

NOTICE: This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Investor Advisory Group meeting on October 27, 2016 that relates to the reproposal, *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*. The other topics discussed during the October 27, 2016 meeting are not included in this transcript excerpt.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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INVESTOR ADVISORY GROUP

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MEETING

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THURSDAY, OCTOBER 27, 2016

The Advisory Group met in the Hamilton Ballroom of the Hamilton Crowne Plaza Hotel located at 1001 14th Street, N.W., Washington, D.C., at 9:00 a.m., Steven B. Harris, Chairman, presiding.

PRESENT

- STEVEN B. HARRIS, Chairman
- MARY BERSOT
- CURTIS BUSER
- DR. JOSEPH V. CARCELLO
- KEVIN G. CHAVERS
- LINDA de BEER
- SARAH DEANS
- DR. PARVEEN P. GUPTA
- NORMAN J. HARRISON
- MICHAEL J. HEAD
- AMY McGARRITY
- PETER H. NACHTWEY
- LAWRENCE M. SHOVER
- DAMON A. SILVERS
- ANNE SIMPSON
- MICHAEL A. SMART
- TONY C. SONDHI
- JUDGE STANLEY SPORKIN
- ROBERT M. TAROLA
- LYNN E. TURNER
- GARY G. WALSH

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JEANETTE M. FRANZEL
JAY D. HANSON

PCAOB STAFF

MARTIN BAUMANN
MARY SJOQUIST

4 MR. HARRIS: And, Joe, that leads us to your
5 working group presentation.

6 MS. DEANS: I think at this point Joe is going to
7 hand it over to me to do some of the talking.

8 Joe is that --

9 MR. CARCELLO: Yes.

10 MS. DEANS: That's the plan. Right. Great.
11 You can click.

12 MR. CARCELLO: You want me to click? That sounds
13 good.

14 MS. DEANS: Okay, thank you. So I'm going to try
15 and -- try to keep quite a brief presentation and
16 hopefully that will allow plenty of time for discussion
17 still at this stage in the afternoon.

18 So we were asked to report as a working group on
19 the proposals about the new -- the auditor's report. So
20 the PCAOB, just to recap, re-proposed in May a standard,
21 the auditor's report, on an audit of financial
22 statements when the auditor expresses a unqualified

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1 opinion. And that was an original proposal back in
2 2013. It's been re-proposed. And as a working group we
3 submitted a comment letter to that back in August. And
4 I'm going to briefly, briefly go through what we covered
5 in our comment letter then.

6 So, summarize the proposals, the proposed
7 auditing standard. The intention was to enhance the
8 form and content of the report to make it more relevant
9 and informative to investors and other financial
10 statement users and include a description of critical
11 audit matters. And that's mass communicated to the
12 Audit Committee or required to be communicated that
13 relates to accounts or disclosures that are material to
14 the financial statements and involved especially
15 challenging, subjective, or complex auditor judgments.

16 There were also some additional improvements to
17 the auditor's report proposed. We haven't touched on
18 those in detail, but obviously we can discuss those
19 afterwards. And also a requirement to dispose auditors'
20 tenure.

21 Given the relatively late stage in this project,
22 as a working group we felt it best to base our comment

1 letter and this presentation today on the issue of
2 critical audit matters. So the proposed rule
3 requirements summarized here, the proposed requested
4 audit report, identify critical audit matters, describe
5 why the auditor reviewed this issue, the principal
6 considerations there, and indicate how the auditor
7 addressed these critical audit matters and refer to the
8 relevant line items and disclosures. That's a very
9 brief summary there, just a recap for everyone.

10 So the working group very much supports this
11 proposal. We believe that the proposed auditing
12 standard does represent a meaningful improvement from
13 the current standard audit report. And if I refer to
14 the mission to protect the interests of investors and
15 further the public interest in the preparation of
16 informative, accurate, and independent audit reports, it
17 seems to me that clearly reports are -- then the
18 proposed standards would be more informative. To me that
19 seems very clear-cut and I think the working group were
20 quite unanimous in agreeing that point, so we think it's
21 very much clear that this would be more informative and
22 therefore very consistent with the mission of the Board.

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1 We take no exceptions. We put here, we don't
2 disagree with any of the four points that were mentioned
3 on the previous slide. We think those requirements for
4 the critical audit matters would be helpful.

5 One point that we really want to emphasize here
6 is the requirement that the disclosed critical audit
7 matters, the discussion should be -- to be most useful,
8 must be highly bespoke to the company. If it becomes
9 standard boilerplate language, that is not going to be
10 helpful to investors and we certainly believe that there
11 will be a direct correlation between how specific that
12 information is and how valuable it will be to the users.

13 Just to elaborate here a bit on this UK
14 experience which has been referred to quite a bit
15 already today, on this matter we've had somewhat similar
16 requirements in the UK now for three years. So for most
17 companies listed on the London Stock Exchange we've had
18 three years of these extended audit reports including a
19 discussion, not quite identical wording, but very
20 similar intent, on the risks of material misstatement,
21 that we've had.

22 I think certainly my experience as a user

1 accounts and for many of the investors I've spoken to,
2 we've undoubtedly found the additional information
3 useful in the auditor's report. And where it's been
4 very highly bespoke to the company we've found it very
5 useful typically. As I mentioned this morning, now it's
6 one of the first things I look at. I'll pick up annual
7 report and go and look at the auditor's report. And
8 that is very different from the past. So it's
9 straightaway going and look at that.

