PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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STANDING ADVISORY GROUP

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MEETING

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TUESDAY
JUNE 24, 2014

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MR. BAUMANN:

The next item, or the last item actually on this page and the first item on the standard-setting agenda for March are the same and it deals with the auditor's reporting model. And we'll spend a little bit of time on this project over the next few minutes. This is really one of the Board's major initiatives, and it did come up before we going to hear about this; I think it was Elizabeth that asked, and so I do want to spend some time.

So before this meeting, as part of the meeting materials sent out to SAG members -- materials related to the ARM project. And what we sent you was the Board proposed changes to the auditor's report in April -- August 13th, 2013. And the fact sheet of what we proposed is in front of you. Just as a reminder, that dealt with the requirement for the auditors to report on critical audit matters, those matters that are addressed during the audit that involve the most difficult subjective or complex auditor judgments, pose the most difficulty to the auditor in obtaining sufficient appropriate evidence and/or pose the most difficulty to the auditor in forming an opinion.
on the financial statements.

We also proposed changes to the responsibilities for auditors with respect to other information in an annual report filed with the SEC that's not part of the audited financial statement, but other information that management might present. The auditor has an existing responsibility to read and consider that information.

We expanded that to read and evaluate that information with specific procedures as to what we meant by evaluation and also proposed that the auditor would report if they found that there was a material misstatement of fact in the other information or if they found that the other information contained a material inconsistency with the audited financial statements.

We didn't require really additional audit evidence or evidence to be gathered around that other information, but those conclusions would be drawn based on reading it and evaluating it in the context of the audit work done and the audit of the financial statements taken as a whole.

We received 246 comment letters on the proposal during the year. We received comment at the last SAG meeting. A major portion of that was getting input from
the SAG members. In addition, in April 2014; and that material is in front of you as well; and many of you here participated in that, there was a two-day public meeting on the auditor's reporting model and we covered various aspects of the various components of this, the critical audit matters, issues around other information, issues pertaining to larger firms, smaller firms, etcetera.

But we also looked at other developments that were occurring around the world. And as part of the materials that I've shared with you I've included excerpts of what's now a requirement in the United Kingdom that went into effect for financial statements filed after September 30, 2013 and periods after that. Is that right, Jessica?

MS. WATTS: Sounds right.

MR. BAUMANN: September 30th, 2013 and after that. And if you read the -- there was one page of that we took out from the U.K.'s standards was pretty principles-based. It said describe those assessed risks of material misstatements that were identified by the auditor and which had the greatest effect on the overall audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team, provide an
explanation of how the auditor applied the concept of materiality in performing and planning the audit and provide an overview of the scope of the audit, and few more words to that. And we've also included a couple of examples of reports that came out of the U.K. for your observation.

So as part of the meeting we had in April representatives from the United Kingdom who participated in some of these audits came over, as well as investment management professional came over, and it was a very positive report back in terms of the fact that the engagement teams felt, quote, "more engaged" in the audit and the fact that their reports were going to contain more useful information for investors.

The engagement partners felt that that was a positive impact on the audit taken as a whole and the investment management professionals who reported at that meeting felt that these more detailed reports gave the market more confidence in the work of the auditor as it spelled out some of the significant risks or critical audit matters, as we would call them here, that the auditor dealt with.
But the examples in front of you -- there's two companies. One of them is -- compared to the traditional couple-of-paragraph report we see here in the United States, there's a six-page opinion of the audit spelling out about 10 different risks of material misstatement and the auditor's responses to those risks that they found. The other one I think is about a four -- about a five-page report or so on similar type matters.

I think the main point in that and what we heard in the April meeting is from those who in the comment letter said this is a real big challenge and for a variety of reasons can't be done. It will slow down the audit, will have other negative consequences, you know, the world will come to an end. That didn't really happen in U.K. The reports were issued pretty much timely from what we observed in a sample we've looked at, pretty much issued on about the same date as they were the prior period. And we inquired about cost, and at least in general the comments that were made at the public meeting were that the additional costs were largely minor. I mean, I'm characterizing that in my own way.

I don't know, Jessica, would you say it was
different? No? That's about what we heard. But that's year one, and we'll have to see how these reports come out in year two. This is just a couple of them that we shared with you just so you could see that this is occurring. Reports came out in a highly principles-based way, the standard.

Shortly after that -- just one other thing -- the European Union came out with requirements after that which have now become final and have included those requirements in just a short page as well, which is similar, that the audit opinion must now include a description of the most significant assessed risks of material misstatement including material misstatements due to fraud, risk of material misstatement due to fraud and a summary of the auditor's response to those risks. In both cases as well the auditor's reports would have to comment on other information accompanying the audited financial statements.

