 the auditor communicated to the audit committee.

9           Second, the audit report is now required to  
10 describe those assessed risks, material misstatement  
11 identified by the auditor, and which have the greatest  
12 effect on the overall audit strategy, the allocation of  
13 resources to the audit and in directing the efforts of  
14 the engagement team.

15           Third, the report should also provide an  
16 explanation of how the auditor applied the concept and  
17 materiality in planning and performing the audit. Last,  
18 the report should provide a summary of the audit scope,  
19 including an explanation of how the scope was responsive  
20 to the risks of material misstatement, and the auditor's  
21 application of the concept of materiality.

22           I think it's very important to emphasize that



1 these requirements in our new standard are set at a very  
2 high level. We want to encourage different approaches,  
3 and to discourage standard paragraphs and boilerplate.

4           So what has the experience been in the UK so far?  
5 The new standard applies primarily to companies having  
6 a primary premium listing on the London Stock Exchange,  
7 and it was effective for periods commencing on or after  
8 the 1st of October 2012. So we now have -- we're now  
9 seeing a significant number of new style audit reports.

10           The reactions from the audit firms, essentially  
11 the Big Six, has been positive, constructive and very  
12 supportive. Many front line audit partners, as Sir David  
13 referred to, are genuinely enthusiastic about these  
14 changes, and have embraced the new concepts.

15           And indeed, it appears to be enhancing their  
16 position with management and the audit committee, and  
17 giving them a chance to demonstrate their depth of  
18 thinking and management challenge. We've not yet seen  
19 any signs of boilerplate or legalese. It is, of course,  
20 early days.

21           We're seeing experimentation and Sir David  
22 referred to the Rolls Royce report, but there are others.

1 We're seeing experimentation and real attempts by the  
2 auditor to be frank and open about their discussions of  
3 the risk they focused on, and how they satisfied  
4 themselves, the application of materiality and the scope  
5 of the audit.

6           Finally, initial reaction from investors has been  
7 very positive. It's given them some insight into the  
8 auditor's world, and disclosure around scope materiality  
9 has begun to generate discussions amongst stakeholders.  
10 This must be a healthy development in respect to both  
11 good stewardship and increasing stakeholders'  
12 understanding of what an audit can and cannot do,  
13 therefore potentially narrowing the expectation gap, and  
14 we hope increasing the confidence in audit, which I  
15 suspect in the UK at least, is at an all-time low.

16           Thank you very much for listening to me.

17           MR. DOTY: Thank you, Chairman Land. Chairman  
18 Schilder.

19           MR. SCHILDER: Thank you, Chairman Doty, and  
20 thank you very much for the opportunity to speak here  
21 about the work of the IAASB on auditor reporting. We are  
22 an independent global standard setter, and an important

1 aim of our work is therefore to facilitate adoption and  
2 convergence of national and international auditing  
3 standards.

4           So I really commend the PCAOB for arranging this  
5 global panel, and I note that our collaboration with the  
6 PCAOB has been a critical part of our work to date. I  
7 also note many positive comments on how far we have come  
8 already.

9           Why is the IAASB seeking to change the auditor's  
10 report? This topic has been on our radar screen for some  
11 time already. In 2006, we commissioned academic research  
12 jointly with the Auditing Standards Board of the AICPA,  
13 and Professor Ted Mock, a panelist this afternoon, and  
14 others, provided us with global input about user's  
15 perceptions of the auditor's report.

16           And then of course the financial crisis has  
17 heightened the demand for more communication from  
18 auditors, and has highlighted over-arching concerns about  
19 the value of an audit and the relevance of the accounting  
20 profession.

21           Well that sparked the IAASB and our work to  
22 consider how best to respond to the needs of users, and

1 audit reporting has been our top priority for the past  
2 two years. We issued two public consultations on the  
3 topic, and note the continued support for moving forward  
4 to enhance the communicative value of the auditor's  
5 report.

6 In our most recent consultation and exposure  
7 draft package in July 2013, unanimously agreed by the  
8 IAASB, focused on audit reporting, on key audit matters,  
9 other information and going concern. It also included  
10 other initiatives to increase transparency about the  
11 audit and the auditor's responsibilities.

12 Overall, as we learned, there's strong global  
13 support for the IAASB finalizing its proposals this year,  
14 and we have determined to do that.

15 Now the topic we refer to as key audit matters or  
16 KAM, similar to your critical audit methods, also CAM;  
17 it's just a K or C so far as we have come already. That  
18 topic is viewed by many as the most significant  
19 enhancement to audit reporting, and we propose to require  
20 auditors of listed entities to communicate KAM in the  
21 auditor's report, and others of course are encouraged to  
22 review that on a voluntary basis.

1           We define key audit matters as those methods that  
2 in the auditor's professional judgment they're of most  
3 significance in the audit of the financial statements of  
4 the current period. KAMs are selected from methods  
5 communicated with those charged with governance, the  
6 audit committee, and thereby providing transparency about  
7 communications that investors have said are important to  
8 audit quality.

9           Looking now at the common levels, investors,  
10 regulators and auditors largely support what we have  
11 proposed. But they've asked for more guidance and more  
12 specificity on how auditors should apply the decision  
13 framework, and they've also urged us to take steps to  
14 ensure that both the methods identified and how they are  
15 described in the auditor's report results in meaningful  
16 communication to investors.

17           Robust application guidance in our standards, as  
18 well as revised examples of key audit matters, will give  
19 an indication of how the IAASB expects the concept of key  
20 audit matters to be applied in practice. Preparers and  
21 others who do not support the concept of KAM often cite  
22 concerns with the auditor providing original information,

1 that is, information that is not otherwise required to  
2 be disclosed in the financial statements.

3           Auditors have asked for more guidance on how to  
4 deal with circumstances that might result in the auditor  
5 communicating about sensitive matters. So our Board is  
6 exploring how to find an appropriate balance between  
7 auditors providing useful information about the most  
8 significant methods in the audit that was performed,  
9 while at the same time respecting the important concepts  
10 of client confidentiality.

11           We are very pleased to support. We have heard  
12 from global groups like the International Corporate  
13 Governance Network, IOSCO, IFIAR, the Basel Committee,  
14 World Bank - for our concept of KAM, and including KAM  
15 in the auditor's report will be a significant change in  
16 practice.

17           So the IAASB will do all it can to support  
18 effective implementation to achieve its intended aims.  
19 Now similar to the PCAOB, we have also substantively  
20 revised our standard addressing the auditor's  
21 responsibilities for other information.

22           Investors and others have emphasized the

1 importance of information included in MD&A and other  
2 areas of a company's annual report. While this  
3 information is not audited, the auditor's attention to  
4 it helps to increase user's confidence in such  
5 information.

6 Our proposals included required auditor reporting  
7 on other information, including identification of which  
8 information has been read by the auditor. We will  
9 re-expose this proposal in mid-April for a 90-day comment  
10 period.

11 Our project also addresses the topic of auditor  
12 reporting on going concern. Feedback to our proposals  
13 has highlighted the need for a holistic approach, that  
14 is, that changes in auditing standards need to be  
15 considered in tandem with changes or clarifications to  
16 accounting standards.

17 We know the PCAOB's separate project in the area  
18 is closely tied to the FASB, and we have had similar  
19 liaison with the IASB to understand how they addressed  
20 this topic and are following their developments with  
21 interest, as we seek to finalize our proposals.

22 In relation to other improvements, the Board

1 supports requiring disclosure of the name of the  
2 engagement partner in the auditor's report for listed  
3 entity audits, and we note, of course, the PCAOB has a  
4 similar proposal in process, and we look forward to  
5 hearing about the Board's plans for a way forward.

6           We also, of course, are taking into account  
7 relevant developments in Europe. I think, simply said,  
8 Europe is a done deal with regard to audit reporting.  
9 You heard from Nick about the UK FRC, and there are now  
10 more and more examples of this new style of audit  
11 reporting.

12           They are coming into the market, providing it can  
13 be done, and does result in helpful information for  
14 investors and others. I must say in my own country,  
15 where it's not in law but on a voluntary basis, already  
16 almost half of listed entities' auditor's reports also  
17 show this new model with great enthusiasm.

18           Stakeholders, including bodies such as the CFA  
19 Institute and the Center for Audit Quality, have  
20 encouraged us to take every opportunity to seek to  
21 minimize differences among the various approaches to  
22 auditor reporting, and we heard it this morning again.



1           We take that, and you do as well, very seriously,  
2 recognizing that we all have a duty in the public  
3 interest to respond to what we have heard through our  
4 multiple consultation processes.

5           So in conclusion, through its work on audit  
6 reporting, the IAASB believes it has a unique opportunity  
7 to increase the relevance of the audit, and to trust in  
8 the profession. Not only will the auditor's report  
9 become more informative, but we expect that this  
10 increased reporting could change the behaviors of not  
11 only auditors, but also management and those charged with  
12 governance.

13           A renewed focus by the auditor on matters to be  
14 addressed in the auditor's report, together with the  
15 increased attention by management and those charged with  
16 governance on financial statement disclosures, stands to  
17 benefit investors, and have a corresponding effect on  
18 audit quality and the credibility of financial  
19 statements. Thank you very much.

20           MR. DOTY: Thank you. We have ample time in this  
21 panel for all the questions, and I want to therefore  
22 begin with one for the panel.

1           Whenever one proposes a change in the audit model  
2 that involves additional disclosure, additional  
3 information, whether it's the name of the engagement  
4 partner, critical audit matters, there are objections in  
5 addition to different litigation regimes, which we'll  
6 talk about later and which will occur.

7           There are objections made which are difficult,  
8 and for which we must take account, we have to think  
9 about. Your experience bears on this. The objections  
10 are message-mixing. If you include information in the  
11 audit report, the message that this is the firm's report,  
12 the message that the binary opinion conveys will be  
13 somehow mixed and confused and obliterated or obscured.  
14 Investors won't understand it.

15           You run the risk, if you include information of  
16 the kind that your regimes are doing and that we are  
17 contemplating, of mixing message.

18           The second is one that is less of a problem for  
19 you, with your legal regime, but is a problem for us, and  
20 that is mission creep. Who are you as an audit regulator  
21 to tell audit committees what they need to know about or  
22 what they need to worry about, in terms of additional

1 information that you're asking the auditor to comment on,  
2 such as the CAM?

3           That really leads -- that collapses into a very  
4 important argument, that by doing any of these things  
5 that we propose in these disclosure releases, we are  
6 compromising the authority, the independence, the  
7 effectiveness of the audit committee. This is a very big  
8 issue for us.

9           What have you found about this? Has -- you have  
10 all got the regime now. You're doing it or you're  
11 outreaching to find out about it.

12           To what extent are you concerned and to what  
13 extent should we be concerned about message-mixing,  
14 obscuring the message of the binary opinion, putting  
15 pressure on audit committees that properly is within  
16 their business judgment, and essentially getting over the  
17 line into compromising the effectiveness of the audit  
18 committee?

19           Is this something that should block us from --  
20 should keep us from modernizing an audit reform model?  
21 What's happened, and what does your experience tell you?  
22 I'm sorry for the sermonette, but you'll hear some other

1 sermonettes from my colleagues as we go forward.

2           MR. LAND: Shall I kick off, Chairman? Of course  
3 in the UK we do have an advantage, as you are well aware,  
4 because we set the corporate governance code, which  
5 covers the responsibilities of audit committees, and we  
6 set guidance for audit committees. So we were able to  
7 do these two things in parallel.

8           The truth was we were changing the rules of  
9 engagement for audit committees about the transparency  
10 of their work, and then it suddenly, as far as I'm  
11 concerned at least, I suddenly realized this would be a  
12 great time to change the audit report, so there was a  
13 little bit of serendipity in all this. So we don't --  
14 we don't have that fundamental problem that you're  
15 dealing with.

16           Having said that, I mean there is no doubt, and  
17 I've seen it to a limited extent on one of my boards,  
18 that the new auditor reporting in the UK can create some  
19 additional tensions between the auditor and management.  
20 I personally think that's a good thing in principle. I  
21 think that, you know, increasing in the right way.

22           I don't think we should be worried about tensions

1 being increased, as long as they're done in a mature and  
2 sensible way, and as I said, I think it's given the  
3 auditors in a sense, if I can put it like this, more  
4 authority.

5 I suppose the naive answer to your question  
6 vis-a-vis the USA, which I'm not really very qualified  
7 to comment on, is of course there's nothing to stop an  
8 audit committee or board inverted commas responding to  
9 what's in a new form audit report in the UK.

10 I mean the logic to me, if I was chairing an  
11 audit committee in the USA, and I say this with very  
12 little knowledge, so forgive me, and your proposal, as  
13 I hope they are, are enacted, my response I think,  
14 hopefully not defensively, would be to consider what more  
15 I needed to say in my audit committee report. So it  
16 seems to me that there's a remedy there.

17 MR. DOTY: Other panelists? Sven?

18 MR. GENTNER: Yeah. I can't yet talk about the  
19 implementation, of course, of our reform because it's  
20 just about to be decided.

21 But I think what has come out of the negotiations  
22 in Europe we feel is a good compromise between a

1 realistic view on what the audit report can convey, but  
2 at the same time also taking into account more the needs  
3 of investors, who are an important audience for the  
4 report, and of course also the needs of the audit  
5 committee.

6 I don't think we're worried about message-mixing  
7 when it comes to our reform. The things that I've  
8 mentioned in terms of the tenure, the length of the  
9 period of the auditor is active there. The issues about  
10 addressing the expectation gap and other things, if  
11 anything, will make it clearer and better understandable  
12 what an audit report can do and cannot do, which I think  
13 are two important elements for investors to understand.

14 There is a risk that you do too much and there's  
15 a risk that you do too little, and I think it's very  
16 important that the investors know exactly what they can  
17 get out of such a report.

18 Finally, I don't think that there is a risk the  
19 audit committee will lose in terms of its importance will  
20 be bypassed or whatever, because both the audit committee  
21 and the investors play an important role in this respect,  
22 and I think these roles will be preserved.

1 MR. DOTY: Thank you.

2 MR. SCHILDER: When you talked about  
3 message-mixing, Jim, what struck me most is the quote  
4 "investors won't understand it." I find that -- it's not  
5 your quote, of course -- I found that almost offending  
6 to investors. Maybe that was true long, long time ago,  
7 but nowadays, I think that will be a completely unfair  
8 argument.

9 Because investors, as we learned from all the  
10 consultations and dialogues, are very interested, and  
11 they are really willing to do a lot of exercise and  
12 effort to really understand.

13 That's behind -- I mentioned the examples in the  
14 Netherlands, which is on a voluntary basis, so companies  
15 have chosen to invite their auditor to already report  
16 this new style, and just that public report from senior  
17 partner from one of the large firms, and I, as did my  
18 clients, in this case, made that choice.

19 So it's not so much about international  
20 compatibility, because these reports will be very unique  
21 per company. But it's also very important to fulfill and  
22 to accommodate outspoken wishes of investors, and

1 investors have been much engaged in this dialogue.

2           Last year, we saw that in many examples where  
3 auditors spoke publicly in the AGM, and then they got  
4 feedback, of course, from investors.

5           So I think we have to take investors' wishes, as  
6 they now have expressed over so many years in so many  
7 ways, to take very seriously, and therefore it will be  
8 very interesting to see the analysis that of course will  
9 come, as so many reports come into the marketplace, how  
10 investors, analysts and others will comment about that,  
11 what is most helpful, what is less helpful.

12           On the other point, on the audit committees, well  
13 a similar observation, that actually these experiences  
14 reinforce the dynamics, the positive dynamics between  
15 management, audit committees and the auditors.

16           It's not only a challenge to the auditors; it's  
17 the other way around as well. It may result in better  
18 and more informative disclosures from management and  
19 audit committees, and certainly the UK is a very  
20 interesting example.

21           So rather than compromising, it's I think  
22 respecting regarding the independence of each of these



1 stakeholders, and as we learned from our work on audit  
2 quality, as additional published in our framework for  
3 audit quality, these interactions between the various  
4 stakeholders are very important, and the more we can  
5 stimulate it, the better.

6 MR. DOTY: Steve Harris.

7 MR. HARRIS: Well Chairman Schilder, first of all  
8 I want to commend you for making the audit report the top  
9 priority over the past two years for the IAASB, and I  
10 commend you for all the work you've done on that. I also  
11 encourage you to finalize the audit report and what  
12 you're doing at the IAASB if possible in 2014.

13 I know it's been a very aggressive schedule, but  
14 I think you've outreached. I applaud you for all the work  
15 that you're doing and have done. Before I get to the  
16 questions, since time does run out, I just want to make  
17 a point somewhat separate, but a point that Rick Murray  
18 brought up on the last panel, which I'd like you to think  
19 about, because I think we ought to think about it.

20 It's not directly related to the audit report.  
21 I will get to the question on the audit report. But Rick  
22 Murray encouraged, as has the ACAP, that the SEC and the

1 PCAOB should compile independence requirements into a  
2 single document, and make this document  
3 website-accessible.

4 So on this issue of independence, I wish you  
5 internationally would consider doing the same thing.

6 Now with respect to the question, in your  
7 remarks, you mentioned the IAASB as exploring how to  
8 address concerns raised by some commenters, about the  
9 auditors providing original information. So would you  
10 please clarify what type of information the IAASB would  
11 consider to be original information, and then for  
12 instance, would the auditors, the disclosure of key audit  
13 matters be considered original information, since it's  
14 not disclosed by management as such?

15 Additionally, would you please expand on how the  
16 Board plans to address this matter. Finally, in  
17 encouraging you as aggressively as I have, to complete  
18 your project in 2014, that's with the caveat that it has  
19 support from users and investors.

20 MR. SCHILDER: Thank you, Steve. Thanks for the  
21 compliments. It was hard work. I can only refer to Dan  
22 Montgomery, my deputy chair and many on the Board and

1 staff that have worked so hard, but inspired by the many  
2 comments that we received.

3           The independence requirements is something that  
4 we are discussing at the moment, and in our proposals,  
5 we also proposed a statement about the auditor being  
6 independent, but then also referring to let's say the  
7 sources of these independence requirements.

8           Now for a multinational group that can be quite  
9 a lot, and the same is true in the public sector. So  
10 we're discussing what is the best way forward there, and  
11 certainly the suggestion from Rick is an interesting one,  
12 whether it would help that you would have somewhere a  
13 combination of all the many requirements.

14           But again, if you take that from a global  
15 perspective, it's not easy, because it will basically  
16 point to the many ethical requirements, not just in,  
17 let's say, the ethics code of the ethics board, but many  
18 national requirements and very specific ones.

19           So there's probably a bit in between, an option  
20 that we will be discussing, whether it would make sense  
21 to focus on the group engagement partner and which  
22 requirements are applicable to him and his team, rather

1 than all the component auditors.

2           So that's basically where we are. So we have not  
3 a final answer yet, but it on one hand needs to be  
4 practical and not result in a long list of many pages.  
5 On the other hand, it needs to be informative.

6           But as we are thinking about the concept of using  
7 that size also for let's say the kind of boilerplate,  
8 relevant boilerplate about responsibilities, this might  
9 be another interesting option.

10           Original information. Maybe the simplest answer  
11 will be what is -- what the company is required to  
12 disclose by the applicable accounting standards. That's  
13 the original information that has to come from management  
14 and the board, and it may not just be accounting  
15 standards.

16           It could be more, national requirements, et  
17 cetera. So that is management's and the board's  
18 responsibility. Therefore, the focus on key audit  
19 matters is what the auditor can comment upon that, from  
20 the auditor's work. And as I mentioned, we start with  
21 what the auditor has reported and will report to let's  
22 say the audit committee.

1           It's quite clear if the auditor would come to the  
2 audit committee and tell them information, where they  
3 immediately say well, we expect that to come from  
4 management or we have already received from management,  
5 that's not what is expected from the auditor.

6           What is expected from the auditor is sharing  
7 significant judgments that the auditor had to make, and  
8 that may include many comments, how that, of course,  
9 relates to specific items in financial statements or  
10 whatever.

11           The point, of course, is that there can be a bit  
12 of a gray line there. If the auditor wants to explain  
13 why certain audit conclusions or certain significant  
14 auditor work was done, you may want indeed to explain a  
15 bit more than already at that point has been in the draft  
16 financial statements or MD&A, whatever.

17           That, we think, would just reinforce the dynamics  
18 between management, the audit committee and the auditor,  
19 and that's why we also think that this should not be  
20 something that is only discussed at the very end of your  
21 reports.

22           It should already be part of the beginning, and

1 focus on what might be key audit matters, and how then  
2 is management disclosing about that, and how the auditors  
3 would help in deciding about it.

4           But again, it's a bit of an area now of starting  
5 experimentation. So I think it's difficult to have a  
6 very black and white response. At least that's how we  
7 approach it.

8           MR. DOTY: Lewis.

9           MR. FERGUSON: Thank you, and thank you all for  
10 coming here from Europe. I just want to re-ask a  
11 question that I asked Sir David Tweedie again, which has  
12 to do with the potential for these additional disclosures  
13 to generate -- to degenerate into a form of meaningless  
14 boilerplate.

15           Clearly, that does not seem to have happened in  
16 the early days in the United Kingdom. I mean it's almost  
17 like a thousand flowers, let the thousand flowers bloom  
18 and that seems to be what happened. Do you see that as  
19 a continuing trend, and how in the IAASB proposal did you  
20 consider that issue, and what have you done to try to  
21 guard against it?

22           MR. LAND: With regard to the UK, well I mean

1 it's a lovely expression. I think we are at this moment  
2 seeing a thousand flowers or at least a hundred flowers  
3 sort of blossoming, and they're all a bit different. So  
4 I think we are very, very encouraged so far.

5 We are seeing, which I think is good, I think we  
6 are beginning to see some healthy competition. It's  
7 obviously it's new. I think we are seeing a bit of  
8 competition between the firms, who can come up with the  
9 most appropriate audit report.

10 You've heard Sir David refer to Rolls Royce,  
11 which I think is a shining example at the moment. So I  
12 think, you know, I think we are going to see some  
13 competition there, which I think is healthy.

14 I mean, the other thing that we were very  
15 conscious of is our amendment to our audit report  
16 standard, which obviously is based on Arnold's standard,  
17 but our amendment to encompass these new requirements.  
18 It was very short indeed.

19 I mean we really did not, you know, it's no more  
20 than a page. I mean we kept it at a very high level, you  
21 know. We've refused in the consultation process to  
22 define too much, and we've made it very clear that we,

1 you know, we expect them to use, you know, use their  
2 judgment and not to revert to boilerplate.

3 I think in terms of managing expectations, one  
4 thing that is inevitably going to happen is you're not  
5 necessarily going to see next year's --

6 I mean if I just take the board I'm on, which is  
7 Vodafone, its key financial risks and therefore the  
8 critical audit matters have basically remained the same,  
9 ever since I've been on the board for seven years,  
10 impairment because the mobile phone industry in Europe  
11 has spent a lot of money and gets impaired.

12 It's tax risk, because we have big fights with  
13 jurisdictions, particularly in India, audits, deferred  
14 tax assets, because we have huge amounts of losses.

15 So next year's audit report from Deloitte, and  
16 Deloitte was the very first to do, to produce a new style  
17 report, isn't likely to look that much different, I would  
18 judge, from last year's report. So we have to manage  
19 expectations there. There's not going to be a new  
20 Vodafone plan necessarily next year.

21 But we've genuinely seen the firms, effectively  
22 the Big Four so far, embrace this, want to -- want to



1 comply with the spirit underpinning our standard, and to  
2 date, I think, should feel very proud at the way they've  
3 tackled this, quite frankly.

4           So I think all that bodes well for the future.  
5 I mean time will tell is the honest answer. But so far,  
6 it's way ahead of our expectations.

7           MR. DOTY: Jay Hanson.

8           MR. HANSON: Echo the thanks to the panelists for  
9 coming today, and I've got another question for Mr. Land,  
10 and the requirements or the -- I think you hesitate to  
11 call them requirements -- but the guidance for auditors  
12 for what to put in the report includes some of the  
13 details about the conduct of the audit.

14           What were the risks assessed, what was the  
15 materiality level applied, how was the scope responsive  
16 to the risk? We've chosen at this point to not go that  
17 direction, to have the details of the holistic conduct  
18 of the audit included, and we've gotten mixed feedback  
19 on some of the outreach about whether investors would  
20 find that useful. So for now we've chosen to not go  
21 there.

22           I'm curious if you, in all your considerations

1 for adopting what you put in place, if you had feedback  
2 from investors about what they would find useful, and if  
3 -- obviously you chose to go this path, but maybe the  
4 decision points that you're weighing and whether to go  
5 this route about the details of the audit versus some  
6 other route, it would be helpful to hear some insight  
7 about that.

8           MR. LAND: I could certainly do that, and I mean  
9 first, it seemed to me -- I mean I was an auditor 20  
10 years ago, but things have changed a great deal. But it  
11 seemed pretty obvious to me that if you are going to  
12 reform the audit report, and it badly needs reforming,  
13 that getting some idea of what the input into the audit  
14 is what is the output seems to me very logical, which is  
15 not just me; which was our starting off point.

16           But in some very extensive consultation, we had  
17 a lot of extensive consultation. We had an open hearing,  
18 such as yours. To the best of my knowledge, the  
19 investors, and you'll be hearing from investor reps from  
20 the UK tomorrow, were pretty unanimous in saying they  
21 thought this would be helpful.

22           Certainly in discussions that we've had post the

1 adoption of this new audit report, investors have  
2 continued to tell us they found it very helpful. It's  
3 quite interesting that there is already a debate that's  
4 started, not that I'm aware at a company level.

5           But there's already a debate started in the UK  
6 amongst investors, amongst stakeholders about the whole  
7 concept of materiality. That's been driven, I'm sure,  
8 by the disclosures that we require and is a requirement,  
9 but also because the FRC has produced a sort of thematic  
10 review on materiality.

11           But it has begun to generate that debate, and I  
12 think the truth of the matter is, and I'm not in any way  
13 being rude about investors, but you know, I suspect that  
14 investors were somewhat surprised when they read in the  
15 Vodafone audit report that materiality right at the very  
16 top is 500 million pounds. I mean that's a lot of money,  
17 as it were.

18           So I think that they've welcomed it. We got very  
19 little pushback from the firms. A little bit of  
20 reservation from the firms, but very little pushback from  
21 the firms, and I think it's led to this sort of debate,  
22 and I think it's a civilized debate.

1           It's not the sort of pointing of finger at a  
2 company. It's really raising questions about the whole  
3 concept of materiality. In opening this black box, which  
4 frankly the audit is in, has always been in, I think  
5 it's very, very healthy.

6           I would also say, and this was not scientific, as  
7 part of our consultation, one of our senior staff  
8 members, McMarrick, who spends a lot of time working with  
9 Arnold and his team, we informally -- he informally rang  
10 13 U.S. investors that he had contacts with, just to see  
11 what their reaction was.

12           You know, it was pretty unscientific and he's not  
13 here to report. But the report back that he gave to us  
14 was yes to materiality, yes to scope and yes to critical  
15 audit matters. Now I'm not suggesting that in any way  
16 is that significant, but when we put it to them in our  
17 language, those 13 were, I'm told, positive.

18           MR. DOTY: Jeanette Franzel.

19           MS. FRANZEL: Thanks for being here today.

20           I'd like to ask to what extent did each of your  
21 organizations analyze costs and benefits of the proposal  
22 before, you know, during the development of the

1 proposals, and then in particular in the UK, what kind  
2 of post-implementation analysis is also being done on  
3 costs and benefits, and what were the results of your  
4 various analyses, and if there are any really important  
5 things that came out of there that we should be  
6 considering as we go through our own analysis of costs  
7 and benefits?

8 MR. LAND: We did consider cost, of course. We  
9 will be doing an analysis at the end of the reporting  
10 season. We haven't done it yet. Our own -- my own view,  
11 and that of my counsel and indeed I think the feedback  
12 from the firm, was that -- it's not scientific because  
13 we haven't done the appraisal, was that the cost  
14 implications are pretty low.

15 I mean at the end of the day, what are they  
16 reporting on? Well you know, in the audit plan, the  
17 audit strategy document, at the beginning of the audit,  
18 they set out the critical audit matters they're going to  
19 focus on.

20 At their closing report, they will report on  
21 those critical audit matters and if those critical  
22 matters have changed will tell the audit committee and

1 report on it. I'm not sure where the other costs should  
2 be.

3 I mean essentially, put very crudely, I'm afraid  
4 in my language is the new-style UK audit report is not  
5 -- I mean the part that has to be written a bit more  
6 carefully is basically what the executive report in the  
7 audit plan says update that the audit committee get.

8 So I just don't see the argument why, apart from  
9 a bit of cost, of a bit more sort of checks and balance  
10 within the firm on this new-style audit report, I don't  
11 really see where the costs, where the new costs should  
12 be.

13 I mean if -- you know, they should be focusing on  
14 these things, whether or not they're reporting on them.  
15 So I just don't buy the cost argument, and I don't think  
16 -- it was certainly nothing -- certainly none of the  
17 firms put it forward as a major impediment.