10 So we said that we strongly support the proposal,
11 but we do ask or request here perhaps the Board to
12 consider the possibility of doing a little bit more. So
13 one thing the Board has not done is required discussion
14 of what the auditor found when it addressed that
15 critical audit matter and what were the results, the
16 procedures, and simply a disclosure of the findings.
17 That is not required.

18 Now, this is a matter where we understand
19 requiring that information could clearly be problematic.
20 We understand that. And instantly is not required.
21 There are other international developments requirements
22 here. It's not required in the IAASB standard, and in

1 fact the existing UK Financial Council standard does not
2 require the disclosure of findings. We understand that
3 at this late stage in the project that could be very
4 difficult. Mandating that disclosure may not be
5 feasible.

6 However, we would like to ask the Board to
7 consider the possibility of modifying a proposal with an
8 additional sentence that we've put here, just to state
9 that the inclusion of informative company-specific
10 findings could be considered best practice in auditor
11 reporting and that that could be encouraged, although
12 it's not required in the auditing standard. Certainly
13 we view specific findings would undoubtedly make audit
14 reports more informative, and that would be consistent
15 with the Board's mission.

16 So to give a little bit of justification for this
17 argument, a few things on the side here. We do regard
18 the disclosure of critical audit matters as undoubtedly
19 useful but incomplete without going that step further to
20 talk about findings. A survey by KPMG found
21 approximately 80 percent of investors argue that they
22 should include findings, that that would be helpful.

1 And the UK Financial Reporting Councilors in a
2 review of the experience of the new auditor's report
3 requirements that investors clearly valued the
4 additional insight offered by extended auditor
5 reporting, and certainly investors have been
6 particularly -- found it helpful when that included
7 findings. So although in the UK there hasn't been a
8 requirement to include findings, that has occurred in
9 some cases.

10 And if we move on, talk about that. Thank you.
11 And just to illustrate a little bit of how well received
12 this has been in the UK, and we mentioned here, the IMA,
13 the Investment Management Association, is now sponsoring
14 an annual award for the best auditor reports. We
15 wouldn't have had that in the past. And an example of
16 one that the IMA recommended is the KPMG Rolls-Royce
17 audit report, and for any of you who are not familiar
18 with this report in the room, I thoroughly recommend it.
19 It's a fascinating example of how an audit report can
20 give so much more information and as the IMA said there,
21 provided a real value-add.

22 And one of the things that that audit report

1 included was findings as to whether management's
2 judgments were balanced, or in the words of the KPMG
3 auditor, mildly optimistic or mildly pessimistic, so
4 giving us theories as to where in the range those
5 judgments came, and that is something that investors,
6 many, many investors that I've spoken to really
7 appreciated.

8 There has been discussion in the UK that -- and
9 there's been an evolution over the three years. So in
10 the first year there was quite a lot of boilerplate
11 information that was not so helpful. There was then a
12 discussion about -- amongst investors and the firms as
13 to what was useful and certainly some of the firms now,
14 three of the four big firms have included findings in
15 some of their reports. So that has been a big
16 development over the three years of evolving sort of
17 best practices.

18 To come back to the point about company-specific
19 information, it's really helpful to get proper
20 information specific to the audit and for example not
21 just have a statement that is something that is obvious
22 anyway from the fact that it was an unmodified audit

1 report. So for example, it's not helpful if the firm
2 keeps repeating that something was within an acceptable
3 range. That's not what we mean by findings.

4 It has to be something that's new information.
5 And clearly we need to get sort of set of
6 differentiation reports. Having the same standard sort
7 of report for everything doesn't help us. We want to
8 get new information and find out exactly something
9 that's relevant to understanding the critical audit
10 matters for that audit, for that company. And we've got
11 a couple of -- a quote there from KPMG.

12 What are the arguments against doing this? I
13 find this quite hard, in a way, because to me it's so
14 clear-cut that including critical audit matters is
15 important, and ideally findings would be very helpful to
16 investors. So the first point I guess is that this is
17 moving in exceeding the auditor's mandate. Yes, perhaps
18 that could be argued, but in my view it's so clearly an
19 improvement that I think the fact that it's such a
20 significant improvement should outweigh that argument.

21 I'm certainly told that some, particularly in the
22 audit committee community, are questioning what

1 investors do with this information. Well, I'm quite
2 disappointed in a way with that comment. And certainly
3 if you look to the UK experience, many investors in UK
4 companies support disclosure, support the new
5 information. They've found it helpful. And there are
6 plenty of examples, and I'm happy to answer afterwards,
7 if people want a couple of sort of more specific points
8 on the kind of thing we've learned and where it's been
9 helpful, but I don't really feel -- I think that's a
10 question to ask investors.

11 Now the third point I do have some sympathy with.
12 I think as a working group we did, that potentially the
13 concluding findings exposes auditors to incremental
14 legal liability. And I'm also well aware the legal
15 environment in the US is different from that in other
16 countries where there have been such developments. So
17 it is something that we understand.

18 And what we've put here is to say that we think
19 the fact of encouraging disclosing findings leaves it
20 then a choice for the audit firm to weigh up the benefit
21 of a better report against that possible cost argument
22 in terms of legal liability. And we also in our comment

1 letter mention potentially supporting a legal safe
2 harbor specific to this findings point, if that was
3 included.

4 So to conclude, we do clearly -- I want to
5 reiterate the fact that we support the proposal as a
6 working group. I think there is strong investor
7 support. I think the international precedents are very
8 encouraging.

9 And although we've had this information in the UK
10 for three years, but it's coming now across Europe next
11 year. So we have more to look forward to in Europe. We
12 do think the proposal, however, could be strengthened if
13 it could be encouraged to include findings. And so if
14 it's possible to go a little further, as we've suggested
15 here, that would be greatly appreciated, I believe, by
16 many investors.