So we are continuing to proceed on our path with respect to reflecting on the comments on the proposal, comments from the public meeting, comments from SAG members and we're working with the Board on our next steps.
I thought I'd take -- there's a couple of cards up. But before I did that -- I see Mike Gallagher was up and Bob Herz. Before I did that, I've talked a little bit about our developments and other global developments, but clearly among those global developments are developments at the International Auditing and Assurance Standards Board, as they are also in the process of developing a new auditor's report -- and Arnold Schilder, a regular observer at our SAG meetings is here today, the Chairman of the IAASB.

And, Arnold, could you give us an update on where the IAASB is?

MR. SCHILDER: Yes, of course. Thank you very much, Marty.

We issued our third consultation audit report in July last year, and it was a very comprehensive exposure draft that included a number of new revised auditor reporting standards.

Comment period closed November 2013. A lot of reactions. And we've had some fulsome discussions with our advisory group and the National Auditing Standard Setters Liaison Group, and in both the PCAOB staff
participated as well.

Our Board had a public meeting last week and I'm very pleased with the progress that we made. It was a full week. We spent over 60 percent of our time on that. And we had our first read through the suite of revised auditor reporting standards. We are track, as Jim also said, for finalizing them at our September meeting.

Our Board has 18 members, 9, as you said, practitioners, 9 including myself non-practitioners. And for approval we need at least 12 in favor.

We essentially closed off the discussions on our overarching reporting standards, ISA 700, and this now includes new requirements to make an explicit statement on independence, naming the engagement partner for listed entities, and also placing the auditor's opinion first as the overall conclusion that should be seen immediately.

A bit more specific on some key components. First, key audit matters. We've made excellent progress on this new standard, ISA 701, and that addresses the communication of key audit matters. Respondents to the exposure draft strongly supported the concept of KAM being based on matters communicated with those charged with
governance, usually the audit committee, firstly focusing on matters of significant auditor attention.

However, findings from field testing and other feedback from auditors, standard setters and regulators suggested clarification was needed to ensure that there was a robust decision making framework to enhance consistency in auditor adjustment focused on topics that would likely be relevant to users. And users have told us that communications about individual methods should be as entity-specific as possible to enable them to understand key aspects of the audit.

And I should also mention that similar to the PCAOB feedback from preparers and audit committees has been less supportive regarding the concept of KAM. In their view it's their role to provide original information to users other than the auditors, and auditors and others including the IAASB itself agree to that. There's no discussion about that principle. But we found therefore the need to further clarify in the standard and in our outreach that the purpose of the auditor communicating KAM is to provide greater transparency about the audit.

We've now refined both the requirements relating
to determining KAM and the application material which is guidance that is essential to the proper application of the requirements in the ISA. It has all set out conservations for the auditor in all cases focused on three areas.

First, areas of higher assessed risks of material misstatements or significant risks identified in accordance with ISA 315. And you hear of course bells ringing to what Marty just quoted. Second, significant audit adjustment relating to areas in the financial statements that involve the application of significant judgment or estimation by management. Third, the effect on the audit of significant events or transactions that occurred during the year.

We've also picked up many of the PCAOB's proposed required considerations in our guidance to help auditors focus on which of the methods that require significant auditor attention were of most significance in the audit and therefore the key audit matters.

And our most substantive Board debates to date relating to KAM have been on the possibility that the auditor might conclude in what we now call extremely rare
circumstances not to communicate a matter that had been determined as a KAM in the auditor's report.

Your feedback to the exposure draft suggested this type of requirement was necessary for the Board's continuing to explore how this could best be done recognizing that it is necessary to put proper parameters around the decision not to communicate a matter and to promote disclosure in most cases.

Like you said, Marty, we have heard much positive feedback through the U.K. experience and we believe we should move forward as well recognizing that communicating KAM will require all of us to take a new and innovative approach to reporting. We are now already talking about implementation support and also post-implementation review.

Some key audit matters briefly on other information. We're also proposing auditor reporting on other information, which in our case is part of a separate project to revise that particular standard, but dealing with of course the information included in a company's in your report.

We received significant feedback to our first
exposure draft and we found the need to re-deliberate the proposals to provide greater clarity on the auditor's work effort and the scope of information to be addressed. We also then had the opportunity to consider PCAOB's proposals on the topic. We re-exposed the standards April this year. Comments requested July 18, and we hope to finalize the standard 2014 or early next year.