18 MR. DOTY: The wings have been very quiet, both  
19 from the staff and the observers.

20 MR. SCHILDER: Just adding a bit to what Nick  
21 said, the consultations he mentioned were of course part  
22 of ours as well, and in a way the various consultations

1 and research was all the time about pros and cons,  
2 because all the time the question is why are you doing  
3 this? Certainly in the beginning, there was more  
4 hesitation than now, I think.

5           To some extent, of course, there is intangible  
6 benefit, the failure to use is not something that you can  
7 easily quantify. You can't think about costs. We  
8 thought like mixed standard usually that should not be  
9 too much of extra cost.

10           But one thing to help this would be the starting  
11 point of what you have communicated with the audit  
12 committee, because there you have the issues as a gross  
13 collection, and also how you have communicated that to  
14 them.

15           So they're deriving something about of that for  
16 external users. It could be not that complicated, and  
17 actually we're pleased to hear feedback from partners who  
18 have done this in practice, and also the results from  
19 field testing that we got and said well, the audit  
20 partners almost intuitively knew what they had to report  
21 about it and how --

22           There can be, of course, special circumstances,

1 where there are very sensitive issues, difficult issues,  
2 which certainly will take more time. But then the  
3 argument could be that it's worthwhile to spend that  
4 time, because it's just a matter of reality, and again,  
5 relevant to users.

6 MR. DOTY: The dilemma we face coming out of the  
7 concept release stage and going into our proposal was  
8 that where other information was concerned and the CAMs  
9 were being suggested, along with the auditor obligation  
10 to evaluate and to discuss the evaluation of other  
11 information.

12 What I actually heard in these meetings was a  
13 very strong investor endorsement of where you were, and  
14 a suggestion that we were really coming in with less than  
15 investors would want and could use, and that investors  
16 might want more from us.

17 On the other hand, we had equally strong voices  
18 suggesting that this was going to be a real departure.  
19 "A significant departure in practice" was the term that  
20 I think you used, Arnold, in terms of getting into  
21 evaluation of other information and discussing or  
22 revealing what our evaluation was.



1           To some sitting here, it might seem with these  
2 two polar opposites of where we were, that we might have  
3 gotten it just about right, that we might be just where  
4 we need to be in terms of coming forth with an  
5 augmentation of the audit report, and new information.

6           But given where you are and what you're hearing  
7 and what you have described to us today, how would you  
8 reply to people who say look, once you cross that line  
9 and once there is other information contained in what the  
10 auditor says about his evaluation or its evaluation of  
11 other information in the audit report, you have really  
12 crossed the Rubicon. You've made a change that has a  
13 slippery slope implication and you won't stop.

14           Is this something we have to worry about, in  
15 terms of any sip of the cup of other information, is  
16 fatal? Leading the witness is something that lawyers  
17 have a bad habit of doing, and chairmen are especially  
18 prone to it. But my colleagues are going to pay me back  
19 later with other panelists.

20           MR. SCHILDER: Thanks. In a way, I'm in an easy  
21 position. I've mentioned in my introduction that we very  
22 soon will re-expose our revision of ISA 720, which deals

1 with the other information, and it's a difficult subject.

2           You can very much simplify it; that's how we  
3 start with a standard already, and you have that as well,  
4 and that deals with the auditor's responsibilities.  
5 There's to be a certain amount of work to be done, and  
6 the only thing we would like to add is to make the  
7 conclusion of that work explicit to users, whereas  
8 nowadays it's implicit. Nobody knows about it.

9           But we have published and exposed the draft to  
10 revise the standard, and we got a lot of critical  
11 feedback, in all fairness, because what exactly is the  
12 other information that you're talking about? What is the  
13 kind of work effort that you're expected to do?

14           That all has been part of our deliberations  
15 before re-exposing. In my now six years as chairman,  
16 it's the first time that we re-exposed something. So it  
17 just illustrates how complicated that is.

18           I hope that we now have struck a reasonable  
19 balance between on one hand the need for transparency  
20 that we see here as well, so making explicit the  
21 conclusion of the auditor's work here, without on the  
22 other hand making it a complete new assurance engagement

1 or so.

2           So basically, the construct is the intelligent  
3 read by the auditor of the other information, and that's  
4 just a matter of reality. You cannot just have the  
5 French statement, but you see the whole context, and you  
6 have to do that with all your knowledge of the company,  
7 and what you have learned during your audit, and then you  
8 have to see where there are inconsistencies or maybe  
9 misstatements, an item that has to be addressed  
10 appropriately by management or you have to make a comment  
11 about it.

12           So that's what we soon will be re-proposing, this  
13 basic concept of this intelligent read. I hope that by  
14 that we have struck a reasonable middle position.

15           MR. DOTY: I didn't mean to goad the wings into  
16 action.

17           MR. BAUMANN: I was just waiting for all of you  
18 to finish your questions, and take my turn. In our  
19 proposal for changes to the audit report here in the  
20 United States, and in the responses to it, there's wide  
21 support from investors for change.

22           The audit profession, like in the UK I think

1 generally is largely supportive of change. Maybe some  
2 differences on the details, but largely supportive of  
3 change to the audit report. Academic research, I think,  
4 largely supports the need for change.

5           The one objection really coming through us is  
6 from preparers, who are throwing a lot of reasons up as  
7 to why changing the audit report is a bad idea and will  
8 have bad consequences. I'm just wondering if any of you  
9 can respond to that, but certainly in the UK, since  
10 you've already had the experience.

11           Was there opposition from management about the  
12 changes to the audit report, or in the EU when your  
13 proposals went out, and in the UK then, what's the  
14 reaction been since you got a report from management?  
15 So both was there opposition and how is the reaction now?

16           MR. LAND: There was no opposition to this from  
17 preparers. Now let me then -- that sounds great. The  
18 truth of the matter is that the preparers, whether to  
19 their credit or not, didn't actually choose to take a lot  
20 of interest in this standard.

21           So from memory of the sort of hundreds of  
22 responses we got, we only got two from preparers. So I

1 can look you in the eye and say it hasn't been a problem.

2 But I do have to put an auditor's caveat on that.

3           But reaction, I mean I think post, I can just  
4 talk about my four boards, and I appreciate it might be  
5 a little -- a little not exactly fair to the preparers,  
6 because they probably know or some at least know that  
7 I'm, you know, I'm involved in this.

8           But it hasn't created, in my experience, any  
9 problems. That's obviously very limited. I haven't  
10 heard of the 30 or 40 reports out there. I wouldn't  
11 obviously necessarily hear. But I haven't heard of big  
12 issues.

13           I mean it has -- you know, you can well see it  
14 will create some tensions, and on one of my boards, you  
15 know, the CEO was a bit sort of uppity about when he saw  
16 the audit planning document, and saw that they were  
17 worried about a particular area of judgment, which -- you  
18 know which was about revenue recognition, which his first  
19 reaction, he wasn't crazy about it.

20           But I think -- I mean that's a good and healthy  
21 tension, I think, as long as it's amongst mature people.  
22 So no. The short answer is we haven't had any problems

1 with preparers and no problems have come through, and  
2 indeed I think the Rolls Royce one, which everybody is  
3 instancing, I mean you know, that style audit report in  
4 the real world would not have been produced in the way  
5 it has without, in effect, the agreement of the company,  
6 because it was pretty pioneering. So they were happy to  
7 live with it.

8           MR. BAUMANN: I wonder in the proposals in the  
9 EU, in comments that you received, did preparers weigh  
10 in on that and what type of -- and the IAASB, what kind  
11 of reaction did they have?

12           MR. GENTNER: As far as I'm aware, and we've had  
13 an extensive public consultation, and you know, we've had  
14 long negotiations in the European process, where all  
15 sorts of parties also contributed, it was not a major  
16 issue that preparers came up with concerns.

17           Obviously, there were some concerns from the  
18 audit industry. But I think we found a good solution.  
19 So my feeling is that no, this is not -- this is not a  
20 key issue, and we believe that the reform will actually  
21 help companies by receiving more information, better  
22 targeted information, and also in their dealings with

1 investors.

2 MR. DOTY: Mr. Kroeker, former chief accountant,  
3 current FASB member.

4 MR. KROEKER: Thank you, Chairman Doty. I know  
5 you've mentioned it's early days and the number of  
6 reports is dozens, not hundreds or thousands yet. But  
7 have there been examples where investors have come back  
8 and said this is important market-moving information, or  
9 information that surprises us?

10 The one example that's been cited, that's been  
11 more forward-leaning, also tends to at least possibly put  
12 the company in a favorable light, and whether or not  
13 there's been other examples, that might put a company in  
14 not such a favorable light, and whether those are the  
15 types of opinions you're seeing in the early days.

16 MR. LAND: I find it very hard to answer that  
17 question, and I think if I could suggest perhaps leave  
18 that question to the panel tomorrow from the UK. Liz,  
19 who is here from a very big investor association, may  
20 have a better view.

21 I honestly couldn't answer that question at this  
22 stage. Certainly I'm not aware that anybody's share

1 price has sort of plummeted, but it really does raise the  
2 question of when should the audit report appear? I mean  
3 at the moment, it appears in the published financial  
4 statements annual report. Maybe it should appear when  
5 the premier announcement is announced.

6 MR. DOTY: Any Board members have any other  
7 questions?

8 MR. HANSON: Professor Schilder, I'd like to ask  
9 you another question on the other information proposal  
10 that you've yet to come out with, and I noted in your  
11 statement that you I think said something to the effect  
12 that you're trying to better identify what information  
13 the auditor essentially looked at, or had the ability to  
14 consider against the audit evidence.

15 I know that that's a concern that I personally  
16 have, is investors won't know the information that's in  
17 an annual report, what was subject to the auditor doing  
18 something to. It might be the most important information  
19 that they -- that an investor might consider the auditor  
20 might not have done anything with, because it was  
21 forward-looking information.

22 I know we're going to hear -- he stepped out of



1 the room now -- from the esteemed Alan Beller this  
2 afternoon about sharp concerns about investors won't know  
3 what information was really subject to some procedures  
4 by the auditor and what wasn't.

5           So I was intrigued by your comment that you're  
6 trying to identify what it was, and I'm just curious as  
7 to where you're heading on how you would do that? I  
8 think about in the context of a comfort letter, and those  
9 of us who have been involved with it, it's a very  
10 extensive process, of actually circling individual  
11 sentences and numbers that the auditor did something to,  
12 and just kind of --

13           How cumbersome that is for somebody to actually  
14 read and understand, and how it's probably not possible  
15 in this context of the audit report? But just thoughts  
16 on where you're headed with this.

17           MR. SCHILDER: In the previous exposure draft, we  
18 had wider concept of what possibly could constitute other  
19 information, including press release, website  
20 information and what have you. What we learned from the  
21 consultation and the feedback is that we should narrow  
22 that down in a more manageable concept.

1           So we have brought that back basically to what we  
2 call the annual report, recognizing that not in every  
3 jurisdiction that is just one booklet or one publication,  
4 but it can be comprising more and several. So that's  
5 why at least it might be better doable to identify it by  
6 starting with the concept of the annual report, but  
7 nevertheless pointing to various publications that would  
8 be constituting that definition of annual report.

9           That certainly would include, if you just take  
10 the MD&A as an example, forward-looking information.  
11 That's why it's also important to explain the work  
12 effort, and there we make a distinction between on one  
13 hand, the inconsistencies between the financial  
14 statements and the other information that of course the  
15 auditor has clearly audited that, and has to perform some  
16 limited procedures to be sure about no material  
17 inconsistencies.

18           But on the other hand, the intelligent read is  
19 more important here. At least you can, as an auditor,  
20 read the other information, even with a forward-looking  
21 nature, with all your understanding of the company that  
22 you have acquired during your audit.

1           Then if you're dealing with restatement, you  
2 would say well, I really can't reconcile that with my  
3 understanding or my assessment of this company. At least  
4 it would take a further discussion. So it's not an  
5 explicit assurance or an additional work to let's say  
6 specifically assure all forward-looking information.

7           But at least you cannot ignore it, and that's why  
8 you have to apply this intelligent read.

9           MR. DOTY: Steve Harris.

10          MR. HARRIS: Chairman Schilder, could you  
11 summarize for us what the key differences are between  
12 your key audit matters and our critical audit matters,  
13 and why you think yours are better in terms of the  
14 investor or the user benefits?

15          MR. SCHILDER: Well at least we like more the  
16 term "key" than "critical." But it is kind of a just  
17 little joke. I think in essence, we do think that both  
18 of us are aiming at providing investors with the most  
19 relevant information coming from the audit, and the PCAOB  
20 in-depth concept has defined it in a bit more detail.

21          We focus on, as I've mentioned, starting with  
22 what has been communicated to those charged with

1 governance. You can discuss whether that includes  
2 everything. But this is just an example of some detail  
3 about how you define it.

4 But we are currently discussing how we should  
5 adjust the language that we have proposed, the exposure  
6 that have to do better justice to the comments that we  
7 have received, and to make it even more clear. Also, on  
8 Lou's earlier point, avoiding to every extent possible  
9 boilerplate language, to really focusing on what is of  
10 relevance to users.

11 I think, Steve, that's exactly what you are  
12 aiming at as well. So we really look forward to our  
13 further mutual discussions on how we are moving forward,  
14 and certainly having had our Board meeting in March with  
15 on one hand a lot of support; on the other hand, a need  
16 to further redefine and going forward to do, I think,  
17 some in May or so.

18 That's a matter for some in-depth discussion.  
19 But very much starting from -- well, what many have said  
20 to us. There is a lot of similarity, and I'm not aware  
21 of a serious difference of opinion in this matter. But  
22 I'm always a bit of an optimist.

1           MR. FERGUSON: I have a question. This grows out  
2 of a just a position I made as I listened to the comments  
3 here. One was Nick Land's comment, that he thought that  
4 in the UK, one of the things that might be happening is  
5 that the various forms of reports could be leading to a  
6 potential kind of competition among the firms, which  
7 might be useful.

8           Then Jim, Kroeker's comment, that the one he did  
9 read, which involved a forward-looking one, appeared to  
10 be, you know, to give a very favorable picture of the  
11 company.

12           Is there a risk here that an auditor who begins  
13 to write a lot finds this a way of sending a quite  
14 favorable message that, you know, these people really did  
15 a great job? They were very thoughtful. We had to look  
16 at all these areas, but they did a very great job.

17           There's a way of sending this kind of subtle  
18 message to not so much users as other potential clients  
19 that, you know, if you hire us, you're really going to  
20 get -- we can say some really good things about your  
21 report. Is there a risk inherent in this approach, that  
22 that's what could happen, particularly if there

1 variability among them?

2           The short question is discuss the negatives and  
3 positives of the variability argument and competition.

4           MR. LAND: That's a very good question. I don't  
5 want to -- I don't want to, as I said earlier today, I  
6 don't want to overstate that sort of firms are going to  
7 hire a tong who can produce the sort of -- either the  
8 most explicit or longest or most granular audit report.

9           But I mean I do think the firms are very  
10 conscious of what everybody -- what their competitors are  
11 doing, and they're no doubt weighing that up and  
12 balancing it. I suppose, I mean it is a very good  
13 question, because I think if you took it to the extreme  
14 in the way you've described, I mean I think there is a  
15 potential risk there if you took it to that extreme.

16           I mean my own view is that that won't happen,  
17 that the auditor will be -- continue to be responsive to  
18 its obligations. I'm readily confident about that, and  
19 it was -- we don't have, I mean we do have pending  
20 litigation against sources in the UK, but we don't have  
21 class actions, thank goodness.

22           I mean, you know, the back of -- the dagger or

1 the sword of litigation, I mean, is hanging over them.  
2 So I don't think we've seen anything, based on one's  
3 knowledge, that I would consider to be a sort of reckless  
4 or over-optimistic statement.

5 I mean the Rolls Royce one, I know we keep  
6 referring to it, but it is, you know, it is a bit of a  
7 sort of mini-landmark in this short period. I mean as  
8 Sir David, it did talk about -- a lot of it was about  
9 revenue recognition, because it's in the aircraft engine  
10 business.

11 You know, on one it said well, on balance we  
12 thought the view the company had taken was sort of  
13 marginally optimistic, and on another key financial risk,  
14 they thought they were being marginally conservative.  
15 I mean it's very early days, but that struck all the  
16 readers as sort of a very balanced view of an audit  
17 report that was pretty granular.

18 I think it's something where you obviously have  
19 to guard against, but I personally don't see there's a  
20 big risk.

21 MR. DOTY: We're going to first thank Chairman  
22 Land, Chairman Schilder and Councilman Gentner for one

1 of the more illuminating panel discussions that you can  
2 imagine, given the task at hand. We greatly appreciate  
3 -- we're in your debt for what you have brought to this  
4 by way of perspective, and I'm sure it's not the last  
5 time we will hear from you.

6 MS. FRANZEL: Do we have time for one last  
7 follow-up question?

8 MR. DOTY: It has to be a very quick hit. You  
9 have the last hit.

10 MS. FRANZEL: Great. I just wanted to follow up  
11 on Steve Harris' question, on the differences. We seem  
12 to be moving in the same direction, but there seem to be  
13 some pretty important differences between the CAMs, the  
14 KAMs, you know, and the other approach of the assessed  
15 risk of misstatement and disclosure of those.

16 How important is it, in your minds, for us to try  
17 to minimize differences now at this point in the process,  
18 or is this something that can be done several years down  
19 the road, after several years' worth of experience?

20 MR. SCHILDER: The answer to that is very  
21 straightforward. Everything that we can do to minimize  
22 differences now is a response to what many have said to



1 us and I know about to you as well. As I said, I don't  
2 think there are important difference in concepts, but for  
3 example of course, there's differences in style. We have  
4 high level principles based in the application material.  
5 You have to have straightforward requirements.

6 But if you combine that with a detailed analysis,  
7 that gives rise to optimism. Nevertheless, we are not  
8 there yet, and therefore I think what we can do in the  
9 next couple of months to further bring that together,  
10 respecting of course your confidentiality requirements,  
11 that will be very helpful.

12 MR. DOTY: We will reconvene at one o'clock.  
13 With that encouraging -- that's an encouraging note on  
14 which to close. We should not let the perfect be the  
15 enemy of the good is what you hear you saying.

16 Thank you all. We'll reconvene promptly at one  
17 here. We have a panel coming on that has a very high  
18 yield rate. So please come back quickly.

19 (Whereupon, the above-entitled matter went off  
20 the record at 12:01 p.m. and resumed at 1:01 p.m.)

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

22 1:01 p.m.

1 MR. DOTY: Well, it is slightly after 1:00 p.m.  
2 PCAOB time. So it's with pleasure that I welcome a truly  
3 distinguished panel. We're moving now into academic  
4 opinion, legal advisory and firm policy matters.

5 Ted Mock is the Distinguished Professor of Audit  
6 and Assurance at the University of California-Riverside.  
7 Prior to joining the University of California-Riverside,  
8 Professor Mock served as a professor of Accounting at the  
9 University of Southern California, professor of Auditing  
10 Research at Maastricht University in the Netherlands,  
11 previously, the Arthur Andersen Alumni Professor at the  
12 University of Southern California.

13 In 1983, he helped found the University of  
14 Southern California Audit Judgment Symposium, now an  
15 international symposium on audit research. His interests  
16 lie primarily in the areas of audit judgment, assurance  
17 service, evidential reasoning.

18 Alan Beller, partner, Cleary, Gottlieb, Stein and  
19 Hamilton. He served as the Director of the Division of  
20 Corporate Finance at the United States Securities and  
21 Exchange Commission, and as senior counsel to the  
22 Commission, from January 2002 until February 2006.

1           But the years tell only half the story. Among  
2 the accomplishments of this extraordinary tenure and  
3 service were the implementation of corporate provisions  
4 of the Sarbanes-Oxley Act of 2002, the adoption of  
5 corporate governance standards for listed companies, the  
6 successful completion of comprehensive  
7 securities-altering reforms.

8           Alan is a frequent commenter and contributor to  
9 the PCAOB's thought process, and we are grateful for it.

10           Douglas Skinner is the Eric Gleacher  
11 Distinguished Service Professor of Accounting at the  
12 Booth School of Business, University of Chicago.  
13 Professor Skinner is a leading expert in corporate  
14 disclosure practices, corporate financial reporting,  
15 corporation finance with a focus on payout policy.

16           His research addresses topics such as the causes  
17 and capital market effects of managers' corporate  
18 disclosure choices; how the legal and regulatory  
19 environment affect managers' corporate disclosures;  
20 managers' incentives to use their discretion in the  
21 financial accounting and reporting process, to manage  
22 reported earnings.

1           Prior to his appointment at the University of  
2 Chicago, he was the KPMG Professor of Accounting at the  
3 Roth School of Business, University of Michigan, where  
4 he had been on the faculty since 1989.

5           Joseph Ucuzoglu, the national managing partner,  
6 Regulatory and Professional Matters at Deloitte in  
7 Washington, D.C. He's a member of the firm's Executive  
8 Committee. In his current role, Joseph Ucuzoglu  
9 participates actively in the management of the audit  
10 practice, serving on both the board of directors and  
11 executive committee of the firm's Audit and Enterprise  
12 Risk Services subsidiary, Deloitte and Touche.

13           Previously, he served as senior advisor to the  
14 chief accountant at the United States Securities and  
15 Exchange Commission. In that capacity, he advised the  
16 chief accountant on complex auditing and public policy  
17 matters, and interacted frequently with other government  
18 agencies and Congressional staff.

19           He serves on the executive committee of USC's SEC  
20 Financial Reporting Institute. So we have a group of  
21 truly heavy and thoughtful commentators, and with that,  
22 Professor Mock, welcome. Please continue. The floor is

1 yours.

2 MR. MOCK: Okay. I thought I was third. Well  
3 Chairman Doty and the Board, thank you for the  
4 opportunity today, and you're welcome for bringing  
5 California sun to Washington yesterday when I came.

6 MR. DOTY: We'll grant you that. We'll give you  
7 that.

8 MR. MOCK: Okay. So my comments today are  
9 founded on research I conducted myself, and the citations  
10 are at the end of the formal comment. I have some  
11 PowerPoint here, if I get this to work and you can see  
12 my opening slide, with has my information.

13 My presentation is actually in four areas.  
14 There's five points listed there, but a little  
15 background, the objective of my comments today, some key  
16 findings in the research that I've tried to help  
17 synthesize, and then some limitations and conclusions of  
18 what I'm going to talk about today basically.

19 As far as background, and Arnold Schilder  
20 mentioned this, I've done research a long time, as you  
21 mentioned in your opening comments. But I started in  
22 this area most with a study that I helped do, that's

1 sponsored by the AICPA and the IAASB, about ten years.

2           But more importantly, I've chaired a group, a  
3 team that the Triple A audit section put together, at the  
4 invitation of the PCAOB, to synthesize research. The  
5 team that has continued doing work on this project for  
6 a long time is listed there. So we have a team,  
7 originally six, but of five of us who put this together.

8           I'd like to, before I go into my discussion  
9 objectives, I'd like to commend and highlight the  
10 critical importance of the PCAOB in supporting the work  
11 of the academic community, by among other things,  
12 formally considering research and I think in most of your  
13 activities.

14           I think this actually is an example of divergence  
15 between what the IAASB is doing and you are doing. So  
16 that's one step forward, I suppose. Okay. As far as the  
17 next section is my primary objective and my comments.

18           My main goal today is to address today's main  
19 topic, which is to consider the need for change in the  
20 auditor's report. I was specifically asked to focus on  
21 the proposed changes to the auditor's report, based upon  
22 published or relevant economic research. So that's the

1 focus of my research.

2           This objective has been addressed in the team,  
3 I'll say our basically, papers and comments that we have  
4 put together. Firstly, it is a synthesis report that was  
5 submitted to you and eventually published, and actually  
6 five other related instruments, including comments to the  
7 Board and also to the IAASB.

8           We organized our research in these three research  
9 areas, research questions that we tried to address, and  
10 everything we've done is kind of organized along those  
11 lines. What specific information do investors and other  
12 stakeholders want to be included in the auditor's report,  
13 based on research.

14           A second research question, how do investors and  
15 other stakeholders use proposed additional auditor  
16 communications in their decision-making, and third, to  
17 what extent can the proposed disclosure be expected to  
18 close the communication and information gaps.

19           The third research question was kind of a  
20 forecast, because research doesn't often lend much  
21 insight on that.

22           The research framework underlying our analysis is

1 based on communication theory, and basically the  
2 expectation gap, looking at that, and particularly  
3 looking at it from the standpoint of an information gap  
4 and a communication gap. The end of my comment is our  
5 framework.

6 Over the time that we've reviewed research, we've  
7 looked at about 130 research studies. In addition to  
8 that, our synthesis built upon an earlier study that was  
9 done by Church, et al. So it's based upon a lot of  
10 research.

11 Key findings. These are findings based upon  
12 published research, and trying to abstract this is a  
13 challenge, but this is what I'd like to say. There are  
14 three overall findings I would like to highlight.

15 Number one, users of financial statements do not  
16 appear to carefully evaluate the current standard audit  
17 report, because it is such a standardized product. Of  
18 course, that's been said many times. The reports are  
19 basically viewed as being the same.

20 However, reports that augment the standard audit  
21 report with information, such as going concern,  
22 uncertainties or internal control weaknesses, do seem to



1 contain additional relevant content.

2           Number two. Users do want -- do seem to want  
3 more information on risk materiality and other  
4 information surrounding the specific audit. In  
5 particular, information -- users are more interested in  
6 information about the audit, like risk and materiality,  
7 than information about the audit process. This is what  
8 research basically says.

9           Number three. While significant research exists  
10 in many areas, there are many areas where a research gap  
11 exists. That is, where there seems to be lack of  
12 sufficient research evidence. A lot of things talked  
13 about today are in that domain. For example, is there  
14 message-mixing? Well, you know, there's no direct  
15 research I've seen dealing with that issue.

16           Oh, okay. Before I go to limitations, I'll make  
17 a couple of comments. Well, limitations and conclusions.  
18 Similar to a financial statement, one should not draw  
19 solely from bottom line. I've given you kind of bottom  
20 line summaries here in this formal concept. But you have  
21 to consider the details provided in various research that  
22 we're looking at, and the comment letters.

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1           The research synthesized has both research  
2 methods limitations and sampling limitations, and there's  
3 no generally accepted research synthesis methodology.  
4 Our group had a real challenge in doing this.

5           Lastly, as has been mentioned earlier, much of  
6 the research -- the topic's been mentioned -- does not  
7 explicitly account for litigation risk or cost versus  
8 benefits in general.

9           To conclude with perhaps the most important  
10 finding of our review, academic research is fairly  
11 consistent across different research methods, time  
12 periods and economic settings, and suggesting that an  
13 important way to improve the communicative value of the  
14 audit reporting model is if it is not boilerplate. Thank  
15 you for the time.

16           MR. DOTY: Thank you.

17           MR. BELLER: Chairman Doty and members of the  
18 Board, I'd like to thank you for -- the Board and the  
19 staff for the opportunity to participate in the Board's  
20 public hearing regarding the proposal to advance the  
21 Auditor's Reporting Model. I'd also like to thank the  
22 chairman for that kind introduction.

1 I would mention that in addition I did, as was I  
2 think mentioned this morning, also serve as a member and  
3 counsel to the co-chairs of the Treasury ACAP in 2007 and  
4 2008, and I am a member of the board of directors and the  
5 audit committee of a public company.

6 Having said all of that, I'm going to of course  
7 speaking this afternoon only for myself, and not for any  
8 of my current or prior affiliations, and my remarks today  
9 are a distillation of a and summary of the views I  
10 presented in a paper for these hearings, that I think  
11 will be published on the PCAOB website after this  
12 session.

13 I'm a strong proponent of changes to the auditor  
14 reporting model, that will improve financial reporting  
15 or improve the understanding of financial disclosure by  
16 investors, other users and markets and, as was also  
17 mentioned this morning, the ACAP recommended that the  
18 Board undertake an initiative to address the auditor  
19 reporting model.

20 Preparers, auditors, advisors, users and  
21 regulators should all be striving for better disclosure  
22 and understanding, especially of the material aspects of

1 financial reporting and financial disclosure. More  
2 information is not necessarily better. Indeed, where the  
3 more overly fact focuses on immaterial items or is  
4 confusing in nature, it is not only not an improvement,  
5 but it also distracts from the usefulness of the overall  
6 disclosure.

7 In my view, the Board's task was to achieve the  
8 better, and not just the more. Today's sessions focus  
9 primarily on the proposal that auditors report on  
10 critical audit matters or CAMs, and I'll concentrate my  
11 remarks on that subject.

12 I also included some observations on the other  
13 information standard in my written presentation, and will  
14 address questions on that subject if anyone is  
15 interested. I regret that in my view, the CAM standard  
16 as proposed would lead to uncertain improvement at best,  
17 in either financial reporting or investor understanding.