17 MR. HARRIS: Joe?

18 MR. CARCELLO: Tremendous job by Sarah, as I knew
19 it would be. Just, you know, maybe three things to
20 emphasize very briefly that I think are certainly
21 consonant with what we had up there.

22 The first would be if we end up in a regime

1 regardless of findings where the CAMs either initially
2 or over time become essentially boilerplate, don't do
3 it. So if you're not willing, PCAOB and SEC, to inspect
4 and enforce, don't do it, because what will happen is
5 even if audit fees don't go up -- people's time is the
6 most valuable thing they have in their life, maybe short
7 of their family. And these reports now will be longer.
8 There is a cost of reading this stuff. And so if it
9 doesn't say anything, it's actually value-destroying.

10 The second thing that I would say is I think the
11 evidence out of the United Kingdom, three years of data,
12 is that it's clear -- I think it's overwhelmingly clear
13 that investors find specific findings highly valuable.
14 I don't know how -- you might be able to argue against
15 this for other reasons, but I don't think you can argue
16 against that it's valuable. I think we have -- I think
17 the evidence is overwhelming that it's valuable.

18 So then the question is if it's valuable and
19 you're not requiring it, you're only suggesting it's
20 best practice, there has to I think be a very compelling
21 argument for why you wouldn't suggest this is best
22 practice when clearly the evidence would seem to suggest

1 that it is.

2 And then I think the third thing that's important
3 to understand is around the legal liability issue. I
4 remember when this issue was teed up, and Marty and
5 others remember this, and there was a series of round
6 tables, there was a series of focus groups, and I
7 remember at one point corralling some investor people,
8 including some of the people in the room today. And I
9 said is this a disguised attempt to get at the auditor's
10 wallet? Is this just a -- kind of a crafty way to grab
11 for the wallet? And they swore up and down that it
12 wasn't.

13 And when we went -- when Sarah and I went to them
14 and said would you support a limited legal safe harbor
15 -- which I understand is complicated. You can't do it.
16 Probably the SEC may not even be able to do it. I'm not
17 sure. It may involve Congress. But at least in terms
18 of the investor folks, to a person, at least the ones we
19 talked to, were very much willing to say if we get this
20 information at least as it relates to this information,
21 not everything else, but this information, findings, we
22 would be very supportive of a legal safe harbor.

1 So this is not some back door way to try to
2 increase legal liability for accounting firms.

3 MR. HARRIS: Jay?

4 MR. HANSON: Well, thanks to the working group
5 for the work you've done on this. It was a good
6 discussion to have today.

7 I want to pick up on something that Sarah said,
8 and Joe as well, about the value. And Sarah and I
9 talked just briefly last night about this, but I'd like
10 to hear more from the other investors in the room that
11 might be invested in UK stocks, or at least evaluating,
12 with some examples of how the information translates
13 into value.

14 And what I think about in this way, and I want to
15 be educated on this to see if I'm thinking wrong, the
16 value to me could be a new area to explore more deeply
17 in terms of the analysis or it might be information that
18 wasn't known from something else in the publicly
19 available filing information, and how maybe that new
20 information translated into something different in the
21 analysis, maybe a change in the model, a change in the
22 assumptions, change in the discount rate to the

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1 multiple, which ultimately affected the decision itself.
2 And then ultimately, does that manifest itself in
3 changes in the price or volume and the observable in the
4 marketplace?

5 And so I'd just kind of like to hear some
6 examples of that, how the good information translates
7 into something actionable, and what's been done. Or
8 maybe if these aren't on the list of things I should be
9 thinking about, maybe things that you do -- how you
10 translate that into value.

11 MR. HARRIS: I was going to ask pretty much the
12 exact same question, since you led with your chin and
13 volunteered, and that is where has it been helpful? And
14 if you could give us more examples.

15 MS. DEANS: Yes.

16 MR. HARRIS: So first you'd answer Jay's and then
17 give us some examples as to exactly --

18 MS. DEANS: Yes I'm happy to give some examples.

19 So I think it's an area where just in the
20 specific nuggets -- I'll give you a couple of specific
21 examples.

22 So one quite small one, but I think it was quite

1 telling. So a company with a big pension exposure, and
2 it had always been using or had been using a pension
3 discount rate that looked higher than norms. And the
4 auditor's report actually talked about that being a
5 critical audit matter, or key audit or risk material
6 misstatement and actually talked about how the company
7 calculated the discount rate.

8 And that they were adding on an arbitrary amount
9 on top of the normally calculated discount rate
10 apparently for, I think it was to do with the risk and
11 that. So they were adding on an amount to the discount
12 rate and that was bringing a higher than average
13 discount rate. And this had got through, apparently the
14 amount involved was not so big as to make the overall
15 financial statements misleading, but it was an item that
16 the auditor commented on.

17 And then that was something that clearly a lot of
18 investors pick up pension deficit numbers in their
19 evaluations of companies that can then be picked up on
20 and discussed as to why that company was taking that
21 approach. And funnily enough the following year, still
22 an important area, still an area the auditor discussed,

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1 but the discount rate had become a little more normal,
2 within the normal range, and that comment had been
3 dropped.

4 And I'm sure that pension investors had gone to
5 the company and asked about that calculation of the
6 discount rate and why this additional amount had been
7 added on, or at least that's my guess. So I may -- that
8 may be a misconception, but that's how it seemed to me.

