NOTICE: This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board’s Standing Advisory Group meeting on November 13, 2013 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 November 13, 2013 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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WEDNESDAY

NOVEMBER 13, 2013

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MR. BAUMANN: All good points also, Scott. So I want to thank SAG members for very good, valuable feedback from the comments made by the members of the PCAOB, the SEC and our distinguished academics. And thank you all on the panel for an excellent job done.

Well, this is the beginning of our discussion about our proposal on the auditor's reporting model. We'll continue this into tomorrow morning but there was a lot to cover and we wanted to discuss it starting this evening.

As I said, we'll probably go one hour on this and then our dinner reception begins at 6:30.

So joining me up here are Jennifer Rand to my left, Lillian Ceynowa to my left, Jessica Watts to my right and
Elena Bozhkova to my right. And who's kicking it off, Jennifer?

MS. RAND: I am. Good afternoon, everyone.

MR. BAUMANN: I'll let you get settled.

MS. RAND: Anything else? All right, we'd like to get into the auditor's reporting model.

The PCAOB issued a proposal a few months ago, August 13th. We've been working extremely hard on the auditor's reporting model, conducting a lot of outreach. Really this proposal leads up to three years of work, including a concept release that we had issued.

In front of you, you have the slides for this session and we had intended to provide background of how we got here, how we got to the board's proposals, what types of issues came into our thinking in developing the proposals as well as the summary.

Oh, pressing the wrong buttons. The disclaimer I think Marty's already covered this morning.

MR. BAUMANN: Right.

MS. RAND: As far as the slides in front of you, given that we have limited time in our remaining session today and given that we're very much interested in hearing
from you rather than us speaking, we don't plan to cover
the slides in any detail. We trust that you've read the
proposals.

We had also provided you with a fact sheet,
two/three-page summary of the key elements in the
proposals as well as illustrative examples of the critical
audit matters.

So you may want to refer to those in connection with
the discussion, but we plan to just cover a few things in
just very high level and then just open up the floor for
discussion.

And our focus today will be on critical audit
matters and tomorrow we'll talk about new elements in the
report as well as other information.

So with that, I'm going to turn it over to Jessica
so she'll provide a high-level overview.

MS. WATTS: All right, so I'm going to just in the
interest of time talk about two slides.

The first slide is an overview of the auditor's
reporting model standard. The proposed standard retains
the pass/fail model of the current auditor's report. We
heard from many commenters that they like this form of
reporting and wanted us to retain it.

One of the major changes of the auditor's report relates to the communication of critical audit matters specific to each audit.

The communication of critical audit matters in the auditor's report is intended to make the auditor's report more informative, thus increasing its relevance and usefulness to investors and other financial statement users.

Additionally the proposal adds new elements to the auditor's report to provide investors and other financial statement users with information about the audit and the auditor. These include auditor independence and auditor tenure.

The proposed audit reporting standard further describes some of the auditor's existing responsibilities, such as the auditor responsibilities for financial statement notes and the risk of material misstatement due to fraud.

The proposed standard retains the existing requirements related to explanatory paragraphs and also retains the auditor's ability to emphasize a matter in the
financial statement.

So the next slide I want to go over is the definition of critical audit matters.

As defined in the proposed standard, the critical audit matters are those matters 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 or pose the most difficulty to the auditor in forming an opinion on the financial statements.

The auditor's communication of critical audit matters would be based on information known to the auditor and procedures that the auditor has already performed as part of the audit.

Thus, the communication of critical audit matters does not modify the objective of the audit or impose new audit performance requirements, other than the determination, communication and documentation of the critical audit matters.

So with that, I'd like to turn it back to Jennifer to start the discussion.

MS. RAND: Critical audit matters is a significant
MS. WATTS: You need --

MS. RAND: Sorry. Turn the mic on. That might help. Critical audit matters is really a very significant aspect of the board's proposal. It's where the auditor would be communicating those matters that were the most significant, the most difficult to the auditor, the issues that kept the auditor up at night, communicate those in the report.

So for the rest of the day today we'd like to focus specifically on critical audit matters.

And I mentioned tomorrow we'll get into new elements so that's independence and tenure, other information and anything else that SAG members may have an interest in and want to discuss.

So with critical audit matters, we have this broken into four different areas where we're interested in your feedback.

First is on the definition and Jessica just covered that. And then next, usefulness of reporting, the determination, communication and the documentation requirements.
So I see some cards up ready to go. I appreciate that, so we'll get into it. So Denny Beresford.

MR. BERESFORD: Well, I've already written a comment letter but I'll summarize my views.

In fact, I also participated in the development of a comment letter by the Institute of Management Accountants and I think it was actually said a little bit better in that letter. My thinking evolved a little bit I guess.

My concern about the critical audit matters, in addition to just adding lots and lots of paragraphs possibly to the report and sort of losing the forest for the trees in some cases, obscuring the pass/fail key paragraph, is that the notion of reporting the critical audit matters, the things that involve the most difficult audit judgments, et cetera, the proposal itself doesn't actually call for the reporting of the auditing procedures.

So instead of actually reporting auditing matters, the proposal calls for a description of the company's reporting of key accounting objective estimates and things of that nature.
So for all practical -- I think they've cut me off on purpose here. For all practical purposes, this is really an indirect way of identifying important matters in the company's financial reporting, for example where significant estimates were made, et cetera, rather than the company, which they're already doing in their MD&A and so forth or a few companies have had road maps to their financial statements and things of that nature.

In fact, as I said, as I read the document, it's silent in the standards section with respect to reporting the procedures.

In the basis for conclusions, it said we're not going to actually require the auditors to report the procedures when they give the CAMs.

