

NOTICE: This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on June 24, 2014 that relates to the Board's Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments. The other topics discussed during the June 24, 2014 meeting are not included in this transcript excerpt.

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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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1 (...)

2 MR. BAUMANN:

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

11 So before this meeting, as part of the meeting
12 materials sent out to SAG members -- materials related to
13 the ARM project. And what we sent you was the Board
14 proposed changes to the auditor's report in April -- August
15 13th, 2013. And the fact sheet of what we proposed is in
16 front of you. Just as a reminder, that dealt with the
17 requirement for the auditors to report on critical audit
18 matters, those matters that are addressed during the audit
19 that involve the most difficult subjective or complex
20 auditor judgments, pose the most difficulty to the auditor
21 in obtaining sufficient appropriate evidence and/or pose
22 the most difficulty to the auditor in forming an opinion

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1 on the financial statements.

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

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

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

20 We received 246 comment letters on the proposal
21 during the year. We received comment at the last SAG
22 meeting. A major portion of that was getting input from

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1 the SAG members. In addition, in April 2014; and that
2 material is in front of you as well; and many of you here
3 participated in that, there was a two-day public meeting
4 on the auditor's reporting model and we covered various
5 aspects of the various components of this, the critical
6 audit matters, issues around other information, issues
7 pertaining to larger firms, smaller firms, etcetera.

8 But we also looked at other developments that were
9 occurring around the world. And as part of the materials
10 that I've shared with you I've included excerpts of what's
11 now a requirement in the United Kingdom that went into
12 effect for financial statements filed after September 30,
13 2013 and periods after that. Is that right, Jessica?

14 MS. WATTS: Sounds right.

15 MR. BAUMANN: September 30th, 2013 and after that.
16 And if you read the -- there was one page of that we took
17 out from the U.K.'s standards was pretty principles-based.
18 It said describe those assessed risks of material
19 misstatements that were identified by the auditor and
20 which had the greatest effect on the overall audit
21 strategy, the allocation of resources in the audit and
22 directing the efforts of the engagement team, provide an

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1 explanation of how the auditor applied the concept of
2 materiality in performing and planning the audit and
3 provide an overview of the scope of the audit, and few more
4 words to that. And we've also included a couple of
5 examples of reports that came out of the U.K. for your
6 observation.

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

15 The engagement partners felt that that was a
16 positive impact on the audit taken as a whole and the
17 investment management professionals who reported at that
18 meeting felt that these more detailed reports gave the
19 market more confidence in the work of the auditor as it
20 spelled out some of the significant risks or critical audit
21 matters, as we would call them here, that the auditor dealt
22 with.

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1 But the examples in front of you -- there's two
2 companies. One of them is -- compared to the traditional
3 couple-of-paragraph report we see here in the United
4 States, there's a six-page opinion of the audit spelling
5 out about 10 different risks of material misstatement and
6 the auditor's responses to those risks that they found.
7 The other one I think is about a four -- about a five-page
8 report or so on similar type matters.

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

22 I don't know, Jessica, would you say it was

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1 different? No? That's about what we heard. But that's
2 year one, and we'll have to see how these reports come out
3 in year two. This is just a couple of them that we shared
4 with you just so you could see that this is occurring.
5 Reports came out in a highly principles-based way, the
6 standard.

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

19 So we are continuing to proceed on our path with
20 respect to reflecting on the comments on the proposal,
21 comments from the public meeting, comments from SAG
22 members and we're working with the Board on our next steps.

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1 I thought I'd take -- there's a couple of cards up.
2 But before I did that -- I see Mike Gallagher was up and
3 Bob Herz. Before I did that, I've talked a little bit
4 about our developments and other global developments, but
5 clearly among those global developments are developments
6 at the International Auditing and Assurance Standards
7 Board, as they are also in the process of developing a new
8 auditor's report -- and Arnold Schilder, a regular
9 observer at our SAG meetings is here today, the Chairman
10 of the IAASB.