9 Another example, so -- and this is a little
10 unfair, but say for example if you took one of the very
11 big retailers in the UK three years ago the issue of
12 supplier income wasn't really discussed in the financial
13 statements. If you look at the auditor's report, that
14 did flag up as a critical audit matter, supplier income.
15 Not really discussed elsewhere. Well, I mean, in the
16 company, but there was subsequently an issue in that
17 area.

18 And of course then it does beg the question of
19 why the auditors were raising it as a critical audit
20 matter and then not talking to the company about getting
21 better disclosure around that topic, but nevertheless it
22 had been flagged up. It was a point that investors were

1 warned about as a potential risk of material
2 misstatement. So that actually was flagging up a very
3 important issue.

4 So those are a couple of areas where sort of I've
5 observed there's been particularly useful information,
6 and there are many others. I'm not sure if anyone else
7 in the room who's looked at UK stocks has any other
8 suggestions to contribute.

9 And also just to come back to the famous KPMG
10 example with Rolls-Royce, I think if you talk about in
11 stock, a lot of those questions that were raised there
12 have been really debated amongst investors. It's
13 important to understand these risks. There's actually,
14 for those of you who haven't seen it, several pages of
15 discussion, and some quite important matters I think
16 have come out through there, a discussion of risks
17 around controls in one division and so forth. And those
18 are really of interest to investors and I've been in
19 many meetings where those points have been discussed.

20 MR. HARRIS: Linda?

21 MS. DE BEER: Thank you, Steve. I think just to
22 add to Sarah's point in South Africa we use

1 international standards in auditing, and obviously the
2 equivalent ISA standard hasn't become effective yet, ISA
3 701, but very many listed companies have already pushed
4 their auditors or the auditors started insisting on
5 early adopting it. So we've seen quite a couple of
6 those audit reports as well.

7 And the one other aspect or benefit, Jay, maybe
8 just adding onto your question, that I've certainly seen
9 is it keeps the audit committees honest as well.
10 Because what's happening now -- and we don't have a
11 requirement that you have in the UK that the audit
12 committees must have sort of reflect or mirror some of
13 the disclosure. As you know, that's not an ISA
14 requirement. But what audit committees now do is in
15 their reporting or in their financial statements they
16 sort of take a proactive step to knowing what will be
17 the key audit methods to explain further what the
18 governance process is all around there.

19 So I think automatically if you look at the key
20 audit methods and at the audit committee reporting,
21 there is just firstly better governance, but also better
22 disclosure for investors to give a more holistic picture

1 of those specific areas.

2 MS. DEANS: One other point, if I could just add,
3 I think the very fact of having the auditor talking
4 about these areas makes it very helpful as the user
5 accounts to engage with the company because it gives you
6 a hook of information and also if the company doesn't
7 want to talk about it, it's much easier when you can say
8 but your auditor has identified this as a risk. So
9 rather than sort of, well, why are you asking about
10 that, to be able to say the auditors are talking about
11 this, makes it harder for a company to close down and
12 not want to talk about the issue. You're informed.
13 You're a more informed investor or analyst.

14 MR. HARRIS: Sarah, in the UK how would you say
15 it's influenced the behavior of the auditor?

16 MS. DEANS: This is -- it's a little harder to
17 say as a user of the accounts rather than an auditor,
18 but I think it's clearly promoted interest in what
19 investors think and feel, because we have now more of a
20 dialogue. I mean, certainly since these have been out
21 there it's been easier to engage with audit firms and
22 point them to where it's been helpful, you know, and I

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1 think it's incredibly important for the audit firms to
2 see this as an opportunity because they're able to
3 actually show the value to investors of all their
4 knowledge.

5 So in the past up until now, auditors have all
6 these masses of information, but we had -- as users of
7 the accounts have seen no sight of that. They're
8 actually able to prove their value a lot more and I
9 think that's incredibly important when there is quite a
10 lot of skepticism, at least amongst the investors I
11 speak to often, about the value of the audit to them.

12 So in terms of has it changed behavior, I'm sure
13 it has, but we don't get a great deal of insight into
14 that. But certainly if I was an auditor and I knew I
15 was going to be talking about this, I think it puts
16 maybe, I would guess, a little extra pressure to be
17 confident of what you're saying.

18 MS. SIMPSON: Sharpens accountability.

19 MS. DEANS: Sharpens accountability, that's the
20 best --

21 (Off microphone comments.)

22 MS. DEANS: Yes, exactly. So I think I'm sure it

1 has changed behavior. It's certainly prompted some
2 useful dialogue between investors and the audit firms in
3 the UK. So I really see it as a positive. And there
4 has sort of been a bit of competition amongst the audit
5 firms to be perceived to be being helpful here and to
6 actually improve the standard, which has been very
7 constructive, I think.

8 MR. HANSON: Sarah, just to clarify, as an
9 investor you're dialoguing directly with the auditors
10 about what's in the audit report?

11 MS. DEANS: Just to clarify, not typically
12 specifically on companies, but on overall what we found
13 helpful, yes, the audit firms have been quite open to
14 having conversations.

15 And in those cases, you know, investors are often
16 maybe bringing examples, obviously there's
17 confidentiality that they are not going to give away to
18 us obviously inappropriate information. But certainly
19 company examples have come up in those conversations of
20 what's been -- typically what's been particularly
21 helpful.

22 MR. CARCELLO: And, Steve, let me add one thing

1 in following up what Sarah said about the effect on
2 auditors. As you know, I'm sure you're in contact with
3 the folks at the FRC and Marek Grabowski and those
4 folks, and they have done quite a bit on measuring
5 what's changed inside audit firms.