18 I have two principle concerns in reaching that  
19 conclusion. First, the audit is a means to an end.  
20 Procedures that in the case of unqualified opinion at  
21 least, provide reasonable assurances that will improve  
22 and increase investor confidence in financial statements,

1 coupled with an audit report that improves investors'  
2 understanding and enhances that confidence.

3           But the CAM standard only gets at financial  
4 reporting indirectly, and targets material financial  
5 disclosure imperfectly. As proposed, the standard will  
6 require disclosure in the auditor's report regarding  
7 audit difficulties, but may not be material to financial  
8 reporting or its understanding.

9           Second, the proposed standard will necessarily  
10 lead to disclosure made, or at least dictated, not by the  
11 issuer but by the auditor. The standard is designed  
12 either to require auditors to disclose information about  
13 issuers, or effectively force issuers to disclose  
14 information that they do not consider material, and that  
15 need not be disclosed under the current securities law  
16 regulatory framework.

17           This hodgepodge approach runs a risk of confusing  
18 rather than informing. In one of the Board's own  
19 examples, an auditor reporting on a hypothetical CAM  
20 identifies and discusses an issuer's significant  
21 deficiency in internal control over financial reporting,  
22 that is not a material weakness.

1           Why is this helpful rather than potentially  
2 confusing to investors, where by definition it is less  
3 likely than reasonably likely, i.e. remote, that the  
4 significant deficiency will result in a material error  
5 in the financial statements.

6           Further, under the disclosure framework,  
7 significant deficiencies are not required to be disclosed  
8 to investors, but rather to auditors and audit  
9 committees, in order to avoid conflating the material and  
10 the immaterial.

11           The Cleary comment letters and my written  
12 presentation suggests an alternative approach, because  
13 I really would like to see an improvement in the  
14 reporting model. To summarize that approach, we  
15 recommend that the Board focus on the disclosure of  
16 critical accounting policies and estimates, which is  
17 directly applicable to and by definition material to the  
18 quality of financial reporting and investor understanding  
19 of that reporting.

20           Auditor attention could be applied through a  
21 standard regarding critical accounting policies and  
22 estimates, and a statement could be included in the audit

1 report to the effect that (a), the correct critical  
2 accounting policies and estimates are disclosed and (b),  
3 the description of the critical accounting policies and  
4 estimates is accurate and complete in all material  
5 respects.

6           This approach directly addresses core material  
7 elements of financial reporting, rather than proceeding  
8 indirectly to address auditing matters that may or may  
9 not be material. It would leave disclosure to issuers,  
10 where it belongs, and have auditors report on issuer  
11 disclosures.

12           Auditors and issuers would in fact, I think under  
13 this proposal, discuss critical accounting matters and  
14 estimates, and there would be more attention and more  
15 robust disclosure about those items. Auditors would have  
16 to make disclosure if they disagreed with issuers about  
17 what the required disclosure was, but otherwise the  
18 disclosure would be issuer disclosure. Discussions  
19 between auditors and audit committees could be fostered  
20 around issuer disclosure, and unquestionably material  
21 matters.

22           On another point, I've also been asked to address

1 the proposed new standards from a legal point of view.  
2 Both standards, CAM and other information, carry legal  
3 implications and impact legal costs. Legal costs and  
4 issues are not in themselves reasons not to adopt new  
5 standards.

6           Indeed, they are acceptable and often necessary  
7 consequence, where the resulting changes bring benefits.  
8 However, the Board should consider the proposed new  
9 standards do raise some significant legal issues that  
10 should be on the table.

11           First, under Section 10(b) of the Exchange Act,  
12 and Rule 10(b)(5) thereunder, an auditor can be liable  
13 if it makes a statement in its auditor's report included  
14 in an annual report of filing that is misleading, where  
15 the requisite scienter standard is met.

16           Both proposed standards would require those  
17 affirmative statements. The requirement of the proposed  
18 other information standard raises more novel issues here,  
19 because the auditor under the proposal must make  
20 affirmative statements about its evaluation of that  
21 information, where the scope of other information is  
22 extremely broad.



1           As I read the proposal, all information, other  
2 than audited financial statements and notes and some  
3 supplementary financial information, must be included or  
4 incorporated into the reports, and secondly, where the  
5 proposed quote-unquote "evaluation procedures" involve  
6 a significant volume of evidence obtained by the auditor  
7 during the course of its audit.

8           Under the Supreme Court's decision in Janus, the  
9 auditor's affirmative statements could be the subject of  
10 a private right of action under 10(b)(5), predicated on  
11 any material inaccuracy or incompleteness of those  
12 statements. The potential liability would be new,  
13 because it does not currently exist on AU 550, where  
14 statements by the auditor as to other information are  
15 made only to the issuer.

16           Under the proposed CAM standard, the auditor  
17 would similarly be required to make a number of  
18 additional affirmative statements, and those statements  
19 could similarly give rise to a private right of action.

20           I readily concede and agree that the affirmative  
21 statements made by an auditor under the proposal we have  
22 suggested, regarding critical accounting policies and

1 estimates, would also give rise to that potential set of  
2 issues, and the real question is whether the current  
3 proposal or the other approach would provide greater  
4 benefits to evaluate against those legal issues.

5         A particular litigation concern is raised by the  
6 proposed requirements under the CAM standard, that the  
7 auditor retain audit documentation with respect to each  
8 non-reported matter that would appear to meet the  
9 definition of a CAM, but was not reported as a CAM.

10         While this may be useful to some, including the  
11 Board, it also creates and requires an auditor to retain  
12 an additional detailed documentary record. This may  
13 accomplish little benefit to investors, while providing  
14 a potentially discoverable road map in litigation, and  
15 should be considered in that light.

16         One last or a couple of last points or issues  
17 under the Securities Act. The proposing release  
18 explicitly notes that consistent with existing AU 550,  
19 the other information standard would not apply to  
20 documents filed with the Commission under the Securities  
21 Act, but rather existing standards would govern auditor  
22 responsibilities for those filings.

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1           There are, of course, other provisions of the  
2 Commission's rules and the Board's standards that apply  
3 to Exchange Act filings and not Securities Act filings.  
4 Perhaps the most apposite example involves management's  
5 evaluation of and auditor's attestation of internal  
6 control over financial reporting, which is required in  
7 an annual report, but which is not required in a  
8 Securities Act registration statement.

9           But Section 11 of the Securities Act would apply  
10 to an Exchange Act filing incorporated by reference into  
11 a Securities Act registration statement. This anomaly  
12 does not seem to me to be one that should overly-concern  
13 the Board in its standard-setting exercise. There is  
14 precedent for it.

15           The proposing release does create and does not  
16 address certain implications for incremental auditor  
17 liability under Section 11 of the Securities Act. In  
18 particular, it's not clear whether the statements  
19 regarding CAMs would or should be viewed as statements  
20 of an expert under Section 11(e), which would make them  
21 subject to Section 11 liability.

22           It's even less clear whether statements regarding

1 other information, based on a quote-unquote "evaluation"  
2 rather than quote-unquote "audit," would or should be  
3 viewed as statements of an expert.

4           In the absence of clear guidance by the Board and  
5 particularly by the Commission regarding these new  
6 statements about CAMs and particularly other information,  
7 Section 11 litigation uncertainty will persist upon the  
8 adoption of such standards, and settlement dynamics,  
9 which are absolutely key and particularly important in  
10 Section 11 cases, will be affected. That's another  
11 consideration that the Board should keep in mind.

12           MR. DOTY: Thank you. Professor Skinner.

13           MR. SKINNER: Thank you. First of all, I very  
14 much appreciate the invitation to contribute to the  
15 important discussion about the Board's proposal.

16           To begin, let me state that I think the Board is  
17 to be congratulated for investing significant resources  
18 to understand whether the current reporting model, which  
19 as the Board observes has been in place without  
20 significant modification since the 1940's, needs to be  
21 modified, given the extent to which our capital markets  
22 and economy have changed since that time.

1 Further, I think most will agree with the general  
2 proposition that expanding the amount of disclosure about  
3 the audit process is potentially beneficial to investors.  
4 My comparative advantage in these proceedings is perhaps  
5 to inform the Board and other interested parties about  
6 the academic literature on disclosure, and offer some  
7 words of caution about the general thrust of the current  
8 proposal, that significantly expands the disclosures  
9 required by, as well as the role of auditors.

10 By way of background, I'm a professor of  
11 Accounting at the University of Chicago, and have served  
12 as editor of the Journal of Accounting Research since  
13 2006. Prior to that, I served as editor of the Journal  
14 of Accounting and Economics for seven years. JAR and JAE  
15 are generally considered, along with The Accounting  
16 Review to be the top academic accounting journals in the  
17 world.

18 So I mention this because I have extensive  
19 knowledge of the accounting literature. My research  
20 interests span financial accounting, auditing, disclosure  
21 and corporate finance, and I generally take a strong  
22 empirically-oriented economic space approach to problems

1 in these areas.

2 I also have consulting experience in these areas,  
3 and have in the past provided input to policy  
4 deliberations at both the FASB and the SEC. I may also  
5 mention that I started my professional life as an auditor  
6 at Coopers and Lybrand in Sydney, so David mentioned this  
7 morning the Colonies. Australia, of course, was  
8 originally a penal colony, so I'm hoping that after my  
9 remarks this afternoon I'm not going to be sent back  
10 there.

11 There's a very large literature in economics,  
12 finance and accounting on disclosure, both mandated  
13 disclosure; that is required disclosures such as 10(k)  
14 filing requirements, and voluntary disclosures, such as  
15 managers' decisions to provide earnings guidance.

16 I'll focus my comments on what economists have to  
17 say about mandated disclosure, since that is what we're  
18 talking about here. As a general proposition, I think  
19 it's fair to say that economists agree that increasing  
20 disclosure has benefits.

21 As the proposal observes, there is much  
22 theoretical work that shows generally that increased

1 disclosure of information, assuming that information is  
2 in some sense relevant and informative to investors, has  
3 benefits in terms of reducing information asymmetries in  
4 capital markets, and can result in improvements in market  
5 liquidity and pricing, including a lower cost of capital.

6           However, there are also costs of mandating  
7 additional disclosure, both direct costs, such as  
8 proprietary and litigation costs, and indirect costs,  
9 which we might refer collectively to as unintended  
10 consequences.

11           In the case of the current proposal, I think  
12 these costs, which are inherently hard to observe and  
13 quantify, could be very significant. Moreover, I have  
14 some skepticism about the potential benefits of these  
15 disclosures, which are perhaps even more difficult to  
16 quantify.

17           This makes it hard to assess the cost-benefit  
18 trade-off involved in making a decision about the  
19 proposals. Let me expand on these points, focusing on  
20 the benefits first. Professor Mock and his co-authors  
21 have prepared a very useful and thorough summary of a  
22 particular part of the auditing literature in accounting.

1           Given Professor Mock's participation here, I will  
2 not reiterate the conclusions of that research. However,  
3 I will observe that as the authors of these studies  
4 acknowledge, much of the evidence offered on the espoused  
5 benefits of the new disclosures is based on survey and  
6 experimental data, as opposed to empirical archival data.

7           There is not much we can do about this. It is  
8 exceedingly difficult to design studies using real world  
9 data, that is, non-experimental or archival data, to  
10 assess the costs and benefits of disclosure.

11           However, in my view, we should be very careful  
12 placing too much weight on survey evidence from  
13 investors, who say they want more disclosure. Given that  
14 there is no cost to them, what else would we expect them  
15 to say.

16           I'm not sure we learned very much about the  
17 benefits of disclosure from this type of evidence. The  
18 logical extension of this idea, that the world will be  
19 better with more disclosure, is sometimes known in  
20 economics as the nirvana fallacy.

21           I would also point out that there is perhaps  
22 reason why the audit report in its current form has



1 survived largely unchanged for many decades, not only in  
2 the United States but essentially throughout the world.  
3 As the economics literature makes clear, auditing  
4 generally, including the traditional pass/fail model,  
5 plays a central role in validating the information in a  
6 firm's general purpose financials.

7           This role predates regulation that mandated the  
8 disclosure of audited financial statements. Audited  
9 financial statements have been used for hundreds of  
10 years, dating back to at least medieval times in England.  
11 This implies that the basic attestation role of auditors,  
12 which includes the pass/fail model, serves an important  
13 economic function as currently configured.

14           Thus while surveys may indicate that certain  
15 users claim not to use the audit report very much, we  
16 should take care in inferring from this that the report,  
17 in its current form, is not fulfilling an important  
18 economic role, given the very strong survival value of  
19 the current model.

20           I worry that tampering with a model that has  
21 survived for so long will have consequences that we  
22 cannot easily predict. Let me turn to some of the

1 potential cost disclosures. First, it seems to me that  
2 the proposed requirement for auditors to report critical  
3 accounting matters or CAM could expand the set of  
4 information disclosed about firms beyond what is  
5 currently required under the securities laws.

6         This seems like a very significant change in the  
7 whole financial reporting model, because it means that  
8 the audit report would potentially become a disclosure  
9 mechanism in its own right, beyond what is currently  
10 disclosed by issuers in their financial statements and  
11 related disclosures.

12         Thus an important element of the current model  
13 that management takes responsibility for preparing  
14 financial statements and that auditors then attest to the  
15 reliability of that information would change, because now  
16 the auditors potentially would actually be disclosing  
17 information about the firm directly.

18         To the extent that the new auditor reporting  
19 model expands firm disclosures, it seems likely that  
20 proprietary costs come into play. These are the costs  
21 to firms of additional disclosures that provide  
22 information, that provide important competitive

1 information about the firm's operations and strategies  
2 to competitors, suppliers, customers or other entities.

3           For example, a bank's risk management strategies  
4 and procedures are likely to be one source of its  
5 competitive advantage.

6           To the extent that the auditor now provides  
7 additional detailed and specific information about the  
8 financial instruments the bank uses to implement that  
9 strategy, other banks may be able to infer useful  
10 information about the bank's risk management program.

11           Auditor litigation costs are also a concern.  
12 There is an extensive academic auditing literature that  
13 examines the determinants of audit fees. It is clear  
14 from both the economic arguments and empirical data that  
15 expected litigation costs are a big driver of audit fees.

16           By expanding the auditor's role and disclosures  
17 in the manner envisioned in these proposals, I think we  
18 can confidently predict that the plaintiff's bar will not  
19 have to work very hard to expand both the extent to which  
20 auditors are held liable for client firm problems, and  
21 the magnitude of the associated damages claims.

22

1           These are the obvious costs.  However, the more  
2 pernicious problems engendered by these proposals fall  
3 under the general label of what economists call the real  
4 effects of disclosure.  The idea here is fairly  
5 straightforward.

6           By changing the mandated disclosure regime, the  
7 underlying actions of the affected economic agents are  
8 not held constant.  That is, if agents know ex ante that  
9 the information they will have to disclose after the fact  
10 ex post has changed, it will change the way they play the  
11 game.

12           The implication here is also straightforward.  
13 Once auditors and client firm management and personnel  
14 know that the auditors will be reporting additional more  
15 detailed information about the auditors as CAMs, it will  
16 likely change their incentives going into the audit  
17 process, and may even change how managers make operating  
18 and financing decisions.

19           For example, if managers now know that auditors  
20 will be reporting detailed information about how they get  
21 comfort about certain of the entities' transactions,  
22 managers and their personnel may well be less open and

1 forthcoming in providing information to the auditor about  
2 these transactions, and may even change the transactions  
3 themselves.

4           This in turn will change how auditors conduct  
5 their audits, as they find the need to find alternative  
6 audit approaches. Moreover, even if we assume that the  
7 actions of the firm and its personnel are held constant,  
8 it seems likely that auditors will extend additional  
9 effort to either avoid having to disclose a CAM, or to  
10 support the required CAM disclosures.

11           Without much doubt, the actions of firms and  
12 auditors will change under the new requirements in ways  
13 that are hard to predict, and that are likely to vary  
14 across firms. This leads me to a suggestion with which  
15 I will conclude.

16           As a reasonably sophisticated consumer of  
17 financial statements for a variety of purposes, one of  
18 the major improvements I have seen in financial reporting  
19 over the last decade has been the addition to the MD&A  
20 of the critical accounting policies discussion.

21           In the interest of minimizing the extent to which  
22 the new audit model expands disclosure, which as I have

1 argued could have a number of potentially costly effects,  
2 I wonder if the CAM proposal could not be modified to  
3 require the auditors to comment just on the critical  
4 accounting policies discussed by management in the MD&A.

5 Presumably, the auditors are focusing attention  
6 and additional work on these already, so that the real  
7 effects problem, as well as the expanded disclosure  
8 problem I have identified above could be minimized.  
9 Thank you.

10 MR. DOTY: Thank you. Joe Ucuzoglu.

11 MR. UCUZOGLU: Thank you, Chairman Doty, members  
12 of the Board and the staff. You should be commended for  
13 the leadership role that you're playing in this important  
14 dialogue.

15 At Deloitte, we have been engaging with a variety  
16 of external parties, exploring the ways in which the  
17 auditor's report should evolve, to meet the information  
18 needs of the capital markets and we're of the perspective  
19 that there is a critical need for action.

20 The profession has been talking about the need to  
21 enhance the auditor's report for over a half century, yet  
22 every time the subject is raised, a myriad of challenges

1 seem to stand in the way of progress. In the late  
2 1960's, the AICPA's Committee on Auditing Procedures  
3 suggested that the prospect of revising the standard form  
4 audit report was much like Moses smashing the tablets  
5 containing the Lord's Commandments.

6 This is not an easy task, but we shouldn't need  
7 divine intervention to make modest changes to the  
8 auditor's report, in response to the information needs  
9 of investors. This can be done.

10 In fact, if one looks back far enough in time,  
11 there are examples of tailored audit reports to the  
12 stockholders of major U.S. corporations in the early  
13 1900's that make specific reference to areas of the audit  
14 that were presumably important in the judgment of the  
15 auditor, one could say a primitive form of reporting  
16 CAMs.

17 Somehow during the past 100 years, we've managed  
18 to go backwards with respect to the information content  
19 in audit reports. Investors are now expressing concern  
20 that the standardized model currently in use is not  
21 meeting the information needs of the capital markets.

22 So in our perspective, the status quo is not an

1 option. We need to combine the benefit of an unequivocal  
2 pass/fail opinion with the transparency associated with  
3 providing some additional color. Frankly, your project  
4 is a pivotal moment to reverse the trajectory of the past  
5 century away from boilerplate, and towards an era of  
6 informative, tailored, transparent communications from  
7 auditors to the capital markets.

8           Enhancing the auditor's report will play an  
9 instrumental role in ensuring a vibrant audit profession  
10 rooted in quality. We've heard several of the panelists  
11 this morning speak of the benefits of enhanced auditor  
12 communication, extending beyond the additional  
13 information content in the report. I would  
14 wholeheartedly echo that sentiment.

15           The very act of an auditor crafting a tailored  
16 communication to external constituencies stands to  
17 enhance the connection of the auditor to the user of the  
18 audit report, the investing public. Reinforcing the  
19 auditor's public interest responsibility and fostering  
20 the healthy exercise of independence, objectivity and  
21 skepticism, attributes that lie at the foundation of a  
22 high quality external audit.



1           As the proposal moves towards finalization, it is  
2 important to be sensitive to the concerns that have been  
3 raised by several stakeholders, as to the appropriate  
4 source of original information about a company.  
5 Management is and should remain the primary voice of a  
6 corporation's financial performance.

7           But the auditor must be the voice of the audit  
8 that was performed, and there is much that can and should  
9 be shared with investors about the performance of the  
10 audit, without infringing on the role of management and  
11 the audit committee in the financial reporting process.

12           Our field testing of the PCAOB's proposal to  
13 identify and report on CAMs indicated that with modest  
14 refinements, the exercise is relatively intuitive and  
15 capable of being exercised. The starting population for  
16 potential CAMs under the proposal is quite broad, and it  
17 could be narrowed to ensure the auditor is focused on the  
18 limited subset of items of greatest importance to  
19 investors.

20           We also did observe the possibility that some  
21 environmental forces could drive the reporting of CAMs  
22 in the direction of standardization. I would like to

1 believe that the market forces that were discussed  
2 earlier would cause auditors to strive for informative  
3 crafted communications.

4 But I do believe it's also necessary for the  
5 PCAOB to make clear, in any final standard, that the  
6 information content is intended to be customized to the  
7 particular facts and circumstances of each engagement.

8 The focus today and tomorrow is appropriately on  
9 the currently proposed changes to the auditor's report.  
10 But I believe it's important to also begin exploring more  
11 fundamental changes that may be necessary to provide  
12 investors with the information they'll need in the  
13 future.

14 When one thinks of the changes in our capital  
15 markets in recent years, including technology, the way  
16 stocks are created, the size, complexity and geographical  
17 scale of corporations, and changes in the investor base  
18 itself, you can't help but think that more fundamental  
19 changes in the public company reporting model are on the  
20 horizon, along with corresponding changes in the  
21 performance and reporting of independent audits.

22 Perhaps auditor assurance on information will be

1 demanded on closer to a real-time basis, and the focus  
2 of auditor reporting may shift away from a point in time  
3 opinion and towards the integrity of the processes and  
4 controls that govern the information that companies  
5 disclose.

6           The type of information that auditors are  
7 associated with will also likely need to expand, and the  
8 PCAOB's proposal has begun an important dialogue.

9           As other information outside the financial  
10 statements becomes increasingly important to investors,  
11 we need to explore the extent to which auditor assurance  
12 and related auditor reporting should be provided on  
13 market-moving information, such as earnings releases, key  
14 performance indicator, non-GAAP information and at some  
15 point even forward-looking information.

16           Now I recognize I've ventured into several areas  
17 well beyond the scope of the PCAOB's proposals, and this  
18 is not to imply that all of this can or should be  
19 accomplished in the context of the current auditor  
20 reporting project.

21           But if we can't get this project done, how are we  
22 possibly going to tackle some of the additional

1 challenges that lie ahead? We need to make this  
2 successful, to set the profession on a positive  
3 trajectory towards an ever-expanding and valuable flow  
4 of information from auditors to the investing public.  
5 Thank you, Chairman Doty.

6 MR. DOTY: Well, question time. Mr. Harris?

7 MR. HARRIS: Well first of all, thank you for  
8 that extremely positive statement, in terms of moving  
9 this project ahead, and your enlightened vision of the  
10 future. I couldn't agree with you more, in terms of some  
11 of the other issues that you mentioned, which are not  
12 directly related to today's assignment. But I do think  
13 that those are issues that the profession's going to have  
14 to focus on as well.

15 You talk about a subset of items of greatest  
16 importance to investors, and I know you've done a lot of  
17 investor outreach. Could you talk a little about that  
18 investor outreach and what, in your opinion, are the  
19 subset of items of greatest importance to investors, and  
20 then getting back to a point that I think that all of us  
21 have raised in one context or another, how do you avoid  
22 creeping boilerplate?

1           MR. UCUZOGLU: With respect to the feedback from  
2 the investor community, I'd suggest that there are two  
3 broad themes, one of which is you the auditor shouldn't  
4 ever forget that we, the investing public, are the  
5 customer. You the auditor learn a great deal of  
6 information during the conduct of the audit.

7           Some of that information would likely be  
8 valuable, in terms of sort of what you thought was  
9 important, how you scoped your audit, what risks are most  
10 significant, where you spent your time, what you did in  
11 response to those risks.

12           We, the ultimate customer, ought to have access  
13 to some summary of that information, and it's a  
14 proposition that's sort of difficult to argue with.

15           The second major theme would be sort of a concern  
16 that the basic financial statements comprise a smaller  
17 proportion of the total mix of information that investors  
18 are using to make decisions, and I don't think we should  
19 lose sight of the fact that the basic financial  
20 statements and the auditors reporting on them still forms  
21 the building block for everything else.

22           If those are compromised and there's questions

1 about their veracity, the foundation for everything else  
2 is impaired. But the basic financial statements and the  
3 reporting on them isn't enough, and that as a result, we  
4 need to explore the possibility of reporting on the  
5 broader set of information contained outside the  
6 financial statements, with the caveat and the concern  
7 from the investor community that having the auditors  
8 involved with that other set of information shouldn't  
9 lead to that disclosure for management becoming  
10 boilerplate, the concern that if the auditors are  
11 involved, it will drive management's disclosure towards  
12 standardization, which would be a bad outcome.

13 MR. FERGUSON: Yes. Thank you all for coming,  
14 and thank you for the very thoughtful papers you have  
15 presented to us. They were both interesting reading and  
16 very thought-provoking.

17 I want to ask the panel to -- you know, one of  
18 the things that makes this process interesting for us  
19 right now is we are doing this while other places in the  
20 world have actually moved beyond it and it's being  
21 tested. We are seeing how it works -- maybe not exactly  
22 the same proposals we have, but proposals that involve

1 the auditor saying much, much more.

2           And I'd like to have your comments on how we  
3 should look at particularly the experience in the UK  
4 right now. I realize it's a different culture. I'm  
5 reminded of that a little bit in some of the objections  
6 that are made in this proposal of the French intellectual  
7 who was asked to assess an idea, and he said, (Well, you  
8 know, it may work in practice, but does it work in  
9 theory?

10           (Laughter.)

11           And, you know, the question here, you know, is  
12 the UK has an experience that appears to be positive.  
13 Investors do not appear to be confused by this  
14 individual, this extra information. What do we make of  
15 that? How should we take that into account? Anybody?  
16 I mean, all of you. All of you. Whoever.

17           MR. BELLER: I'll take a first crack at that. I  
18 guess I have two observations. One, and I have not read  
19 anywhere near all, but I have read a couple of the UK  
20 reports. I think the guidance that the standard provides  
21 is very high level, much more high level than the PCAOB  
22 proposal.

1 I think that gives scope for auditors who are  
2 trying to do what Joe suggested, to really write  
3 customized disclosure about the most important matters.  
4 I dare say those most important matters -- the couple of  
5 ones I have read, those most important matters do come  
6 down to, in many cases, critical accounting estimates and  
7 policies that we talk about in our somewhat different  
8 regulatory framework.

9 So I think the way they have gone at it is one of  
10 the explanations for why you've gotten what I think are  
11 pretty beneficial results.

12 The second thing I would say is more cautionary,  
13 which is I know how to run Compare Right. Every company  
14 in America knows how to run Compare Right. I dare say  
15 they know how to do it in the UK as well. And I do worry  
16 that Company A will see something that Companies B, C,  
17 D, and E and its industry have done, and they have  
18 disclosed a little less information or they have  
19 disclosed a little more information.

20 And my unfortunate -- I won't call it a  
21 prediction because I'm not -- I don't think it's fair,  
22 but my unfortunate concern is that over time -- and we've



1 seen this with risk factors in the United States, and  
2 we've seen it with MD&A in the United States. The  
3 tendency is towards uniformity and boilerplate and away  
4 from customized and original disclosure.

5           You and I should have this conversation in three  
6 years, and we'll see how they did. That's my --

7           MR. SKINNER: Could I add a couple of things?  
8 This will -- I was very interested this morning to hear  
9 Mr. Land's comments, and one of the interesting things  
10 about what he said, based on the initial experience in  
11 the UK, including his own experience, he talked about  
12 what I had mentioned, you know, using this language of  
13 real effects. He actually mentioned that there was  
14 tension between management and the audit team as a result  
15 of the new disclosures.

16           And, you know, to follow on what Alan just said,  
17 I think looking at the first year's experience is  
18 actually not going to be representative of what we see  
19 going forward in the sense that I think going through  
20 this process once management will learn some things about  
21 what is going to be disclosed that they didn't think  
22 about the first time around. And it may be very

1 interesting to see how this disclosure evolves in the  
2 next two or three years.

3           The other thing about the UK model that is  
4 different to the proposed model here, of course -- and  
5 Mr. Land also talked about that -- was that there was a  
6 corresponding change in the Audit Committee model of  
7 disclosure that was paired with the auditor model that  
8 is not going to occur here.

9           So in the U.S., under the current proposals,  
10 unless something happens at the SEC or the FASB in  
11 conjunction with this, there is going to be an expansion  
12 of disclosure by the auditors and through the audit  
13 report that we have not seen in the UK. And I think  
14 that's a pretty significant difference.

15           MR. DOTY: Ted Mock, you had a light on?

16           MR. MOCK: I think actually that school is out on  
17 many of these issues, and that is one of the  
18 difficulties, isn't it? In the synthesis we sent to the  
19 board, we identified research gaps basically, and there  
20 is lots of them. But we are slowly seeing some things  
21 happening, right? I mean, we have some experience in  
22 France as to what -- some commentary about auditors, what

1 effects they may or may not have, basically.

2           As I learned this morning, what, half of the  
3 reports in Holland now have some sort of expanded  
4 disclosure. So we will slowly get evidence we need, but  
5 it takes time. And eventually we will see them published  
6 in JAR and JAE I think.

7           MR. DOTY: Jay Hanson?

8           MR. HANSON: Well, thank you all for coming, and  
9 I want to especially thank our two esteemed professors  
10 for all the hard work you do in shaping the young minds  
11 that will be sitting at this table years from now giving  
12 us their views on the projects or issues of the day, as  
13 well as the research that you do.