Finally, going concern. Our exposure draft included auditor reporting on going concern. Like the PCAOB, we recognize the need to work closely with the accounting standard setters towards a more holistic approach to going concern, and we have been doing so in particular at the IASB. However, it's unlikely that changes will be made to the accounting standards of the IASB, so the IAASB has decided to revert to exception-based reporting in the auditor's report; i.e., including statements about going concern when a material uncertainty has been identified, which it will be now very close to the new legislation in Europe and I think as well where PCAOB currently is.

And our work continues to look at how it might increase auditor attention on going concern and response
to calls arising from the financial crisis. And at our meeting last week we had some lively debates around the possibility of a new requirement aimed at enhancing the auditor's consideration of the adequacy of disclosures around going concern issues, including the need for and adequacy of disclosures about underlying events or conditions where a material uncertainty does not exist, the so-called close calls. And course that's of interest to the slides from the FASB in the area of significant doubt that had been alleviated by management plans.

Well, that's the area that we're discussing. We believe that it is important to help to drive behavioral changes in the way that both management and auditors approach the assessment of going concern, so it's important that we get it right.

Two closing comments: First, the IAASB started this project in 2006 with Independent Research Commission by us and the AICPA Auditing Standards Board. We then had two global rounds of consultations, 2011, 2012, and then the exposure draft in 2013. And I really would express how grateful we are for the dialogue that we had during this process with the PCAOB at various levels, the
Financial Reporting Council, but also the European Commission and European Parliament. And we appreciate that the PCAOB has to operate within confidentiality requirements, so we're very grateful for the dialogue that we could have.

And finally, in line also with what you said, Marty, does it work? Let me give you one quote from an investor from the U.K. who has often been very critical to the auditing profession, Iain Richards from Threadneedle Asset Management. Quote, "While we are clearly at a very early stage in the development of this enhanced reporting, we have been pleasantly surprised by the usefulness of some of the disclosures. There is a strong subjective element in how we as shareholders assess the stewardship of a business and the quality of its reporting and auditing and these reports provide an important medium that can contribute to that. In a world that is rarely black or white, they also help underpin the credibility and trust that needs to be inherent in the relationship between the leadership of a company and its shareholders."

Pleasantly surprised. I wonder how long ago it is that an investor was able to say that about an auditor's
MR. BAUMANN: Arnold, thanks very much for that update. And as I said, there are a number of cards up. Mike Gallagher was first.

MR. GALLAGHER: Thank you, Marty. Marty, I wanted to share with this group that the Center for Audit Quality has updated its response to the project, specifically indicating the results of field tests that were recently completed with respect to the auditor's reporting model.

So the field tests focused on a couple of things: CAMs was primary focus and for the CAM field test nine audit firms participated. Fifty-one issuers participated. With respect to other information, it was a smaller size. Six firms and fifteen issuers.

Before I get into the details; and I won't get into much, I'll give a very quick high-level summary of what the field tests found, but there were clearly some limitations to the field tests, a couple of which -- and probably the most significant of which, given the desire on the part of issuers to remain confidential and not have the information go beyond the accounting firm that did the work, we were not able to get a reaction from investors.
So without getting the benefits, which is clearly what we would get from an investor perspective, you know, severe limitation, and we understand that.

The other limitation was it wasn't done under live conditions. So we looked at 2012 audits for purposes of developing the CAMs. So we didn't have the benefit of so-called game day conditions in terms of what it meant, in terms of time, when that time would occur and the impact on the audit.

That said, I think there were some useful findings that came out of the effort that should be considered as a data point. And I appreciate the time that we spent with, Marty, you and your team, and Jeanette participated from the Board perspective, a couple of weeks ago to listen to what we found in the field test.

And so at a very high level a couple of things:

One, very similar to what I heard Arnold just say with respect to refining the population from what you would pick CAM, and as we talked about in previous SAG meetings we think it would be useful to refine it down from three maybe to one key source, which is information communicated to audit committees. We think that you'd capture things that
are relevant there and without having to go through a larger population, which is largely redundant.

The other thing to consider there would be a materiality lens. I think materiality is implicit, but if there can be some more explicit recognition that, you know, the things that would end up in CAMs, to avoid too many CAMs, should be focused on things that are really meaningful and material. And recognizing that sometimes is in the eye of the beholder, many times in the eye of the beholder, but we make those decisions every day.

