

**NOTICE:** This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on June 18, 2015 that relates to the Board's project on *Auditing Accounting Estimates, Including Fair Value Measurements and Related Disclosures*. The other topics discussed during the June 18, 2015 meeting are not included in this transcript excerpt.

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1 MR. BAUMANN: Well thank you very much for getting  
2 back after break. I see everybody running to their seats  
3 and trying to hit our target time.

4 We're in the home stretch here, but we have a very  
5 important discussion left in the remaining time, and that  
6 is moving ahead and continuing to make progress on our  
7 proposed standard on auditing accounting estimates and fair  
8 value measurements.

9 As we know, financial statements are largely a  
10 conglomeration of estimates and fair value measures, so  
11 there can't be a more important auditing standard.

12 Barbara Vanich has been leading the project and will  
13 lead the discussion. Barbara?

14 MS. VANICH: Thank you, Marty, and good afternoon.  
15 It's my pleasure to talk to the SAG this afternoon about  
16 our project on auditing accounting estimates and fair value  
17 measurements.

18 Before I start to talk, we're going to try to keep  
19 this light. We realize you've had a lot of heavy lifting.  
20 It has been a very technical agenda, so I'll talk briefly,  
21 and then we'll give you a chance to put in some comments.

1           But I would like to introduce my righthand women,  
2 literally, to my side, my teammates on this project,  
3 Dominika Taraszkievicz and Nike Adesoye.

4           So this afternoon, we're going to talk about various  
5 aspects of the project.

6           First, we'll spend a few minutes providing a brief  
7 introduction, which will include a summary of our  
8 activities since we last briefed you on this project last  
9 November.

10           Next, we'll talk about the general direction of the  
11 project. This will include a brief discussion of the need  
12 for standard setting, along with the areas of the project  
13 where the staff feels fairly confident about making a  
14 recommendation to the Board.

15           We previously talked about the need for standard  
16 setting back in October. However, today's discussion will  
17 reflect some refinements based on comments received on the  
18 staff consultation paper on accounting estimates and fair  
19 value measurements.

20           We're interested in whether SAG members believe  
21 there may be additional needs for the staff to consider.

1           The discussion on the general direction of the  
2 project will also include a brief overview of the areas  
3 that based on comments or other outreach the staff feels  
4 prepared to talk to the Board about a recommendation. SAG  
5 members will have their chance to provide a view on these  
6 areas.

7           And then lastly, we want to talk about three areas  
8 where the staff continues to perform research. For each of  
9 these three areas: addressing significant measurement  
10 uncertainty; emphasizing professional skepticism; and the  
11 use of third parties; we'll talk about certain  
12 alternatives, many of which were provided by commenters.

13           SAG members will then have a chance to provide views  
14 on the alternatives discussed along with alternatives that  
15 we might not have mentioned.

16           This morning we heard from some great panelists and  
17 had lots of great discussion on specialists, how and in  
18 what way they interact with companies and auditors. Some  
19 of what you heard this morning has direct relevance on our  
20 discussion regarding the use of third parties, so when we  
21 get to that part of today's conversation, I'll summarize my  
22 thoughts on what I heard because I think you may have

1 already responded to some of the alternatives and questions  
2 we want to ask today.

3 So very briefly, it has been about ten months since  
4 we issued the staff consultation paper on auditing  
5 accounting estimates and fair value measurements. We had a  
6 special meeting of the SAG last October. We had a great  
7 discussion about the consultation paper at that time.

8 The comment period ended in November, and we  
9 received 40 comment letters. We discussed a summary of  
10 those comments with the SAG in November.

11 Since then, the staff has completed a detailed  
12 analysis of the comment letters received. We've conducted  
13 additional research on measurement uncertainty and on the  
14 use of third parties. And we also participated in a panel  
15 discussion on biases related to estimates and fair value  
16 measurements at the 2015 PCAOB-AAA Annual Meeting.