And then in the three or four examples that are given, they actually put in the procedures, which is kind of an interesting inconsistency I guess you might say about how those procedures are handled.

So it seems rather inconsistent that the approach that the PCAOB is using is to focus on auditing matters and yet not discuss any of the auditing, frankly, which I support.
I think that getting into discussing auditing on a piecemeal basis raises separate questions about what would be the opinion on each of those issues.

But as I said, it then becomes one of is this the auditor's responsibility to be listing all of these things or is it management's responsibility?

And in the letter that I wrote, I identified what I thought would have been the types of items that would have been reported by two of the boards on which I've previously, fairly recently served.

And those items are very well spelled out right now in both MD&A and financial statement footnotes so the reporting of those end CAMs would be a duplication.

In addition, of course, there would be the administrative, I hesitate to use this but I'll use it, nightmare of the auditors and the company having to negotiate what goes in the CAMs in the audit report versus what does the company put in its own disclosures and having to negotiate those among the auditors' legal counsel, auditors' national offices, et cetera, et cetera, et cetera.

And all things considered, I just don't see this
As a major step forward. It seems like it's just repeating information that's in the financial statements already.

If there's a need to have these things better highlighted, I think that's management's responsibility and, as you can probably guess, I am not in favor.

MR. BAUMANN: Denny, I'll just make a very brief comment. There's a lot of cards up so we'll come back maybe to the comments later and I know Jennifer and others will want to react as well.

And she didn't go over, Jennifer did not go over the background but in the concept release we asked, many people talked about the auditor talking about the financial statements or the auditor talking about the audit.

And there was a lot more support for the auditor talking about the audit than about the financial statements, that the financial statements were the prerogative of management.

And so what we elected here was that option of the auditor talking about the audit and those matters that were most difficult and challenging to the auditor.

Now, whether they're similar matters that
management's reported on in the financial statements, they might be.

On the other hand, it could be that there was a particular systems problem that forced the auditor to get a very difficult time getting audit evidence because of the breakdown in systems.

Whether management intended to talk about that or not, who knows. Maybe they will after the auditor says they're going to talk about it.

But in any event, we approached this from what were the most difficult things to the auditor, the most difficult judgments the auditor had to face?

And this is not information necessarily in the financials. This is what the auditor found to be difficult and challenging.

But we'll take your comments up further about should procedures be in there or not, but there's so many cards up, let's turn to Barbara Roper.

MS. ROPER: Thanks, Marty. And I appreciate your scheduling part of this discussion today because, my apologies in advance, I will not be able to join tomorrow's discussion.
I think there are a couple of things about this.

You know, I have a son. I'm sure he would have loved over the years to tell me, you know, each grading semester, mom, I passed all my courses. I personally found it useful to get a little more information than that.

I think the same, and not to be flippant, but I think the same is true here. The current report with pass/fail does not adequately distinguish between the volume of companies, the vast majority of whom pass.

Investors have been saying for years that they want more information, you know, that the auditor is supposed to be working for them, reporting to them.

And they want more information from the auditor about issues related to the audit that would help them make more informed decisions about the companies in which they invest.

In an ideal world that would be enough. Investors want the information. It's reasonably cost-effective for auditors to provide the information. We should be talking just about how we do it and move on. Obviously it's more complicated than that.

I was talking at lunch today a little bit about the
fact that I think in this new world of everything has to be economic analysis it's very important to think up front about the problems that you're trying to solve through a regulation.

And clearly one of the problems that you're trying to solve is that investors don't think they're getting enough information out of the current audit report.

But I would argue that this proposal is relevant to a number of other important issues that this board is addressing.

In the current system, pass/fail and no other information, you know, so what are the incentives in that system?

And for the companies that we're worried about, not the good, aboveboard, strong financial reporting companies but the companies we're worried about, the current incentive is to get as aggressive as possible in their accounting consistent with a clean opinion.

If you require the auditor to report about critical issues, some of that may surface in that context, that they may find a way to give a clean opinion.

But they may raise in the context of this reporting
about critical issues elements that would point to certain aggressive practices.

That could change the incentives for issuers to get less aggressive. That would be an overall good thing that this could achieve.

You know, there's also a concern we talk about a lot, is that auditors are not sufficiently focused on the fact that they're working for investors and not management.

And requiring them to think more clearly in their auditor's report about what they think they should be communicating to investors about the key critical issues in the audit, what made this audit tough, might help to focus them a little more on their obligations to investors, you know, in a more concrete way.

You know, to the degree that they have to report out about these things and make a public record about what they thought were critical issues, they might be a little tougher in standing up to management in areas where they need, frankly, to be tougher in standing up to management.

And so I think when you look at this issue it's not just that investors would find this information useful,
and I thought the examples that you provide were good. It proved to me that this can be done in a way that's not just boilerplate. This could provide interesting, valuable information to investors.

But beyond that, there are regulatory issues that you all struggle with, how do you improve professional skepticism, how do you improve auditor independence, that this proposal could help to address. It's not a silver bullet, but it could help to address.

One other point, I would just say procedurally when you think about economic analysis and you look at the court decision that has driven the SEC further in this direction, one of the key functions of that, one of the key issues that they focus on, is the need to assess reasonable regulatory alternatives that have been suggested.

And I know there are a number of suggestions that investors have made about information that they would like to see in the audit report that are not reflected in the board's proposal.

And I would encourage you as you analyze this issue and do the economic analysis that one of the things you do as part of that is analyze the various proposals that
have been forward and have a good reason, have a good explanation, a reasonable basis for the decision not to adopt some of these other proposals because it shouldn't, frankly, be enough that some issuers don't want the auditor talking to investors or that some auditors are uncomfortable in that role. There ought to be a good regulatory analysis of why that is or isn't valuable information to have in this report. Thanks.