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

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

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

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

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1 participated as well.

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

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

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

17 A bit more specific on some key components. First,
18 key audit matters. We've made excellent progress on this
19 new standard, ISA 701, and that addresses the
20 communication of key audit matters. Respondents to the
21 exposure draft strongly supported the concept of KAM being
22 based on matters communicated with those charged with

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1 governance, usually the audit committee, firstly focusing
2 on matters of significant auditor attention.

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

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

22 We've now refined both the requirements relating

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1 to determining KAM and the application material which is
2 guidance that is essential to the proper application of
3 the requirements in the ISA. It has all set out
4 conservations for the auditor in all cases focused on three
5 areas.

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

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

20 And our most substantive Board debates to date
21 relating to KAM have been on the possibility that the
22 auditor might conclude in what we now call extremely rare

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1 circumstances not to communicate a matter that had been
2 determined as a KAM in the auditor's report.

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

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

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

22 We received significant feedback to our first

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

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

21 And our work continues to look at how it might
22 increase auditor attention on going concern and response

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1 to calls arising from the financial crisis. And at our
2 meeting last week we had some lively debates around the
3 possibility of a new requirement aimed at enhancing the
4 auditor's consideration of the adequacy of disclosures
5 around going concern issues, including the need for and
6 adequacy of disclosures about underlying events or
7 conditions where a material uncertainty does not exist,
8 the so-called close calls. And course that's of interest
9 to the slides from the FASB in the area of significant doubt
10 that had been alleviated by management plans.

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

16 Two closing comments: First, the IAASB started
17 this project in 2006 with Independent Research Commission
18 by us and the AICPA Auditing Standards Board. We then had
19 two global rounds of consultations, 2011, 2012, and then
20 the exposure draft in 2013. And I really would express
21 how grateful we are for the dialogue that we had during
22 this process with the PCAOB at various levels, the

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1 Financial Reporting Council, but also the European
2 Commission and European Parliament. And we appreciate
3 that the PCAOB has to operate within confidentiality
4 requirements, so we're very grateful for the dialogue that
5 we could have.

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

21 Pleasantly surprised. I wonder how long ago it is
22 that an investor was able to say that about an auditor's

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1 report. Thank you.

2 MR. BAUMANN: Arnold, thanks very much for that
3 update. And as I said, there are a number of cards up.
4 Mike Gallagher was first.

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

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

15 Before I get into the details; and I won't get into
16 much, I'll give a very quick high-level summary of what
17 the field tests found, but there were clearly some
18 limitations to the field tests, a couple of which -- and
19 probably the most significant of which, given the desire
20 on the part of issuers to remain confidential and not have
21 the information go beyond the accounting firm that did the
22 work, we were not able to get a reaction from investors.

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1 So without getting the benefits, which is clearly what we
2 would get from an investor perspective, you know, severe
3 limitation, and we understand that.

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

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

16 And so at a very high level a couple of things:
17 One, very similar to what I heard Arnold just say with
18 respect to refining the population from what you would pick
19 CAM, and as we talked about in previous SAG meetings we
20 think it would be useful to refine it down from three maybe
21 to one key source, which is information communicated to
22 audit committees. We think that you'd capture things that

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1 are relevant there and without having to go through a
2 larger population, which is largely redundant.

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

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

22 And then the last item with respect to CAMs, again,

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

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

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1 performance requirement would be.

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

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

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

21 That letter from the CAQ I think is now up -- has
22 been delivered to us and is available with other comment

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1 letters that we've received on our website.

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

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

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

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

20 I was in the U.K. subsequent to that and at the point
21 that they were -- had issued some of these reports or were
22 working on them. And I'll reinforce that the reaction

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1 there among audit committee people there, particularly
2 what I'll call the not-inside-baseball people, or maybe
3 it should be not-inside football people; in other words,
4 they didn't come from the profession, they hadn't been with
5 one of the firms or whatever, they were people that had
6 been in business or had been regulators or whatever, was
7 extremely positive to the expanded reporting. And so they
8 really started to get much better insight into what was
9 looked at in the audit and what was found and the like.