Two other things that related to documentation: One related to when auditors -- we found a pretty big range of documentation when auditors decided how many potential CAMs might there be and what's the documentation requirement. For the CAMs particularly, the CAMs are left on the cutting room floor. Making sure that we've got the right level of documentation. And even for the CAMs that go forward, how to document those going forward. Not looking for a cookie cutter, but maybe just a little bit more in terms of guidance, in terms of what the expectation would be from a documentation perspective.

And then the last item with respect to CAMs, again,
a very broad range and diversity with respect to how the
CAMs were written. Some in terms of the level of detail,
the range of detail, just the volume. It was quite a
range. And while you certainly want a certain range, you
don't want these to be cookie cutter. We don't want them
to be boilerplate. And that's one of the risks here. And
so it's not a paint-by-numbers exercise, but perhaps
there's an opportunity to put goal posts out there where
you get an expected and a good range of outcomes, because
I think there should be a range. And they all should not
look the same, but is there an opportunity to kind of narrow
the field from what we saw in the field tests.

With respect to other information, really one key
finding; and again it's something we've talked about in
previous SAG meetings, confusion over what "evaluate"
means, and is that a higher standard than we're performing
under today? Clearly, when you think about read and
consider versus evaluate and report, it sure sounds like
it's more. And so making sure we're capturing the intent
of what the Board is trying to achieve and is "evaluate"
the correct word or is there a better word that would create
more clarity and consistency in terms of what the
performance requirement would be.

But overall I'd go back and say -- you know, go back to the meetings that we had at the beginning of April. Very positive. I thought it was -- having the opportunity to participate, for which I was very grateful was -- I thought the meetings were terrific. I was there for the two days. And we're very supportive of the project and hopefully this is a useful data point that you can consider as it goes forward. Thank you.

MR. BAUMANN: Thanks, Mike. It is very useful, obviously any input like that that we receive to help us refine whatever our next step may be in terms of a re-proposal or whatever we do next. Hopefully we get it better. And as the IAASB has done, continue through the process of consultation, proposal, etcetera, to work through refinements to make sure we get the best product.

The auditor's report hasn't changed in the United States in about 75 years or so, so if we're going to change it, let's make sure we get as much information as we can and do it as well as we can. So thanks for that.

That letter from the CAQ I think is now up -- has been delivered to us and is available with other comment
letters that we've received on our website.

The next card that I saw go up was Bob Herz.

MR. HERZ: Thank you. Again, this is on the auditor's reporting model, and for this purpose I will not include the evaluation of the other information, just the reporting on CAMs or key matters. One is an observation and one is more of a comment.

The observation is just to add to what Mike talked about, the CAQ, and this is a much less robust or scientific sample, but I had the opportunity to participate in two meetings, one in the U.S. and one in the U.K. of audit committee chairs and members.

The U.S. meeting, which was sponsored by the NACD, I think a lot of the concerns that you've been hearing about disclosure of original information potentially in the report, lack of clarity on certain things and all the other points that we discussed at a prior meeting were raised by audit committee members, or a number of audit committee members.

I was in the U.K. subsequent to that and at the point that they were -- had issued some of these reports or were working on them. And I'll reinforce that the reaction
there among audit committee people there, particularly what I'll call the not-inside-baseball people, or maybe it should be not-inside football people; in other words, they didn't come from the profession, they hadn't been with one of the firms or whatever, they were people that had been in business or had been regulators or whatever, was extremely positive to the expanded reporting. And so they really started to get much better insight into what was looked at in the audit and what was found and the like.

In that regard -- and I guess kind of in the camp of you'd be disappointed if I didn't say this, Marty, but at one of the prior meetings I said when you guys had some -- a couple of examples of the kind of things that might be reported and how they might be reported, I made the observation that they kind of pointed to the area and the like, but then they didn't say, well, what did the auditor do and what did the auditor find?

And so when I read the U.K. examples; and we've got two of them here, Rolls Royce and HSBC, I thought it was very good the way they did that. It didn't leave you hanging there. It kind of wrapped it all up.

MR. BAUMANN: Yes, I think all of these experiences
and field testing and IAASB's outreach and those kind of comments are helpful, which we did hear at the two-day meeting about not just what was the matter, but what happened to it. So that's come across as well, what was the auditor's response to this critical audit matter? We've heard that a number of times.

So we've gotten a lot of good input on this from a variety of -- from a lot of outreach on this project, from Jessica and team, who continue to move along on the development of our next proposal on this.

Elizabeth Mooney?

MS. MOONEY: So it sounds like the U.S. is pretty behind, I mean, 75 years, you mentioned in the U.S. And the U.K. that -- the discussion. So it's encouraging that we're continuing to look pretty hard at this. But I'm curious just on the Rolls Royce; and I don't know if there's anyone here who can speak for KPMG, but what is there response and when you've talked to them about how difficult it was for KPMG to go through this exercise for the Rolls Royce audit report, for instance? The challenges.