14           I think this is a unique opportunity to have two  
15 professors with very different views of what their  
16 research suggests about the need for additional  
17 information in an audit report. With Professor Mock's  
18 research and Professor Skinner's research and views --  
19 kind of taking a little different view on that. And I  
20 realize that academics, when given the chance, will  
21 usually take up the opportunity to critique each other's  
22 views and positions.

1           And so since I've got the two of you sitting  
2 here, and you seem to be on kind of different pages, I'd  
3 like to hear your perspectives on each other's views and  
4 get a little discussion going about how we reconcile your  
5 two positions.

6           MR. MOCK: I should go first because Professor  
7 Skinner commented a bit on our study. I'm not sure we  
8 disagree so much. I think he said basically that  
9 required disclosure has positive effects potentially.  
10 I believe you said that basically, and so I think that's  
11 kind of confirming of the general results that we see in  
12 our research.

13           It is a tremendous challenge integrating mixed  
14 evidence over a bunch of studies. That's for sure. But  
15 I'm not sure -- I mean, I would agree with him that the  
16 data often we look at in terms of surveys, these kind of  
17 things, is not the strongest evidence you would like to  
18 have. You'd like to have stronger evidence in different  
19 ways.

20           But I think in general we have the same  
21 conclusion. Do you agree with that?

22           MR. SKINNER: Pretty much. So, I mean, I would

1 make a couple of observations. One thing I think when  
2 you're looking at the benefits and costs of disclosure,  
3 and, you know, not just in the auditing context or even  
4 in the financial reporting context, but generally there  
5 is a huge literature in economics on disclosure and  
6 regulation.

7         You know, it's in the law literature, in the  
8 economics literature, and so, you know, I spoke to that  
9 literature as opposed to specifically the accounting  
10 literature. And I think one of the big problems is, it  
11 is very hard to get a -- to measure costs and benefits.  
12 It is basically impossible. And so, you know, one of the  
13 things we sort of know theoretically -- and, you know,  
14 it's pretty much got to be the case that if you put more  
15 disclosure out there and increase transparency, it can't  
16 be a bad thing. So there are clearly benefits. It is  
17 just very hard to actually quantify those benefits.

18         So to give you an example, there is a tremendous  
19 amount of research in the last 10áyears or so on the  
20 benefits of IFRS adoption. And if you look around the  
21 world -- and I couldn't tell you how many studies there  
22 has been on this and how much discussion there has been

1 about it, cost of capital goes down with improved IFRS  
2 reporting. But the benefits are pretty small.

3           So, you know, there is going to be benefits in  
4 terms of cost of capital, how large are those benefits  
5 in the U.S. You know, that may be small. But the  
6 problem is, if you ask investors, you get the problem  
7 that I mentioned briefly which is you survey them, and,  
8 you know, what -- if you ask someone, "Do you want more  
9 information?" they are pretty much going to say, "Well,  
10 yeah, I'd like more information." So I'm not sure how  
11 much you learn about that.

12           And so then you've got to counterweight that  
13 against the cost. And like I said, the real effects'  
14 costs -- I don't know that we really understand those  
15 very well, and that's why I'm a little cautious about  
16 this proposal because, you know, I think we are even  
17 seeing a little bit of evidence from the UK about, you  
18 know, some of the dynamics between management and  
19 auditors changing. We don't really know much about that,  
20 so --

21           MR. DOTY: Jeanette Franzel?

22           MS. FRANZEL: Thanks to the panel for your

1 insightful comments and views and research. I found this  
2 panel very helpful and interesting.

3           Alan, I want to go back to the principles that  
4 you set forth. I find them very intriguing, and I'd be  
5 interested in knowing more about how you developed these  
6 principles. And then I'd be interested in hearing the  
7 other panelists' views on these principles and where we  
8 might be out of line perhaps, or where you see a lot of  
9 additional work that we would need to do under some of  
10 these.

11           And then, finally, I'm thinking maybe we need an  
12 eighth principle to deal with the long-term view as we  
13 are looking at potential changes. So your comments on  
14 those principles would be appreciated from all the panel  
15 members. But, Alan, if you wouldn't mind starting off  
16 by letting us know, how did you develop these principles,  
17 or where did they come from?

18           MR. BELLER: Oh sorry. This is the audit as a  
19 means to an end principle or --

20           MS. FRANZEL: This is on page 5 of the written  
21 statement that I've gotten from you.

22           MR. BELLER: Ah, okay. Hang on. Let me -- I

1 won't say they come -- I think -- I can't tell you that  
2 I've surveyed the academic literature and derived them.  
3 There are no sources for these. These are -- if you  
4 start with my kind of first principle, which is what we  
5 should be striving to do here, including with the changes  
6 to the auditor reporting model, is to enhance audit  
7 quality and to enhance investor understanding of what  
8 financial -- of what is being said in financial  
9 reporting.

10           These are for me the things that kind of fall out  
11 of that -- that fall out of that concept. And certainly  
12 the first five are -- or the first six are, but the  
13 second -- the seventh is really just cost -- benefits  
14 should exceed cost -- that's a truism, a  
15 difficult-to-apply truism, as Professor Skinner has  
16 pointed out, but a truism nonetheless.

17           I think the other six really are subsets of the  
18 -- we should be trying to improve financial reporting.  
19 We should be trying to enhance investor understanding.  
20 You know, to repeat myself, my concern about the CAM  
21 proposal is I think there is a more direct way to get to  
22 a better place. And I think -- I don't think that



1 issuers should be the source of disclosure and auditors  
2 should be the source of attestation is a -- is something  
3 written on a stone tablet somewhere. I think if you  
4 depart from that principle, you risk confusion. And that  
5 is the reason I view that as a kind of guiding principle.  
6 I don't think it has any -- it doesn't have any value  
7 standing there by itself. It is because of the  
8 consequences of it that I am concerned about it.

9 MR. DOTY: One of the problems -- Jeanette, am I  
10 clear? One of the problems I have --

11 MS. FRANZEL: I wanted to see if any of the other  
12 panelists wanted to comment as well on the principles.

13 MR. DOTY: Joe, do you want to hit it first?

14 MR. UCUZOGLU: Sure. Many have observed that one  
15 of the overriding principles here ought to be that  
16 management is the source of original information. And  
17 often the conversation ends there, and we don't go the  
18 next layer down with respect to original information  
19 about what. If it's original information about the  
20 company's accounting policies, and original information  
21 about the company's controls, management ought to be the  
22 source of that original information.

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1           But if it's the original information about the  
2 audit that was performed, the auditor may well  
3 appropriately be the source of that original information.  
4 And so the auditor shouldn't be introducing wholly new  
5 topics that don't fit within the various categories of  
6 what management has already disclosed.

7           But there is clearly an interest from investors  
8 to understand how the auditor went about approaching the  
9 task, scoping the audit, where they focused, what kept  
10 them up at night. And if that's the kind of original  
11 information we are talking about, it ought to come from  
12 the auditor.

13           The one other area that I would touch on -- and  
14 it has been hinted at throughout the morning -- is this  
15 subject of materiality. And it is not currently part of  
16 the proposal that was put out. But we're of the view  
17 that there would be a benefit along the lines of helping  
18 users understand how the auditor went about approaching  
19 the audit for the auditor to disclose materiality.

20           MR. DOTY: Brian, your flag is up.

21           MR. CROTEAU: Thank you very much. Joe, I think  
22 you might have just started to answer the question I was

1 going to ask you, but I just wanted to be clear. When  
2 you described the CAMs maybe need relatively minor  
3 modification relative to the way they have been teed up  
4 in the proposal, I just wanted to be sure I understood,  
5 when you're talking about things like a going -- an  
6 ongoing concern or a material weakness or a disclosure  
7 that is otherwise not required, you would in some way  
8 scope those out or rewrite the definition of CAM to  
9 exclude those, is what I think I understand you to be  
10 saying. But I just wanted to be sure of that, because  
11 if that's the case I think some might think of that as  
12 more than a minor change, but I just want to be sure  
13 we're clear.

14 MR. UCUZOGLU: So if we took them one by one,  
15 with respect to the possibility of the auditor touching  
16 upon going concern, I actually think the likelihood of  
17 the auditor venturing into territory that management  
18 hasn't covered would be mitigated if the FASB -- when it  
19 moves forward with its work on going concern.

20 With respect to the possibility of the auditor  
21 touching upon a control weakness that was less severe  
22 than a material weakness, that would be the auditor

1 venturing into an area of management's controls that the  
2 securities laws currently don't require management to  
3 disclose. And so one can have a debate about whether  
4 that is information that should or shouldn't be in the  
5 public domain, but that debate ought to take place in the  
6 confines of disclosure requirements imposed upon issuers.  
7 So I would scope out a requirement for the auditor to  
8 mention a controlled deficiency less severe than a  
9 material weakness.

10 MR. DOTY: Marty, your flag is up.

11 MR. BAUMANN: Thank you. I have a question for  
12 Professor Mock and Joe Ucuzoglu. Both Alan Beller and  
13 Professor Skinner have suggested a solution to improving  
14 the auditor reporting model via the auditor reporting on  
15 critical accounting estimates.

16 So there's a number of issues there potentially,  
17 aside from maybe suitable objective criteria upon which  
18 auditors could report on CAE.

19 I guess the question I have for you, Professor  
20 Mock, and for you, Joe, based upon your outreach and your  
21 research, which included that users want more information  
22 from the auditor on risk, materiality, and other

1 information surrounding the audit, do you think that  
2 would meet investors' needs in any way, the additional  
3 reporting on critical accounting methods? And that is  
4 for Joe and Professor Mock.

5 MR. MOCK: I think the research would support  
6 that, but there is nothing -- there are very few specific  
7 studies that look at those particular issues. So the  
8 general conclusion was, yes, it would probably be viewed  
9 positively. Now whether it would be -- affect decisions,  
10 affect behavior, these kind of things are basically  
11 unanswered.

12 MR. UCUZOGLU: I think there are two broad  
13 objectives that the PCAOB proposals are trying to  
14 accomplish, one of which is, you know, captured in the  
15 form of reporting critical audit matters, giving users  
16 a better understanding of where the auditor assessed  
17 there to be risk; and, second, to have the auditor say  
18 something about what they did with respect to other  
19 information.

20 I would actually view the auditor making a  
21 statement about the propriety of management's disclosures  
22 in the area of critical accounting policies and estimates

1 as being perhaps more responsive and relevant to the  
2 second of those objectives -- the auditor reporting on  
3 other information -- than the first.

4           And there is clearly some level of crossover.  
5 But as we work through how to come up with a subset of  
6 information outside the financial statements that is both  
7 within the competence of the auditor and has a close  
8 nexus to the audit that was performed, that critical  
9 accounting policy disclosure is a rich source that  
10 potentially lends itself to some direct targeted form of  
11 auditor reporting.

12           MR. DOTY: One of the problems which I have as an  
13 aging securities lawyer holding a job for which I am not  
14 qualified and get no -- is to try to get below, to get  
15 beneath the objections that we hear in these meetings to  
16 determine how serious do they go. I mean, we have heard  
17 the words pernicious and undermines and -- there have  
18 been a lot of the adjectival -- the usual adjectival  
19 advocacy that comes with strong opinions from strong  
20 minds.

21           So mindful of that, I am trying to be sure that  
22 I understand what people whom I consider to be my mentors

1 mean. And I start with Alan Beller as one whom I  
2 consider to be my mentor.

3 And going back to your advice to the co-chairmen  
4 of ACAP, Alan, I do not understand your position to be  
5 that we can't have -- that we, at our peril, disclose  
6 anything new.

7 Going to Joe Ucuzoglu's comments, and picking up  
8 on your concern about risk factors and MD&A, there is  
9 nothing statutorily that keeps the auditor from saying  
10 more than they now say, transgressing this line of what  
11 is said by management and commented on by manager, and  
12 it makes me wonder, where would we be if we had not begun  
13 with risk factors and MD&A.

14 There has been some boilerplate that has vexed  
15 all of us, but I don't think you're saying that your  
16 proposal or your alternative formulation keeps the  
17 auditor out entirely of the area of saying something new.

18 MR. BELLER: I guess a couple of thoughts. One,  
19 I think if the auditor and the -- with respect to the  
20 specific proposal about critical accounting policies and  
21 estimates, I think if the auditor and the Audit Committee  
22 have the kind of conversation that I am used to having

1 with an auditor as a member of an Audit Committee what  
2 you would ideally get is better critical accounting  
3 policy and estimate disclosure by preparers and some sort  
4 of affirmative statement by auditors as to the -- it's  
5 all there. They have identified all of them, and they  
6 have described them correctly.

7           Just to be clear with what Joe said, I don't  
8 think of this as just another -- as part of the other  
9 information standard. I think it is -- I think auditors  
10 do enough work around critical accounting policies and  
11 estimates that it is fair to ask auditors to -- I'm not  
12 the standard setter, but you can -- you can develop a  
13 standard that would support an affirmative statement.  
14 Maybe it's a statement of negative assurance, but some  
15 kind of affirmative statement around critical accounting  
16 policies and estimates.

17           So that would not lead to -- unless the issuer  
18 said, (No, I'm not going to do that, and the auditor  
19 says, (I have to do that, then it goes in the audit  
20 report.

21           With respect to CAMs, beyond that, I guess two  
22 thoughts for you. One, I really do think if you get the



1 critical accounting policies and estimates right -- and  
2 I'm not sure they're right in the current disclosure  
3 regime. I don't think -- too much of it looks like  
4 Footnote 1 or Note 1 to the financial statements as  
5 opposed to what it should be.

6 But the answer to the question, what keeps the  
7 auditor awake at night ought to be in that list of  
8 critical accounting policies and estimates. It shouldn't  
9 be, "Oh, my goodness, I had to spend 60 more hours than  
10 I expected I would auditing the cash reconciliation of  
11 the intercompany accounts." And I'm honestly not sure  
12 that that is not a CAM under your current definition.  
13 So that's one thought.

14 Our comment letters have said this, my written  
15 presentation said it, the oral one did not -- if you're  
16 going to go the way of the auditor talking about the  
17 audit, one, Joe and I agree -- and I use the significant  
18 deficiency example just because it's so glaring to me,  
19 but it's not obviously the only issue. There shouldn't  
20 be auditor disclosure about issuer matters.

21 Secondly, there has to be -- in my view, there  
22 should be a much more powerful materiality filter than

1 there is in the proposal to get to the stuff that really  
2 is important. And the final point I would make because,  
3 I'm sorry, but the UK idea of materiality is \$500ámillion  
4 or 500 million pounds.

5 I understand that that is the way auditors begin  
6 their analysis, but I'll also tell you when I sat at  
7 Corpfin -- and I'm sure the SEC folks here today would  
8 agree -- the SEC is never and should never sign off on  
9 a quantitative materiality standard. You go down a very  
10 slippery slope if you start talking about, well,  
11 materiality for this company is \$300ámillion, because  
12 SAB-99 tells us correctly that that's not the way to  
13 think about it.

14 MR. DOTY: Mr. Kroeker? Sir?

15 MR. KROEKER: Thank you. I had a followup, Alan,  
16 and Professor Skinner perhaps as well, on the critical  
17 accounting policies and estimates. It occurs to me that  
18 is certainly one area where there is a big -- a potential  
19 for overlap with what we do at the FASB.

20 And to be clear, the first piece of this -- I'm  
21 speaking only on my own behalf. I'm not representing the  
22 Board in this view. But it does intrigue me as to

1 whether that means we ought to be thinking about perhaps  
2 folding critical accounting policies and estimates into  
3 a financial statement footnote requirement, which would  
4 then, by that very nature, require auditor direct  
5 association. They already have certainly association  
6 with those in the context of you need to know what those  
7 are in order to do your audit. But if you pulled that  
8 into direct obligations that we impose through GAAP  
9 standards, would that -- I guess what would be the pros  
10 and the cons of that? Would that address the auditor  
11 association?

12           And also perhaps might address, Alan, your issue  
13 of it looks today like Footnote 1, and maybe we could get  
14 rid of redundancy and focus those on what they are  
15 supposed to be focusing on.

16           MR. SKINNER: Yes. I mean, I would agree. I  
17 think that would be very helpful because my impression,  
18 similar to Alan's, is that that initial footnote, as it  
19 currently stands, is not very helpful. And I think the  
20 point I was generally trying to make was that having some  
21 form of consistency about what the issuer's disclosure  
22 requirements are, including the accounting standards and

1 what the auditor was reporting on, having those things  
2 meshed together I think is pretty important. And, I  
3 mean, the UK example, we are seeing that in a different  
4 form, but we are seeing that same thing.

5           The thing that concerns me a little bit about the  
6 U.S. proposal right now is that the auditors, you know,  
7 in some situations I think would go beyond what the  
8 issuer is currently required to disclose, whether it's  
9 through the FASB or the SEC regulations. And that is --  
10 we just don't know what that is going to do.

11           MR. DOTY: I have one more question, but I want  
12 to be sure my colleagues have a chance. Jay, do you have  
13 --

14           MR. HANSON: Yes, I've got one for Alan and one  
15 for Joe. So, Alan, you were heavily associated with  
16 ACAP, sat there during all of the discussions. And I  
17 thought it was interesting this morning on the panel, the  
18 opening panel, that most of the members here supported  
19 what we're doing relative to CAMs and the proposal, and,  
20 obviously, several wanted to go further than what we've  
21 done. And yet you're kind of in a different space than  
22 they are about this, and just your thoughts about not --

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1 I know you can't speak for other ACAP members, but just  
2 your thoughts about maybe why you're in a different place  
3 than some of the others are.

4           And before you answer, I'll just give Joe a  
5 question to think about, which is if you can just talk  
6 a little bit more about the field testing that you've  
7 done and maybe some of the discussions you have had with  
8 management and audit committees about the proposal,  
9 because we have more than 200 comment letters from  
10 preparers saying we don't like this, and you've probably  
11 had discussions with about 25 percent of those people  
12 that sent us comment letters, and just your thoughts and  
13 discussions that you had with the preparers about your  
14 views versus their views being against it.

15           So I'll turn to Alan.

16           MR. BELLER: I heard the back end of that panel.  
17 So I think perhaps the principal reason I'm coming out  
18 at a -- and I'm not sure it's a hugely different place,  
19 because some of what Jeff Mahoney said sounds a little  
20 bit like what I was saying in terms of focusing on the  
21 critical stuff and the policies and estimates and not  
22 into the weeds of the audit.

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1 I challenge the notion. I guess I have  
2 principally two answers for you. One, I challenge the  
3 notion that the details of the audit process are what --  
4 and, look, I'm not going to say investors shouldn't have  
5 what they think they want, because they're the investors  
6 and -- but the details of the audit process just strike  
7 me as much less important in terms of both of my  
8 objectives of enhancing understanding and making the  
9 audit better than some of the things I have been talking  
10 about.

11 The second reason is I think just your experience  
12 -- my experiences formed me. I spent a lot of time with  
13 the preparer community. I spent a lot of time with audit  
14 committees. And I -- you know, I can't deny the fact  
15 that I come with a little bit of that perspective. And  
16 I think that probably somewhat shapes my views.

17 I honestly have not spoken to -- and I have  
18 talked to a fair number of preparers. I'd love to hear  
19 what Joe is going to say, because I haven't talked to a  
20 single preparer who is really enthusiastic about this.  
21 I am more enthusiastic about it than they are.

22 MR. DOTY: Lewis?

1           MR. UCUZOGLU:     Well, you have found more  
2 preparers who are enthusiastic about this than I have.  
3 You had asked, Jay, about some of our experiences during  
4 the field testing process. I would say that the number  
5 one concern that has been articulated really relates to  
6 this possibility of the auditor disclosing original  
7 information about the company's financial accounting and  
8 controls.

9           And the subset of that broader set of concerns  
10 that is most often raised is this issue of the auditor  
11 disclosing a significant deficiency that management  
12 wasn't otherwise required to disclose. I suspect if the  
13 proposal were modified in such a way to alleviate that  
14 outcome that it would take a lot of noise out of the  
15 system. There have also been concerns raised about  
16 issues such as timing and the crunch to get the report  
17 out, concerns around or the effect on the dynamic in the  
18 board room with respect to auditor -- Audit Committee  
19 communications.

20           But, frankly, one can come up with a long list of  
21 the risks of doing something and moving forward. What  
22 I'm equally focused on is the risk of not doing

1 something. And I was struck by sort of one particular  
2 piece of Professor Mock's research; 91 percent of users  
3 of audit reports don't read it.

4           So if you're sitting in my shoes, and 91 percent  
5 of your customers don't read your basic product, what is  
6 the risk to the viability and relevance of the profession  
7 of not evolving to meet the information needs of  
8 investors? And that ought to be every bit as much front  
9 in mind as the risks which I believe are manageable of  
10 crafting the proposal in such a way that it can be moved  
11 forward.

12           MR. DOTY: Lewis?

13           MR. FERGUSON: I guess the question I have grows  
14 out of some of the discussion here, and particularly the  
15 assumption that there seems to be that the proposal that  
16 Alan had and Professor Skinner had that instead of our  
17 proposal on CAMs that what the auditor do -- should do  
18 is really comment on whether the critical accounting  
19 policies are the right ones and whether the information  
20 about them is correctly stated.

21           It seems to me in many ways they are quite  
22 different approaches in certain cases. They wouldn't



1 necessarily always be, and that's what I want to get to.  
2 But they are different approaches in the sense that we  
3 are asking the auditor to speak originally, but not about  
4 -- we are just asking the auditor to speak originally  
5 about what the auditor did, as Joe said. What did he do  
6 in the audit? And what were the critical matters?

7           And those may or may not intersect with the  
8 critical accounting policies. And it seems to me that  
9 we have at least come -- or at least I have come to  
10 believe, in listening to investors, that investors would  
11 like to hear about what the auditor did.

12           I mean, what I thought was interesting about the  
13 discussion about Footnote 1 is it strikes me that if the  
14 company is in fact adequately disclosing the critical  
15 accounting policies, in fact the auditor may do nothing  
16 but look at critical accounting policies. I mean, is  
17 that a fair statement? Does that reconcile things or  
18 not? Or are we in fact talking about two really quite  
19 different approaches here?

20           MR. BELLER: I think we are talking about two  
21 different approaches. I'm not sure they are completely  
22 different. I think they are related. And it goes back

1 to the question that we sometimes use to frame what we  
2 are trying to get to here, which is, what keeps the  
3 auditor awake at night?

4           And as a lawyer who thinks about financial  
5 reporting and financial statements and financial  
6 disclosure, and talks a fair amount to auditors, I think  
7 what keeps auditors awake at night is principally, I blew  
8 the audit and the numbers are wrong.

9           And, you know, the individual items of that  
10 question really should be -- and if they're not, issuers  
11 and auditors are not doing their jobs currently -- should  
12 be what is listed in critical accounting policies and  
13 estimates. Those are the things that are the likely  
14 items that will lead to a blown audit.

15           And if I'm an investor, that is what I really  
16 want to know the most. I take the point that investors  
17 want to know how auditors conduct the audit and what they  
18 scoped out, and that is a different point. But it is not  
19 a completely unrelated point to my vision of what keeps  
20 auditors awake at night. And I think you've got to kind  
21 of think about the two of them together.

22           MR. DOTY:     Joe?     Steve?     Is there another

1 comment? Sorry. Sorry, Doug.

2 MR. SKINNER: I just had one simple observation.  
3 Having read a number of the examples we now have from the  
4 UK, a lot of them actually do look quite similar to the  
5 critical accounting policies. I mean, if you look at the  
6 -- I've read the HSBC audit report that came out a few  
7 weeks ago, the Rolls Royce one. Some of the things are  
8 very similar, and the informative part is of course what  
9 the auditors did about this.

10 So I think there could be a fair bit of overlap  
11 between potential CAMs and what we are seeing in the UK.

12 MR. DOTY: Steve?

13 MR. HARRIS: I think I take the Sir Tweedie view  
14 that was expressed this morning about original  
15 information, I think, Alan, which is somewhat at odds  
16 with yours, and in terms of keeping the auditor awake at  
17 night, and more in lines of what, Joe, you were  
18 articulating. And nobody did more work on Sarbanes-Oxley  
19 and promoting the rules and regulations in a timely  
20 fashion or a more brilliant job than you did.

21 But I read Section 101 as giving the PCAOB  
22 considerable authority in this area and considerable

1 liberal authority in terms of information provided by the  
2 auditor to the user, or in this case the investor. I  
3 mean, 101 says -- which defines the mission (to protect  
4 the interests of investors in the preparation of  
5 informative audit reports.

6           And so what informative audit reports? I think  
7 what I'm hearing from users or investors is it goes a  
8 little bit beyond enhancing investor understanding of  
9 financial reporting. So I think there is a disconnect,  
10 and I think that to the extent that we can either bridge  
11 that disconnect, I think that it's important that we  
12 continue to focus on it, because I think once again there  
13 is the expectation gap in terms of what is expected from  
14 the audit report.

15           And then I'd just ask the question, in terms of  
16 your analysis and your testimony, which once again I  
17 thought was typically excellent, you focus a lot on the  
18 Treadway Report. But I'm wondering, what is your  
19 original statutory authority with respect to supporting  
20 your view about the auditor not providing original  
21 information about the company, putting aside whether we  
22 should or we shouldn't? Is there any statutory authority

1 along those lines, or is it just -- is it the --

2           MR. BELLER: I don't think -- I don't think this  
3 is -- let me be absolutely clear. I don't think this is  
4 a question of authority. I think 101 gives you the  
5 authority to make and adopt the proposal that you've  
6 made. I think the question is whether there is a better  
7 idea, but it's not -- do not misread me as saying you  
8 don't have the authority to do it. I don't think that's  
9 an issue. There may be others who disagree with me, but  
10 I don't think that's an issue.

11           MR. HARRIS: And then, how do you both -- we have  
12 asked this question of all the witnesses. How do you  
13 avoid the creeping boilerplate? And what do you put in  
14 the audit report? And what do you put in an appendix?

15           MR. UCUZOGLU: I will start, Steve. You know,  
16 this idea of an appendix has been raised at various  
17 times. And it is at least worthwhile to consider whether  
18 there is some important baseline information that doesn't  
19 change over time from year to year, and that folks ought  
20 to have access to sort of go back and refresh the basic  
21 confines of an audit, but that essentially clutters up  
22 the report and has the potential to obscure the really

1 important stuff that does change from year to year.

2           And so I wouldn't necessarily be averse to at  
3 least exploring the idea of some basic information about  
4 sort of, what is an audit, in an easily retrievable form  
5 or linked to a report. It is worth exploring.

6           With respect to the issue of boilerplate, there  
7 are a host of reasons that we are all well aware of as  
8 to why pressures might exist to move in that direction.  
9 But I actually believe that the most powerful tool that  
10 you have within your disposal is to make clear in the  
11 standard that some form of standardized, you know, I  
12 pulled this off the shelf for this industry -- you know,  
13 while it might serve as a guidepost in terms of you ought  
14 to think about these particular matters, and here is some  
15 of the types of information that might be relevant, that  
16 at the end of the day it ought to be a tailored  
17 communication and that you mandate that through the  
18 standard, which would, again, sort of put the auditor in  
19 a position of meeting the professional standard that we  
20 are required to tailor something specific to the  
21 circumstances of the engagement.

22           MR. DOTY: Jeanette, you have a parting shot

1 coming.

2 MS. FRANZEL: I'm struck a little bit by the  
3 hints of cynicism among the panel that the various  
4 players in the system will take this requirement and do  
5 the wrong thing with it. You know, they will quickly  
6 turn it into boilerplate. You know, auditors will stop  
7 communicating with audit committees, and management and  
8 auditor communications will be chilled.

9 And so I want to explore a little bit, because I  
10 think, Doug, you raised the issue about management and  
11 auditor communications and how that could deteriorate  
12 potentially with this type of a requirement. Alan, I  
13 think you raised the same concern. And, Joe, you thought  
14 that this is a manageable risk, so I'd like to hear all  
15 of your comments on that issue.

16 MR. SKINNER: Yes. I mean, I was just raising  
17 the general economic principle, which I think is pretty  
18 well established that whenever you change the disclosure  
19 regime, the mandated disclosure regime, whoever is  
20 subject to that disclosure are going to change their  
21 actions in some fashion. And I think, you know, it is  
22 likely this will happen.

1           Now, some people talked this morning about this  
2 happening in a positive way, that the auditors and the  
3 management had a more energetic discussion. So it may  
4 be a positive change rather than a negative change.

5           But, I mean, I don't think there is any doubt  
6 that, you know, some of -- the proposal, when you read  
7 it, says at some places things like, (Well, what the  
8 auditors are doing right now won't change. All we're  
9 doing is we are making that information available.

10           I think that is not the case. I think as soon as  
11 you disclose something you then are going to change  
12 economic behavior. And I think what I don't know and  
13 what is very hard to predict is how exactly that will  
14 change.