6 And we alluded to this earlier, one of the
7 unintended consequences, in this case a good unintended
8 consequence, is the staff are more engaged in their
9 work, they're more excited about their work, they feel
10 like what they do every day actually matters more
11 because they see the fruits of their labor in a report
12 that people will read other than a three-paragraph
13 report, as Sarah said I think earlier and others have
14 said, that people typically in the past didn't even
15 read.

16 MR. HARRIS: Mike, and then we'll just go around.
17 I'm sorry. Well, wait a second. Jeanette? Let's
18 recognize the Board first.

19 MS. FRANZEL: Thanks, Steve. Thanks for this.
20 And I'm wondering, Sarah, can you elaborate a bit more
21 on the very specific issue of company-specific findings?

22 And I can kind of see this going in two different

1 directions and so if you have examples of both, that
2 would be helpful. So in one case maybe it's a difficult
3 audit area and the auditor finds that there's just a
4 whole lot of uncertainty and there's nothing really that
5 anybody does about it. And what kind of -- have you
6 seen examples of that, whereas in other cases maybe the
7 auditor found that something needed to be refined or a
8 disclosure needed to be expanded. Management did that.
9 How far do they go in discussing the findings? They
10 say, you know, this was difficult and as a result of our
11 work management expanded its disclosure, or do they say
12 talk about the inadequacies first of the initial
13 disclosure and then the subsequent changes.

14 So anyway, examples on both types of findings and
15 results, if you have any.

16 MS. DEANS: Yes, so and I guess to caveat this a
17 little bit, clearly most of the auditor's reports yet do
18 not include findings. The majority do not. It's very
19 much a minority yet. And those findings, again, vary
20 enormously from the very, very detailed examples we have
21 at Rolls-Royce, which I'm sure you've seen, right
22 through to some of the less helpful, you know, blander,

1 not very company-specific that was within a reasonable
2 range type comment that doesn't really help us.

3 So this is based on not a huge number, but yes,
4 we have seen cases where, for example, it's been
5 commented that errors were found but those were then
6 corrected. And after they'd been -- after an error had
7 been corrected, then the auditor was happy. But that
8 was an insight again that was new. Whereas in other
9 areas there is a lot of just sort of, this is the work
10 we did and this is a risk area without -- either no
11 finding or no very specific finding other than there
12 wasn't anything that required -- well, they didn't say
13 that, but there was clearly nothing that kind of further
14 seemed to be required at that point.

15 If you look at most of the findings, the PwC ones
16 tend to just be of the it was within a reasonable range
17 and there we left it, sort of thing. If you look at
18 some of the others, one thing actually I should comment
19 that I found quite helpful, at least in terms of
20 presentation, was what I liked about this most recent
21 year's reports from Ernst & Young, from EY, had the
22 column, this is what we reported to the audit committee.

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1 Now having said that, some of those comments then
2 below that are quite bland and you think, well, that
3 must have been a boringly thing.

4 (Laughter.)

5 MS. DEANS: You didn't tell them much, but at
6 least I like that way of framing it, that then here is
7 the result, this is what we presented and talked to the
8 audit committee about.

9 I don't know how much that answers your question,
10 but it is still relatively early days, at least for
11 findings.

12 MS. FRANZEL: Thanks.

13 MR. HARRIS: Mike?

14 MR. HEAD: One, because I was on this committee
15 I have the insights, and this was a topic that again I
16 was very passionate about. But the first comment on
17 findings and results that I wanted to emphasize. We as
18 maybe auditors or accountants our self automatically go
19 to a finding must be an exception, versus a finding can
20 be, they did a great job in this area and we applaud or
21 agree with management's judgments.

22 Now you're not going to see that kind of wording

1 in this kind of report, but it should be balanced about
2 positives and potentially negatives, if there are some,
3 without assuming it's all going to be negative.

4 And I correlate what I think the value is here.
5 I think all of us would agree when you're doing what
6 I'll call a service center type audit where you're
7 actually auditing and saying what the state should be,
8 what your results were, if there was any exceptions, can
9 it be relied on? And then that type of audit, which kind
10 of relates to where we've went on the broker-dealers
11 with the 17(a), you know, this isn't going there, but
12 this is going that direction. You're trying to get more
13 color on that -- the audit process and what the results
14 of the audit process would be. And that starts moving
15 you down, well, did it work the way you intended during
16 the period, not just as of a point in time?

17 I guess the last thing to me is I'm big on
18 transparency. Everything we're talking about that could
19 be including findings or results have -- are being
20 discussed in the audit committee meetings by management,
21 by the auditors with the audit committee members and at
22 times at the full board. So this is not something

1 that's not already being done privately. It's just
2 giving the investors or the shareholders or stakeholders
3 transparency or insight to it. So those are my
4 thoughts, my top of mind.

5 MR. HARRIS: Parveen?

6 MR. GUPTA: Sarah and Joe, I guess what I was
7 wondering, maybe you covered this point and I missed it
8 as I stepped out for a few minutes, for the first couple
9 years certainly expanded disclosures in the audit report
10 and the information that we are talking about would be
11 new information and useful. Was there any conversation
12 in your working group that what discipline can be put
13 around the fact that maybe after two, three, four years
14 it could become a boilerplate report? And if so, how do
15 we handle that?

16 Because, you know, when you go in this direction,
17 you want to make sure that you mandate something that's
18 going to be useful to the capital markets for the longer
19 term rather than just couple years and then the
20 excitement kind of dies down and it's the same report
21 like we've seen the risk disclosures in the 10-K in the
22 US, at least.

1 MR. CARCELLO: Yes, I'll give some thoughts,
2 Parveen, and then obviously I want to hear what Sarah
3 has to say and what she has seen.