MR. HERZ: Yes, I also thank you, like Barbara, for spending some time today because I also will not be here tomorrow and, because of that, I had actually sent Marty a couple much more technical-type questions I had.

I'm generally supportive of the approach you seem to be taking. I'm also glad that it seems to be, at least at this stage, pretty similar to the IAASB's approach. Of course, they call it key audit matters, also KAM, but, you know, got to be divided by the same language so to speak.

But my two questions were, one, it seemed like the requirement to communicate CAM was only in the context of an unqualified audit.

And I could think of circumstances like we have a
qualification on a specific accounting matter and it would
still be relevant to talk about CAM. That not right?
That's just the way it reads to me.

MR. BAUMANN: In a qualified opinion, you'd also
report critical audit matters. It is in the amendments.

MR. HERZ: Okay, then I must have read it wrong
because the lead-in says in an unqualified audit the
following requirements --

MR. BAUMANN: Not that there are many qualified
opinions filed at the SEC, but it would apply.

MR. HERZ: Okay, good. And then secondly, just in
reading some of the examples there, particularly the first
two, the allowance for sales returns and the deferred tax
assets, and maybe I'm too much of a nerd and an auditor
but it kind of left me a little unsatisfied or it wasn't
clear to me -- yes, I knew that clearly, because the auditor
gave a clean opinion overall, that they must have concluded
satisfactorily on this.

But it kind of says here's the issue, here's the
problem, blah, blah, blah, and by the way the company's
accounting's in Note 6. There needs some better overall
contextual thing to lead into the whole CAM.
MS. RAND: Did you have anything specific in mind? We recognize it in the audit opinions and the financial statements as a whole. We didn't think it was appropriate to have piecemeal opinions on each thing.

MR. HERZ: I understood that problem so --

MS. RAND: So was there, kind of in that context --

MR. HERZ: I would just kind of, you know, a lead-in, something that, you know, the context of our overall audit which we above concluded, blah, blah, blah, the following critical matters arose.

So at least you alert the, I think an uneducated, average reader would kind of say, oh my God, this is the sales returns. They couldn't get happy with that.

MR. BAUMANN: We do say in the body of the opinion that the critical audit matters communicated below do not alter in any way our opinion of the financial statements taken as a whole.

But your point is well taken and it's somewhat similar to Denny's point, that should there be the procedures that were performed or something else, but then you do run into the problem of piecemeal opinions.
So both good comments that we'll figure out how to deal with, but thank you and thanks for the support on what we've done.


MR. WEIL: Okay. Is it working? Can you hear me?

MS. RAND: Yes.

MR. WEIL: I sent you folks some comments. That's not what I'm going to talk about now. You have that. I'm talking now as a member of an audit committee, sometimes audit committee, financial expert, sometimes not.

And I'm sitting there in an audit committee meeting and the auditor says to me, quote, "The PCAOB requires that I report to you," dot, dot, dot, and everybody's eyes glass over with boredom.

And the piece of paper he's got in front of me goes on for five or six pages of clear stuff they've taken from some template that they have at their audit firm and they reproduce and give it to us.

And absolutely nothing useful ever happens after "The PCAOB requires that we report to you" on X. Let's get through that. Let's get through that and get on to
the discussion of what's important.

Now, what I hear here is we're going to have even
more of that. "The PCAOB, in addition to what we've
already told you about, has required that we tell you about
these other things."

And I'm not saying these things aren't important,
but you guys have got audit committee overload.

The audit committee does not get to schedule the
length of its meetings in the board meetings I go to. The
chairman of the board sets the overall agenda for two or
three days and the audit committee gets some time and the
auditor speaks.

And I do not believe that putting this on the plate
is going to increase the amount of time available for real
discussion.

So I'm urging you to think about what in other
context people call regulatory overload. If you're going
to put this one in, think about taking something else out.

Denny wants to get rid of it altogether and maybe
that's the right way to go, but I'm just telling you that
from being in an audit committee "The PCAOB requires us
to report to you on" X is mind numbing.
MR. BAUMANN: Just a comment on that. When you said then they went on to talk about a lot of important stuff, I'm sure the PCAOB requires that the auditor talk about all those important things that you just referred to.

And maybe in some areas the requirements aren't as important at a particular company and, therefore, the auditor certainly has the flexibility, hopefully, to put the important things up front and then say, in addition, there are other communications and here they are and say but at your particular company this year these were not particularly important matters.

But that's another area. That's the audit committee report. This is about what investors are saying for years and commissions have been saying for years.

The single pass/fail audit report is not serving the needs and how can we improve the audit report, so that's our goal here.

You know, this certainly would have to be discussed with the audit committee but we believe these would be the important matters that were in that audit committee discussion that would wind up in this critical audit matter
discussion. Who was next?

MS. RAND: Scott Showalter.

MR. SHOWALTER: Thank you. This semester I gave my graduate students assignment to compare your proposal to the IAASB, so I had to do a deep dive on both and read them.

And comments were made and, Bob, you mentioned about proposal. What concerned me was how similar they actually were but how different they were and the concern about a user understanding the difference when they're reading reports.

It's not just difference between key audit matters versus critical and it seems like you could come to agreement about that.

But the way you start, they start at governance, you start at lower border definitions, so several comments have been made about working with IAASB already today.

I would just encourage you to try to reconcile that because I think the user of these reports may lose out in the end because of the differences and not actually understand that they actually came from different things.

They may think because one is the key audit matter
versus another one is critical they're the same thing. I
don't think they are. I think they're developed
differently and I'm not sure they would really understand
that.

You said you're on the group, Marty. I would encourage you to do that. From a minor technical thing
--

MR. BAUMANN: And Dan Montgomery, who's the chair of the IAASB's task force on their reporting model, is here
today as well.