15           MR. DOTY: It has been a terrific panel. Ah, 50  
16 seconds, Alan.

17           MR. BELLER: Sorry?

18           MR. DOTY: Fifty seconds.

19           MR. BELLER: Okay. Jeanette, the cynicism, to  
20 the extent you are detecting it, comes out of thirty-plus  
21 years of experience. And it's not unique to your  
22 proposal. The MD&A suffers from this problem. Note 1



1 suffers from this problem. Critical accounting policies  
2 and estimates suffer from this problem.

3           One thought I have is I think -- I mean, when I  
4 was at Corpfin, we -- comment letters, stop writing  
5 boilerplate. It's a long, slow struggle. One thing,  
6 aspirationally, I would suggest, not just what Joe was  
7 talking about but all three agencies take an initiative  
8 to try to encourage preparers, auditors, to do a better  
9 job of that kind of -- of that kind of disclosure.

10           On the cynicism about audit committees -- the red  
11 light is on, so I'm not going to say anything.

12           MR. DOTY: Eternal vigilance.

13           This has been an extraordinary panel. You all  
14 have made a great contribution to the dialogue. Thank  
15 you.

16           I am going to introduce the new panelists as you  
17 all vacate and as they come to the rostrum. We are on  
18 time and we are going to stay on time, but thank you all.  
19 This has been wonderful.

20           This panel -- we have -- we are now going to  
21 focus on -- this was a panel that showed the range of  
22 perspectives on this proposal. We are now going to talk

1 about critical audit matters related to the audits of  
2 large companies, and we have an extraordinary panel.

3           Ann Cavanaugh has been a Managing Director and a  
4 global head of accounting policy at BlackRock since  
5 December 2011. She is a member of BlackRock's New  
6 Products Review Committee, which analyzes and approves  
7 new products offered to clients, and their Global  
8 Valuation Committee.

9           She is involved in the firm's project to assess  
10 IFRS implementation and is one of 35 women selected to  
11 participate in BlackRock's inaugural Global Women's  
12 Leadership Program. She served as the Director of  
13 Accounting Policy at BlackRock from July 2008 until  
14 December 2011. She previously served as the Director of  
15 Accounting Policy at Merrill Lynch from October '85 --  
16 '95 until July 2008.

17           Wallace Cooney is Vice President of Finance and  
18 Chief Accounting Officer of Graham Holdings Company,  
19 where he is responsible for accounting, internal and  
20 external financial reporting, consolidated budgeting and  
21 forecasting and income taxes.

22           Previously, he was Director of Consolidation

1 Accounting and Financial Reporting at Gannet, where he  
2 directed internal and external financial reporting, and  
3 before joining Gannet he was an auditor at  
4 PriceWaterhouse.

5 He serves on the Committee on Corporate Reporting  
6 of Financial Executives International, a current member  
7 of our standing advisory group. And it is always good  
8 to see Wallace here.

9 Kevin Reilly, America's Vice Chair, Professional  
10 Practice and Risk Management, Ernst & Young. He is  
11 responsible for the national office accounting, auditing,  
12 and U.S. Securities and Exchange Commission reporting  
13 functions. He oversees the quality and the risk  
14 management activities of the firm's assurance practice.  
15 He has been with the firm for more than 30 years during  
16 which he served as a coordinating partner for major  
17 clients and the media and entertainment sector and for  
18 financial services, private equity industries.

19 He previously served on FASB's Financial  
20 Accounting Standards Advisory Council, a current member  
21 of the PCAOB's standing advisory group.

22 Aulana Peters, a former partner of the law firm

1 of Gibson, Dunn & Crutcher from '84 to '88, a  
2 Commissioner of the SEC from 2001 to 2002. She was a  
3 member of the Public Oversight Board of the AICPA. She  
4 has also served as a member of the FASB's Steering  
5 Committee for its financial reporting project and is a  
6 member of the Public Oversight Board's Panel on Audit  
7 Effectiveness.

8 She serves also on the Comptroller General's  
9 Accountability Advisory Council and the Board of Trustees  
10 of the Mayo Clinic, a director of Northrop Grumman, 3M,  
11 and Deere & Company. And she also served on the board  
12 of Merrill Lynch during the past five years.

13 A panel extraordinarily well qualified to talk  
14 about this in terms of the impact on major companies.

15 Ann, would you please proceed? Thank you.

16 MS. CAVANAUGH: So thank you for the opportunity  
17 to be here today and share BlackRock's views regarding  
18 the proposed changes to the auditor's reporting model.

19 For most of you -- I'm going to assume they  
20 already know -- BlackRock is a global investment manager,  
21 overseeing approximately \$4.3 trillion of assets under  
22 management at year-end 2013. BlackRock, together with

1 its subsidiaries, manage approximately 3,400 investment  
2 vehicles, including registered investment companies,  
3 hedge funds, exchange traded funds, collective trusts,  
4 as well as separate accounts.

5           As an investment manager, we are in the unique  
6 position to provide commentary on the proposal from  
7 several different perspectives. One, that of a corporate  
8 preparer; two, that of an investment fund preparer; and,  
9 three, as a user. For purposes of my remarks today, my  
10 response primarily will reflect those of our research  
11 analysts as users of both financial statements and  
12 auditor opinions.

13           So overall we commend the PCAOB for undertaking  
14 a project to enhance auditor communications and provide  
15 information useful to users of financial statements.  
16 Overall, we support the concept of communicating critical  
17 audit matters and believe that much of the framework will  
18 provide useful information.

19           As users of financial statements, our analysts  
20 have expressed that they find value in identifying  
21 critical audit matters, particularly matters resulting  
22 from changes in principles or in areas that involve

1 significant judgments, which therefore may require  
2 further analysis and discussion with management in order  
3 to be properly understood and reflected in their analyst  
4 models.

5           The additional information provided will be  
6 particularly useful to our analysts to the extent that  
7 it provides a better understanding of financial risks,  
8 including future cash flows of a company.

9           We are concerned, however, that some investors  
10 may misinterpret the communication of a critical audit  
11 matter as indicative of an issue with respect to the  
12 quality of financial statements. And, as a result, we  
13 would suggest additional language be added to the  
14 auditor's report to explain that critical audit matters  
15 are not necessarily indicative of a financial statement  
16 deficiency.

17           We wish to emphasize that certain entities, such  
18 as 1940 Act investment companies, have inherently less  
19 complex business models than traditional operating  
20 companies, and, therefore, may not warrant disclosure of  
21 critical audit matters.

22           Because mutual funds assets are primarily

1 invested in securities, it is likely that the only fair  
2 valuation of investments would be deemed a critical audit  
3 matter. Given the extensive disclosures that are already  
4 required under the FASB's Accounting Standards  
5 Codification 820, we recommend clarifying that routine  
6 audit procedures, such as testing Level 1 and Level 2  
7 fair valuation inputs would not be deemed critical audit  
8 matters, absent significant judgments therewith.

9           Accordingly, we would suggest there should be a  
10 rebuttable presumption that the auditor's report on most  
11 investment companies state that there are no critical  
12 audit matters to communicate.

13           From a preparer's perspective, we do believe  
14 there will be additional time and expense associated with  
15 interacting with and providing information to auditors  
16 in connection with the required assessments and reporting  
17 of critical audit matters and their documentation of such  
18 matters.

19           We do not believe that the auditor should be  
20 required to document why all other possible critical  
21 audit matters were not included as critical audit matters  
22 in the auditor's report.

1           We continue to recommend that the description of  
2 critical audit matters in the auditor's report exclude  
3 audit procedures performed or an indication of the  
4 resolution. In order for the auditor to convey the  
5 context around such matters, it may be necessary to  
6 include expansive details that could overwhelm the  
7 auditor's report.

8           Additionally, inclusion of such information may  
9 lead a user to believe that the auditor is expressing a  
10 piecemeal opinion on individual matters, and any given  
11 -- and any audit procedures enumerated may be taken out  
12 of context or misunderstood, given their necessarily  
13 abbreviated descriptions.

14           Furthermore, we are concerned it may be difficult  
15 to succinctly convey the nature of an audit procedure in  
16 a manner that qualifies -- I'm sorry, in a manner that  
17 provides users with an understanding of the full scope  
18 of these procedures and the quantitative and qualitative  
19 factors that went into reaching their decision.

20           We recommend that the Board clarify that  
21 highlighting audit procedures should be infrequent.  
22 However, if included, only those most significant



1 procedures should be identified and then only when it is  
2 important to understanding why the matter was identified  
3 as a critical audit matter.

4           With regard to the auditor's responsibilities for  
5 other information, BlackRock supports including a  
6 statement clarifying the auditor's responsibility for  
7 other information and documents containing financial  
8 statements. We do not, however, support changing the  
9 auditor's responsibility for other information to  
10 evaluate such information versus the current requirement  
11 to consider the information.

12           We believe that the scope of the audit procedures  
13 involved in evaluating the material inconsistency and  
14 material misstatement of fact criteria should be related  
15 solely to financial information included in the filing,  
16 such as MD&A and exhibits, and should not extend to  
17 documents incorporated by reference, some of which may  
18 have been superseded, and should not extend to other  
19 non-financial information.

20           Such procedures are not routinely performed today  
21 on documents incorporated by reference, contrary to the  
22 statements that were included in the proposal which

1 states that the Board believes, in practice, some  
2 auditors currently perform procedures related to other  
3 information similar to procedures in the proposed other  
4 information standard.

5           However, if procedures are applied to other  
6 non-financial information, these criteria may require  
7 significant judgments given the complexity of many  
8 corporate agreements. We do not believe that the costs  
9 associated with such procedures, including preparation  
10 of related audit documentation, would justify the benefit  
11 received.

12           Many analysts and users of financial statements  
13 already assume that MD&A and exhibits are read by the  
14 auditors for consistency with the financial statements.  
15 And, therefore, we believe that reporting on those  
16 procedures performed would clarify the auditor's role and  
17 responsibility.

18           In closing, we support the Board's efforts for  
19 increased transparency and providing additional useful  
20 information to users of financial statements. As users  
21 of financial statements and auditors' reports, our  
22 analysts have stated that succinct disclosure of critical

1 audit matters in the report is a step forward toward  
2 accomplishing that goal.

3           We encourage the PCAOB to work together with the  
4 IAASB to standardize, to the extent possible, the form  
5 and content of the auditor's reports in order to increase  
6 comparability and ease of use for users who may be  
7 readers of reports subject to both sets of standards.

8           Thank you for your time and attention to this  
9 matter.

10           MR. DOTY: Thank you.

11           Wallace Cooney?

12           MR. COONEY: Good afternoon. Thank you for  
13 hosting the public meeting and inviting me to participate  
14 on the panel. This project has been underway for many  
15 years now, and I commend the Board for all the outreach  
16 that has been undertaken during this time. The Board has  
17 shown great interest in hearing from all interested  
18 parties on this topic over a long period of time.

19           Management has a very distinct role, so I will  
20 offer my observations on the proposed reporting of CAMs  
21 from a financial statement preparer perspective. I  
22 believe that my observations are shared by many in the

1 preparer community.

2           On several occasions, the Board has pointed out  
3 that the auditor's report has changed very little since  
4 the forties. Just from a personal standpoint, I don't  
5 really see it that way, since the opinion was expanded  
6 in 2004 to include a report on the internal control over  
7 financial reporting. And from a preparer's standpoint,  
8 that was a huge change, a major overhaul, that  
9 fundamentally expanded and changed the financial  
10 reporting process and the audit process. At many  
11 companies, audit fees doubled or tripled as a result of  
12 this new requirement.

13           My hope is that the Board will consider the  
14 implementation problems with ASÁ2 as they deliberate on  
15 the best approach for this project.

16           Another point I'd like to make is from a preparer  
17 perspective, receiving a clean opinion is a major  
18 accomplishment each and every year. A lot of effort is  
19 undertaken by management and auditors. It is substantial  
20 and costly from the more routine and material components  
21 to highly subjective, judgmental, and complex areas.

22           A clean opinion comes at the end of a very

1 comprehensive and robust audit process and only once all  
2 important matters are resolved and many, many questions  
3 are answered and lots of dialogue and supporting  
4 documentation and discussion. And at the end of the day,  
5 the auditors need to be fully satisfied in terms of  
6 resolving all of those issues. So I believe a clean  
7 opinion should mean a lot to investors.

8           With respect to CAMs, overall, I have concerns  
9 about the proposal as drafted. The examples, quite  
10 frankly, are more troubling than some of the concepts.  
11 And so I believe it's imperative that the Board lead a  
12 comprehensive field test to assess whether the proposal  
13 will produce the information that investors are seeking  
14 at an acceptable cost.

15           With respect to the proposal, it does not include  
16 an AD&A, which was of great concern to the preparer  
17 community. The CAM approach, however, does have some  
18 elements that we have similar concerns with as follows.  
19 My primary concern relates to preserving and not  
20 confusing the distinct roles of management, auditors, and  
21 Audit Committee.

22           Management is responsible for financial statement

1 preparation and the footnotes and ensuring full  
2 disclosure of important qualitative and quantitative  
3 financial information, including the MD&A. Open  
4 communication between auditors, management, and the Audit  
5 Committee is vital to this process.

6         The proposal, in certain cases, could require  
7 auditors to be the original source of new information as  
8 well as highlighting potentially items that aren't  
9 particularly important.

10         The audit report, in my view, should not be used  
11 as a vehicle to communicate new information. This will  
12 serve to inhibit a healthy and well-functioning financial  
13 reporting process. And if there are shortcomings in the  
14 financial reporting model currently, the FASB or the SEC  
15 should work to address these concerns. And management  
16 will take the lead on improving whatever shortcomings are  
17 of concern.

18         Written auditor communications, from my  
19 standpoint, are really the beginning part of a dialogue  
20 between auditors and audit committees. And the written  
21 reports have limited value without the important  
22 discussion that takes place between auditors and audit

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1 committees as well as management. Ideally, all important  
2 matters are discussed in detail, context is provided,  
3 there is an opportunity for a robust dialogue and  
4 followup on specific questions or concerns as necessary.

5           With CAMs included in audit report, there really  
6 would be no effective mechanism for any dialogue with  
7 investors. In certain cases, this could result in  
8 questions coming to issuers about an auditor's report,  
9 about what they might have meant in talking about a CAM,  
10 which would put issuers in a difficult position.

11           As I mentioned earlier, the CAM examples in the  
12 proposal are of significant concern. Disclosure by the  
13 auditor of a significant deficiency is not currently  
14 required, so this example is in direct conflict with  
15 existing rules. Discussion of an immaterial corrected  
16 error would not, in my view, seem appropriate for  
17 discussion as a critical audit matter. Since management  
18 isn't required to disclose these matters, I don't believe  
19 it is appropriate for the audit report to provide detail  
20 on them.

21           I am also concerned that auditors will err on the  
22 side of including too many CAMs, and they will spend too

1 much time documenting why certain matters should not be  
2 included as CAMs. This could worsen the so-called  
3 disclosure overload problem that is subject -- by the SEC  
4 currently.

5           And from my personal experience, auditors, in my  
6 view, should spend more time performing audit work, less  
7 time documenting the work that they have done.  
8 Documentation requirements are overwhelming audits and  
9 could be an obstacle to auditors spending time on  
10 important issues.

11           Much of the work on CAMs is expected to be  
12 completed near the end of the audit -- another concern  
13 because it could be a distraction for auditors and  
14 management as they are wrapping up critical areas. The  
15 proposal is also unclear but seems to imply that a  
16 discussion of audit procedures with respect to critical  
17 audit matters is preferred. And, in my view, quite  
18 frankly, talking about audit procedures may be more  
19 appropriate than analysis of management's financial  
20 statements.

21           I am concerned about audit fees potentially  
22 rising and would encourage a robust cost-benefit



1 analysis.

2           Lastly, there is no substitute for actually  
3 reading the financials, and I think there is some risk  
4 that an auditor's report that included CAMs could be used  
5 by a reader as a shortcut, a cheat sheet, that investors  
6 would rely on to dummy down the extensive and important  
7 disclosures that an investor gains from actually reading  
8 the entire financial statements and the 10-K.

9           MR. DOTY: Should we drop the project and forget  
10 about it?

11           (Laughter.)

12           You don't have to commend us if you think we  
13 should drop the project and forget about it. Is that --

14           MR. COONEY: I actually don't --

15           MR. DOTY: No change in the binary model?

16           MR. COONEY: I actually don't think you should  
17 drop the project. I had a few --

18           MR. DOTY: I'm waiting for the reason why.

19           MR. COONEY: I have a few other just overall  
20 general comments. I think that at the end of the day my  
21 personal opinion is the CAM approach has a lot of risks  
22 associated with it. The concept release talked about

1 required emphasis of matter paragraphs. I think that  
2 approach would be preferred.

3           The other idea that has been discussed was some  
4 type of auditor association with critical accounting  
5 policies and estimates. And I think, again, that would  
6 be a preferred approach in general.

7           If the CAM approach is continued, I believe that  
8 the requirements should be tightened to avoid the  
9 unintended consequences and to make the process more  
10 efficient.

11           That concludes my remarks.

12           MR. DOTY: Kevin Reilly?

13           MR. REILLY: I thought the last panel solved all  
14 the CAM-related issues, so I'm a little uncertain as to  
15 what you want me to cover, Mr. Chairman. But I thank you  
16 and appreciate the opportunity to be with you today and  
17 talk about issues surrounding the projects, specifically  
18 as they may relate to critical audit matters or CAMs.

19           My firm, and the profession more broadly, has  
20 been supportive of exploring ways to improve the  
21 informational value of the auditor's report, and we  
22 commend the Board and the staff -- Marty tells me the

1 staff does all the work around here -- for the many  
2 efforts on this project. And I certainly hope that the  
3 Board has found the many suggestions we have raised in  
4 our letters, our comment letters, including those from  
5 the Center for Audit Quality, to be constructive and  
6 helpful as you work through this challenging effort.

7 I also want to acknowledge and appreciate the  
8 work of Arnold Schilder and his team from the IAASB as  
9 they pursue and tackle the similar issues.

10 My firm, Ernst & Young, is supportive of the  
11 concept of CAM disclosure in the audit report, be it with  
12 a C or a K, and believe the concept, if it is properly  
13 developed, could help investors focus on aspects of the  
14 company's financial statements that were important or  
15 challenging in the audit.

16 But I think the real lightning rod on the CAM  
17 front doesn't so much involve the identification of the  
18 CAM; it really revolves around what the auditor should  
19 say about the CAM in the audit report.

20 The proposing release notes that the report  
21 should identify the CAM, describe the considerations that  
22 led the auditor to conclude that the matter is a CAM, and

1 then reference where that matter is covered, where  
2 applicable, in the company's financial statements.

3           We understand these broad objectives, and we  
4 think this general framework makes sense. However, we  
5 do have some significant concerns with how the approach  
6 has been applied in crafting the specific examples that  
7 appear in the proposing release.

8           Wally touched on some of those concerns. You  
9 have heard them front and center relative to the many  
10 comment letters that we have seen, the original  
11 information issue that was covered in the last panel, the  
12 redundant, potentially lengthy repetitive disclosures  
13 that may appear in the audit report, a discussion about  
14 audit procedures and how that could lead some to conclude  
15 the auditor is issuing a piecemeal opinion.

16           And, last but not least, you know, the example  
17 language focused so much on the difficulties and  
18 challenges faced by the auditor in a particular area that  
19 it left me wondering whether we are serving to undermine  
20 the company's accounting and reporting for that very  
21 matter.

22           So, Mr. Chairman, you raised a good question at

1 the last panel which is, okay, well, smart guy, what is  
2 really bothering you with respect to what is proposed?  
3 So let me give you some granularity with respect to that  
4 question.

5           So go to the deferred tax valuation allowance  
6 example that is contained in the proposing release. It  
7 has four paragraphs, runs for a page and a half, uses the  
8 term (difficult or (difficulty a half dozen times. And  
9 I get it; deferred taxes are challenging.

10           The example also highlights a number of very  
11 specific matters we thought would be company disclosure  
12 areas, such as the occurrence of an unexpected cost  
13 increase in an important component part that is expected  
14 to unfavorably impact future profitability.

15           The example also makes reference to various audit  
16 steps or actions, such as consultations with others  
17 outside the engagement team, that we don't really see as  
18 particularly relevant to the overall disclosure. We  
19 think the overall objective -- to inform financial  
20 statement users of those matters that were truly  
21 important or challenging in the audit -- can be met with  
22 a much more pragmatic approach.

1           This alternative would require a crisp,  
2 fact-based outline of the issue that does not compete  
3 with the company's disclosure or reflect original  
4 information about the entity, to an outline of the  
5 principal reason and not a checklist of any and all  
6 influences that may be in the mix, but the principal  
7 reason why the auditor believes the matter is a CAM.  
8 And, finally, a reference to where the matter is covered  
9 in the company's financial disclosures.

10           So let me boil that down to how this approach  
11 would differ from what is reflected in the proposing  
12 release. So we think this approach could distill the CAM  
13 in two or three sentences, and let me read the suggested  
14 format for you. "Our assessment of the company's  
15 evaluation of the realizability of deferred tax assets  
16 and the related determination of the valuation allowance  
17 required for such assets was a critical audit matter in  
18 the audit of the company's financial statements.

19           Deferred taxes are material to the financial  
20 statements. The company's realizability assessment  
21 involves many complex and subjective judgments, including  
22 those used to prepare forecasts of future taxable income,

1 and this was a challenging audit area.

2           The company's accounting policy for deferred  
3 taxes and its valuation of the realizability of deferred  
4 tax assets are covered in Notes 2 and 12 to the financial  
5 statements."

6           We think this approach -- it's shorter and more  
7 to the point -- still accomplishes the objective --  
8 telling investors what were the critical audit matters  
9 faced by the team in the execution of the audit.

10           I expect one reaction to the suggestion is that  
11 it will potentially drive some to have CAM disclosures  
12 take on a more standardized language format. It's clear  
13 boilerplate is now viewed as the new four-letter word in  
14 this discussion.

15           I fully appreciate that some are calling for this  
16 project to drive audit report disclosures of special  
17 insights, views, or impressions on a company's financial  
18 reporting. We think attempts to meet such objectives  
19 could lead to some harmful consequences.

20           In a more freeform writing world, two different  
21 auditors could have different views and perspectives on  
22 similar fact patterns. The resulting diversity in what

1 might be said, and how matters might be characterized in  
2 the two instances, could lead to misinterpretations by  
3 financial statement users.

4           Do more details point to more problems with the  
5 company's account? Do more details or color commentary  
6 on the audit -- does it really point some towards a more  
7 thorough audit? I don't think so, and I think those are  
8 some of the harmful and unintended consequences that  
9 could be achieved if we head in this direction.

10           We think a concise articulation that is to the  
11 point, even if the description becomes somewhat  
12 standardized, would nonetheless be valuable to users of  
13 the financial statements. We also think that  
14 highlighting the CAM in the audit report will lead to  
15 improved financial reporting in those identified areas  
16 for the benefit of investors and other financial  
17 statement users.

18           So, to sum up, we support CAM. We have some  
19 significant indigestion relative to the examples in the  
20 proposing release. We are hopeful that the approach I  
21 have outlined could be considered by the Board and staff  
22 in terms of moving this ship forward. And I look forward



1 to your questions on this area.

2 MR. DOTY: Thank you.

3 Aulana Peters?

4 MS. PETERS: Good afternoon, all. Thank you for  
5 this opportunity to share my views on the Board's Release  
6 Number 2013-005 on changes -- proposed changes to the  
7 auditor's report.

8 As you know from my written statement, I firmly  
9 believe that users of financial statements could benefit  
10 from an expanded audit report, and I support the PCAOB's  
11 efforts to improve the current form of auditor report.

12 The question is, of course -- and all of the  
13 panels today have tried to answer this question -- what  
14 should the auditor's report communicate? In my view, the  
15 contents of the report should relate directly to and  
16 illuminate the auditor's opinion. Therefore, it should  
17 include more information about the audit process, and  
18 also my friend Alan Beller is not going to be happy to  
19 hear me say that. Are you still here?

20 (Laughter.)

21 About the audit process and the approach, the  
22 audit approach, so that users of financial statements

1 better understand the role and responsibilities of the  
2 auditor. In other words, I would focus on information  
3 designed to reduce the expectation gap, and that rather  
4 than to rebalance a lack of symmetry between information  
5 accessible and available to management and that available  
6 to investors.

7 I was going to -- but I am going to make a point  
8 now that I was going to save to the last, and that is  
9 about the investors about whom we should be concerned,  
10 that we are concerned about. These investors, I would  
11 like to emphasize, are institutions with -- and powerful  
12 institutions with considerable resources. I will only  
13 say that. And that the lack of symmetry I think is more  
14 perceived than real and actual.

15 That is not to say that they don't -- shouldn't  
16 get some of what they are asking for, but the Board  
17 should keep in mind that these are not uninformed and --  
18 well, just uninformed individual investors.

19 The Board's proposed standards for audit reports  
20 that express an unqualified opinion would require the  
21 auditor to identify and address critical audit matters,  
22 CAMs, which are defined as -- and this is -- I paraphrase

1 it, so you can pull me up short if I'm doing so  
2 inappropriately -- defined as (matters which the auditor  
3 found to be the most challenging and difficult to audit  
4 with respect to the complexity of the issue presented,  
5 the amount of effort required, and the ability of the  
6 auditor to obtain sufficient, appropriate evidence.

7           This definition, while it focuses most certainly  
8 on issues that auditors must and do address, does not  
9 seem, in my reading of the release and the standard, does  
10 not seem to take into account the notion of materiality  
11 or the fact that auditors apply a risk-based approach in  
12 performing their audits today, not only in planning them  
13 but in, also, executing them.

14           I would suggest that the factors that should be  
15 used to define CAM should be based on what the auditor  
16 determines presents the greatest audit risk and the  
17 greatest risk of material misstatements in the  
18 financials, whether due to error or fraud. In my view,  
19 such information would be much more useful to the user  
20 of financial statements and understanding the auditor's  
21 opinion on those statements.

22           Again, in my reading of the release and the

1 language in the proposed standard, the focus on requiring  
2 the auditor to report problems and challenges encountered  
3 during the audit, rather than to outline the process  
4 through which the auditor reached his or her opinion in  
5 question. That is the focus. My concern about this  
6 approach is that matters which present the auditor with  
7 significant challenges and require a lot of effort to  
8 audit may not be material and may not present a risk of  
9 material misstatements in the financials, or they may be  
10 completely unrelated to management's financial condition.

11 As the Board knows, if auditors encounter  
12 difficulties, they are resolved during the course of the  
13 audit, thus requiring a detailed account of challenges  
14 and difficulties, all of which have been either  
15 eliminated or resolved before the unqualified opinion is  
16 issued, in my view is more likely to cloud the reader's  
17 view of a final audit result and might undermine the  
18 value of the auditor's pass-fail opinion.

19 For me -- this probably will reveal that I watch  
20 far too much television -- they are just sort of like  
21 asking the auditor to perform an autopsy on a living  
22 patient. If you've given a pass-fail, the patient is

1 still alive. We should not be performing a post mortem  
2 in that respect.

3 I think that an audit report structured on a --  
4 this is the lawyer coming out. If I didn't like the  
5 definition, I am going to suggest another one. So, but  
6 I think we get to the same place. I would recommend that  
7 the definition of "CAM" focus on identifying the most  
8 significant risks of misstatements and the specific  
9 financial misstatements, whether due to error or fraud,  
10 and the risk that the audit procedures selected and  
11 applied selectively might not uncover such misstatements.  
12 That approach would be, in my view, far more useful in  
13 understanding the auditor's opinion and the financial  
14 statements themselves.

15 Significantly, if the auditor's report focused on  
16 how the auditor planned and executed the audit with the  
17 greatest risks in mind, I believe that the most complex,  
18 the most subjective, and the most challenging matters  
19 should be revealed in any event in that process and  
20 discussed, albeit in a different context -- the context  
21 of what were the risks as opposed to what were the  
22 problems.

1           One final point, and I'm just going to say it  
2 because everybody else has pointed to significant  
3 deficiencies, which I believe the standard would require  
4 disclose, or at least that's what the panel seemed to  
5 indicate. And putting my Audit Committee hat on, I  
6 really do agree with the suggestions that that would not  
7 be beneficial necessarily to users of the financial  
8 statements.

9           In my experience as an audit committee, of  
10 course, these significant deficiencies are reported on  
11 an ongoing basis. But I can tell you that the two or  
12 three that might be reported in a quarter, most of the  
13 time there is something new in the second quarter and the  
14 third quarter and the fourth quarter. And frequently,  
15 of the significant deficiencies that are uncovered either  
16 internally by the Finance Department or the external  
17 auditor, they are resolved before they are even disclosed  
18 to the Audit Committee.

19           As I sit here -- and I am in favor of full  
20 disclosure -- I really do not see that it advances the  
21 goal of understanding the opinion on the financial  
22 statements to know that there were five or six

1 significant deficiencies that were all resolved and that  
2 did not have a material effect on the final product.

3 Thank you very much.

4 MR. DOTY: Thank you.

5 Steve Harris, questions?

6 MR. HARRIS: Yes. I was struck on the last panel  
7 -- I'm not sure I remember who the panelist was. I think  
8 it may have been Joe Ucuzoglu who mentioned it, where he  
9 said that 91ápercent of the users do not read the  
10 product. I have heard that before; the percentage may  
11 differ.