4 But to me, let's say Company ABC has six critical
5 areas and actually presents findings in years one, two,
6 three, four and so forth. The real important
7 information is going to be change. And if you don't --
8 if all you end up getting is it's the same six every
9 year and it's the same wording every year, then
10 essentially what you're saying is absolutely nothing
11 changed inside that company on those six areas. That's
12 just not believable.

13 So if that's the case, what it's suggesting is
14 that there's not that kind of disclosure around change,
15 and that would be a problem if that was the case.

16 MS. DEANS: Yes, and this question's been sort of
17 talked about quite a lot in the UK. Is there a danger
18 of this? We've had it three years. Is it just going to
19 come -- in fact, actually so far that hasn't happened
20 because I think the process has been evolving so much
21 anyway that things have changed and moved on.

22 But certainly one of the examples of sort of best

1 practice which some of the firms are doing, at least
2 some of the time, is to talk about exactly that, where
3 things have changed. So for example, if something was
4 a key risk last year and isn't in there now, to give
5 some explanation of what's changed. Sometimes it's
6 obvious. That division was sold, so we're not worried
7 about it anymore. But other times it's not.

8 And also when new risks have evolved. And even
9 again, and I hate having to always give the same sort of
10 example of best practice, but if you look at how again
11 the Rolls-Royce most recent auditor's report, actually
12 gives a little chart of sort of where things have moved.
13 So this risk is actually a bit bigger this or a bit more
14 of a concern this year versus a previous year, and this
15 one has sort of moved down the track a bit.

16 So not just which ones have come on and which
17 ones are dropped off, but actually the evolution of
18 we're a bit more worried about this and we're a bit less
19 worried about this now, which is again very useful and
20 I think is an indicator of the quality of what the
21 auditor is doing is quite an interesting one. We know
22 which ones we're actually talking about.

1 Those kind of processes that they're thinking
2 through, this has become more important. Whereas
3 exactly if an auditor's report is just -- and so far we
4 haven't had it that much the same as last year's and the
5 same as the year before's. Then I think you start
6 worrying. Do you really believe that nothing has changed
7 or is that simply the auditor not doing a great job? So
8 again it's helpful insight into the quality of the
9 auditor potentially. And it's still again early days,
10 but I think that will be interesting as we go further
11 down this track.

12 So I think, yes, of course I understand there is
13 that risk there. And absolutely, to Joe's point, if
14 this just becomes boilerplate language and doesn't tell
15 us anything specific and so forth, it's hopeless and it
16 is just more pages for no purpose. And that's not what
17 we want.

18 But actually I think enough does move on and if
19 it's really the auditor's going for best practice and
20 helping the investors understand evolution of risks,
21 that's helpful and that's actually a useful history then
22 of how things have moved on. There was a problem with

1 internal controls last year in this division. Has that
2 improved this year and has it improved so much that this
3 is no longer a risk or is it just evolving, or is there
4 actually still worry or even worse?

5 So I think there's a lot we can learn from that,
6 so long as the process is done well.

7 MR. HARRIS: Robert?

8 MR. TAROLA: Robert Tarola. I find this quite
9 ironic that we're -- that there's resistance to this in
10 the auditing profession, because as I'm listening to all
11 the analysis, this could be the solution to a couple of
12 the problems we talked about today. It appears to me it
13 will raise the value of the work of the auditor to their
14 ultimate customer. It would provide the transparency
15 that folks believe is important in reporting to outside
16 parties for an issuer.

17 It should make the profession more exciting, that
18 you would want to join. In fact, the way I think about
19 an auditor, it's just the front end of the analysis
20 process. It's the same person on each end. The auditor
21 is a front-end analyst and the investor rep is the back-
22 end analyst. They have to have the same skills, the

1 same insights, the same knowledge of the company and
2 business models and how they all work.

3 So the public accounting profession really needs
4 a makeover in terms of its marketing. And this may be
5 the impetus for a makeover.

6 MR. HARRIS: Well, being an audit committee chair
7 and an auditor and somebody who's well versed in the
8 profession, those are very interesting comments.

9 MR. TAROLA: Well, I was going to start --

10 MR. HARRIS: But you wear so many different hats
11 that it's interesting.

12 MR. TAROLA: Well, when I wear a preparer hat or
13 an audit chair hat, it's a bit scary --

14 (Laughter.)

15 MR. TAROLA: -- to be frank, because you're
16 really now -- your scorecard is going to be made public
17 as a preparer and as a, you know, governance committee
18 of the company. So that's a bit scary.

19 I think the other -- I think on the auditor side
20 I'm sure they're nervous about added liability, and I
21 think Joe's idea is a really good one. Maybe a safe
22 harbor for audit committees, too.

1 (Laughter.)

2 MR. HARRIS: Only for you, Bob.

3 (Laughter.)

4 MR. HARRIS: Linda?

5 MS. DE BEER: Thank you. Just two comments, if
6 I may, and it's more from my experience where we debated
7 this as the advisory group with the IAASB. Jeanette,
8 the comment or the question you asked about the entity-
9 specific information just triggered the thought in my
10 mind, and there were lots of discussions at that point
11 in time really to try and avoid industry disclosure.
12 And I think that is a really important point that must
13 come through.

14 And, Sarah, you spoke about sometimes the entity-
15 specific information might be a little bit more bland
16 and the range is a little bit more general, but there
17 was, especially at the initial stages of the debate, the
18 real concern that instead of auditors drilling in to the
19 specific critical audit methods or key audit methods
20 within the entity, the role they sort of talk about
21 industry-specific, you know, this is in the platinum
22 industry and the market is distressed.