MR. BAUMANN: We had some people at the public meeting, but I don't think we -- do we have anybody from
that firm?

Yes, Tony Cates. That's right. We had Tony Cates from that firm who talked about that experience, but we didn't have a representative of the company at the public meeting. If you're asking what the company's reaction was?

MS. MOONEY: No, I'm just asking how hard it was for KPMG to put together this audit report, if it was -- what their experience was in terms of it being -- how it was received, what challenges they faced, what they left out.

MR. BAUMANN: Jessica?

MS. WATTS: I think KPMG actually put out a survey on putting together these audit reports. And then there have been several articles about these particular KPMG audit reports. And there's this one particular auditor has done these more extended auditor's reports, Rolls Royce and then there's another that he has done. Anyway, they've -- KPMG has said that they had put out these two specific audit reports that went a little bit further than what the U.K. required. And they had done it to be provocative and try to get feedback, and the feedback had
been very good about -- from investors, that they thought that this was really helpful to have the -- not only what the auditor did, but what the auditor found.

And so, the investors have liked it. And from what we understand from KPMG, it wasn't that difficult. But that was really from these articles is where we've learned it, and then from discussions with Tony Cates during the meeting.

MR. BAUMANN: What we did here during the public meetings was that -- again, I think I mentioned this, the teams were -- the engagement teams were motivated, they felt that their audit report was going to be more useful and the areas that they worked on could be more relevant potentially to investors. And the items that were disclosed, it's not as if they'd pop up at the last second. These were typically the items that were probably the most important items addressed throughout the audit, discussed probably a number of times with management and the audit committee.

So in terms of the extra effort, the extra effort seems to be in the writing of the matters, but not a matter of, well, what are we going to talk about as the critical
matters? The engagement team, the company and the audit
committee pretty much seems to have an idea that these are
the issues we all talked about during the year. These were
the real troublesome issues in terms of auditing. So not
surprised at what was disclosed in the auditor's report.

Jeff Mahoney?

MR. MAHONEY: Thank you. I had a question and a
comment. Elizabeth essentially took my question, but one
add-on to that, to the extent that this group will have
future discussions in connection with this project, I
think it would be very useful to have Mr. Sikes or Mr. Tate
or someone from the firm, someone from other firms that
have issued these types of opinions to speak to this group
so that we can ask them questions and get more insights
from them. So that's my question.

My comment is that with respect to the Rolls Royce
opinion, and in particular with respect to the findings
paragraphs, and in particular the findings paragraph with
respect to the measurement of revenue and profit in the
civil aerospace business and the findings paragraph in
connection with evaluation of Daimler AG's put option,
that type of disclosure I think is very much in line with
much of the input from the user community that was provided
to the Treasury Committee a number of years ago. It's also
very consistent with the Council's numerous letters on
this project over the years and with many of the user
investor surveys and studies, and with the PCAOB's own
outreach to investors in connection with this project.

That's my comment. Thanks.

MR. BAUMANN: Yes, that finding is we found the
resulting estimate was acceptable but mildly optimistic
resulting in a somewhat lower liability being recorded
than might otherwise have been the case, that type of
language. So, interesting language. But certainly we
have heard from the investor community that that type of
assessment of estimates is what the investor community is
interested in, in addition to a recitation of these were
the most significant risks and here's how we audited it.

So that's a consistent comment, Jeff, I think from the
investor community over time.

Lew Ferguson, you had your card up a minute ago?

MR. FERGUSON: I just wanted to point out that one
of the things that I felt was very interesting about the
comments that Cates made when he said that these reports
were very dramatic because they were different than anything that had ever been put out before. But he was concerned and he said in these particular companies it was likely that the companies would probably not change from year to year. So the next report might look exactly the same and people would begin to say, okay, well, here we are back to a new kind of boilerplate and this is not dramatic anymore and to sort of want ever more information.

MR. BAUMANN: Yes, that point was made and I think everybody acknowledged this is -- year one looked very interested in the U.K. and what is year two going to look like will be a very important experience.

Guy Jubb?