12 But my feeling is that if we have a report, the  
13 report ought to be read and it ought to be informative.  
14 And so the question is, how do we get a report which is  
15 read and informative?

16 And then, Aulana, you know, getting back to you,  
17 you stressed, you know, by and large we are dealing with  
18 the BlackRocks of the world, although you mentioned  
19 BlackRock, but you used institutional investors -- no,  
20 no, you used the term (institutional investors. But I  
21 don't want to believe that the retail investor is dead  
22 and buried in this country. Hold on for a second. So

1 what I want to do --

2 (Laughter.)

3 So what I want to do is I want to try and figure  
4 out, how do we get an audit report which is read and used  
5 not only by the institutional investor, who is plenty  
6 sophisticated, but the individual investor? And what do  
7 we do, and what's critically important?

8 But that was -- I wasn't addressing the comment.  
9 I was going to -- because you can all answer that. But  
10 I did have a question, and I --

11 MS. PETERS: I would defer to Kevin for your  
12 first question, and then I'm happy to address the second  
13 one if you'd like.

14 MR. HARRIS: The clock ticks. I wanted to ask  
15 Ms. Cavanaugh a question, because you indicate here that,  
16 (we recommend clarifying that routine audit procedures,  
17 such as Testing Level 1 or 2 fair valuation inputs would  
18 not be deemed critical audit matters, absent significant  
19 judgments therewith. I think everybody would agree with  
20 that.

21 MS. CAVANAUGH: Right.

22 MR. HARRIS: The question I have got is, what do



1 we do about Level 3? And where should that be reported?  
2 And for all practical purposes, it can't be valued or  
3 it's very difficult to value. So does that have any  
4 place in the audit report, or where does that come up?  
5 And where should that be disclosed to the investor? So  
6 I know there are a lot of questions up there. Go for it.

7 MS. CAVANAUGH: We were -- I was intentionally  
8 silent when I put that paragraph together because I do  
9 think when it comes to Level 3 there may be, when you're  
10 talking about hard to -- difficult-to-value securities,  
11 that may be something that would warrant a CAM  
12 disclosure. And I think that's one of the reasons why  
13 -- there was a question in the proposal that said,  
14 (Should certain entities be completely scoped out,  
15 meaning investment companies, and we don't think they  
16 should be completely scoped out. We think you have to  
17 look at the nature of what the transactions are.

18 So for Level 3s, they may warrant CAM disclosure.

19 MR. REILLY: Steve, on your first question, the  
20 91 percent, I would submit to you that I do think  
21 financial statement users do use the report. When you  
22 say, (Read the report, I think they focus in on one

1 thing, which is the binary nature of pass-fail. And if  
2 it's a pass, move on. If it is not a pass, or there is  
3 an emphasis of matter paragraph being stressed in the  
4 report, I do think those reports get a lot of focus.

5 MS. PETERS: Steve, I can count on you for  
6 seizing the wrong end of my double-edged sword, in terms  
7 of the comment that I make. I did not -- I'm not going  
8 to back off my remarks that most -- 90 percent of the  
9 investors out there are institutional investors, but I  
10 also said they deserve the information that they need to  
11 make their investments.

12 However, my point is that there really -- I don't  
13 think there are any more investors like you and me. I  
14 don't rely on my own acumen, investment acumen in making  
15 investments. I turn to my financial planner to do that.  
16 Warren Buffet does that. So I really think that your  
17 focus needs to be on making a useful audit report that  
18 does not muddy the waters, that really gives information  
19 that illuminates and focuses on, what does this audit  
20 opinion mean?

21 And from my point of view, it would be requiring  
22 the auditor not to discuss problems and like -- and

1 making his job seem more Sisyphus-like than it perhaps  
2 really is, but would discuss the actual audit and what  
3 the risks were and how they address those risks.

4 MR. COONEY: I would just make one comment.

5 MS. PETERS: And not many from Missoula will  
6 understand that.

7 MR. COONEY: With respect to level of knowledge,  
8 I think at the outset at least we had commented that it  
9 would seem reasonable that the Board would expect users  
10 to be reasonably well-educated. And I guess from my  
11 standpoint the audit report could certainly highlight  
12 areas, whether it's through a matter of emphasis or  
13 whether it's through some type of association with the  
14 critical accounting policies for users.

15 But, really, I think any reasonably well-educated  
16 investor should be able to look at an annual report, go  
17 through the MD&A and the financials, and there is a lot  
18 of information in there. And I'm not sure it's  
19 necessarily the auditor's job to go back and pull out all  
20 the pieces of information that someone might find  
21 important. That's really an investor's job to do that.

22 MR. DOTY: Jay? Oh, of course.

1 MS. CAVANAUGH: One other comment I wanted to  
2 add. I think, you know, from speaking to our analysts,  
3 their prime concern is they are interested in cash flows,  
4 companies, financial risks. And by at least highlighting  
5 the CAMs, without giving a lot of detail, it at least  
6 alerts them to discussions that they then may want to go  
7 back and discuss with management. It allows them --  
8 pinpoints to them what particular areas are that they  
9 really need to get more information on.

10 So they don't expect everything to be in the  
11 auditor's report. I think that would be -- what we heard  
12 is disclosure overload. But what are those key points  
13 that they can then take back to management and drill  
14 deeper on?

15 MR. FERGUSON: Okay. I have a question that is  
16 directed I guess to the whole panel but primarily to  
17 Kevin as a preparer and to Ann as an investor, a user of  
18 financial statements. And it's a question I seem to keep  
19 asking and it may reflect --

20 MR. REILLY: I'm not a preparer. That would be  
21 a clear independent --

22 (Laughter.)

1 MR. FERGUSON: Whatever it is you are.

2 MR. REILLY: Let the record show --

3 (Laughter.)

4 MR. FERGUSON: I know you're relevant. I don't  
5 know what you are, but I know you're relevant to my  
6 question.

7 This question may reflect either my fixation or  
8 my lack of imagination. But, you know, we're doing this  
9 project in the midst of a lot of stuff that is happening  
10 in the world. And we are actually beginning to see some  
11 real examples of new models that are out there. The UK  
12 has one, the Netherlands is now doing it, Arnold Schilder  
13 has got a proposal that is very close to ours.

14 And as either a firm that has audited financial  
15 statements and has had to write audit opinions in the  
16 United Kingdom, or for you who I assume have investments  
17 in companies in the United Kingdom and in the  
18 Netherlands, where you have seen these new reports, do  
19 you find that what is coming out of there is confusing  
20 to you? Or is it useful?

21 And certainly in the UK I know the reports have  
22 not been standardized. They have been kind of all over

1 the lot. Has that been a problem in auditing these  
2 things? Has it been a problem in preparing your report?  
3 So just -- I'd just like to get the panel's impression  
4 of what they have seen going on around the world.

5 MR. REILLY: Great question, and a fair question.  
6 I think, as Professor Skinner mentioned in the last  
7 panel, I think the UK experiment, which is now live and  
8 in color, we are still in the early days. As I said in  
9 my prepared remark, we think CAM, concept of CAM, is a  
10 good thing and will be helpful to users of financial  
11 statements, irrespective of geography.

12 The real issue is, how do you translate that into  
13 practice? And how is it made practical? And I'm hearing  
14 a whole lot of pie-in-the-sky concepts in the various  
15 interactions this morning and earlier this afternoon.  
16 And I'm just struggling with, how do we land the plane  
17 and bring this thing, you know, to fruition?

18 MR. FERGUSON: But it is happening in the UK.  
19 You're doing it. Are you able to do it? Is it  
20 impossible? What is the experience there?

21 MR. REILLY: It is most definitely not  
22 impossible. As you said, it is happening now. I will

1 tell you, though, you know, we have seen it in other  
2 countries, and let me share with you a reaction that I  
3 found interesting relative to what has happened in France  
4 over the last 10-plus years.

5           So they adopted a justification of assessments  
6 approach for commentary in the audit report. They did  
7 that in I think 2003. They did a fairly comprehensive  
8 look-back in 2012 or '13 as to how is it going. They  
9 found a lot of movement towards standardization, not  
10 unexpected.

11           But one of the things in the report that I found  
12 fascinating is -- one of the observations, and that is  
13 things are moving towards standardization. But in an  
14 otherwise black and white audit report, the commentary  
15 is a helpful shade of gray.

16           So, again, I don't think we are going to be able  
17 to make this perfect. I think we need to make it  
18 practical. And I think by making it practical it will  
19 still be useful to investors.

20           MR. DOTY: Jay?

21           MR. HANSON: I've got a question primarily  
22 directed at Ms. Cavanaugh. I really appreciate that you,

1 on this panel especially, and the one most directly  
2 connected to people that actually make investment  
3 decisions. And so I'm going to ask you to imagine what  
4 your analyst -- how your analyst would answer this  
5 question.

6           So Commissioner Peters suggested that instead of  
7 focusing on the most difficult matters at the end of the  
8 day that the auditors spent the most time on, kept them  
9 up at night, that the approach be a little bit more  
10 holistic around what were the risks that the auditor  
11 considered initially.

12           And that is very similar to this UK model that --  
13 I don't think you were in the room this morning as we had  
14 the discussion about it, but it was their approach is  
15 focused on, what were the most important risks that were  
16 identified in the audit plan? What was the materiality  
17 level established? And then how did the scope of the  
18 audit address all the risks? And that's a very different  
19 model than, what were the most difficult areas of the  
20 audit, all things considered?

21           And I know we talked for a bit about the --  
22 Steve's question about the Level 1/Level 2 securities,



1 that routine procedures aren't necessary to include. And  
2 your comment letter also referenced that the audit  
3 procedures performed on a given CAM would not be helpful  
4 except would maybe tend towards a piecemeal opinion.

5           But what are your views on whether an approach  
6 more like what Commissioner Peters suggested, that  
7 holistically describing the most significant risks and  
8 what the plan was to address them as something -- an  
9 alternative to what we propose for CAMs, maybe how you  
10 think your analysts would react to that.

11           MS. CAVANAUGH: I mean, I think just based on the  
12 conversations that we have had with them, and based on  
13 what I'm hearing here, they would probably be more in  
14 line with that holistic financial risk type approach as  
15 opposed to what is currently in the document today,  
16 because I think financial risk and cash flows is what  
17 they are interested in. And what is going to give them  
18 that information is going to be most useful.

19           MS. FRANZEL: My comment is along the same line  
20 as Jay's. You know, all day here we have been listening  
21 to concerns about the CAM approach, but support for the  
22 concept and support for the notion of, you know, getting

1 the right information to investors that they need.

2           And so I'm really struck by Aulana's suggestion  
3 here because it seems to just tie together a whole lot  
4 of what we have been hearing, you know, and that is  
5 really the suggestion that the CAM should be based on  
6 what the auditor determines to present the greatest audit  
7 risk and the greatest risk of material misstatements in  
8 the financials.

9           It is similar to the UK and EU approach, and we  
10 have been hearing that we need to somehow figure out how  
11 to bring our approaches closer together. We have heard  
12 concerns about materiality and the potential for  
13 disclosure of immaterial and irrelevant information, and  
14 I think that this type of a framework would help maybe  
15 mitigate some of that risk.

16           We have heard concerns about non-helpful  
17 information, you know, potentially irrelevant and  
18 confusing information. So I guess I would like each of  
19 the panelists to comment about your thoughts on, would  
20 this help mitigate some of your concerns? And would this  
21 be useful to investors if, in fact, the CAMs were based  
22 on a framework that really focused on those areas of the

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1 highest risk of misstatement in the financial statements?

2 And let's start with Ms. Cavanaugh.

3 MS. CAVANAUGH: I do. I do, because right now,  
4 the way the PCAOB proposal is written, it is -- as we  
5 mentioned, you could wind up with CAMs, which may not be  
6 very material to the company. In those instances, I  
7 don't think our analysts are going to find a lot of value  
8 from there.

9 Overall, their big picture view was, what are the  
10 risks to the company? You know, anything I can learn  
11 about that, I don't need it detailed within the auditor's  
12 report, but something that will pinpoint that and allow  
13 me to go back to management and further explore. That's  
14 what they are looking for. So I think what you are  
15 proposing is something that would likely be more amenable  
16 to them.

17 MR. COONEY: Yes. As I mentioned earlier, when  
18 management prepares the critical accounting policies and  
19 estimates, we focus on the significant items. They are  
20 generally material. They are generally going to be, in  
21 my view, similar at the end of the day. If we went  
22 through a CAM process, I would think there would be a

1 fair amount of commonality.

2           So cutting to items that are material by  
3 definition, things that, you know, not including some of  
4 these other items that we have covered earlier, and  
5 focusing on critical accounting policies and estimates  
6 with potential changes as was discussed in the prior  
7 panel about ways to improve that and make that perhaps  
8 more of a collaborative process with the auditors I think  
9 would be the best approach in terms of getting to where  
10 -- getting to where you all are headed hopefully.

11           MR. REILLY: I think, as I understood your  
12 question, I think there is a lot of overlap in terms of  
13 the various buckets here. But in terms of what thoughts  
14 we have conveyed to the Board and the staff is, you know,  
15 we cover a lot of ground with the Audit Committee.

16           Under ASÁ16, we are required to raise the  
17 significant issues and cover a whole host of different  
18 matters with the Audit Committee, and we think what is  
19 missing, at least relative to the identification of CAMs,  
20 is, okay, you look at this big inventory of stuff, what  
21 were the most important things out of that inventory?  
22 And we think what would be helpful is building in an

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1 additional filter which covers, what were those things  
2 that you spent the most time with, the most interaction  
3 with, the Audit Committee in discussing.

4           And we found that that lines up with the way  
5 practice is running right now. You know, I remember an  
6 Audit Committee meeting on that. I'd go through the  
7 whole enchilada on ASÁ16, and the Audit Committee Chair  
8 looks at me and says, (Thanks for the warning, Kevin.  
9 But tell me, what were the handful of matters that really  
10 cause you some indigestion relative to the execution of  
11 the audit? We think it would be helpful to bring that  
12 practical approach into a final standard.

13           MS. FRANZEL: Aulana, did you want to comment on  
14 your own suggestion?

15           MS. PETERS: I'm not sure that you really needed  
16 to hear more from me, other than to say I don't disagree.  
17 In fact, I agree with the comments on my comments.

18           I would say that I intentionally did not focus on  
19 circumscribing the auditor's report solely within the  
20 parameters of auditing standard -- what is it now? I  
21 knew it when it was -- 16. 16. I think that that is  
22 important, but I think that the approach that I suggest

1 gets you there anyway, and also makes sure that any new  
2 issues that crop up that change from quarter to quarter,  
3 from year to year, gets pulled into a more expanded  
4 auditor's approach as things change at the issuer  
5 themselves.

6           So I agree, but I wouldn't leave it --  
7 circumscribe it with audit -- communications between the  
8 auditor and the Audit Committee for that reason.

9           MR. DOTY: Marty?

10           MR. BAUMANN: Thanks. I have a question for  
11 Wally Cooney. Thanks for being here, Wally, and  
12 participating. And thanks for being in our SAG.

13           We have a long list of investors who have sent us  
14 comment letters, and we have surveys prepared for the  
15 Investor Advisory Group, all of which -- covering  
16 trillions of dollars of assets under management, and we  
17 have letters from BlackRock and Vanguard and the Council  
18 of Institutional Investors.

19           All of those letters indicate that investors are  
20 looking for much more from the audit report and from the  
21 auditor. The BlackRock letter says, What type of  
22 information? "The additional information provided will

1 be particularly useful to our analysts to the extent it  
2 leads to a better understanding of financial risks,  
3 including future cash flows of the company."

4           Jeff Mahoney was here this morning and saying  
5 that our CAM is useful but only to the extent that it  
6 talked more about an assessment of the critical audit  
7 matter and, you know, management's estimates and  
8 subjective judgments, et cetera.

9           So many of these, I assume, are some of your  
10 owners in your company. So how do you respond to the  
11 owners of your company who say, (I want more information,  
12 and I want it from the auditors, about the critical  
13 aspects of the audit, about the difficult judgments in  
14 financial reporting, and about the information that will  
15 lead to better understanding of cash flows. And I want  
16 to hear that from the auditors. And how do you respond  
17 to your owners and say, (I don't think the auditor's  
18 report should include any of that?

19           MR. COONEY: Okay. Well, I mean, my experience  
20 may not be similar to everyone else's. But I've been to  
21 a lot of annual meetings and a lot of investor days at  
22 several companies I have worked for when I was an

1 auditor. And in all those years, there has never been  
2 a single question, ever, in my career that has ever been  
3 directed to an auditor. Not once, at any annual meeting  
4 or investor day.

5           We are -- the company I work for is not widely  
6 traded. I'm not aware of a single question ever being  
7 posed by any investor about the audit or the auditor.  
8 Questions are directed to management.

9           I believe, you know, based on my experience that  
10 shareholders want -- generally want information from  
11 management, from the people who run the company and  
12 manage the business. Auditors certainly gain a lot of  
13 knowledge about the company, about the management team,  
14 et cetera, but, really, at the end of the day, the  
15 management really has far more knowledge and expertise  
16 about the company. They're in a much better position to  
17 answer questions effectively and provide information that  
18 I think is most useful to investors.

19           With respect to some of the surveys and the  
20 comment letters that I looked at from investors, I think  
21 someone mentioned earlier that they didn't find surveys  
22 particularly helpful because generally the question is,



1 do you want more information and they say (yes. That's  
2 not necessarily a great barometer for what is actually  
3 valuable.

4 I didn't find many of the comment letters -- and  
5 I didn't read them all, so there may be some out there  
6 -- that were really that specific about specifically what  
7 they thought would be valuable. They just said, (We  
8 think discussion about CAMs would be valuable. We would  
9 like to know more information about the audit. But I  
10 didn't find anything in particular that I found  
11 compelling, this, you know, idea that there's a real  
12 desire or clamor for information.

13 And in my personal experience, I just haven't  
14 ever been asked a question or seen a question been asked  
15 at a meeting about the audit or the auditors.

16 MR. DOTY: You are drawing me out, Wally. Annual  
17 meetings have been structured often to discourage large  
18 attendance and questions from -- of the auditors. Aulana  
19 is nodding. I take that as a concurrence.

20 The knowledge about the audit has been limited.  
21 There is a proposal by the Basel Commission and the  
22 others that there be a vastly expanded discussion of the

1 audit that go to the regulator, directly to the  
2 regulator.

3 I must say, speaking, again, as one unqualified  
4 for the job of judging auditors that it seems to me that  
5 that has been part of the problem that we have, that what  
6 you've got -- an MD&A is what you're going to get.

7 I think I hear Kevin as saying that in fact a  
8 more general -- if the proposal and the CAMs offered  
9 guidance at a more general level and avoided the detail,  
10 examples, stayed away from the more detailed examples,  
11 that that would be something that auditors might welcome,  
12 and that it might actually help management do a better  
13 job of communicating with its shareholders, such as  
14 BlackRock.

15 Doug Skinner, very important academician. I let  
16 him out of here without asking him whether we should  
17 simply wait to see if the market starts to price American  
18 equities at a disadvantage to European equities. I think  
19 this was involved in Lewis' comment. There is some  
20 Chicago research that suggests that is going to happen.  
21 So maybe 10 years from now we wake up and we find that,  
22 in fact, we are trading at a discount because we are

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1 conceived to be -- perceived to be a more retrograde  
2 disclosure regime.

3 I am leaning on you, but is it really in the  
4 interest of preparers to say, (We just don't want it when  
5 BlackRock wants it, when TIAA-CREF wants it, when people  
6 such as Aulana Peters say that there would have been --  
7 the audit profession, which she advises would have been  
8 better off if there had been more interaction with  
9 shareholders at annual meetings.

10 When Kevin Reilly says that he thinks that in  
11 fact we can do it, are doing it in London, when Alan  
12 Beller says, you know, you might even go farther than  
13 just critical audit matters. You might even start having  
14 auditors make judgments about whether the companies --  
15 and communicate whether they think the company's critical  
16 accounting policies are better. We seem to be coming in,  
17 as I said this morning, somewhere between what the most  
18 expansive view of what the auditors ought to say would  
19 be and what in fact others have done abroad.

20 How far -- this is Marty's -- this really is  
21 where Marty is going. How far are you willing to go in  
22 saying, (We just don't want anything anytime soon? And

1 if you want something, if there is something more to do,  
2 if it's -- is it something that has to be -- that  
3 management influences, controls, and dictates? Is that  
4 the problem? You are concerned that you are losing  
5 control with the CAMs of something management has  
6 traditionally controlled? Because that's an independence  
7 issue.

8 MR. COONEY: I am not sure I have communicated my  
9 position well, because I am actually not opposed to this  
10 proposal. I have a lot of concerns that I think other  
11 people share.

12 In my comments, I talked about if you are going  
13 to go forward with a critical audit matter framework,  
14 which I don't have strong conceptual issues with, that  
15 I thought you should more tightly define the framework.  
16 And I had some ideas that I put in writing. They were  
17 also in the -- in some of the other prepared comment  
18 letters as well.

19 I personally think a matters of emphasis would be  
20 a better approach because I think it could a little bit  
21 more -- it could be a better framework to do that.

22 I actually think that Alan Beller's suggestion,

1 and others -- one of the accounting firms talked about  
2 auditor association with critical accounting policies,  
3 which would be a significant change. So I think that all  
4 of these options should be looked at carefully.

5 I don't have strong opposition to critical audit  
6 matters in general. I just have some concerns about the  
7 way it would be applied, and it wouldn't be my first  
8 choice. But I believe that, based on all of the work  
9 that you've done, that this is an important project, and  
10 that you should go forward with some type of change. And  
11 what that is I think we are just here to talk about  
12 today, about what the best way would be to go forward.  
13 But I'm not personally opposed to that.

14 And as I said earlier -- I answered Marty's  
15 question directly -- my experiences at the companies I  
16 have worked for is just my experience. Just because I  
17 haven't heard a question ever about an audit or an  
18 auditor doesn't mean people from BlackRock and other  
19 companies who are in that profession, that maybe they  
20 hear it all the time, I just haven't personally.

21 He asked me, (How do I answer owners in our  
22 company? I have never had the opportunity to answer them

1 because I have never gotten questioned.

2 MS. PETERS: May I address that? Because,  
3 Chairman Doty, I did nod when you described what the  
4 current situation is generally at annual shareholders'  
5 meeting, but I don't think, while I agree with that  
6 observation, that it really discounts Mr. Cooney's  
7 observation that rarely is there a question put to the  
8 auditor, who is at every annual meeting that I have  
9 attended in the past 23 years of serving on a total of  
10 seven different Fortune 500 boards -- I am not touting  
11 myself, but just sort of defining my experience.

12 Has there been a question put to the auditor  
13 about the balance sheet or the profit and loss statement,  
14 or anything that would go to understanding better that  
15 pass-fail opinion on the financial statements? And I  
16 have attended meetings where there have been 5,000  
17 people, 5,000 shareholders there, down to currently  
18 people tend to try and winnow it down to 50 attendees and  
19 15 minutes.

20 But that is not the universe. Sometimes these  
21 meetings last for three hours, and in those meetings the  
22 questions don't arise, and I won't bore you with the

1 questions that do.

2           MR. HANSON: Aulana, I would like to just ask you  
3 a followup from your role as an Audit Committee Chair,  
4 Audit Committee member, and the large esteemed companies  
5 that you are associated with, and just a reflection that  
6 from the discussions I have had with some Audit Committee  
7 Chairs, their pushback or feedback comes very similar to  
8 what Wally has said, that they don't get questions from  
9 investors about what the auditor thinks. And their  
10 earnings calls or other direct interaction with  
11 investors, they don't see the swell from that side  
12 coming.

13           And just I wonder about what your experience has  
14 been relative to investors either directly talking to  
15 you, which I know is a challenge with a lot of  
16 committees, you know, the connection to investors, but  
17 on earnings calls or other situations where you have seen  
18 a manifestation of this demand that we -- we are talking  
19 about.

20           MS. PETERS: Well, first of all, for the record,  
21 I am currently not an Audit Chair. I have served in that  
22 capacity, but currently I am not. So, and because I am

1 not and haven't been, say, for the past five or six  
2 years, I am usually not in the front line of  
3 communications with investors.

4           But I do know from my work on boards of directors  
5 and on audit committees and governance committees that  
6 most of the inquiries that come into us for more  
7 information are -- say over the past 10 years, are more  
8 related to governance issues rather than issues relating  
9 directly to the financial condition of the company or  
10 financial statements. Is that an answer? Is that -- did  
11 I get your question, Jay, or --

12           MR. HANSON: Yes. I think that's reasonable.

13           MS. PETERS: Okay.

14           MR. FERGUSON: I have a question.

15           MS. PETERS: We get a lot of them.

16           MR. FERGUSON: Given the fact that in this panel,  
17 and in the previous panel, when Alan Beller and Doug  
18 Skinner were on and talked about critical accounting  
19 policies and then approach on that, would it be a good  
20 idea for -- and given the fact that those two are related  
21 but not necessarily coextensive, would it be a good idea  
22 for us to require both of those? That the audit report

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1 include CAMs and include a statement that the critical  
2 audit policies are, in the auditor's opinion, in fact,  
3 the critical audit policies, and that what the company  
4 has said about them is complete information? That we do  
5 both, because they are not coextensive. What do you guys  
6 think about that?

7 MR. REILLY: Good question. But, you know, when  
8 we started talking about this issue in 2010, 2011, one  
9 of the suggestions the CAQ put forward was a separate  
10 attestation of the segment of MD&A that comprises the  
11 discussion of critical accounting policies.

12 MR. FERGUSON: I take it you were in favor of my  
13 suggestion.

14 MR. REILLY: We were. And we thought it -- there  
15 was a great deal of overlap. We heard from investors  
16 that these are the types of things that they have  
17 particular concerns about. Alan Beller mentioned in the  
18 last panel discussion that, you know, there is some  
19 degree of unevenness relative to the extent of the  
20 disclosure and discussions in this broader area. And we  
21 thought this would be one tool to employ that would help  
22 with providing information to investors.

1 MS. PETERS: I would like to be clear and at the  
2 same time respectful. Since I -- although CAMs are not  
3 coexistent with critical accounting policies, I have to  
4 reiterate the fact that since I don't like the way you  
5 have defined CAMs -- and I think you -- I would recommend  
6 and suggest that you take a different approach to your  
7 definition, you will get to where -- you will probably  
8 get to where the other panel was trying to lead you  
9 ultimately.

10 So I would say, no, I don't think it would be  
11 helpful to require both a discussion of critical  
12 accounting policies and CAMs, mainly because I don't  
13 think the way you defined (critical accounting -- audit  
14 matters that that will be particularly useful. With  
15 respect.

16 MS. FRANZEL: Let me take this one step further.  
17 And I want to address this question to Ms. Cavanaugh,  
18 since you are here representing investors. You know,  
19 today we have heard a lot about focusing on critical  
20 accounting policies, management estimates, and risk of  
21 material misstatements. And if we were to somehow mix  
22 all this up into the perfect solution, in the definition

1 of a CAM or whatever we're going to call it, would those  
2 types of things be, you know, what your analysts look to  
3 when they're looking to make investment decisions?

4           Because in your statement, you know, you say that  
5 additional information would be particularly useful to  
6 the extent that analysts can use it to better understand  
7 financial risks and to -- including future cash flows,  
8 to have those conversations with the company.

9           So some of these things we have been talking  
10 about -- critical accounting policies, management  
11 estimates, material areas of risk. Are those the types  
12 of areas that would be helpful?

13           MS. CAVANAUGH: For the analysts --

14           MS. FRANZEL: Right.

15           MS. CAVANAUGH: -- you are asking? You know, I  
16 think it really varies. They didn't give us a lot of  
17 specifics, but I think, you know, for example, loss of  
18 a major customer relationship. That's something they may  
19 be interested in that may impact cash flows.

20           So items that might highlight, you know, issues  
21 with revenue recognition may lead them, then, to go back  
22 to management and say, (Well, why was that the case? Was

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1 it because of the loss of a customer relationship? And  
2 allow them to dig deeper, and that's not information I  
3 think you would normally obtain today in the financial  
4 statement.

5           So I think it varies, but some indication of  
6 where risks and changes have taken place ultimately will  
7 get them what they want, which is cash flows.

8           MR. DOTY: If there are no further questions, it  
9 may be that we have saved four and a half minutes for the  
10 next panel. But we shouldn't adjourn without telling you  
11 what a terrific job you have done in responding to the  
12 questions, to the dialogue, to the back and forth, and  
13 how valuable your written submissions are. This is a  
14 real contribution to the seriousness of what we have to  
15 do.

16           With that, I think we could move on to the next  
17 panel. Thank you.

18           We'll take a break now. We have 10 minutes --  
19 15. We have 15 minutes, so we're going to start -- we  
20 can start, instead of at 4:10, we can start at 4:05. We  
21 can start a little past 4:00. 4:05.