1 And, you know, that sort of becomes a critical
2 audit method because that information would certainly
3 not be useful at all. And I think it's very important
4 that the wording must be tight enough to avoid that sort
5 of general disclosure, critical areas for the industry
6 as a whole versus that company specifically.

7 The other point that came through very clearly as
8 well, and Mike, when you spoke it reminded me, was that
9 a lot of the people around the table at that advisory
10 group felt very strongly that they're not really
11 interested in audit procedures. They sort of want to
12 know what the issue was and what the finding is. They
13 couldn't really care all that much what the auditor did
14 to get the comfort that he needed, but more sort of what
15 the ultimate outcome or finding is.

16 And I think there is a risk that if auditors
17 start disclosing a lot of procedures, it will again
18 become really boring reports that people won't read.

19 MR. HARRIS: Curt, I think you had your card up
20 next.

21 MR. BUSER: Thanks, Steve. So like Bob, I think
22 this has a lot of opportunity for the whole audit

1 profession, and from an assurance standpoint I think
2 it's potentially a very good product.

3 I have a couple questions though that I'm just
4 curious in terms of how the working group thought about
5 it. So first, if there are no findings or they're
6 boilerplate-type answers, does that create a false sense
7 of assurance?

8 Related to that, do the critical audit matters
9 create kind of a piecemeal opinion approach with respect
10 to the report on the financial statements otherwise
11 taken as a whole? How do you think about materiality
12 and disclosure requirements around that?

13 And then last, as it relates to internal
14 controls, right now we have a criteria, as least as I
15 understand it, that obviously the material control
16 weaknesses, they need to be disclosed and talked about,
17 significant deficiencies, obviously talked about with
18 the audit committee and kind of resolved.

19 So does this change that standard? So does this
20 kind of enforce significant deficiencies to be publicly
21 disclosed as a critical audit matter, or how do you then
22 kind of say no, no, no, you don't have to talk about

1 that, but it's a significant matter? Thanks.

2 MR. CARCELLO: Yes, I'll start off, but again I
3 certainly want to hear what Sarah has to say.

4 Curt, these are, as I would expect, excellent
5 issues to raise. On the first if there's no findings or
6 if the findings are boilerplate, does that give you a
7 false sense of assurance -- and I think if the Board
8 decided to do what we're suggesting that they might,
9 which is to encourage findings but not require them, I
10 think the reality is inside the United States, and we
11 recognize this, that at least initially there's probably
12 not going to be a whole lot of findings.

13 I mean, we're not finding a whole lot of findings
14 right now in the United Kingdom. So I don't think
15 there's going to be a global conclusion about an issuer
16 if there aren't findings. Now maybe down the road 10
17 years, 15 years, 20 years, but let's worry about that 10
18 years from now.

19 On the second issue, the piecemeal opinion, and
20 certainly this is a concern that's been expressed, it
21 doesn't appear to me, but I want to hear what Sarah has
22 to say, to have been a problem in the United Kingdom.

1 I think the marginal investor in most stocks today is
2 pretty sophisticated and I think they're going to
3 understand that it's not a piecemeal opinion, but I want
4 to hear Sarah's explanation or experience in the United
5 Kingdom.

6 The significant deficiencies is maybe not a fair
7 thing to throw to her because I don't believe there's
8 reporting on internal control over financial reporting
9 in the United Kingdom. This is not something we talked
10 about, Curt. I know it's a major concern of issuers and
11 of audit committees and of auditors, so it's a fair
12 point and I think it would have to be looked at further.

13 I think to -- not to move forward in encouraging
14 findings because of that, I think that can be solved
15 even if that's scoped out. That's not a strong enough
16 reason not to do it.

17 MS. DEANS: Okay. So to add to that, is there a
18 risk with a sort of piecemeal opinion? I just don't
19 think that's been perceived as a problem in practice
20 over the three years. We understand, or at least the
21 professional investors I speak to understand the overall
22 audit opinion. And then this is additional helpful

1 information. And I just don't perceive it's a problem.

2 I think -- was there -- sorry, was there also a
3 question about materiality that we didn't cover there?

4 MR. BUSER: Yes, and if you're going to talk kind
5 of on a piecemeal basis or call that out, I mean, how
6 does materiality kind of play into that especially as --
7 if a critical audit matter how would it affect your
8 materiality assessments?

9 MR. CARCELLO: Again, that didn't come up, Curt.
10 We didn't even talk about that. I'd have to think about
11 it more, but it's a fair point.

12 MS. DEANS: I guess that does -- we'll say just
13 maybe one tab one point, which is one area where the
14 U.K. has also gone further is actually requiring
15 disclosure about materiality and the calculation of
16 materiality. And I know that that has sort of fallen by
17 the wayside a bit here, but I -- personally actually I
18 found it very interesting. And actually if I was to put
19 my finger on where I think practice has most been
20 affected or things appear to have changed most as a
21 result of extending required information in the
22 auditor's report, I'd actually look to that because

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1 first year we had a lot of outliers taking a pretty high
2 percentage of pre-tax profit. So that's been changing.

3 MR. HARRIS: Judge, you're not allowed to put
4 your card down.

5 MR. SPORKIN: The only thing that -- I've
6 listened now for this whole day and I was thinking what
7 are we talking about?