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

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

22 MR. BAUMANN: Yes, I think all of these experiences

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1 and field testing and IAASB's outreach and those kind of
2 comments are helpful, which we did hear at the two-day
3 meeting about not just what was the matter, but what
4 happened to it. So that's come across as well, what was
5 the auditor's response to this critical audit matter?
6 We've heard that a number of times.

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

11 Elizabeth Mooney?

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

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

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1 that firm?

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

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

12 MR. BAUMANN: Jessica?

13 MS. WATTS: I think KPMG actually put out a survey
14 on putting together these audit reports. And then there
15 have been several articles about these particular KPMG
16 audit reports. And there's this one particular auditor
17 has done these more extended auditor's reports, Rolls
18 Royce and then there's another that he has done. Anyway,
19 they've -- KPMG has said that they had put out these two
20 specific audit reports that went a little bit further than
21 what the U.K. required. And they had done it to be
22 provocative and try to get feedback, and the feedback had

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1 been very good about -- from investors, that they thought
2 that this was really helpful to have the -- not only what
3 the auditor did, but what the auditor found.

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

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

20 So in terms of the extra effort, the extra effort
21 seems to be in the writing of the matters, but not a matter
22 of, well, what are we going to talk about as the critical

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1 matters? The engagement team, the company and the audit
2 committee pretty much seems to have an idea that these are
3 the issues we all talked about during the year. These were
4 the real troublesome issues in terms of auditing. So not
5 surprised at what was disclosed in the auditor's report.

6 Jeff Mahoney?

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

16 My comment is that with respect to the Rolls Royce
17 opinion, and in particular with respect to the findings
18 paragraphs, and in particular the findings paragraph with
19 respect to the measurement of revenue and profit in the
20 civil aerospace business and the findings paragraph in
21 connection with evaluation of Daimler AG's put option,
22 that type of disclosure I think is very much in line with

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1 much of the input from the user community that was provided
2 to the Treasury Committee a number of years ago. It's also
3 very consistent with the Council's numerous letters on
4 this project over the years and with many of the user
5 investor surveys and studies, and with the PCAOB's own
6 outreach to investors in connection with this project.

7 That's my comment. Thanks.

8 MR. BAUMANN: Yes, that finding is we found the
9 resulting estimate was acceptable but mildly optimistic
10 resulting in a somewhat lower liability being recorded
11 than might otherwise have been the case, that type of
12 language. So, interesting language. But certainly we
13 have heard from the investor community that that type of
14 assessment of estimates is what the investor community is
15 interested in, in addition to a recitation of these were
16 the most significant risks and here's how we audited it.
17 So that's a consistent comment, Jeff, I think from the
18 investor community over time.

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

20 MR. FERGUSON: I just wanted to point out that one
21 of the things that I felt was very interesting about the
22 comments that Cates made when he said that these reports

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1 were very dramatic because they were different than
2 anything that had ever been put out before. But he was
3 concerned and he said in these particular companies it was
4 likely that the companies would probably not change from
5 year to year. So the next report might look exactly the
6 same and people would begin to say, okay, well, here we
7 are back to a new kind of boilerplate and this is not
8 dramatic anymore and to sort of want ever more information.

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

13 Guy Jubb?

14 MR. JUBB: Speaking as a major U.K. investor, I
15 wasn't so much pleasantly surprised by the enhanced
16 auditor reporting, but I was certainly very encouraged by
17 where we are going for many of the reasons that have already
18 been discussed. But I would like to highlight in terms
19 of feedback and therefore to help the PCAOB -- is the use
20 of specificity in terms of the auditor reports that have
21 been used. We have two very good examples in Rolls Royce
22 and Barclays. I should add that the Rolls Royce one is

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1 generally regarded as the high bar in this and it wouldn't
2 be suggested that all auditor reports in the U.K. have this
3 transparency. But the willingness to refer to the Daimler
4 option that Jeff mentioned earlier, that gives the
5 investors of itself a degree of greater confidence in the
6 audit approach that was taken.