17 It was through preparing for that panel discussion  
18 and listening to the SAG meeting back in October and then  
19 reviewing the notes from that meeting that we got to one of  
20 our topics for discussion this afternoon, and that is how  
21 to better emphasize professional skepticism in a new

1 standard on auditing accounting estimates and fair value  
2 measurements.

3 So let's turn our discussion to the need for  
4 standard setting. As Marty talked about this morning,  
5 considering the need for standard setting is a key part of  
6 our economic analysis.

7 The staff included a discussion of our preliminary  
8 view on the need for standard setting in the staff  
9 consultation paper, and that need included audit  
10 deficiencies noted by the PCAOB and by other audit  
11 regulators, changes in the financial reporting frameworks,  
12 growing reliance on the work of third parties, and concerns  
13 expressed by some over perceived inconsistencies in the  
14 existing standards.

15 Through comment and SAG discussions, we have  
16 identified several other needs that we're going to spend  
17 time on a little bit later today, but the first, as I  
18 mentioned, is how to greater emphasize professional  
19 skepticism in a new standard.

20 And then lastly, and I think this also came up in  
21 the discussion today, what could the staff do to further  
22 address significant measurement uncertainty?

1           And with that, I'll just open the floor to SAG  
2 members, if you have any views on the needs for standard  
3 setting that I just covered.

4           All right, Tom Selling?

5           MR. SELLING: Thanks, Barbara.

6           I was happy to see in the previous session that we  
7 had a presentation in oil and gas because it represents, I  
8 think, a very interesting case study when we're thinking  
9 about estimates in general.

10           That's because for most of the oil and gas  
11 estimates, management can produce the numbers in a filing,  
12 but on the other hand, unlike the auditing rules that we  
13 have, management also has the option to outsource that  
14 information content to a specialist.

15           Another interesting contrast I think is that  
16 although auditors perform limited procedures on the oil and  
17 gas disclosures, that information isn't audited either.

18           So it's an interesting case study, and specifically,  
19 if you look at AU 328 Paragraph 4, it states that  
20 management must be responsible for making the fair value  
21 measurements and the disclosures included in the financial  
22 statements.

1 I think this is interesting because the PCAOB owns  
2 this language, that unlike other disclosures in a filing, I  
3 am not aware of the securities laws that explicitly state  
4 that management is responsible for the numbers.

5 Management does have specific responsibilities for  
6 financial reporting in the securities laws, and I'm not a  
7 lawyer here, and so I fully expect John White to be  
8 responding pretty soon about this, but to my mind, this  
9 particular provision in Paragraph 4 that we see in 328 and  
10 we see in similar places imposes additional requirements  
11 over and above the securities laws.

12 My point is that this is not immutable, that it's  
13 not something that's given to us from the outside. And  
14 it's possible to rewrite that paragraph such that, like oil  
15 and gas, we can give the preparer an option, that the  
16 preparer can either obtain an estimate from an independent  
17 specialist or not, and if a preparer -- and particularly  
18 with respect -- and the reason why I'm focusing on 328 is  
19 because I think fair value estimates are a good place to  
20 start rather than talking about estimates in general, but  
21 given that there are evaluation experts out there, this  
22 would be a good place to start.



1           And perhaps when that's the case, then if the fair  
2 value estimate is outsourced, that triggers one certain  
3 type of level of audit responsibilities and procedures.  
4 When it's insourced, then we have the traditional  
5 specifications, which are already in 328, and to my mind  
6 are perfectly adequate -- I shouldn't say perfectly  
7 adequate, but to my mind are what you would expect in that  
8 regard.

9           And on top of that, perhaps when it's material,  
10 either the audit report or the notes to the financial  
11 statements could provide appropriate disclosures when an  
12 independent specialist is elected.