22 (Whereupon, the proceedings in the foregoing matter went

1 off the record at 3:41 p.m. and went back on the record  
2 at 4:05 p.m.)

3 MR. DOTY: All right, the sixth panel, Critical  
4 Audit Matters Related to the Audits of Smaller Companies.  
5 Kurt Schacht, Managing Director of the Chartered  
6 Financial Analysts Institute, he heads the ethics and  
7 professional standards area there, leads advocacy and  
8 think tank functions. He is an attorney and the CFA  
9 charter holder. Previously, he spent 15 years in the  
10 investment management industry as a chief legal and  
11 compliance officer for a large public pension plan and  
12 later a hedge fund. He was Chief Operating Officer for  
13 a retail, mutual fund complex. He serves as a member of  
14 the SEC's Investor Advisory Committee. And he's also a  
15 member of the PCAOB's Standing Advisory Group.

16 Andy Bishop is the CFO and the Chief Accounting  
17 Officer of Hallador Energy Company. Previously, he was  
18 with PriceWaterhouse. He also served on the Audit  
19 Committee of SemGroup Energy, SemGroup Energy Partners,  
20 now Blueknight Energy Partners and we welcome Andy.

21 Dr. Cartier Esham serves as Executive Vice  
22 President for Emerging Companies at the Biotechnology

1 Industry Organization and in this role she manages and  
2 directs BIO's policy development, advocacy research, and  
3 educational activities, and initiatives for emerging  
4 companies which comprise approximately 90 percent of  
5 BIO's member. Prior to joining BIO, Dr. Esham was the  
6 Vice President and Director of Research at Dutko  
7 Worldwide, a private consulting firm based here in  
8 Washington. And she also has published papers in peer  
9 reviewed science journals.

10           Joan Waggoner, a partner in Professional  
11 Standards at Plante Moran, she specializes in accounting,  
12 auditing, ethics, professional liability and quality  
13 control issues. She has recently completed her service  
14 on the Professional Practice Executive Committee of the  
15 Center for Audit Quality. She has also served on various  
16 subcommittees and task forces of the CAQ and has  
17 participated in various roundtables of the U.S.  
18 Government Accountability Office, the SEC, and the PCAOB,  
19 so we welcome all of these panelists who have important  
20 views to share.

21           Kurt, you want to lead us?

22           MR. SCHACHT: Thank you, Chairman Doty and the

1 rest of the PCAOB Commissioners and PCAOB staff. Thank  
2 you very much for including us in this discussion today.

3 I am Kurt Schacht. I'm from the CFA Institute.  
4 That's the Chartered Financial Analyst people. It's a  
5 global organization now of 120,000 professionally trained  
6 financial analysts around the world. We have another  
7 250,000 or so people in our 3-year program. So it's  
8 growing tremendously and it's our next generation of  
9 financial analysts.

10 In that capacity and working for CFA as well as  
11 having the pleasure and the opportunity of being involved  
12 in the SAG for a number of years, our organization, I've  
13 been helping our organization and its members in talking  
14 about improved audit quality. For many months now, and  
15 as you know, some of these debates have been going on for  
16 decades, as a means to improve the audit process, its  
17 independence, its quality, particularly of things like  
18 outputs around the Auditor's Reporting Model.

19 We very much appreciate the PCAOB and its staff  
20 and the very interesting and challenging position that  
21 they find themselves in. Trying to change audit rules  
22 is a very slow process to begin with, but particularly

1 when you're talking about anything that is a major  
2 regulatory change. And we've witnessed that time and  
3 again over the years as to how difficult it is,  
4 particularly when there's very deeply ingrained  
5 professional and commercial interest in not changing the  
6 practice. The road to reform is always very long. It's  
7 always more difficult. And it's always more acrimonious.

8         We certainly put the Auditor's Reporting Model  
9 change proposals in that category. We're very hopeful  
10 that we're getting closer to some changes there, but  
11 honestly I felt that in times past in a number of  
12 different settings, but I think now with the two  
13 proposals from the IAASB and from the PCAOB on the table  
14 around key and critical audit reporting matters, that  
15 maybe we're a little bit closer.

16         From an investor perspective, from the user of  
17 financial statements perspective, our very clear and  
18 consistent input from professional analysts and from  
19 investment manager members and you've heard reference  
20 today to several of our different surveys in this regard,  
21 is tell us more information. We like the pass/fail  
22 opinion, but tell us more information because the



1 Auditor's Reporting Model is now behind the times. It's  
2 been permitted to remain a bit of a remnant of the audit  
3 practice of decades gone by and it is no longer in  
4 keeping with the information demands of the marketplace  
5 in the 21st century. That's just sort of plain and  
6 simple how many of our investor members feel.

7           Having an auditor's signature is nice. Having a  
8 rotation of the firm is nice. Having more information,  
9 useful information from the Audit Committee or from the  
10 issuer, that's all fine and well, but in the view of many  
11 of our members, those are minor players in comparison to  
12 what would be a well-articulated discussion of the audit  
13 like we're proposing, like you're proposing with the  
14 critical audit matters discussion and coming from the  
15 auditor.

16           So that's our view. That's what we have  
17 communicated in this venue and other settings quite  
18 often. I certainly do understand the practitioner issue  
19 or concerns about this. The standard nature and the  
20 beauty of long-standing historical practice is important.  
21 I understand all of the opposition, the commercial issues  
22 associated with this issue and certainly appreciate the

1 skill with which the practitioner and issuer community  
2 weigh in on this. But the fact of the matter is that  
3 everything else in the world of finance has changed  
4 dramatically in the last five years and over the last  
5 decade, rapidly changing around audit practice in terms  
6 of information, the speed, the quality, the transparency  
7 of it, and certainly the usefulness of information.

8           Let me address two real quick things that we come  
9 across in terms of this debate. We hear repeatedly that  
10 the financial analyst community is never satisfied. They  
11 never have enough information. It's never good enough.  
12 It is never of high enough quality. It's just another  
13 one of those requests from the financial analyst  
14 industry.

15           The other thing is that very few investors ever  
16 read the financial statements. A lot of our  
17 professionally-trained investors read financial  
18 statements, but very few investors read them, much less  
19 the footnotes, much less the audit opinion. So why on  
20 earth are we building up this very expensive rule book,  
21 regulatory rule book and the corresponding outputs that  
22 no one is apparently using?

1 I think you all know the answer to that. I think  
2 we've talked about it a number of different times. And  
3 the fact of the matter is that these practices and rules  
4 are so very fundamental to the integrity and quality of  
5 our markets. Investors know that they exist. They have  
6 to exist. They're required of those seeking public  
7 investment and if they violate those rules, there is some  
8 hell to pay in terms of having violated those. I think  
9 everybody gets that their existence is not a 100 percent  
10 guarantee on fraud or cheating or even 100 percent  
11 enforcement by PCAOB or SEC or that investors even  
12 understand or appreciate the complexity of the outputs.

13 What investors do know is that the rigorous  
14 nature of these is a condition to taking their investment  
15 money. It is a type of discipline and responsibility  
16 that is not optional in the U.S. publicly-traded markets.

17 That brings me very quickly to talk just a little  
18 bit about the smalls and mediums, whether the audit  
19 reporting model rules changes be waived for smaller  
20 issuers. We have never in our organization supported a  
21 variable system for publicly-traded companies based on  
22 market cap or size. If you want access to the public's

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1 money on the same terms as other public companies, we  
2 think the rules ought to be the same. We do get that  
3 being public is expensive. It's very complicated. It's  
4 complex. The regulations overlap sometimes and maybe  
5 they're even over broad. But if you understand that and  
6 you don't like that, then maybe you list on a lighter  
7 touch exchange or a lighter touch regulatory regime.  
8 That is your option. But if you want to access these  
9 markets and stand toe to toe with other seasoned issuers  
10 whose reputation and confidence level and standing in the  
11 marketplace are built on regulatory rigor, we don't  
12 expect there should be a free pass. We think that's the  
13 right approach from an investor protection standpoint.  
14 Thank you.

15 MR. DOTY: Andy Bishop. Thank you.

16 MR. BISHOP: I would like to extend my  
17 appreciation and thanks to the Board for including me in  
18 this panel discussion. Hallador is an underground and  
19 surface coal mining company serving Indiana and Florida  
20 electric utilities. Our mines are located in Indiana.  
21 We trade on the NASDAQ. It's HNRG. Get it, N-R-G. H  
22 for Hallador (R-G. We are a small reporting company as

1 defined by the SEC rules and our public float June 30 was  
2 \$75 million, although our market cap exceeds \$240  
3 million.

4 I started my career at PriceWaterhouse in 1975 in  
5 the Oklahoma City office after graduation from the  
6 University of Oklahoma, that's the team that trounced  
7 Alabama in the Sugar Bowl.

8 (Laughter.)

9 Thank you. In 1984, I transferred to the Denver  
10 office. Practically all my audit clients were SEC  
11 registrants. In 1990, I joined Hallador as the CFO, left  
12 in '93 and then came back again as CFO in 2009. From  
13 1993 to March 2009 I was the Executive VP and CFO and a  
14 third owner of the SEC Institute. During those 16 years,  
15 I also assisted Hallador in preparing their SEC filings.  
16 In July of 2009, I sold my interest in the SEC Institute.  
17 I also served on the Audit Committee of SemGroup Energy  
18 Partners, now called Blueknight which is a NASDAQ company  
19 from July 2007 to July 2008.

20 Before I go further, I should tell you that the  
21 views I express today are my personal views and do not  
22 necessarily reflect the views of any of the officers

1 and/or directors of Hallador.

2           So for the past 29 years, I've been intimately  
3 involved in this space and along with many others have  
4 noted that the auditor's report has not substantially  
5 changed. Now is the time for change. And nobody likes  
6 change but a wet baby.

7           I recall years ago in the self-regulation days  
8 when the Big Eight, now the Final Four, I picked the  
9 Gators, audited each other. I worked both sides of that  
10 fence. I firmly believe in less regulation than more,  
11 although I have to admit there were serious flaws in that  
12 system. We audited each other and I recall each firm  
13 received an A plus year after year. It's not unlike  
14 asking your mother if you're good looking.

15           The PCAOB system was a much-needed change. Other  
16 information in the auditor's report, I'm in favor of  
17 having the auditor's report on the other information  
18 disclosed in the 10-K. Also consider a mechanism where  
19 they also report on the earnings release. The earnings  
20 release moves the market more than the 10-K disclosures.

21           For smaller companies that don't have an audit of  
22 internal controls, I assume that other information

1 includes management's representation that the internal  
2 and disclosure controls are effective. It is not clear  
3 to me how the auditors will report on the proxy statement  
4 that's incorporated by reference to the 10-K. The  
5 proposed standard states that this information is  
6 covered, but what will be the mechanism to make it clear  
7 to investors that the information was, in fact, read and  
8 evaluated by the auditor. Also, it's not clear to me  
9 that the XBRL data that is filed as an exhibit to the  
10 10-K is covered by the proposed standard.

11           Critical audit matters. Rather than have the  
12 auditors include in their report the critical audit  
13 matters, I believe the Audit Committee Report should be  
14 expanded to include such matters. If the auditors are  
15 not in agreement with the report, they have the  
16 obligation to report such and include those critical  
17 audit matters that were excluded from the Audit Committee  
18 Report. Most likely, this would be a joint effort  
19 between the Audit Committee and the auditors. The CFO  
20 and/or the CAO have an intimate knowledge of these  
21 matters and such matters are included in management rep.  
22 letter to the auditors and also included in the auditor's

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1 communication to the Audit Committee.

2           This approach would also be more cost and time  
3 effective as we have strictly reporting deadlines and at  
4 times obtained the final wording from the auditor slows  
5 down the process. That being said, the rightful home for  
6 the Audit Committee Report is the 10-K, not the proxy  
7 statement.

8           Maybe this concept is a jurisdictional concern  
9 and we sure don't want Audit Committees regulated by the  
10 PCAOB. I'm sure the SEC and the PCAOB can come to an  
11 understanding if this approach was considered.

12           I would like to take advantage of this esteemed  
13 captive audience to touch on some other matters that I  
14 have observed over the years. Number one, referring to  
15 auditors as independent auditors could be misleading to  
16 the average investor. The issuer-pays model compromises  
17 objectivity and professional skepticism, always has,  
18 always will. For instance, GE, General Electric, pays  
19 KPMG over \$100 million for their independent audit. Best  
20 I can tell, GE has been a client for over 100 years and  
21 probably will be for the next 100 years. For simplicity,  
22 let's just say the annual profit on the audit is \$25

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1 million. The present value of \$25 million for the next  
2 100 years approaches \$500 million, depending on  
3 assumptions. Now that's an asset that would be  
4 safeguarded by any firm. What defies logic is if KPMG  
5 audit partners invest \$25 to buy one share of GE stock,  
6 then KPMG is no longer independent. This might be heresy  
7 to some, but why not tweak the rules to allow some  
8 ownership by partners and staff. Certain partners and  
9 staff could be subject to Section 16 reporting, the same  
10 as D&Os and others.

11           Number two, another way to look at audit fees'  
12 independence is how significant the fees are to the firm  
13 as a whole or to that particular office. For instance,  
14 the KPMG Louisville, Kentucky office is the reporting  
15 office for the Yum! Brands engagement. The audit fees  
16 are about \$7 million. Is \$7 million significant to the  
17 firm? Doubtful, but how about that office? It could be.  
18 Now the point being that investors have no way of  
19 knowing. Maybe more transparency regarding these matters  
20 would assist investors in determining true independence.

21           I'm not picking on KPMG. The other firms have  
22 the same issues.

1           Number three. Being a smaller reporting company,  
2 we are exempt from the 404 audits of internal control,  
3 so are emerging growth companies. I thought the passage  
4 of SOX was great, especially the CEO and CFO  
5 certifications and creation of the PCAOB. That was good,  
6 common sense regulation. However, I think the cost of  
7 404 internal controls audits far exceeds the benefits.  
8 I am not in the camp that if the regulation only saves  
9 one life is worth it. One would think other  
10 jurisdictions around the world would jump on the 404  
11 audit bandwagon if it was such a good deal. But we might  
12 be the only country.

13           All CEOs and CFOs certify as to the effectiveness  
14 of the internal controls four times per year. That  
15 should be sufficient. As mentioned earlier, this  
16 management assertion would be subject to the auditor's  
17 obligation to report on other information in the 10-K.

18           Let the investors decide if they see value in the  
19 requirement. Make it an optional requirement subject to  
20 shareholder approval. Call it (Say on SOX. In the  
21 interim, the SEC could at least raise the public float  
22 from \$75 million to \$250 million or higher as recommended

1 by the Advisory Committee on Small and Emerging Companies  
2 in their March 2013 letter.

3           Number four, another required cost that far  
4 outweighs the benefits is XBRL. At a minimum, small  
5 reporting companies and emerging growth companies should  
6 be exempt from this tedious and time-consuming project.  
7 For sure, the requirement to detail tag the footnotes of  
8 the financial statements is ludicrous. We are followed  
9 by three analysts. They seem to be oblivious to XBRL.  
10 I'm surprised Congress did not exempt the emerging growth  
11 companies from XBRL in the JOBS Act. Maybe they too were  
12 oblivious.

13           The only groups I know singing the praises of  
14 XBRL are the service providers. We have fewer public  
15 companies on the national exchanges than 17 years ago,  
16 8,800 in 1997 compared to 5,000 or so today. XBRL might  
17 have made some sense years ago to assist the SEC in their  
18 mission to protect investors, but today it does not.  
19 EDGAR is a fabulous tool. XBRL is not.

20           Number five. In my opinion, either the CFO or  
21 the CAO, Chief Accounting Officer, or a member of the  
22 Audit Committee should be required to be a CPA.

1           Number six. I applaud the PCAOB for moving  
2 forward with the requirement to name the audit partner.  
3 For the last two years, we have named the audit partner  
4 and the concurring partner in our information statement  
5 filed with the SEC. We also include their ages and their  
6 tenure as auditors. We considered including biographical  
7 information for the partner not unlike that required for  
8 our own D&Os. I do believe that more than just the name  
9 of the partner is needed. Their age, years on  
10 engagement, industry experience, and any regulatory  
11 issues would also prove useful.

12           As has been said many times, a little something  
13 signed is the best disinfectant.

14           Number seven. We include the Auditor's Review  
15 Report in our firm 10-Q. Over 15 percent of the S&P 500  
16 does the same. I'm surprised that the percentage is so  
17 low. Consider extending the other information standards  
18 of the quarterly review procedures and encourage or  
19 require the inclusion of the Review Report in the 10-Q.

20           Number eight. Final comment, kudos to the SEC  
21 for jumping off the IFRS bandwagon. Thank you for this  
22 opportunity to speak to you today.

1 MR. DOTY: Thank you. Cartier Esham.

2 MS. ESHAM: Good afternoon, Chairman Doty,  
3 members of the Board. My name is Cartier Esham and as  
4 stated I'm the Executive Vice President of Emerging  
5 Companies at BIO.

6 Roughly 90 percent of BIO's 1100 member companies  
7 are pre-revenue emerging businesses. Thus, product sales  
8 do not fund biotech research which can cost upwards of  
9 \$1 billion. Instead, companies turn to external  
10 investors to finance their drug development programs.  
11 The capital markets play an important role in biotech  
12 capital formation and I want to thank you for the  
13 opportunity to speak with you today about ensuring that  
14 small public companies are given the opportunity to  
15 succeed on the market.

16 Because small biotechs do not have product  
17 revenue, burdensome regulations have an outsized effect  
18 on them. A one-size-fits all compliance requirements  
19 regime diverts funds from the lab and slows the  
20 development process. The JOBS Act has shown that a  
21 common sense regulatory approach helps biotech capital  
22 formation. In fact, nearly 80 biotechs have gone public

1 in the last two years, a dramatic surge considering that  
2 two years prior the JOBS Act, we only saw 30 biotech  
3 IPOs. The reasoned regulatory approach prescribed by the  
4 JOBS Act has been a success. Bio is hopeful that the  
5 PCAOB will bear in mind the importance of right sized  
6 regulatory requirements as it considers changes to the  
7 Auditor's Reporting Model.

8           We agree with the GAO's finding that the proposed  
9 critical audit matters would for any science company not  
10 enhance the usefulness of the auditor's report or add  
11 value to the users.

12           As a representative of emerging growth companies,  
13 the proposal would only add significant cost burden on  
14 growing companies without providing a corresponding  
15 benefit to its investors. The PCAOB is proposing release  
16 notes that is virtually certain that an auditor would  
17 identify critical audit matter based on the proposed  
18 standard in any given audit report. Meaning, we can be  
19 similarly certain that the audit cost will go up. Quite  
20 simply, the new proposed standard would increase the  
21 scope of work necessary to complete an audit and these  
22 costs would be passed on to emerging growth companies and

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1 its investors which can ill afford such a substantial  
2 capital diversion.

3           Again, as stated by the GAO, these additional  
4 requirements they determined would not improve audit  
5 quality.   Emerging growth companies in the biotech  
6 industry have few employees and a simple corporate  
7 structure, so it does not require an overly detailed  
8 analysis to understand the inner workings of their  
9 business.   BIO fully supports strong investor  
10 protections, but the primary value of a biotech company  
11 is and will be based on its scientific disclosures and  
12 not additions such as proposed.

13           But I also believe that the provisions in the  
14 JOBS Act were designed to ensure that a one-size-fits all  
15 approach and increasing regulatory burdens on small  
16 companies should be actively discouraged, unless the SEC  
17 determines that any such additions are "necessary or  
18 appropriate in the public interest, after considering the  
19 protection of investors and whether the action will  
20 promote efficiency, competition, and capital formation."  
21 We believe the proposed standard would increase the  
22 auditor's scope of work and the audit fees for the

1 company would not provide -- would not meet that test to  
2 providing additional value to investors and would divert  
3 valuable time and resources away from these small  
4 companies' core missions.

5           In the case of small biotechs, this would mean a  
6 diversion away from funding scientists and their efforts  
7 to research and develop the next generation of medicines,  
8 a result Congress clearly sought to avoid.

9           Bio urges the PCAOB not to apply the standard to  
10 emerging growth companies which have thrived under a  
11 common sense regulatory regime rather than the  
12 one-size-fits all burden. And we thank you for your time  
13 and I look forward to answering any questions you may  
14 have.

15           MR. DOTY: Thank you. Joan Waggoner.

16           MS. WAGGONER: Chairman Doty, Board, Chief  
17 Auditor and staff, thanks for inviting me to participate  
18 in the meeting. I am a partner in the Professional  
19 Standards Group of Plante Moran which is a regional  
20 public accounting firm in the Midwest. My previous firm,  
21 Blackman Kallick, merged into Plante Moran almost two  
22 years ago.



1 I've been asked to discuss CAMs, the CAMs aspect  
2 of the proposed model from the viewpoint of the smaller  
3 auditing firms.

4 First of all, I would like to thank the Board for  
5 all the work it has done to reconsider the Auditor's  
6 Report Model. This project is, I think, one of the most  
7 difficult that the Board has undertaken since its  
8 inception, given all the diverging points of view and  
9 interests that are involved, and to focus the auditor's  
10 voice on only audit matters has been a very interesting  
11 concept to contemplate.

12 My partners and I discuss the typical CAMs that  
13 we would expect to see in our practice. We would expect  
14 to see predominantly valuation allowances or impairment  
15 issues on asset accounts as the most common theme,  
16 although there are certainly others. I have included a  
17 list in an exhibit at the end of my statement that is  
18 more specific and complete. I have also highlighted  
19 those that we think are especially relevant to emerging  
20 growth companies. We do recognize though that the  
21 determination of CAMs is very specific to a particular  
22 issuer and requires significant judgment on the part of

1 an auditor.

2           From reviewing the comment letters of the smaller  
3 accounting firms, there seems to be a reluctance to total  
4 embrace the inclusion of CAMs in the auditor's report.  
5 From discussing the issues with my partners, we also have  
6 some worries about certain aspects of CAMs, although we  
7 are supportive of the Board's objective to make the  
8 auditor's report more meaningful to investors.

9           Now I should warn you there will certainly be  
10 some similarities in my following remarks about these  
11 concerns with what you have already heard today, but I  
12 will be looking at them from a different perspective  
13 which is from the smaller accounting firm and smaller  
14 issuer companies.

15           I believe the concerns emanate from a couple of  
16 things. First, some of the reluctance may come from  
17 accounting firms' lack of history in disclosing original  
18 information. I believe that many of the CAMs would  
19 correlate with other disclosures already present in the  
20 10-K or that arguably should be in the 10-K. However,  
21 we may end up with some instances where we are faced with  
22 the potential disclosure of original information.

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1           This disclosure of original information is not  
2 natural to auditors. And since the beginning of recorded  
3 time, we have been following the model of management  
4 asserts, we attest. This model has been reinforced over  
5 time as auditors' responsibilities have changed, most  
6 recently with the Sarbanes-Oxley internal control work  
7 where again management asserts and we attest.

8           The force is strong within us that original  
9 information should be authored by management. And I  
10 should clarify that what I mean by original information  
11 in this context would be control deficiencies and other  
12 things like corrected or uncorrected misstatements. And  
13 so that is what we are thinking of as being original  
14 information.

15           It is important though that the auditor's report  
16 be relevant to investors. And so the big questions with  
17 many of the small firms is will the inclusion of CAMs and  
18 auditor's report benefit the investors in small  
19 companies? As my partners and I were thinking through  
20 the possible CAMs we would expect to see in our practice  
21 of smaller issuers, we were not sure how information  
22 would be used or interpreted by investors who do not

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1 fully understand the complete auditing process.

2 I understand that the Center for Audit Quality  
3 has initiated a field test of the proposed Auditor's  
4 Reporting Model and I am very interested in reviewing the  
5 results of that testing once it is completed to help us  
6 see more clearly the value of CAMs to the investors in  
7 small companies.

8 In addition, in the comment letters I saw a lot  
9 of commentary indicating the concern that the CAM  
10 paragraphs might be construed to be piecemeal opinions  
11 within the financial statements or otherwise diminish the  
12 value of the pass-fail model.

13 At this point, we do not have clear information  
14 about how investors in small companies would use or  
15 perceive that information and so it is hard to conclude  
16 one way or the other as to whether or not the opinion  
17 would be enhanced or diminished by the inclusion of CAMs.  
18 But I believe that it is very important that investors  
19 understand that the audit is of the financial statements  
20 taken as a whole and that the CAMs be presented in a  
21 manner such that they enhance, rather than diminish the  
22 opinion.

1           Also, I expect that the volume and the cost of  
2 CAMs will be proportionately greater for smaller issuers  
3 and especially for emerging growth company audits. Many  
4 smaller issuers have excellent controls and processes,  
5 some including some emerging growth companies have not  
6 yet built the necessary financial infrastructure because  
7 of spending priorities. I expect that this lack of  
8 financial infrastructure would most often result in a lot  
9 of CAMs or at least some lengthy ones, disproportionate  
10 to the larger filers.

11           Lastly, many of us have concerns regarding the  
12 availability of firm resources during a very busy time.  
13 We expect that significant firm resources in terms of our  
14 most senior and experienced people will be necessary at  
15 the end of an engagement to determine the CAMs and also  
16 the content of the additional paragraphs in the report,  
17 especially for some of the smaller and emerging growth  
18 company issuers.

19           We worry that this additional responsibility at  
20 the end of the engagement may strain resources so that  
21 attention would be diverted from other value-added audit  
22 responsibilities. I believe these factors are the

1 primary ones that worry smaller auditing firms with  
2 respect to CAMs. The big unanswered question though in  
3 my view though still to come is whether or not investors  
4 in smaller companies will find CAMs useful. Once that  
5 question on the information available from these surveys  
6 and to the Board's satisfaction, then it will perhaps  
7 easier for the Board to be confident in its direction  
8 regarding CAMs.

9 I do have a couple of suggestions for the Board's  
10 consideration to address some of these above concerns  
11 which are included in my written statement which can be  
12 looked at at another time.

13 Lastly, one of the questions in the proposed  
14 guidance was whether or not the guidance should be  
15 applicable to emerging growth companies. On one hand,  
16 as I mentioned previously, I would expect that for the  
17 typical emerging growth company that there would be CAMs,  
18 maybe many CAMs to be considered for inclusion in the  
19 auditor's report. On the other hand, I would expect that  
20 the market place's primary interest in these companies  
21 at this stage of their development is whether or not the  
22 issuers has the potential to be successful in its mission

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1 or its product. And if this is so, then the cost-benefit  
2 may not be there for CAMs.

3           Again, thank you for the invitation for me to  
4 participate on this panel and I look forward to our  
5 discussion.

6           MR. DOTY: Thank you. Jeanette.

7           MS. FRANZEL: Thank you for being here today and  
8 sharing your perspectives with us regarding smaller  
9 companies and smaller audit firms. I'd like to ask each  
10 one of the panel members in your experience what do you  
11 see in terms of how investors communicate with the  
12 company and with the boards in the smaller company  
13 environment that maybe we should be considering as we are  
14 considering this standard.

15           And Cartier, if you could also add comments about  
16 EGCs as well. So we can just work our way down the panel  
17 and anyone who would like to start.

18           MR. DOTY: They're all looking at you, Andy.

19           MR. BISHOP: We have three analysts that follow  
20 us. Each quarter when we report our numbers, they come  
21 up with an update of their reports and they have never  
22 asked any questions about the accounting. They ask

1 questions on why maybe costs went up, why margins went  
2 down, but no questions on accounting.

3           Personally, I don't have a problem with this  
4 approach. I would like to see it done by the Audit  
5 Committee as opposed to the auditors though. If we are  
6 doing what is called a non-D&O road show, we go out and  
7 talk to investors. Again, no questions. They're more  
8 interested is the coal business going to be around for  
9 a while? That was their concern.

10           MR. DOTY: Any other points of view on the panel  
11 to address Jeanette?

12           Cartier?

13           MS. ESHAM: I am going to provide an answer and  
14 again, I hope it's the answer you're looking for in the  
15 sense of small companies and investors and I'm talking  
16 institutional investors actually have a very prolonged,  
17 often, relationship in determining whether or not a small  
18 company is going to go public. In regards to -- one of  
19 the things I wanted to comment in regards to some of the  
20 comments I've been hearing this afternoon in the sense  
21 of more information is better, I think that's true. But  
22 in the case of certainly the biotech community, we worked



1 for years with the passage of the JOBS Act on that more  
2 information sort of mantra and that was really carried  
3 out in the provision of testing the waters such as  
4 provisions of testing the waters which has allowed and  
5 I think been perceived by both investors and the small  
6 companies as a huge success with the ability to  
7 communicate more information. But again, it's really  
8 been, the conversation has really been focused about  
9 educating about their ability, of the science, and the  
10 ability to carry that science forward.

11 We have not heard a lot of questions in regards  
12 to auditing report content, although we have had a  
13 history of working with this Board and providing numerous  
14 comments on a variety of the excellent work that you're  
15 doing in looking for improvements.

16 MS. FRANZEL: And do you see differences between  
17 the EGCs and the other small companies that you deal with  
18 in terms of that communication?