MR. SHOWALTER: So who should I talk to on this, you or Dan? Okay, so --

MR. BAUMANN: You're talking to both of us, so that's good.

MR. SHOWALTER: Okay. But I think it is important to the user. You talk about the user. We ought to probably not encourage that.

One technical thing is that if you go to Paragraph 7, and this is the difference between International and PCAOB version, International I think gives the impression that you could actually issue an opinion with no key audit matters.
Your Paragraph 7, you actually say in most you will.

Well, I would suggest in Paragraph 9 the fact that it says you will always have to talk about the most difficult audit judgment, the most difficult evidence and the most difficult thing means you will always have a critical because it's the most difficult. So if I have ten things it's the most difficult in each one of those. So you've got an inconsistency between Paragraph 7 and 9.

MS. RAND: Okay, thank you. Steve Buller.

MR. BULLER: Thank you. So we also submitted letters to the IAASB and FASB and both are on the website, so. And as part of our letter submission, we generally talk to our analysts.

We have, you know, roughly 100 analysts throughout the organization and we try to talk to roughly 15 or so and get their thoughts on what their teams think about this proposal, and this one actually was a fairly spirited discussion.

But the analysts generally were supportive of the proposal. Their conclusion was that they think it's useful to have the critical audit matters disclosed. They did favor brevity.
I think that it was important to them that they understand what the matter was, why it was a critical audit matter, where it is in the financial statements so they at least are informed that there is an issue there where the auditor spent time and they then can have additional substantive discussions with management if they need to to understand why it was and how it was dealt with.

There are certain entities which have, I think, an inherently less business model, less complex business model, and, as a result, there will be routine matters that should not require identification, or if they do require identification, they're infrequent.

I think it's important people don't confuse the fact that someone spends a substantial amount of time with the fact that an issue is a complex issue or a critical issue.

In our case we have a lot of investment companies that are 34 registrants that would qualify.

I think that one thing we were concerned about, and this is as a preparer now, is we potentially have a lot of matters which could be considered critical audit matters and we're worried a bit about the fear auditors
may have to over-document why a matter is not disclosed as a critical audit matter just because they spent audit time in the area.

So as a result, we thought there was some use in the IAASB model where they at least start determining which matters are critical audit matters or key audit matters by identifying those which were communicated with those charged with governance or basically the audit committee as a starting point for the matters which they would identify for potential disclosure.

We also did not support including the audit procedures in the opinion. We think that it's possible to take those out of context.

We already provide enough information for somebody to really understand what was done. It probably would overwhelm the audit report and we do worry a bit about people misinterpreting those and having it look a bit like a piecemeal opinion.

I think though, however, there are cases where an auditor may need to provide disclosure and I can't think of many examples but perhaps where there is a disclosure of a significant control weakness, it's not a material
weakness, that somehow had an impact upon the
determination of a financial result outcome.

   The PCAOB probably should provide additional
guidance on when the auditor should disclose information
that is not in the financial statements if they're going
to include it as part of the audit procedures performed.

   But so, overall, we were in favor of the
communication of critical audit matters and key audit
matters also.

MS. RAND: Steve, just interested in, wanted to
explore one of the -- You had a lot of good points. You
make -- One of them was, kind of the source of the
communications being limited eventually to the audit
committees.

   And in the PCAOB's proposal we don't limit it to
that. But we say, likely the matters in the report we
would expect would be discussed with the audit committee.
Nonetheless, we also direct auditors to look at what was
documented in their engagement completion memo, which
would include summaries of significant issues and findings
in the audit, as well as the matters that were reviewed
by the engagement quality reviewer.
One question I personally have, so this is my own view, is if it was limited to just the audit committee, could that potentially, could there be an unintended consequence that auditors may be concerned about including something, or communicating something to the audit committee, for fear that that's now the target list of things that could potentially be in the report?

So, you know, it places greater emphasis on those communications. And could that have an effect? So, just interested in your reactions, since you did mention that suggestion.

MR. BULLER: Well, so our general impression is, and this is in part our experience and from our analysts, is that auditors tend to over communicate to audit committees matters.

And as a result, we find it hard to believe there would be something disclosed in an opinion that would not be disclosed to the audit committee. I think it's just hard to understand why they would ever do that.

First of all, if it's in the opinion, it's of such importance. And to not disclose that to the audit committee, I think would raise issues as to the intent and
competency of the auditor.

MS. RAND: Okay. Thank you. Next on the list is Loretta Cangialosi.

MS. CANGIALOSI: Okay. Actually I'm going to talk about, I think I'm going to talk about three things on your list there. The first of which is definition.

And, you know, before I came into this meeting I had some concerns about how critical audit matters would be interpreted by investors and others.

And sitting here now, I've heard people talk about, you know, aggressive practices, and, you know, they're thinking about, well why was it critical? And they would discuss it with management, and how they dealt with it.

One of my real concerns here is, there's an awful lot of very subjective things that go on as a result of the accounting policies that we must follow. I'll take something that's, I'll say simple but complex, which is a Level 3 fair value measurement, okay.

And if I have to do a 20 year forecast, okay, you can be sure that that is going to be difficult. It's going to be difficult to audit. It's a 20 year forecast. So to the extent that these are like normal things. Are they
hard to do? They're hard for me to do, let alone hard for
the auditors to audit.

So I think my concern here is really that people
come in with a mindset that there's something going on here
when a critical audit matter is flagged. It means it's
hard to do. It doesn't mean it's wrong or aggressive.

And so, I think there needs to be some education
around some of these things, that investors should expect
to see these. I mean, they are what they are. You've
written out what you would determine, and the degree of
subjectivity.