13           Now, my remarks are, I think, a little bit forward-  
14 looking here because I think we'd all agree that everything  
15 here has to be predicated on what we talked about before,  
16 that there has to be an environment where there is a proper  
17 specialist infrastructure, where there are certification  
18 and independence requirements, so I think that, you know,  
19 moving to what I am talking about here would be highly  
20 incremental, but I believe, and I'd like to encourage the  
21 PCAOB and the SEC to work toward that type of goal.

1           There is nothing in the securities laws that say  
2 management has to produce the numbers. Management has to  
3 disclose the numbers, and they have to have controls over  
4 those disclosures, they have to have disclosure controls  
5 and procedures, but there's nothing that says they actually  
6 have to produce the numbers, and as we move toward more  
7 current evaluations and things like that, I think we ought  
8 to think about or rethink the model.

9           MR. BAUMANN: Just an observation, and I think maybe  
10 securities lawyers at the table might have observations as  
11 well, Tom.

12           I don't think the AU 328 Paragraph 4 was intended to  
13 put any burden on the part of management via auditing  
14 standards, so I think this statement is a reflection, in my  
15 view, of the fact that there are books and records laws  
16 with respect to securities laws for companies to keep  
17 accurate books and records and produce financial statements  
18 that present fairly financial information in conformity  
19 with the accounting framework.

20           So I don't think that sentence states anything other  
21 than what is already required by securities laws, so I  
22 don't know if anybody has any other perspective on that,

1 but on that point, I don't think companies look to our  
2 auditing standards and say there's a new requirement there  
3 for them.

4 MR. SELLING: Well, but by extension, the audit  
5 report then says that management is responsible for the  
6 numbers, and our responsibility is to audit them.

7 And I could be wrong, but I don't believe that comes  
8 out of securities laws. I think that that audit report  
9 language comes out of the auditing standards, and that  
10 language is not immutable. The language could say  
11 management is responsible for most of the numbers, with the  
12 exception of the fair value of our loan portfolio.

13 MR. BAUMANN: Loretta Cangaliosi?

14 MS. CANGALIOSI: Yes, I just feel compelled to  
15 respond to that. Stop laughing, Larry.

16 (Laughter.)

17 MS. CANGALIOSI: But, you know, management is  
18 responsible for the entire financial statements: the  
19 footnotes, the entire thing, okay? And we take  
20 responsibility for it.

21 The fact that we hire a specialist, again, my first  
22 comments were that that's not a throw-it-over-the-wall

1 exercise. It isn't as if I hire a specialist and I tell  
2 him go out and do this. I am involved in that, and it's my  
3 responsibility to not only understand the inputs and help  
4 provide the inputs, but to understand the outputs of that  
5 specialist.

6 I can't outsource, and I never can outsource, my  
7 responsibilities for the financial statements or the  
8 internal controls. I don't know any company that operates  
9 on a different standard than that. Wally, do you have any  
10 thoughts? No.

11 So I guess I feel like I own those financial  
12 statements, so when they go out, it's my name that's on  
13 those financial statements, and I need to make sure that I  
14 am comfortable with what has been put in, even by a  
15 specialist, because they are mine.

16 MR. SELLING: I would say that's because the audit  
17 standards say that you need to own those financial  
18 statements, otherwise we're not going to audit them. And  
19 you are describing what is. I am describing what can be,  
20 and what can be without an Act of Congress.

21 You may disagree with what my vision is, and you may  
22 think that we are in the best of all possible worlds that

1 way, but I think there is a lot of evidence to indicate  
2 that it's not working too well as the need for management's  
3 estimates increase.

4 MR. BAUMANN: Bruce Webb?

5 MR. WEBB: Well, I 100 percent agree with Loretta  
6 that irrespective of their use of a specialist, management  
7 is fully responsible for the financial statements, just as,  
8 irrespective of their use of specialists, the auditor is  
9 fully responsible for the opinion expressed on those  
10 financial statements.