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

15 We have also seen -- and I think we haven't referred
16 to this here, but we have also seen a parallel improvement
17 in audit committee reporting as well. This has been on
18 the go for some time, but it has had a step up in terms
19 of seeking to provide greater transparency. And when we
20 as users are looking at the auditor report, we are also
21 in -- on the one had have that. In the other hand we have
22 the audit committee report. And the more that one can

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1 actually develop this framework of reporting between audit
2 committees and auditors in a joined up way, I think that
3 that will be valuable for investors and we'll also avoid
4 some degree of inappropriate duplication.

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

14 What hasn't actually landed so well yet is
15 disclosures about materiality. And I know that whether
16 or not materiality should be disclosed is a sensitive
17 issue. We have certainly found in principle it is a good
18 disclosure. The terminology that is used has still got
19 a high degree of technicality to it, but there's one number
20 that keeps on resonating, and that's the number five.
21 Everything is five percent of something. And I didn't
22 know that until we had these auditor reports and I'm now

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1 starting in my conversations just to ask, well, -- why is
2 it always five percent and what should it be five percent
3 of, or what it should be of? So there's a whole dialogue
4 that's taking place there.

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

20 Two final points, if I may. It has increased
21 interest among investors. I have been struck by the
22 increasing number -- still quite small, but amongst the

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1 U.K. institutional investor community. There are now
2 more investors who are willing to step up to the plate to
3 have a discussion about this. And when two becomes four,
4 four becomes eight and I am confident that that will
5 progress slowly.

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

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

21 MR. BAUMANN: It was a long but very worthwhile
22 comment, so thanks for that real live input from a user

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1 of these reports in the United Kingdom. That's very
2 valuable, Guy.

3 Tom Selling and then Barbara Roper?

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

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

21 My point is that CAM reporting is perhaps more
22 important from a control perspective, even as important,

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1 as Guy points out, the informational perspective is. The
2 old phrase about sunlight being the best disinfectants,
3 I think this takes this actually to an additional degree
4 where we're actually asking the auditor to shine the
5 spotlight on them as they do this. And the remarks that
6 I've heard so far seem to indicate that when an auditor
7 does this that has an additional effect on, number one,
8 the pride they take in the audit, as well as the quality
9 of the audit.

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

18 We're going to be talking about revenue
19 recognition, and I think it's clear from the materials we
20 received in advance that revenue recognition will be
21 increasing the number of judgments that auditors will be
22 required to make. It's not clear what the PCAOB can do

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1 about this acting alone, but the question needs to be
2 asked, and in answering we're discovering that another
3 root cause of the flaws is our standard-setting
4 infrastructure.

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

14 My third point is that the auditor's reporting
15 model should provide information about choices of
16 accounting policies when non-authoritative GAAP is the
17 source. One of the things I noticed about the Rolls Royce
18 report is that the opinion paragraph is qualitatively
19 different than what we have. The report separately states
20 that the financial statements are true and fair. And
21 separate from that the report states that the financial
22 statements are in accordance with IFRS as adopted by the

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1 EU.

2 We use the term "fairly presented" in context with
3 the standard. In addition to that, we recently have a new
4 codification that has changed the status of the financial
5 statement accounting concepts and it's not clear to me that
6 people actually know what GAAP means. Just last week I
7 was at a meeting of the Accounting and Assurance Standards
8 Committee of my state's CPA Society and they asked me to
9 put together a one-hour presentation on what exactly does
10 GAAP mean? I thought that's pretty interesting coming
11 from a group of CPAs.

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

22 MR. BAUMANN: Thanks, Tom. Thanks for all those

1 comments.