If you're doing a forecast, let me say it's
subjective, right. We all agree that different people
will come up with different forecasts, you know, the amount
of audit effort to address the matter.

So a lot of these things, my concern is that if the
definition is kind of being, people are interpreting it
to mean something funny is going on, or something
aggressive, or something that needs to be fixed. I don't
if that's exactly what's written here. So that was my
first thing on the definition.

My second is on the determination and the
communication. And I do have some concerns with that of, in some cases, I'll say overload of critical matters being put in, with people rising to a level of looking at these, and deciding, you know what, I'm not taking any risks. I'll put everything in. In which case it becomes less and less valuable, I would think, to an investor. Because they'll have to wade through a whole bunch of things that maybe aren't so big. But, you know, and we see this all the time with the SEC, when they come back and go, why did you disclose that? And people say, because I didn't want to get a comment.

I can see the similar thing happening here. And it will dilute the effectiveness of the communication if that occurs.

My other thing is, with respect to some of these factors, and it's not that I don't like the factors. It's really going to be within the implementation, and how this gets looked at within an inspection.

So, is an inspector going to be looking at every one of these factors, and expect a paper on what was considered, why was it considered, every single thing, you know? So you will actually drive how effective the
communication is by how much they dig in and ask for in all of this documentation.

So, you know, I do have some concerns about litigation as well. We have a lot of very clever lawyers in the room. And, you know, I can easily see audit firms having more litigation as a result of this. And I'm not saying that's a reason not to do it.

But we should just be aware of the potential consequences with somebody saying, well, you know, didn't you think an investor would be, would want to know that? Well, I don't know. I'm not in the head of an investor, you know. I'm following the rules.

And you've set out rules. But I do think that this could potentially lead to a lot more litigation. I'm not sure what you do with that. Other than, probably it's in the implementation that I would caution and kind of take a measured approach.

MR. BAUMANN: Loretta, thanks for all those comments. I have a question, and maybe one or two comments. Barbara Roper talked before about, from an economic analysis perspective, we have to think about, what's the problem?
And the problem is that investors clearly have articulated, and a number of commission have articulated over the years, that the auditor's report just doesn't communicate enough about what the auditor did and found. And we're trying to solve that problem.

And some said, and wanted us to go really far, and say have the auditor really talk about the financial statements, and give some analysis of the financial statements. And from looking at alternatives, we looked at this and said, we think, really, the auditors should stay in the attest role and talk about, stay with their audit, and what they did in their audit. So that's how we selected that.

And one thing we did stay away from, though, you said maybe an investor would care about one thing versus the other. We didn't write this from the perspective of a report on those things in your audit that investors would care about, or a report on those things that were the most difficult things to you to try to avoid that problem.

Now, the lawyers may say, there's still an issue there. And so we're looking for solutions. But we didn't go to, what do you think a mind of the investor that would
be the most important thing in the audit? But what was
the most difficult issues for you, the most subjective and
tough issues for you?

So we did try to think about a lot of those points
that you're raising. I guess my question to you, and if
you don't have an answer that's fine. But I hope preparers
of financials, like you, Loretta, and thoughtful ones,
also point out their concerns about this. But also maybe
have other ideas for solutions.

Because this is a problem in need of a solution.

And if you think there's some aspects of this that raise
consciousness, like being too many matters reported, et cetera.
Are there ways in which we can improve this? And that's
what we're looking for very much in your comment letters.

So whether you have a comment now, or you want to think
about that.

MS. CANGIALOSI: Yes, you know, and I -- One of the
things that I know, there's a pilot that someone is going
to run with the audit firms, I think. And to look at
exactly how you would go about this, and what kinds of
things would go in.

And I think it's really through that that we're
going to learn kind of what those solutions might be.
There's nothing like doing it to inform you of, you know,
what the difficulties are.

MR. BAUMANN: Yes, we did, that was discussed at
the open meeting when we proposed this with the Board. And
some of the Board Members felt it would be a good idea.
And I agree with that.

If auditors were working with their clients and
audit committees today, and said, let's take a look at last
year's financial statements, and last year's audit. What
might we have reported as a critical audit matter? And
try to see what different parties think about that. So,
we do think that's a valuable idea. Wally Cooney. We
have another preparer.

MR. COONEY: Yes. I think everyone here
appreciates the balancing act that you all have had to go,
in terms of formulating this proposal, and all the outreach
you've done over the last few years. I guess, I had a few
comments.

And, you know, to your point, Marty, I think as we
work on comment letters, I think you hopefully will get
a lot of practical suggestions.
As we were first going through this, I think people are focusing on some of the concerns that they have. And then, you know, and hopefully we'll have time, before we send letters, to step back and think about, you know, what alternatives we have.

Because if you just hear about concerns, without some resolutions, then, you know, it may not be that helpful. I think in general, you know, I supported some type of matter of emphasis proposal.

And in reading through the proposal, I think the overall framing and the objectives appear to be, you know, read fairly well. They appeared reasonable to me. But when I got to the examples I became a little bit concerned that perhaps there's just too much information that might be considered to be appropriate level of detail.

And two things I would mention. In the tax example there was a fair amount of information in there about lines of business that I'm not sure would necessarily be in an MD&A. Wouldn't really be necessarily anywhere in the, from a management standpoint.

And it just appeared that that could be new information that was being reported in the auditor
opinion, that wasn't anywhere else in the financials.

The other example was what appeared to be a description of a significant deficiency, which as you know, is not required currently to be included in 10-K filings. And so the example appeared to be reporting a significant deficiency in the auditor opinion, which is at odds with what the current requirements are.