11 MR. BAUMANN: Thank you.

12 Harrison Greene?

13 MR. GREENE: I am not an expert on the securities  
14 laws, but I know in every 10-K, there is usually a  
15 certification by management that they take responsibility  
16 for the financial statements and preparation of the  
17 financial statements, internal controls and everything, and  
18 those sorts of things, and particularly with our fiduciary  
19 rules, there is a requirement that management is  
20 responsible.

21 They have to do a statement of responsibilities in  
22 their annual reports to us that they're responsible for the

1 preparation of the financial statements in accordance with  
2 GAAP, that they have to have internal control structures  
3 set forth, they're responsible for all that.

4 The auditor is only opining on those financial  
5 statements that are prepared by management, so they're  
6 management's sole responsibility for the preparation and  
7 the content of those financial statements and notes.

8 MR. BAUMANN: I'd like to get Barbara back, more on  
9 topic on the subject of auditing estimates in our project.  
10 Ken, unless you had something more you wanted to -- ?

11 MR. GOLDMAN: I remind those that are involved with  
12 public companies' CFOs, just think of your management rep  
13 letter that you signed, which goes, it used to be 5 or 10  
14 pages, probably 20 pages long, which does clearly lay out  
15 all the responsibilities that I think we all feel we do own  
16 and control.

17 I could not agree more with the comment. I have  
18 always felt there are certain things you cannot outsource.  
19 One of those is the accounting and the sanctity of the  
20 accounting numbers and the planning, and so I am very much  
21 in favor of that and the responsibility thereon.

1           One of the things, I think the other point I did  
2 want to make though is, you know, there are some things I  
3 think we go about on the estimates that we put in our  
4 filings which frankly I am not always sure, it would be  
5 interesting to have a discussion here with some of the, you  
6 know, users and not the preparers of the statements,  
7 because my sense sometimes is we go through a lot of work  
8 to create some of those estimates, which I am not sure are  
9 used very well, and I'm not sure could be improved.

10           So I hope we get more into how to make that part of  
11 the filings more applicable and more useful, but I think in  
12 terms of ownership of statements and numbers,  
13 certifications thereon, I think that, you know, anyone that  
14 I know that practices in our roles takes those, you know, I  
15 could almost say damn, but certainly extremely seriously.

16           MR. BAUMANN:   Wouldn't your disclosure of critical  
17 accounting estimates help users use the information --

18           MR. GOLDMAN:   I don't know if that's true.  I would  
19 like to test that, because I can't recall ever having an  
20 investor, an analyst, a sell side or buy side ever ask me a  
21 question on that, ever, and so I am glad for someone else

1 to say anything different, but I am not sure, you're  
2 shaking your head, you do or don't get -- ? So we don't.

3 So I am just positing that maybe we could do some  
4 improvement on that section, so again, there's other people  
5 here, maybe a lot smarter -- I am sure a lot smarter than I  
6 am on that, but I just know, when I talk to investors, I  
7 don't get questions on that. I get a lot of questions on  
8 MD&A and a lot of other things, but that is one area I  
9 can't think of the last time I got a question on it,  
10 honestly.

11 Oh, one other thing. And just to put a, you know, a  
12 bullet point on the importance of the management rep letter  
13 and why we do own responsibility, is I do remember there's  
14 some folks that when things are incorrect there, that's, in  
15 theory, you're lying to the SEC. That's the law as I  
16 understand it.

17 So that management rep letter and everything you do  
18 to make sure those numbers are correct, you own.

19 MR. BAUMANN: All right. Bill Platt?

20 MR. PLATT: Okay, and Barbara, I am going to try to  
21 pull it back to the question you asked when you started  
22 with us, so back to a different topic, but related.



1           You know, you talked about, in the feedback process,  
2 you identified that additional consideration would be given  
3 to incorporating more on professional skepticism and then  
4 management uncertainty. And I would be supportive of both  
5 of those concepts.

6           You know, I often think in standard setting, we silo  
7 our activities into what the activity is, estimates, and we  
8 don't think holistically enough about it, and I think, if  
9 you were to look at, for example, and not to bring up a  
10 sore subject that Bob raised this morning, but internal  
11 controls, you would see a lot of audit deficiencies in the  
12 area of internal controls related to management estimates  
13 and the controls around management estimates.