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

15 So, Barbara Roper?

16 MS. ROPER: So I'll be very quick. Add my voice
17 to those who think this is very responsive to what
18 investors have been saying for years they want to see in
19 the audit report. I don't know that you have to be this
20 prescriptive in how you would adopt the standard, but I
21 found particularly useful the approach that says this is
22 the risk, this was our response, these are our findings.

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1 So in some ways I would hope that the standard would ensure
2 that all of those points would be addressed in this kind
3 of reporting. I think that in part drives the kind of
4 specificity that makes this useful.

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

12 MR. BAUMANN: Thanks. We did, too.

13 Steve Buller and then Rick Murray.

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

19 I actually found the Rolls Royce report fairly
20 useful. The Barclays report seemed to have a lot of
21 boilerplate and it looked a lot to me like a significant
22 risk factors disclosure in MD&A. So if you look at some

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1 of the topics, provision for uncertain tax positions, IC
2 systems and controls, risk of fraud and revenue, risk
3 advancement, override of controller controls, litigation
4 of regulatory claims, they read boilerplate. I'd be
5 curious if when people did their examination of individual
6 firms if those same paragraphs were recurring in reports
7 issued by the same firm.

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

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

18 MR. MURRAY: Thank you, Marty, and just very
19 briefly, just a quick observation. It's clear that there
20 is considerable encouragement in the British experience
21 with first-year exercise that needs to be pursued and
22 understood. At the April event and subsequently we've

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1 also had a number of comments, both from the U.S. and the
2 U.K. to be cautious about the enabling value in the U.K.
3 of an integrated regulatory regime and a benign legal
4 culture. I don't suggest that those would necessarily
5 change the outcomes in the U.S., but we hadn't heard any
6 comments about it in this discussion and they were the two
7 most significant additional comments that came forward
8 from April that hadn't made it to the floor and I just
9 wanted to note that they should be considered going
10 forward.

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

13 MR. MAINE: I am an audit committee chairman and
14 I'm generally supportive of this. Guy's point though
15 about conversations with seven audit committee chairmen
16 resonated with me, and I'm curious to know whether you're
17 considering the practical consequences of this for audit
18 committees, particularly in light of Regulation FD and
19 where it's taboo to have selected disclosures. Does this
20 end up with audit committee conference calls with
21 investors I have interested in accounting and auditing
22 issues? If so, don't know. Want to point that out.

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1 MR. BAUMANN: Yes, I think that those are important
2 questions. What we think is that it gives investors and
3 audit -- investors, not audit committees, because these
4 are things that are not new to the audit committee, we
5 hope -- investors an idea of what were the most significant
6 judgments the auditor had to make as part of the audit.
7 That could trigger, I think, as in the case that Guy pointed
8 out, investors talking to management as part of an earnings
9 call or whatever that might have been, is to tell us a
10 little bit more about the auditor's challenge in this area.
11 But certainly all legal ramifications are -- all
12 consequences are to be considered on our end as part of
13 this, so thanks for that.

14 Brandon?

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

20 I want to encourage the Board to think about the
21 parallel of executive compensation disclosure, which of
22 course we as investors get in great detail, and the

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1 adoption of say on pay advisory votes and the success of
2 that process post Dodd-Frank in encouraging both
3 improvements to the executive compensation process here
4 in the United States as well as dialogues and
5 responsiveness by compensation committees to investor
6 concerns and contrast that with the lack of attention paid
7 to audit firm ratification votes here in the United States.

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

17 And I also want to encourage the Board to consider
18 as a long-term goal the inclusion of audit quality
19 indicators in the audit report or some other form of
20 disclosure as being beneficial to that process, to use the
21 audit vote as a mechanism to encourage both dialogue as
22 well as accountability for effective audits.

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1 MR. BAUMANN: I think that's very valuable input,
2 but having said that, when I was an audit partner I took
3 great excitement and pride in that 99 percent.

4 (Laughter.)

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

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

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

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

22 And then the other one is more of a question. You

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

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

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