I guess, somebody made a point about perhaps limiting the audit matters to the audit committee, reported items. And I think, in general, I'd probably be in favor of that approach. Partly because, to simplify the job of figuring out what needs to potentially be considered.

And to limit it to becoming potentially a really onerous exercise, with the idea that anything that could potentially go in an audit opinion would almost surely have to have been communicated to an audit committee before. I guess just another general comment. And it was that, you could be highlighting items that aren't particularly important. And Loretta got to this when she talked about things that are hard.

And there are some really important things that are
in the financial statements that perhaps, you know,

wouldn't be mentioned. And I guess a general concern that
we've had is that people look at the audit opinion. And
they look at it as a shortcut to identify the items that
might be particularly important that an investor should
look at.

And investors really need to look at the financial
statements, the footnotes, the MD&A, the critical
accounting policies, the entire Annual Report, not just
a few bullet points that the auditor mentions.

And I think there's some danger that that could be
a shortcut to people, to investors looking at the Annual
Report and the financials.

MS. RAND: Thanks, Wally. Lisa Roth.

MR. BAUMANN: I just wanted to make a comment if
I could, just with respect to one or two of those things.
And, Wally, those are really good comments. You're a very
good reader. We did point out in some of these examples
that there could be things --

We structured them in a way that there could be
something that wasn't otherwise in the financial
statements. There could be a significant deficiency that
was the most difficult matter, that required the auditor
to really extend their audit procedures. And it was very
difficult to get evidence because of that.

But only a material weakness has to be disclosed
by management, and not a significant deficiency. So
therefore, we wanted to point out that there could be
things disclosed through these CAMs that may not otherwise
be required to be disclosed.

So we intentionally did that to bring out that
issue, and make sure people addressed it. And commented
pro or con with respect to that. So thanks for pointing
that out. But that was done intentionally to get feedback
in that area. Lisa Roth.

MS. ROTH: Thanks. So I'm a regulatory compliance
auditor, not a financial auditor. So when I look at the
critical audit matters and those questions, I find them
to be really thoughtful and meaningful. And I'm sure you
work out the technical semantics, and so on, to make it
a really great addition to the audit program.

But I also recognize that the incorporation of the
reporting in that manner greatly expands the scope of the
audit, if not the liability to the auditor. And I fear
the next impact will be a heightened fee, higher fees.
I would imagine those of you who are financial
auditors are going to charge more for that kind of audit.
So I think it's important to recognize that about 3,000
broker-dealers that are subject to PCAOB audits are
nonpublic, privately held, nonpublic, non-custodial
firms. And they'll be subject to those audits.

And as Barbara mentioned, the auditor's working for
the investors, meaning the shareholders, not the firm.
But in those instances firms don't have investors. And
1,000 of those broker dealers are not only nonpublic, non
custodial, but they have less than a million dollars in
annual revenues, and two or fewer business lines in what
are deemed to be generally low risk areas.

So for those firms in particular, the imposition
of audit standards of this scope, I anticipate will be
financially burdensome, with none of the impact that
you've set out to accomplish. Because these firms don't
have public investors. Their customers won't ever see the
audits or the reports because they're privately held. And
the impact is lost.

So I would encourage the Board to consider limiting
the scope, or limiting the audience for this type of reporting, to those firms that will benefit, or those investors that will benefit from it the most.

MS. WATTS: Lisa, I'd like to address two points in your question. First, we don't plan on actually increasing the scope of the audit. This would be based on what the auditor has already done throughout the audit. So we do recognize that liability or fees could increase. But it's based on what the auditor has already done. So the costs should be related to communication, determination and documentation. So that was one point.

And then the other one was, on brokers and dealers, we did recognize that in the release that brokers and dealers have a different ownership structure than issuers. And we put in some examples of how we understand that. And asked questions on whether or not this should apply to brokers and dealers.

MS. ROTH: Yes, thanks. And I will respond to that in a written comment letter. And I thought that the example that you used applies very well to a custodial broker dealer. And I'll comment in writing with respect to the rest of the community. Thanks.
MR. BAUMANN: Thanks, Lisa. And Gaylen Hansen.

MR. HANSEN: Yes, Marty, I think what this is all about is balance. And I think you've framed it very well, the responsibility management and the auditor.

But I can tell you, you know, over the years I've been to a lot of these audit committee meetings. And the auditor comes in and says, we didn't have any difficulties. And that's just nonsense. I've lost a lot of sleep over the years, laying awake at night worrying about things, as I'm sure many people here have. And those are the things, those few things is what has to be communicated.

But if I go to Paragraph 8, and we've had, I've heard a number of people talk about it. Critical audit matters ordinarily are those ordinarily required to be in the engagement completion document, the engagement quality review discussion, or in the discussions with the audit committee.

I don't like limiting it to even those. I think it's anything that has that auditor laying awake at night worrying about it. So while I'm in favor of this, and I think you've struck a good balance, and you're going to, with all the comments that are going to come back, I'm sure
that you, I believe that you're on the right direction here.

I think, you know, to Jennifer's comment though, that you could get some unintended consequences if you start limiting things when it comes to critical audit matters. So that's basically how I feel about it.

MS. RAND: Thank you, Gaylen. Wayne Kolins.

MR. KOLINS: Thank you, Jennifer. A couple of comments, one narrow, one a little broader. A couple of times it was mentioned about the significant deficiencies, and one of the possible items that might lead you to a critical audit matter.

Aside from the question of whether that's other information, or additional information over and above what's in the financial statements, there's another potential consequence is that absence of any characterization of a critical audit matter attributable to a significant deficiency, and could imply that it's a positive opinion on the effectiveness of internal control. So it's one thing to consider.