19 MS. ESHAM: Well, the other small companies we  
20 deal with are private companies, so that's in the venture  
21 capital world.

22 MR. DOTY: Jay?

1           MR. HANSON: I've got another question along the  
2 governance theme and I'll pick on Andy first, but I'm  
3 interested to hear all of your views on this.

4           Andy, your suggestion is having the Audit  
5 Committee report the critical audit matters and I  
6 appreciate many people have that same view that may be  
7 an appealing way to go and we're doing much more  
8 interaction now in the last year or so with Audit  
9 Committee chairs and Audit Committee members and getting  
10 good sense of what the larger company Audit Committees  
11 are doing.

12           We have fairly significant, albeit anecdotal  
13 feedback, and the smaller the company, the less robust  
14 the Audit Committee discharges their responsibilities and  
15 part of it is the ability to track Audit Committees that  
16 have the skills to do and part of it is maybe just not  
17 knowing what to do.

18           And I'm not going to ask you to comment on your  
19 Audit Committee because that will put you in a tough  
20 spot, I know you and I have been around a lot and talked  
21 to lots of companies and lots of preparers. And just  
22 your sense as to with regard to the operationality of

1 your suggestion for the smaller companies having the  
2 Audit Committees do it, whether today you think there's  
3 the skill set and the capability across the universe of  
4 the smaller companies, just from your experience? And  
5 appreciate any of the rest of your comments about your  
6 observations about the effectiveness and the ability of  
7 the audit committees of smaller companies to do more than  
8 they're doing now.

9           MR. BISHOP: The way I see it playing out is that  
10 I would sit down with the Audit Committee chairman and  
11 together I'd put together the bullet points. I'd say  
12 here's what we're going to talk about. And he says I  
13 think that's right. And the auditors would have given  
14 their report, too. And he would say, Andy, you draft it.  
15 That's probably how it would shake out. He would agree  
16 with the points.

17           MR. HANSON: Any comments from the rest of you on  
18 this?

19           MR. SCHACHT: I'm not sure, Jay, I fully  
20 understand your question, but big company, small company,  
21 medium company, there's plenty and plenty of resources  
22 out there in terms of how you properly empanel and engage

1 in the activities of an audit committee. So it's not for  
2 lack of resources. Whether small issuers can attract the  
3 same level of competence and capability that the larger  
4 issuers do on the Audit Committee is clearly, they're  
5 clearly at a deficit to do that. So I would say,  
6 generally speaking, there is not the same level of  
7 experience and expertise on the smaller company boards  
8 and on the Audit Committee. I think we're getting there.  
9 I think there's certainly a heck of a lot more attention  
10 being paid to it than ever before. And I think people  
11 are waking up to the fact that if there is one key  
12 important check and balance on corporate governance for  
13 investors it is the Audit Committee that, in fact, is  
14 probably the king of all the corporate governance bells  
15 and whistles and protections.

16 MS. WAGGONER: In addition having the Audit  
17 Committee prepare a report of some sort that timely goes  
18 out along with the auditor's report has a great appeal  
19 to it. As I was listening and hearing about the UK model  
20 where the FRC is in that enviable place where they can  
21 both set corporate governance regulations and also the  
22 auditing standards. You know, that's like a perfect way

1 to bring it all together which is to say you get an  
2 auditor's report that's very much complemented or  
3 complements the report from the Audit Committee and  
4 everything just works much more as everyone is  
5 collaborating to get good information out to investors.

6 MR. FERGUSON: I have a question, initially  
7 directed to Andy, but the rest of you pop in if you want  
8 to. As I heard you, you said that you thought critical  
9 audit matters, if they were disclosed at all, should be  
10 done by the Audit Committee rather than the auditors.  
11 Those are two different kinds. They're not identical  
12 proposals, so the kind of disclosure would not be  
13 identical, let's assume you're correct about that. Given  
14 the fact that we have no jurisdiction over that and that  
15 would have to be done by the Securities and Exchange  
16 Commission and I would defer to my colleagues from the  
17 SEC here, but my understanding is that the SEC has a  
18 really, really full docket now. And I would suspect that  
19 this might be pretty low on their list of priorities.  
20 If that were the case, is having the auditor do it such  
21 a bad idea, in your view, that we should simply drop this  
22 project?

1 MR. BISHOP: No, I don't think you should drop  
2 the project. Maybe SEC could rearrange their priorities  
3 and move this up to the top.

4 MR. FERGUSON: Assume they don't rearrange and  
5 I'm not speaking for my friends from the Commission here.  
6 They do what they want to, but let's just assume for  
7 purposes of this argument, they're not going to rearrange  
8 their priorities for this.

9 MR. BISHOP: Then we'll go with what you have,  
10 let the auditors do it. But for the Audit Committee to  
11 do it, the Audit Committee Report needs to move to the  
12 10-K. It doesn't make any sense to get the 10-K out and  
13 then two months later the Audit Committee Report comes  
14 out in the proxy statement needs to go out and the 10-K  
15 and again, that's probably their jurisdiction. But  
16 that's how I look at it.

17 MR. DOTY: Steve Harris.

18 MR. HARRIS: Mr. Schacht, you heard what Ms.  
19 Waggoner said about the disclosure of original  
20 information. And my question is why you think it is  
21 important that auditors provide additional information  
22 directly to investors?

1           MR. SCHACHT: I think there's been a -- just to  
2 maybe reiterate some of my opening remarks, we've been  
3 talking about this now for decades about the quality of  
4 the information that's coming from the professional firm  
5 that's actually being voted on by investors and being  
6 paid for by investors, and the quality of what -- the  
7 usefulness of that information. And I'm not an expert  
8 on the history of original information coming from the  
9 Audit Committee versus the company, but I think the fact  
10 of the matter is that everything else is changing in the  
11 world of finance and around the process of being a public  
12 company.

13           And I don't think there's any reason why the  
14 audit profession and the profession that they are  
15 providing, the service that they are providing for  
16 investors should somehow be exempt from those changes and  
17 from the very dramatic differences at how markets operate  
18 and how markets trade and how people invest.

19           And so it may be long-standing, commercial,  
20 historical practice. I get that, but does that mean we  
21 never change it? I don't think so.

22           MR. DOTY: Mr. Baumann, Chief Auditor.

1           MR. BAUMANN: Thanks, I have a question for Joan  
2 and Cartier. Both of your comments, you indicated an  
3 expectation of increased costs as a result of this and  
4 maybe disproportionate costs on smaller companies. CAMs,  
5 as we've talked about them in the proposal, are based  
6 upon what the auditor has done. It's fundamental to  
7 their work, critical audit matters are documented in  
8 their work papers, discussed with the engagement quality  
9 reviewer. That's probably the critical audit matters  
10 that's contemplated are probably the topics that are most  
11 discussed between the auditor and the Audit Committee.  
12 So there's nothing new about developing a CAM. It is the  
13 fundamental things that are being discussed with the top  
14 management of the firm and the audit firm, the engagement  
15 team, the engagement quality review, the Audit Committee,  
16 et cetera. So we're talking about here about putting in  
17 the audit report what's probably already written in the  
18 Audit Committee Report, except maybe more succinctly.

19           In addition to that, we heard today from several  
20 people, most notably from the UK experience where they're  
21 actually having these enhanced disclosures. And Nick  
22 Land from the FRC indicated he didn't see any reason for



1 increased costs as a result of this for similar reasons.  
2 So given the fact that all of these matters are just  
3 matters that are already addressed with the Audit  
4 Committee and it's really adapting something that's  
5 already written to the Audit Committee for consumption  
6 by the investor and there's some experience overseas that  
7 it doesn't have any cost, where do you have the  
8 expectation of significant costs?

9 MS. WAGGONER: Certainly one of the big factors  
10 for the smaller companies is the cost associated with  
11 transition in the very first year because of what we  
12 would expect to be a heavier volume of CAMs that would  
13 exist for certain of the smaller companies and the  
14 emerging growth companies.

15 On a recurring basis, one of the things we were  
16 trying to think through is what would cause that cost to  
17 continue to be higher than we would expect. And I think  
18 it's because you know where those systems, the systems  
19 of the smaller companies aren't necessarily geared up in  
20 the early part of their lives to capture all the  
21 information needed for accounting purposes and so forth  
22 and so on, that things will just pop up a little bit

1 more. We would expect a little bit more of a volatile  
2 environment.

3           So even though I would expect from year to year  
4 there would be recurring CAMs of which perhaps the cost  
5 to process the auditor's report would not be excessively  
6 high. There is an associated cost with the volatility  
7 at the end of an audit which will take up a lot of time  
8 from folks disproportionate to the engagement. So I  
9 think that would be the continuing factor that we would  
10 see.

11           MR. BAUMANN: Just an observation again, even  
12 though there could be more issues in a smaller company,  
13 again all of those issues should still have been  
14 discussed by the engagement team, evaluated by the  
15 engagement team, discussed with the Audit Committee if  
16 there are important issues so again, even if there's  
17 more, they've already been communicated to the Audit  
18 Committee and now it's a matter of communicating them in  
19 some lesser format or some -- to the investor.

20           MS. WAGGONER: Arguably, quite true, but the  
21 crafting of new ones for purposes of public dissemination  
22 would still be a significant cost because it's not just

1 correcting the spelling and put it out there, you know.  
2 It does go through a few levels of review and  
3 consideration and so forth and that is going to be taking  
4 the time of the most senior people in the firm to get  
5 those handled properly.

6 MS. ESHAM: Just to agree with several of the  
7 points that Joan raised and I think as we read the  
8 proposal, I think a couple of the concerns that we have  
9 are again, they're almost -- there was an implication  
10 that essentially every auditor would have a critical  
11 audit matter outside of the context of the audit report  
12 process which includes the dialogue between management,  
13 the Audit Committee and the auditor. So I think there  
14 were a lot of may's and could's of what that might entail  
15 that is concerning and so the presumption is that it  
16 inevitably will require more work and thus more fees by  
17 the emerging companies.

18 And the price tag of paying for extra auditing  
19 fees is not the only cost to an emerging growth company.  
20 Again, when you have a company that has 25 employees, and  
21 again, their core mission is in our case research and  
22 developing medicines, it is perhaps a hiring of extra

1 staff. It is a longer runway of paying for auditing fees  
2 that are diverting funds away from again their core  
3 mission which is of concern as proposed.

4 MR. DOTY: I think Kurt wanted to comment on  
5 that.

6 MR. SCHACHT: I think the interesting thing  
7 that's going on is that everybody is still very gun shy  
8 about SOX 404 and sort of early experience with that and  
9 maybe the miscalculation of the cost benefits of that and  
10 I don't think anybody wants to make that mistake again.  
11 But I would tend to see this similar to as you just laid  
12 it out that it's not a lot of additional work. It's not  
13 the same dynamic as we were experiencing with a brand new  
14 Sarbanes-Oxley and that when you look at the audit  
15 completion document or the report of the Audit Committee  
16 that most of the work is done, it's just a matter of how  
17 you would price the step of actually having to make a  
18 professional disclosure about that and I really don't  
19 know how that would happen.

20 MS. WAGGONER: If I can make one more point.

21 MR. DOTY: Please.

22 MS. WAGGONER: Thank you. There is in a lot of

1 the smaller company audits, it is a kind of a rush to the  
2 finish. The deadline looms and everybody is very focused  
3 on getting the audit done and management is working to  
4 get the financial statements done. There's still a lot  
5 of stuff happening at the last minute because a lot of  
6 these audits are not the most efficient audits in the  
7 world just because of the way the data is gathered and  
8 so forth and so on.

9           So there's also not just a cost, but the rush to  
10 the finish is a real thing that exists for many, many  
11 audits of small companies.

12           MR. BAUMANN: That environment sounds like it's  
13 even more important for the investors, therefore to  
14 understand, there's critical audit matters in those  
15 companies. So that's my view.

16           MS. WAGGONER: And indeed, you may be quite  
17 correct, Marty, on that. I think the proof is actually  
18 going to be as we see things roll out and how the  
19 information is used, I still haven't heard anything  
20 definitive on exactly how the investors in smaller  
21 companies actually would utilize the information. And  
22 I think that is arguably a very important thing to be

1 resolved before we move forward on this, simply because  
2 it is so important to the smaller companies and the  
3 emerging companies because of the cost.

4 MS. ESHAM: I did just want to respond to that to  
5 make sure I didn't leave that just hanging out there, but  
6 again, I think from our point of view, the value of small  
7 companies, again, I can speak most assuredly about the  
8 biotech industry again. In our conversations with  
9 investors and what we hear from our CEOs is the value of  
10 the company rises and falls on the product -- their  
11 ability to advance their product, the science that  
12 they're working on. That's the value of a small business  
13 of an emerging growth company. So I do just want to  
14 emphasize that.

15 Again, going back to the discussions that were  
16 held in both the House and Senate during the JOBS Act  
17 debate, that is why you see provisions specifically laid  
18 out in the law that recognize one, the importance of  
19 allowing these emerging growth companies to transition  
20 into the public market. That's why there are exemptions  
21 to certain things. That's why there is not a  
22 one-size-fits-all framework in that. And again, it's

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1 pertinent to this argument, the one that specifically  
2 talks about the supplemental information in the form of  
3 the AD&A proposal and determine that that is not  
4 appropriate to apply to emerging growth companies.

5 MR. DOTY: I want to follow up on this with both  
6 of you because I want to talk about, get your reaction  
7 to what I'll call the bonding principle. The JOBS Act  
8 didn't wall off the PCAOB from the audit report and it  
9 certainly didn't suggest it was out of the question to  
10 add further information. It did go, as Cartier points  
11 out, to the question of an AD&A which we've taken some  
12 pains to distinguish from.

13 But is there any concern on the part of either  
14 you, Cartier Esham or Joan Waggoner, about the precedent  
15 we have with what I will call blue light districts that  
16 have been launched with the best intention of creating  
17 more rapid capital formation? And I'm thinking of the  
18 London AIM market and sort of the American Stock  
19 Exchange's ill-fated excursion into a midcap market. The  
20 Nuevo Mercado and certain other areas.

21 Are you concerned or should we be concerned or  
22 should we be concerned that if we have a rule that

1 requires some kind of amplified audit discussion, if we  
2 modify the audit reporting model at all for big  
3 companies, for other companies, everybody else but EGCs,  
4 that if we don't fashion a rule that can be applied by  
5 EGCs, we have -- and it's required to be applied by EGCs,  
6 that we have created the beginnings of a kind of blue  
7 light district for some of the companies that we're most  
8 interested in growing.

9           I do understand that audits are cost. Kurt makes  
10 the point that none of the reforms in Europe have really  
11 delayed the completion of the audit cycle, but I hear  
12 Joan point out that it's harder for smaller companies.  
13 It's a messier situation, but the fact that the smaller  
14 companies will perhaps have less in the way of critical  
15 mass on controls, more of the critical audit matters,  
16 including perhaps more related party transactions and  
17 other issues that auditors have to look hard at and that,  
18 in fact, they are less likely to be free of any concern  
19 for the auditor. Isn't that a reason why we should be  
20 concerned that whatever we say about the actual  
21 disclosures that it should apply to everybody? That we  
22 don't want to have a situation in which we're creating

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1 a class of second class companies that can go on the  
2 exchange and are we really doing no favor to emerging  
3 growth companies if we create the lowest expectations for  
4 their auditors in terms of what we want them to tell the  
5 public?

6 Discuss among yourselves, please.

7 (Laughter.)

8 MS. WAGGONER: Well, you know, I am in actual  
9 total agreement with Kurt, that if you enter the public  
10 markets, you accept the level of responsibility and  
11 accountability. But when we are considering changes to  
12 the auditor's process and the auditor's report, I think  
13 we need to distinguish between two things. Is the change  
14 being designed to protect the markets, to protect the  
15 marketplace? Or is it to enhance the information  
16 available to the marketplace?

17 I would suggest that if the goal is to protect  
18 the marketplace, certainly I think rules should get  
19 applied across the board or with a much higher level of  
20 cost-benefit analysis or a lower threshold, if you will.

21 If the goal is to enhance the information  
22 available in the marketplace, that might be a lesser

1 standard. And so the cost-benefit analysis would go --  
2 the threshold would be higher. And it is then for us to  
3 contemplate are the proposed changes to the auditor's  
4 report to protect the marketplace or to enhance the  
5 information available to the marketplace?

6 MR. DOTY: A choice the logicians always struggle  
7 against that opting from one or the other.

8 Cartier, how about it? Isn't the biotech  
9 industry one that needs to be worried about having the  
10 emergence of a blue light?

11 MS. ESHAM: One, I do not think that we are a  
12 lower class small business on the market today.

13 I did have a question and I apologize for my own  
14 ignorance, but in the London example that has been  
15 brought up today, are there exceptions to emerging  
16 growth, small companies within that system that's being  
17 applied?

18 MR. BAUMANN: Right now, that applies to the  
19 largest companies, the FTSE 350. So it's not just  
20 emerging growth companies. They applied it initially to  
21 the FTSE 350.

22 MS. ESHAM: Just to clarify, we don't have --

1 there's not an example then in London of how this would  
2 or would not affect emerging growth companies as of yet.  
3 I just wanted to clarify that.

4           So again, I think Joan raises a great way to put  
5 it is protect and inform and on the informed side, again,  
6 I think the question and again, very specifically  
7 focused, my comments are very specifically focused on the  
8 proposed CAM and in that sense I don't think that we  
9 agree that the added regulatory burden would equate to  
10 again as prescribed by the JOBS Act necessary and  
11 appropriate to protect or benefit the public.

12           Secondly, I do also want to make clear that in  
13 the greater context of are there ways to improve the  
14 auditing process or the auditing report as to how that  
15 may inform. We've certainly been engaged with your work  
16 since 2010, 2011 and I think, in fact, have been  
17 supportive of certain proposals such as one made in our  
18 comments in 2011 around clarifying language within the  
19 auditor's report. So I want to distinguish between a  
20 very specific issue that my comments were directed at  
21 today, the proposed CAM. But again, we are willing and  
22 have been working with this Committee on looking for

1 improvements, to ensure that that doesn't happen, any  
2 blue light districts sort of situations, it's not --

3 MR. DOTY: I was impressed with Joan's paper  
4 because I think you, in fact, have five very pragmatic  
5 suggestions for CAMs and for the reporting level change  
6 which are quite specific. You do not seem to be  
7 concerned that any expansion of the information in the  
8 audit reporting model conjures up concerns about  
9 excessive liability.

10 You don't believe that any attempt to reform the  
11 audit reporting model necessarily involves devaluing the  
12 binary report. I may be misreading you, but your  
13 concern about that, but you have you have suggestions  
14 to avoid it.

15 I come away with the sense that you think that on  
16 the whole, while there's some work to do on this proposal  
17 that it's time to expand the reporting model and that  
18 your firm can do it.

19 And you can do it on a cost-efficient basis for mid cap  
20 and small cap issuers. Am I wrong?

21 MS. WAGGONER: Chairman Doty, I must say that  
22 nobody reads between the lines better than you. Well,

1 yes, I would say we think that the CAMs model is a  
2 reasonable one to apply and that it's workable as a  
3 thought process. We would not be worried about our  
4 ability to write the CAM. We certainly have plenty of  
5 talent in-house to do that.

6 The cost I don't know, but we did not actually  
7 develop any sort of estimates about what the add-on costs  
8 would be associated with it, so I cannot speak to that.  
9 We've already spoken about it a little bit.

10 On the litigation front, we're not in the same  
11 world as the large firms and I knock on wood when I say  
12 that. So I can't really speak to the litigation side of  
13 things because it's not the world we live in at this  
14 point.

15 MR. DOTY: You may feel it's ungentlemanly of me  
16 to try to create these differences between you and  
17 Cartier, but that's the kind of ruthless, mean regulator  
18 that I am. At this point, I'm going to pass the -- pass  
19 it on to Jeanette, to my colleagues?

20 MS. FRANZEL: We heard earlier today concerns  
21 from a number of panelists about the lack of sort of a  
22 materiality threshold or filter in the current CAM

1 proposal. And I'm wondering if we were to address that  
2 issue, would that alleviate to any degree some of the  
3 concerns that you have with the current CAM proposal?

4 Joan, and whomever else would like to address  
5 that question?

6 MS. WAGGONER: I think it would be helpful to add  
7 a materiality factor to it just to make it absolutely  
8 clear. I rather think it was kind of implicit in the way  
9 it was written and I wasn't concerned that it wasn't  
10 there. But as I've listened to the comments, it strikes  
11 me why not be perfectly clear.

12 MS. FRANZEL: Would that help with some of the  
13 messiness and the small companies that you -- when I was  
14 listening to you talk about sometimes it's just difficult  
15 to pull data together, I guess I was interpreting that  
16 as sort of maybe deficiencies in internal controls, but  
17 not ones that would rise to material weaknesses, but that  
18 was one of the examples we heard earlier that gee, if  
19 that's a CAM, all of a sudden that may not be material  
20 and that may be original information being disclosed by  
21 the auditor.

22 MS. WAGGONER: One of the things as I was

1 thinking through the CAMs definition was was it workable?  
2 And at first I began to believe that if we were just  
3 auditing something very inefficiently, that that might  
4 be something that qualified as a CAM. But then I  
5 realized as I continued to look at it and think about it,  
6 that I believe it wouldn't necessarily be that it was an  
7 inefficient audit area as long as the test was based upon  
8 good quality evidential matter that was clear.

9           And so for instance, I was thinking of the area  
10 of customer contracts and revenue recognition. And maybe  
11 the system of the issuer doesn't capture all the  
12 information that it should in order for us to be able to  
13 figure out, should it be 2014 revenue? Should it be 2013  
14 revenue or whatever. And so perhaps the testing that we  
15 do is extended. But if the customer contract is very  
16 clear as to what the terms of sale are, then we have good  
17 and sufficient evidence supporting the revenue cutoff  
18 procedures as we call them.

19           And so I don't think that would end up being a  
20 CAM because it just doesn't seem to hit on the  
21 definition. If, however, the customer contract isn't  
22 clear, if the customer contract was pulled off the

1 internet and used by the company because it didn't want  
2 to pay some legal fees right off the bat, which I don't  
3 recommend by the way, you have a lack of clarity and then  
4 you just might be in CAM country. Did that address?

5 MR. HARRIS: I am just wondering Joan, how do you  
6 avoid boilerplate? We've discussed that all day, but in  
7 terms of the CAM, how you constrain it to what's most  
8 important to the user?

9 MS. WAGGONER: The big risk, I think, in writing  
10 CAMs is the ones that recur year after year, pretty much  
11 the same thing. And in a way, if you have a heightened  
12 level of detail, the detail might change from year to  
13 year and that might keep them kind of fresh. But I worry  
14 about the recurring items, but for any particular year,  
15 those recurring items may still be very relevant and  
16 helpful to investors. So I'm hoping that the world  
17 continues to evolve and that we understand the increased  
18 importance of a fresh look at things every year. And I  
19 think we can do it. I think we can do it.

20 MR. HARRIS: And how about the others of you. Do  
21 you have any ideas in terms of how we streamline this to  
22 avoid boilerplate and what's most important to the



1 investor or to the user?

2 MR. BISHOP: Sitting here thinking about what's  
3 been discussed, just going through my mind, Hallador has  
4 always been a trendsetter in disclosures. I thought  
5 well, maybe I'll just file the Audit Committee Report as  
6 an exhibit to my 10-K and see what comes out of that.  
7 I have to get the okay from my auditor. They may not  
8 like that idea, but that would give you what you want.

9 MR. HARRIS: Do you have a problem with that?

10 MR. BISHOP: I'm just thinking, I wouldn't have  
11 a problem, the rest of the Board, auditors might have a  
12 problem with that, but that gets the answers what you  
13 guys are looking for.

14 MR. HARRIS: Would anyone else have a problem  
15 with that?

16 MR. FERGUSON: One of the things several of you  
17 have mentioned is the fact that for smaller auditors and  
18 smaller audit firms having to identify CAMs and write  
19 them up would be a squeeze at the time you have to issue  
20 your report. I'm not an auditor, so but it would have  
21 occurred to me that given that there are critical audit  
22 matters that they should have been identified in the

1 first risk assessment meeting for the auditor. And that  
2 they then should, in fact, inform the audit work that you  
3 do because they are, after all, critical to the audit.  
4 And if that's the case, why can't these things be written  
5 up during and early on in the process so the most that  
6 has to happen in the end is simply a review of what's  
7 already been written. Because it strikes me if you find  
8 a critical audit matter right before you're about to  
9 issue the opinion, something has gone wildly wrong with  
10 the audit. Am I wrong?

11 MS. WAGGONER: One of my recommendations was in  
12 my letter is that the planning and Audit Committee  
13 standards of the PCAOB be amended to include the  
14 preliminary spade work on CAMs in the planning process,  
15 and in the early communications with the Audit Committee  
16 because I think we can really help the workload issue at  
17 the end if we know and can expect which are the -- well,  
18 we try to identify risk of material misstatement early  
19 on and so that kind of goes hand in glove with  
20 determining the critical audit matters.

21 And I believe that on a recurring basis they can  
22 be identified early on. I'm just saying we have a more

1 volatile situation sometimes with certain of the small  
2 and emerging companies such that issues, new issues will  
3 pop toward the end of the audit. Those are the ones I  
4 was referring to on a recurring basis.

5 MR. BAUMANN: A follow up if I can. Andy, a  
6 comment, discussion on cost was primarily focused on  
7 Cartier and Joan, but you indicated earlier that you  
8 didn't have a disagreement with CAMs, that primarily  
9 you'd like to see them in the Audit Committee Report.  
10 Secondly, if that didn't happen then continue our  
11 project for the audit report. But did you agree with my  
12 assessment of they shouldn't necessarily cost a lot given  
13 the fact --

14 MR. BISHOP: I agree with that. Where the costs  
15 will come in is the wordsmithing of how this is going to  
16 deal with the words. I think we all know what the issues  
17 are. How is -- do you put a comma here, do you  
18 capitalize that? That's what's going to --

19 MR. BAUMANN: So in other words, the bulk of the  
20 work has already been done on the CAMs.

21 MR. BISHOP: Yes.

22 MR. BAUMANN: I had one other follow up with you,

1 you did talk about the disclosure of the engagement  
2 partner's name in your information statement filed with  
3 the SEC. Any reaction from the engagement partner about  
4 disclosing the name and/or any costs involved with that?

5 MR. BISHOP: No. At first, I think they thought  
6 why are you doing that? Well, I think it's the right  
7 thing to do. And at the end of the day they agreed.

8 MR. HARRIS: Just out of curiosity so many people  
9 don't think it's the right thing to do. Why do you think  
10 it's the right thing to do? I mean the entire profession  
11 disagrees with that.

12 (Laughter.)

13 MR. BISHOP: I look at it, I have to disclose my  
14 name, my age, my bio, my compensation, what I've been  
15 doing the last ten years. And I'm paying these guys a  
16 lot of money, so what's wrong with disclosing their name?  
17 I don't see anything wrong with it at all. It's done in  
18 other countries, too.

19 MR. HARRIS: Does anyone on the panel have a  
20 problem with that?

21 (Laughter.)

22 With the auditor disclosing their name on the

1 audit report? I take that everybody's saying they don't  
2 have a problem. Okay.

3 MR. DOTY: Your good humor and your  
4 -- throughout all of this, your good humor and your  
5 willingness to indulge us is, of course, appreciated and  
6 it relieves a long afternoon. But mainly we appreciate  
7 the kind of insight you brought from small companies, the  
8 care that's gone into the preparation of your written  
9 work which is really very good and which will be an  
10 important part of this record.

11 And your interest in this whole project.

12 Oh, Brian, my regulator.

13 MR. CROTEAU: Sorry, thanks. Before you wrap up,  
14 I just wanted to add not that I think -- hopefully people  
15 would not be confused by this, but Lew's comments about  
16 the SEC's workload and any considerations relative to the  
17 Audit Committee Report. Certainly, since there is now  
18 an open public comment period, if people do believe that  
19 we ought to be doing something with the Audit Committee  
20 Report, they should still continue to make those  
21 recommendations. We certainly do consider all the  
22 feedback and we will continue to think about those type

1 things. Lew's hypothetical applied to the panel  
2 discussion here, just in the event people are listening  
3 and might be writing comments, I just wanted to make that  
4 clear.

5 MR. DOTY: Fair enough. You have given us  
6 insight into an important part of this whole picture that  
7 we cannot go forward without. And to get where we need  
8 to go, and to do something meaningful with the audit  
9 report, we need to take account of the things you've  
10 raised and the kind of intelligence and wisdom you've  
11 brought to us. Thank you. We adjourn. We will convene  
12 again in the morning. See you all then.

13 (Whereupon, at 5:13 p.m., the meeting was  
14 adjourned, to reconvene the following day, Thursday,  
15 April 3, 2014.)

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C E R T I F I C A T E

This is to certify that the foregoing transcript

In the matter of: Auditor's Reporting Model

Before: Public Company Accounting Oversight Board

Date: 04-02-14

Place: Washington, DC

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