14           And so I would think that if we were going to do a  
15 standard, you would at least more than just say AS 5 is out  
16 there, go follow it. Use it as an opportunity to clarify  
17 what expectations might be, what performance might be, and  
18 the like.

19           And so the more you can take concepts like  
20 skepticism, controls, and look at it holistically in a  
21 standard so when an auditor goes to it, they can kind of,

1 if they're auditing in that area, think about it broadly, I  
2 think would be helpful.

3 MS. VANICH: Well, thank you, Bill. Bob Herz?

4 MR. HERZ: Yes, not the same point as Tom's, but it  
5 did remind me of, you know, Level 1 fair value estimates,  
6 they're traded, they're quoted, you can look them up and  
7 all that. Level 3 requires a lot of work and assumptions  
8 and expertise and all that.

9 But there is kind of the stuff in between.  
10 Sometimes it's Level 2, you know, where there's pricing  
11 services, and for whole swaths of classes of assets, they  
12 have fairly uniform methodologies.

13 And I think I probably raised this in the session  
14 last October, but would a service bureau type approach kind  
15 of work there in terms of a structural solution for, you  
16 know, that might be more efficient across the system,  
17 versus every audit firm have to go to each one and, you  
18 know, and all that, and it might encourage, you know, Race  
19 to the Top in terms of some of those, you know, if in fact  
20 they have to be quality outfits and all of that and  
21 independent and that, you know.

1 I can't remember the lady's name over there --  
2 Susan, yes, I was impressed with what she had to say about  
3 Harvest and all that, and I'm not sure why every firm and  
4 every engagement team needs to reduplicate the effort.

5 MS. VANICH: Okay, thanks. Thank you, Bob.

6 Now I want to focus briefly on some areas where, as  
7 I mentioned earlier, the staff feels fairly confident that  
8 we're nearing being able to make a recommendation to the  
9 Board.

10 So the single-standard approach, which was discussed  
11 in the staff consultation paper, under that approach, the  
12 staff would draft a recommendation to the Board, a single  
13 standard that addressed auditing accounting estimates and  
14 fair value measurements.

15 Today, just by review, we have auditing accounting  
16 estimates, AU Section 342, we have a standard on fair value  
17 measurements, AU Section 328, and then we also have some  
18 valuation guidance in AU Section 332.

19 A number of commenters, including auditors, thought  
20 that developing a single standard to address both estimates  
21 and fair value measurements would have advantages. I will  
22 mention that not all commenters agreed.

1           However, the commenters that did not agree,  
2 generally their comments focused on the difference between  
3 fair value measurements and other types of estimates rather  
4 than on how the audit approach would differ. The IAASB and  
5 AICPA have one standard that addresses both fair value  
6 measurements and estimates. Commenters who were not  
7 supportive of a single standard did not attribute their  
8 views to any issues with those standards, and so the staff  
9 feels fairly strongly that that is a good recommendation  
10 for the Board.

11           Another point is that the further integration with  
12 risk assessment, and I think this is consistent with some  
13 of the discussion we had earlier that standards should be  
14 risk-based and audit attention should be focused where more  
15 risk of material misstatement lies.

16           In the staff's view, a potential new standard that's  
17 further integrated with the risk assessment standards would  
18 help auditors improve their overall risk assessment and the  
19 responses to the risk of material misstatement, including  
20 risks associated with estimates and fair value  
21 measurements.

1           This view was discussed in the staff consultation  
2 paper. In the staff consultation paper, we had included  
3 several potential amendments that would be made to the risk  
4 assessment standards. Commenters generally agreed. Some  
5 gave us some editorial suggestions which the staff is  
6 certainly going to consider, but there was general support  
7 around further aligning the standard with risk assessment,  
8 and we're certainly interested in SAG members' views on  
9 additional ways we can further integrate the standard.