MR. JUBB: Speaking as a major U.K. investor, I wasn't so much pleasantly surprised by the enhanced auditor reporting, but I was certainly very encouraged by where we are going for many of the reasons that have already been discussed. But I would like to highlight in terms of feedback and therefore to help the PCAOB -- is the use of specificity in terms of the auditor reports that have been used. We have two very good examples in Rolls Royce and Barclays. I should add that the Rolls Royce one is...
generally regarded as the high bar in this and it wouldn't be suggested that all auditor reports in the U.K. have this transparency. But the willingness to refer to the Daimler option that Jeff mentioned earlier, that gives the investors of itself a degree of greater confidence in the audit approach that was taken.

Another example is the BP audit report where the auditor by name tells us that he went to Moscow three times to verify the accounting treatment that was used for the Rosneft interest in BP, and that enabled my firm, Standard Life, to go to the BP AGM and ask a question about that. If we had not had that disclosure, we would have not been able to ask that question and we would -- it enhances accountability.

We have also seen -- and I think we haven't referred to this here, but we have also seen a parallel improvement in audit committee reporting as well. This has been on the go for some time, but it has had a step up in terms of seeking to provide greater transparency. And when we as users are looking at the auditor report, we are also in -- on the one had have that. In the other hand we have the audit committee report. And the more that one can
actually develop this framework of reporting between audit
committees and auditors in a joined up way, I think that
that will be valuable for investors and we'll also avoid
some degree of inappropriate duplication.

Thirdly, it has enabled a dialogue to take place
about audit issues. This year so far I have had
discussions, face-to-face discussions with the chairman
of seven FTSE 100 audit committees about their auditor
report. That is seven more than I have had in my 20-year
career at Standard Life in dealing with engagement. But
importantly, I'm using the word "having a conversation,"
because this isn't about hard engagement at this stage.
It's about having a conversation about what is being used.

What hasn't actually landed so well yet is
disclosures about materiality. And I know that whether
or not materiality should be disclosed is a sensitive
issue. We have certainly found in principle it is a good
disclosure. The terminology that is used has still got
a high degree of technicality to it, but there's one number
that keeps on resonating, and that's the number five.
Everything is five percent of something. And I didn't
know that until we had these auditor reports and I'm now
starting in my conversations just to ask, well, -- why is it always five percent and what should it be five percent of, or what it should be of? So there's a whole dialogue that's taking place there.

Now having said all that, whilst I am having the conversations and no doubt other investors in this room are, I'm not entirely convinced that audit reports are being well communicated into the capital market system. They are not featuring in the slide decks that are used by investor relations programs in going out to see companies, and therefore I think it is a very narrow pool of people who are actually reading these auditor reports at this stage, and one of the encouragements that has to be given is how to broaden that. And I think in terms of the -- as time goes by and the engagement that the PCAOB has with audit committees it is to encourage audit committees, as I shall be, to actually get the executives to bring this into mainstream investor relations and not the narrow pool.

Two final points, if I may. It has increased interest among investors. I have been struck by the increasing number -- still quite small, but amongst the
U.K. institutional investor community. There are now more investors who are willing to step up to the plate to have a discussion about this. And when two becomes four, four becomes eight and I am confident that that will progress slowly.

And finally, the year-two issue which was being mentioned as to how this is going to be kept fresh, how it is going to be updated. I feel mildly optimistic that we'll get some useful reports coming through. It will require a little bit of hard work and to have -- the one area which I would like to see more transparency on that we have not seen referenced is the contextual factors such as any pressures that there might be on the management to meet market expectations, which should perhaps in exceptional situations sharpen the auditor's pencil or the impact of executive incentives if they are target-related and how the auditor perhaps has assessed those.

But this is part of the journey, to give this rather long comment, but while it's fresh in my mind I wanted to share it.

MR. BAUMANN: It was a long but very worthwhile comment, so thanks for that real live input from a user
of these reports in the United Kingdom. That's very valuable, Guy.

Tom Selling and then Barbara Roper?

MR. SELLING: Thank you, Marty. I thought this would be an appropriate moment to make some quick observations about three topics we're talking about today, because I think they're highly interrelated. The auditor reporting model is one, revenue recognition is another, and also the root causes of the audit issues reported by IFIAR. I want to make three points and I want be extremely brief.

The first point is that one of the root causes of the problematic audits we're all concerned about may indeed be a lack of transparency about what an auditor actually does and the ARM project may help with that. I for one would be extremely pleased if the audit reports on critical audit matters would be along the lines of the samples that you gave us, Marty, even if they devolved into the boilerplate that we're speaking about or that we're concerned with.

My point is that CAM reporting is perhaps more important from a control perspective, even as important,
as Guy points out, the informational perspective is. The old phrase about sunlight being the best disinfectants, I think this takes this actually to an additional degree where we're actually asking the auditor to shine the spotlight on them as they do this. And the remarks that I've heard so far seem to indicate that when an auditor does this that has an additional effect on, number one, the pride they take in the audit, as well as the quality of the audit.