And the other one is, the FRC in the UK has a standard that it's already been issued, it's already in
implementation now. There's been a handful of reports
issued under it. I think it was for years, beginning after
October 1st, 2012. There'll be a lot more issued after
the year end.

To what extent are you going to be reviewing the
feedback from those, or any -- It would be great if a pilot
test could be done on those. Because those would be
reflective of live situations, versus a retrospective
pilot done on engagements that were conducted in 2012.

MS. RAND: I think I heard one question regarding
the FRC. And I wasn't sure if I missed a second question.
Did you have a second question there?

MR. KOLINS: Well, the first question was about the
significant deficiency. That wasn't a question. That
was just a comment. And it was a question on the FRC, to
what extent could you think about, you know, some kind of
a pilot being developed to look at that, even though it
is in a different environment?

It's in the UK environment. But the standard is
relatively similar to that of the PCAOB. It's probably
closer to the IAASB proposal. And they do have a
requirement to indicate what the, how the audit approach
has been reflective of the critical audit matter. So there are auditing procedures on a high level that could be in there.

MS. RAND: We have been actively monitoring the FRC's project, as well as certainly the IAASB developments in France, which happened several years ago. You're correct, the FRC --

And I'm not sure if everyone's aware of it. But in the UK the FRC issued a new audit report. Those are standards that are currently effective. And I think at the beginning of this year we'll be seeing a lot of those reports come out. I think, as you've rightly pointed out, there's just a handful right now.

But they are, they're a different approach. They talk about there are some differences. So I think it's useful to have different approaches, at least as we're in a development period.

Because to the extent commoners can review different approaches by the PCAOB and others, I think we can benefit in trying to develop an approach that would be suitable. So I think it's helpful to have other examples.
We'll certainly be looking at that, as well as monitoring comments that come in on the IAASB, and comments that come in to us, as far as our next steps. But we're certainly aware of that, and considering it.

MR. BAUMANN: Thanks. In the interest of making sure we don't keep you here all night, and we appreciate the amount of attention you've given to all of these matters today. I see, I think only four cards up. If I'm missing any, let me know.

But I see Mike Gallagher's, Bob Guido, Barbara Roper, and Jeff Mahoney. If there's any others, please raise your hand. So maybe we can take those four, and then call it a day and get back to business tomorrow morning.

So, Mike.

MR. GALLAGHER: So, Marty, your point about maybe being provocative in the examples, about showing a case where it's information not otherwise disclosed, I think is helpful.

And I think it will be mission accomplished in terms of your objective, in eliciting feedback. So that's definitely one of the areas that I hear a lot. And it's kind of connected also, you know, being the original source
And Jennifer's point about potentially chilling the dialogue, you know, with audit committees. I know, Jennifer, that comment was in the context, if the audit committee information was the sole source, would that potentially make an auditor cautious about putting something on the agenda with an audit committee? That fear is there.

By the way, I am for narrowing it. Because I can't imagine a case where an auditor, based upon information not communicated to the audit committee, came up with something that he or she put in CAM. I think that auditor would have a major problem with the audit committee in that case. That, you know, you --

MR. BAUMANN: Just to comment on that one. It's really the opposite that we're concerned about. And that is, therefore, CAM doesn't get reported, because it was kept out of the audit committee report.

MR. GALLAGHER: Okay.

MR. BAUMANN: So that's the risk that we're concerned about. We also can't see a case where you wouldn't report a CAM that didn't get reported to the
committee. But if you're limited to only things that were reported to the committee, then potentially there's something that would not be reported as a CAM. That was the thinking there, anyway.

MR. GALLAGHER: Fair enough. But, Marty, I guess what I would --

MR. BAUMANN: Again, just to be controversial, to provoke --

MR. GALLAGHER: What I would say is, that's operator error in my mind. You know, just because the auditor chose not to communicate something to an audit committee, doesn't mean he or she shouldn't have, okay.

And so, you know, the point being that, you know, there's an expectation that the most critical matters that, you know, come up during an audit must be reported to an audit committee. And I can't imagine a case where an auditor would say, okay, I've got to communicate something in CAM.

And that's outside the universe of things that I've communicated with an audit committee. And so, you know, having a more narrow focus in the spirit of not having CAMs go on forever, number one. And in the spirit of an auditor
being comfortable of limiting, you know, the numbers to
a manageable number.

You know, it seems to me narrowing that universe
is helpful. But the two issues that I think you're going
to need a lot of feedback on, the original source of
information, you know.

And is this a back door way of requiring registrants
to disclose things otherwise not required through the
auditor's report? And then the chilling of the dialogue.

MS. RAND: Mike, I have a follow up question
regarding the issue, which is an important issue, and one
we did flag in our proposal, is something like significant
deficiencies that might, would not be communicated.

But let's say it is a critical audit matter in
auditing a particular area. And the auditor, you know,
should the auditor then leave that out of the list of a
critical audit matter, because it's not otherwise
communicated?

You know, what would be the resolution for those
type of things that otherwise are the types of things that
kept the auditor up at night?

MR. GALLAGHER: Yes. And I think it's a fair
point. And the two issues that I hear, that are of concern. One is, have we lowered the bar in terms of requirements for communicating things below material weakness to significant deficiency?

And I do take your point. How do you communicate that issue with respect to the audit, and how the auditor got comfortable, and what kept the auditor up at night?

The other thing is potential litigation, you know, where there's discussion at an audit committee around a matter of litigation. And whether or not it should be disclosed or not.

And if the answer was no, not required under the standards, could this be a back door way of requiring disclosure in the CAMs?

And obviously, to Marty's point earlier, if an auditor is going to disclose something in the CAMs, you better believe management's going to disclose it in the financial statements.

MR. BAUMANN: Thanks, Mike. Bob Guido.