10           The staff is also considering, though, that some  
11 commenters said having information or requirements about  
12 assessing risk within the standard on estimates and fair  
13 value measurements would be helpful, and so I guess as  
14 maybe a way of handling both comments, we've thought about  
15 just including maybe placeholders or some explanatory  
16 material to help auditors understand how this standard  
17 would work with the risk assessment standards.

18           And the last point I want to cover in this session,  
19 or this section, of our discussion this afternoon, is that  
20 in the staff's view a new standard would retain the three  
21 existing approaches for testing estimates and fair value  
22 measurements subject to certain refinements.

1           These approaches are included today in both AU  
2 Section 342 and AU Section 328, and that partially is the  
3 reason why we think that a single standard is a very good  
4 recommendation for the Board.

5           The staff has not seen evidence that these  
6 approaches are flawed. When I talk about refinements to  
7 the existing requirements, those refinements would include  
8 changes to emphasize skepticism and would also include  
9 taking maybe the existing requirements, but making sure  
10 they're broad enough to apply to both estimates and fair  
11 value measurements.

12           Commenters were broadly supportive of retaining the  
13 common approaches in a new standard, and no new approaches  
14 were suggested.

15           With that, I'd like to again allow SAG members, if  
16 you have any views on these areas, to provide comment.

17           MR. BAUMANN: Tom, is your card up again? If you  
18 want to make a comment, go ahead.

19           MR. SELLING: All right. This will be just 30  
20 seconds.

21           I just want to correct the record that the  
22 certification does not say that the financial statements

1 are the responsibility of management. The certification  
2 says based on my knowledge, the financial statements and  
3 other financial information included in this report fairly  
4 present in all material respects the financial condition,  
5 et cetera, et cetera, for the periods presented in this  
6 report.

7 Then it goes on to talk about its responsibilities  
8 for internal controls over financial reporting and for  
9 disclosure controls and procedures.

10 I was not proposing to change any of that, all I was  
11 proposing is that in the interests of efficiency, that  
12 auditors are better at verification and assessing the  
13 reasonableness of estimates, that there should be some  
14 flexibility given to management to obtain independent  
15 estimates that would be subject to different auditing  
16 standards than estimates that were generated by management.

17 MR. BAUMANN: Thanks. Philip Johnson?

18 MR. JOHNSON: Thank you, Marty.

19 I certainly agree that as Wallace mentioned in the  
20 October 2014 session that one standard is preferable, and  
21 so I do agree with the general direction of the project,  
22 certainly agree with that.

1           But I would raise one cautionary note, and that is  
2           it's always easy to keep adding requirements as commenters  
3           make points, and rarely do we take the matters away. And  
4           so we can get into a situation where I think, as Wallace  
5           mentioned in the last session, in this particular area, we  
6           shouldn't take away judgment, and therefore, having higher-  
7           level principles, I think, are important here so that  
8           practitioners can use the judgment when they're doing  
9           auditing estimates and fair values, because it's not a  
10          precise science.

11          So I would just have that cautionary note, that if  
12          we add too much from what commenters are saying, we could  
13          get into -- ourselves into a straitjacket of dealing with  
14          everything in one particular way.

15                 MR. BAUMANN: Right, thanks.

16          We certainly take commenters' points into account  
17          and address them as part of our proposals and releases and  
18          consider which ones we should take and which ones we  
19          comment on that we thought about and just, maybe it's  
20          application guidance or something in the release.

21                 Bob Herz?

22                 MR. HERZ: You may get to this next as you proceed.



1           But I remember when I was reading the material,  
2 there's something that kind of said that the best evidence  
3 is looking at subsequent events, and I would disagree with  
4 that unless it's like two minutes afterwards, because the  
5 world changes, the facts on which the estimate was based  
6 change, so that doesn't mean you don't look at it and, you  
7 know, the reasonableness is the underlying thing, but be  
8 careful not to reinforce the notion that, you know, as  
9 Loretta said, it's going to turn out to not be that way.  
10 That doesn't mean it wasn't a good estimate at the time.