My second point is that audit quality is directly related to the number of tough judgments that managers have to make and auditors have to somehow certify as reasonable. That seems to be the clear message from the IFIAR report that we'll be discussing and I found that virtually all of the audit flaws were driven by the auditor's inability to reliably state that management's estimates of future events appear reasonable.

We're going to be talking about revenue recognition, and I think it's clear from the materials we received in advance that revenue recognition will be increasing the number of judgments that auditors will be required to make. It's not clear what the PCAOB can do
about this acting alone, but the question needs to be asked, and in answering we're discovering that another root cause of the flaws is our standard-setting infrastructure.

Revenue recognition as a project took 12 years, but yet today -- only today, it seems, the PCAOB is going to be asking what challenges to auditing the new judgments that will be required will present to auditors? The FASB has recently stated in Concept Statement No. 8 that cost-benefit analysis is a pervasive constraint. And when we are asking now after 12 years how auditors should respond to that new standard, I wonder and I hope we'll consider whether we're putting the cart before the horse.

My third point is that the auditor's reporting model should provide information about choices of accounting policies when non-authoritative GAAP is the source. One of the things I noticed about the Rolls Royce report is that the opinion paragraph is qualitatively different than what we have. The report separately states that the financial statements are true and fair. And separate from that the report states that the financial statements are in accordance with IFRS as adopted by the
We use the term "fairly presented" in context with the standard. In addition to that, we recently have a new codification that has changed the status of the financial statement accounting concepts and it's not clear to me that people actually know what GAAP means. Just last week I was at a meeting of the Accounting and Assurance Standards Committee of my state's CPA Society and they asked me to put together a one-hour presentation on what exactly does GAAP mean? I thought that's pretty interesting coming from a group of CPAs.

And so I think I would like to encourage us to consider when we talk about the audit reporting model what GAAP means within the context of a particular audit. When non-authoritative GAAP was relied on significantly, I think that that's part of the judgments that ought to be disclosed within the auditor's report. One of the reasons I bring that up now is because the Rolls Royce report doesn't have quite the same problem because the status of the conceptual framework within IFRS is different than it is under U.S. GAAP. Thank you.

MR. BAUMANN: Thanks, Tom. Thanks for all those
We have a number of cards up. This session was scheduled to end at 2:45, then we begin discussion of audit quality indicators -- I'm sorry, audit quality initiatives. So we're going to continue for a few more minutes to try to answer -- get a few more cards up on this issue. And I have one or two more comments to make on the agenda, so we're going to try to do this in about 5 to 10 minutes, all of this, and then we're going to move on. That's going to shorten the break to about a -- maybe just grab a beverage or something as you head out to your break-out sessions. So we're taking time away from our break here, but I think the discussion is lively and worth it.

So, Barbara Roper?

MS. ROPER: So I'll be very quick. Add my voice to those who think this is very responsive to what investors have been saying for years they want to see in the audit report. I don't know that you have to be this prescriptive in how you would adopt the standard, but I found particularly useful the approach that says this is the risk, this was our response, these are our findings.
So in some ways I would hope that the standard would ensure that all of those points would be addressed in this kind of reporting. I think that in part drives the kind of specificity that makes this useful.

The risk was always that if you did this, went this route, that it would devolve into something that was so general or boilerplate as to be meaningless. I find these to be really -- I thought the samples that the Board prepared for an earlier SAG meeting were encouraging. I found these to be really very high quality useful for investors.

MR. BAUMANN: Thanks. We did, too.

Steve Buller and then Rick Murray.

MR. BULLER: Thanks, Marty. Just a couple brief comments as I also found the reports very useful and I'd encourage you to include additional examples as you find them, even between now and the next SAG meeting just because they're of great interest.

I actually found the Rolls Royce report fairly useful. The Barclays report seemed to have a lot of boilerplate and it looked a lot to me like a significant risk factors disclosure in MD&A. So if you look at some
of the topics, provision for uncertain tax positions, IC systems and controls, risk of fraud and revenue, risk advancement, override of controller controls, litigation of regulatory claims, they read boilerplate. I'd be curious if when people did their examination of individual firms if those same paragraphs were recurring in reports issued by the same firm.

MR. BAUMANN: Yes, there's definitely variation in the reports, and that's -- we did put two reports in here that were I thought both interesting, but different characteristics as well in terms of the depth of one and focused more just on the significant risks in the other. But I agree with your observation.