MR. GUIDO: Mike just summarized a lot of my comments and observations. So thank you. I would like to just drop back for a second though. The last 12 years,
I want to go on record as saying, that the audit firms report to the audit committees. So I want everyone to fully appreciate that that's happened in the capital markets.

Audit firms understand they report to audit committees. So with that in mind, I also say that good audit committees, and most audit committees that I'm familiar with, do talk about the qualitative aspects of management judgments, estimates and accounting policies.

And I'll tell you, if they get close to the line there's a lot of problems by the audit committees. So I just want everyone, you know, to know that there is pushback there. We're not just letting the audit firms or management do their thing.

There is a lot of checks and balances that are happening every day. And I can't overemphasize that. I like conservative accounting. I like conservative reporting. And the firms that work with me know that. And so does management, that I sit on Boards of Directors.

So there are a lot of checks and balances that have happened since Sarbanes. And there were probably a lot before Sarbanes. Having said that, I was -- if the
critical audit matters live, I really like the idea of narrowing.

I'm one for a lot of communications. And I believe, very strongly, there ought to be a lot of communications at the audit committee level. And there ought to be a lot of things, probably in that closing document, or whatever we call it now, that don't go into a CAM. And I think that's fine.

If we say that there's indicators that they have to be, then I think that the CAMs, or excuse me, the closing documents and the communications with audit committees, you know, will be shortened. And that's an unintended consequence. I would encourage, if we do pilot testing, that, Marty, you mentioned, you know, the preparers, and the firms, and the audit committees.

I would get users involved. I think somehow users got to get involved in pilot testing too, to get feedback from users. And then last, but not least, I don't know what the issue is on this significant deficiency.

I would agree with you, if I were a registrant, and someone brought a significant deficiency in the CAM, I'd have a disclosure somehow. But again, that's backdooring
what Sarbanes-Oxley requires on material weaknesses.

So, anyway, but I'm for more limiting if we go with -- If CAMs stand, I would rather see less, and really focus on those, and have users focus on those, are the more significant matters. Thank you.

MR. BAUMANN: Thanks, Bob. And again, thanks for the comments on the fact that we were transparent in this document about including certain things, so we could get input back on those kind of things. Barbara.

MS. ROPER: Right. One thing I want to clarify, and then I want to add one thing. First of all, when I was, in my initial comments it strikes me that there are two different things you need to do in your analysis.

One is, that there is this central point of what information investors want in the audit report, that's relevant to their investment decisions. The other is how this proposal relates to other priorities of the Board.

So when I talk about things like changing the incentives with regard to regressive accounting, that's not as the primary goal of this proposal. It's a way to think about the other positive impacts that it could have.

But in response to that, we get the issue about
there are certain things that are hard, and there are
certain things that are very subjective. And it is very
different, as an investor, if you're looking at an audit
report where you're talking about, well the financial
statements were pretty straightforward.

There was very little subjectivity. The issues
were pretty, you know, I mean, that's a different report
than one that there's a lot of stuff here that's really
hard. And there's a lot of stuff here that's really
subjective.

And as an investor I would think you would look at
those financial reports differently. And you should.
And the audit report, by reporting critical matters, could
help you do that.

You know, on this issue of the population of things
that might be CAMs. I too find it virtually impossible
to imagine that an auditor would communicate to investors
something they wouldn't communicate to audit committees.
And I would find that very troubling if they did.

But beyond that, I also think that there is, that
we don't want -- If you look at different areas, you look
at disclosures about risks in mutual funds. You get 20
boilerplate disclosures that tell you absolutely nothing about risks in mutual funds. And I think, you know, or anything that you would care about as an investor in choosing that fund over a different fund.

And I think in your examples you've done a good job of writing these in a way that are, you know, provide useful information. They're robust enough to be there. And they don't go on for 20 pages. We don't want, I don't think, I don't think most of us want 20 pages of boilerplate discussion.

So I don't necessarily disagree with the comments from people who say, you want to keep this focused on the really critical issues, and not just sort of go -- You don't want to create an incentive to report everything that might come up. I don't think you've done that.

But just the point being, I don't necessarily disagree with the comments of those who say, keep this focused on the really critical issues.

MR. BAUMANN: Yes, that's been good counsel for us. So thanks for pointing that out again. And, Jeff Mahoney, you get to have the final word. Or, you're the last person to keep us away from the reception.
MR. MAHONEY: Okay. In that case, I'll be very brief, extra brief.

MR. BAUMANN: No, that was not the point.

MR. MAHONEY: I just want to commend the Board and staff. And I personally believe that this was a very important recommendation of the Treasury Advisory Committee. So I just want to commend you for sticking with this, and getting to the point of issuing a proposal, and having a full due process around this important recommendation.

Just two brief points. One, I share the concern about having an overload of disclosure regarding critical audit matters. There's too many. We end up having a phone book that's not going to be helpful to investors, or anyone else.

But I'm also concerned on the other end that there would be a significant number of companies where the auditor, in their judgment, would decide that there should be no disclosure at all. If that ends up being the case, I think that's also going to be a real problem, in that it's going to undercut the basic objective of the project.

Second, my reading of the input from investors, and
a lot of the surveys and studies, one of the common themes was that they wanted more insights from the auditor, focused on some of the key estimates and judgments. And so to the extent that through the auditor's judgment, they disclose critical audit matters, that are something other than some of the key estimates and judgments, and that ends up being a common practice.

I think many of the investors who were supportive of this project are going to be disappointed, since that's what many thought they were going to get out of this project. Thank you.

MR. BAUMANN: Okay. Thanks, Jeff. And thank you, all of the members of the SAG, and all observers here, for very valuable input on all of our discussions today, and particularly right now on the audit reporting model, one of our most important priorities.