8 MR. HARRIS: Judge? Judge, hit your mic.

9 MR. SPORKIN: What we're talking about is what
10 you need to do in this profession as it's been done in
11 the legal profession, medical profession is branding.
12 If an organization has a brand that it's known that you
13 don't get their name on it unless you've done the
14 greatest job in the world. I mean, you don't get a
15 Sullivan & Cromwell's name on a report unless they
16 believe it's the right thing to do. Not the client.
17 Sullivan & Cromwell won't put their name on something,
18 or Korvath, Wachtell & Lipton. It's a branding. You
19 got to get a brand that says this accounting firm you're
20 not going to get that name on that accounting firm
21 unless it's the report that we want to go out. You
22 won't get a Wells Fargo -- your name on Wells Fargo

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1 unless it's right.

2 And they know. I mean, how do these people know?
3 They can read the report and they can know something's
4 right or something's wrong. They could ask the right
5 questions. Why is it? Or you never see them getting
6 into the kinds of problems with some of the accounting
7 firms you're getting into. Is it trying to get minimum
8 standards or is it trying to get the best standards? I
9 mean, you see the commercial, people go to BDO if they
10 got a problem. I don't know whether it means they're
11 the best, but what I'm saying is that you want to brand
12 your organization, that nobody gets my name unless it's
13 the way we want it, not the way the client wants it.
14 You can't buy our name. I don't know if that means
15 anything, but I'll tell you that's what I see here.

16 MR. HARRIS: Thank you. And, Lynn?

17 MR. TURNER: A couple things. As one of the
18 people in the room that's actually written critical
19 audit matter memos at the completion of an audit having
20 to identify those, I think it's going to take some time
21 just based on this conversation for the investor
22 community to really understand. Probably have to be

1 some education because some of these CAMs do stay the
2 same year to year. They do not change in companies,
3 especially industry-specific. So to expect things to
4 see change time to time to time, that's probably --
5 maybe some cases that will occur, but it's certainly not
6 going to occur.

7 And also as I listened to that discussion
8 earlier, it tells me there's going to have to be some
9 education of the investor community and they're still
10 going to have to do their homework. In fact, your
11 earlier conversation led me to believe that probably
12 going to need to be a lot of education of the investor
13 community if that's what the expectation was.

14 The second thing is on findings I actually think
15 better than the Rolls-Royce report in this case is the
16 Dutch report on Aegon. I think it's an excellent report
17 because it does get into the findings and does I think
18 a very good job of coming back. I forget which Board
19 member asked about the value associated with the stuff,
20 but the Aegon report to me laid out more of the
21 information I'd want to know with respect to the risk in
22 the company and where some of the things were going and

1 what the auditors did to address those. So I thought
2 that was a pretty thing -- pretty good disclosure.

3 But then with respect to your notion of a legal
4 safe harbor, I find that to be most disturbing, because
5 you've turned around and told me this is such critical
6 information, I need to become informed and it needs to
7 be very good and really tell me what the auditor thinks.
8 But on the other hand, if they mislead me, I can't hold
9 them accountable. So I would vehemently oppose any safe
10 harbor.

11 I would rather not have the CAMs than to have the
12 CAMs with the safe harbor. I think as we saw, as we've
13 seen in the past with some of the things, when you
14 provide those legal protections the accountability goes
15 away and the quality goes down, so I think the safe
16 harbor is a disaster in waiting.

17 MR. HARRIS: Tony?

18 MR. SONDHI: Thank you. I actually did -- wanted
19 to address that last point that Lynn was making, and I
20 really do think that the safe harbor would be a
21 disaster. But I also at the same time believe that --
22 very strongly again, that saying such and such

1 disclosure or something is encouraged is also a very big
2 problem for a very simple reason: I served on a
3 committee that helped write the International Accounting
4 Standard on the cash flow statements and very narrowly
5 lost the fight to get the direct method. And the IASC
6 chair at that point, David Cairns, told me that he
7 wanted -- he agreed with me that it should be direct
8 method. He says but he was hoping to accomplish it by
9 encouraging.

10 And if you look at both the U.S. GAAP on cash
11 flow statements and the international, they both start
12 with the same thing in the first paragraph: you -- the
13 direct method is better. You are encouraged. But the
14 problem is when you go to the glossary of terms,
15 "encouraged" is defined as you don't have to do this.
16 And that's the definition people are using. They're not
17 looking at it in terms of what the language tells you.
18 So using "encouraged" I think is a problem.

19 I think Lynn is also right that it may take us
20 awhile as investors to learn that some of these CAMs are
21 going to stick around, and there is a reason for them to
22 stick around. But I have two responses to that: One is

1 that I am willing to learn. I would like to find out.
2 But I'm also tired of the kind of boilerplate
3 information that I see.

4 I'll give you an example. A few years ago I had
5 found a company that in its footnotes said -- what its
6 footnotes were saying was that the basket of currencies
7 that they operated in were weakening against the dollar,
8 but when I turned to the stockholder's equity where they
9 had the cumulative adjustment, that change suggested the
10 opposite. And I couldn't reconcile those two, so I
11 finally called the CFO and he -- when he got -- he said
12 I'll figure it out and get back to you. And he called
13 me back to say that he was disappointed that I didn't
14 understand something that simple. He says we've just
15 simply had that disclosure for the last 10 years. We
16 like it and that's why it's sitting in there --

17 (Laughter.)

18 MR. SONDHI: -- which I think was his way of
19 saying, sorry, we missed something.

20 But the point is that these boilerplate terms,
21 these kinds of things that get into the disclosures and
22 they don't go out -- so there is a danger when something

1 sticks around for too long. So but I would sort of
2 very, very strongly suggest not to have anything that's
3 encouraged.

4 MR. HARRIS: Well, Joe and Sarah, thank you very
5 much. I think your comment letter is self-explanatory,
6 speaks for itself, and we very much appreciate your
7 having gotten it to us in the timely fashion that you
8 did.

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