I think we have on this subject three more cards and then we just -- you pointed to four more cards. Rick Murray, Doug Maine, Brandon Rees and Rachel Polson, and then we need to get on.

MR. MURRAY: Thank you, Marty, and just very briefly, just a quick observation. It's clear that there is considerable encouragement in the British experience with first-year exercise that needs to be pursued and understood. At the April event and subsequently we've
also had a number of comments, both from the U.S. and the U.K. to be cautious about the enabling value in the U.K. of an integrated regulatory regime and a benign legal culture. I don't suggest that those would necessarily change the outcomes in the U.S., but we hadn't heard any comments about it in this discussion and they were the two most significant additional comments that came forward from April that hadn't made it to the floor and I just wanted to note that they should be considered going forward.

MR. BAUMANN: Valuable point and certainly made at the April meeting with the different legal environments.

MR. MAINE: I am an audit committee chairman and I'm generally supportive of this. Guy's point though about conversations with seven audit committee chairmen resonated with me, and I'm curious to know whether you're considering the practical consequences of this for audit committees, particularly in light of Regulation FD and where it's taboo to have selected disclosures. Does this end up with audit committee conference calls with investors I have interested in accounting and auditing issues? If so, don't know. Want to point that out.
MR. BAUMANN: Yes, I think that those are important questions. What we think is that it gives investors and audit -- investors, not audit committees, because these are things that are not new to the audit committee, we hope -- investors an idea of what were the most significant judgments the auditor had to make as part of the audit. That could trigger, I think, as in the case that Guy pointed out, investors talking to management as part of an earnings call or whatever that might have been, is to tell us a little bit more about the auditor's challenge in this area. But certainly all legal ramifications are -- all consequences are to be considered on our end as part of this, so thanks for that.

Brandon?

MR. REES: Thank you, Marty. I wanted to pick up on a comment you made in the introduction regarding the value of CAM disclosure and audit reports for proxy voting by investors, and I think this also speaks to the goal of encouraging investor audit committee dialogue.

I want to encourage the Board to think about the parallel of executive compensation disclosure, which of course we as investors get in great detail, and the
adoption of say on pay advisory votes and the success of that process post Dodd-Frank in encouraging both improvements to the executive compensation process here in the United States as well as dialogues and responsiveness by compensation committees to investor concerns and contrast that with the lack of attention paid to audit firm ratification votes here in the United States.

Before this meeting I pulled the vote results from this year's proxy season for the Russell 3000, and the average vote, average ratification vote was at 99 percent, which was a largely meaningless -- in my mind, largely meaningless vote because investors have nothing to vote on. We have no information besides the level of fees and the ratio of audit to non-audit related fees to guide us on. And that's why I'm genuinely excited about the inclusion of CAMs in the audit report.

And I also want to encourage the Board to consider as a long-term goal the inclusion of audit quality indicators in the audit report or some other form of disclosure as being beneficial to that process, to use the audit vote as a mechanism to encourage both dialogue as well as accountability for effective audits.
MR. BAUMANN: I think that's very valuable input, but having said that, when I was an audit partner I took great excitement and pride in that 99 percent.

(Laughter.)

MR. BAUMANN: So now you've shattered me here. I thought it meant something about my work. Oh, well.

MR. REES: If I could just briefly respond to that. For the 50 companies that lost their say on pay vote, the sky did not fall, and in fact many of those companies have responded by improving their executive compensation process. And they are just advisory.

MR. BAUMANN: Last word on this topic, Rachel Polson.

MS. POLSON: One is a comment and one is a question. One relates to the proposed other information standard is definitely would appreciate from the auditor's perspective clarification on the steps related to evaluate what you specifically want us to do, because I can see auditors taking the approach of spending time actually doing a lot of additional audit procedures and there would be a lot of excess cost for the companies related to that.

And then the other one is more of a question. You
know, we talked about the audit deficiencies reports that are out there that are being issued by the inspection reports, and is the thought that if these critical risk matters are included in the report, that that will have the auditor's reflect more closely on where the audit risks are to make sure that they do have the appropriate findings and the responses documented so that they aren't missing that information. Is that one of the outcomes you're hoping with this?

MR. BAUMANN: Yes, I think that's another benefit of the enhanced auditor reporting is by the auditor pointing out the most significant risks. I do think the auditor naturally will pay more attention to those matters, I believe, as part of their audit work. And maybe management will pay more attention to their related disclosures in those areas as well. So I think there's potential positive intended consequences that come out of enhanced auditor reporting.