11           MS. VANICH: If I could just respond to that, we  
12 weren't suggesting that it's always the best way to audit,  
13 but it certainly in cases can be an effective way to audit  
14 when a subsequent event is relevant.

15           MR. HERZ: That's got to happen pretty quickly,  
16 though.

17           MS. VANICH: David Kane?

18           MR. KANE: Yes, Bob Herz read my mind.

19           We've generally found that the subsequent event, in  
20 and of itself, doesn't constitute sufficient appropriate  
21 audit evidence. Fair market value and markets change,

1 fluid, so I think it can give you a false sense of security  
2 on that.

3 And it also doesn't appropriately reflect the  
4 measurement uncertainty. So let's just say you had a bond  
5 at 1231 that was, you know, par was 100, and it settled in  
6 February at 100, and there was a 60 percent chance it was  
7 going to pay you, and a 40 percent chance it wasn't.

8 Well, the settlement value ended up being \$100.  
9 That doesn't necessarily mean what the fair value was, and  
10 a market participant would factor in that possibility of a  
11 credit loss. So we see some teams actually placing over-  
12 reliance on that, so I just get a little bit concerned if  
13 you were to kind of reorder it that the inference might be  
14 made that that is actually more, you know, of a reliable  
15 method than some of the others.

16 MR. BAUMANN: Thanks. Good points, in both cases,  
17 but I think we want to think not just for fair value  
18 measures, but remember the project, we're talking about a  
19 single standard for accounting estimates and fair value  
20 measures, and certainly settlement of a lawsuit before the  
21 financial statements goes out is probably better evidence  
22 than whatever estimate legal counsel may have given or

1 management may have come up with as part of their  
2 determination of that lawsuit, so there are probably some  
3 estimates where the subsequent event provides maybe better  
4 evidence than the estimate itself.

5 So I think we will certainly think about that, but I  
6 understand your point on fair value securities compared to  
7 maybe some other estimates, however, where it really is a  
8 confirming event compared to what may have been a rough  
9 estimate of what that settlement cost might have been in a  
10 lawsuit.

11 Sri Ramamoorti?

12 MR. RAMAMOORTI: With respect to the comments on  
13 the three existing approaches, the testing management's  
14 process, developing an independent estimate, and evaluating  
15 subsequent events, I had two kind of thoughts, but this is  
16 more for discussion. You know, I am not myself very sure  
17 where I am going with this, but I think it will be  
18 important.

19 So we talked about sensitivity analysis, but we also  
20 talked about there being kind of a black box, and you know,  
21 we don't really know what's going on, it's beyond our

1 capability as auditors, it's maybe too complex and we're  
2 not trained, whatever.

3 Well, I think it's imperative that we learn and we  
4 continually evolve in terms of our competencies, and we  
5 improve the whole process, and so rather than just conduct  
6 sensitivity analysis, I'd like for us to maybe think about  
7 stress testing these models, and the idea there would be  
8 can we come up with tighter internal estimates with greater  
9 degrees of confidence? Can we do that, and how can we, you  
10 know, move in that direction, at least, over time?

11 And then, maybe even more controversial, back-  
12 testing, which is this business of looking at subsequent  
13 events, and let me take you to the extreme end: Professor  
14 Baruch Lev at New York University has actually talked about  
15 how when you have intangible assets that are really  
16 difficult to value, but as time passes and subsequent  
17 events provide you more information, then yes, now you know  
18 how the modeling should have been done.

19 I don't deny there is hindsight and all that, but  
20 what he says is, how about then going back and just for the  
21 heck of it recalibrate the financial statements to look at,  
22 you know, how would it change?

1           So you're going back now that you know what you  
2 should have known but you didn't because it was, you know,  
3 early in the game.

4           And so the idea of back-testing would really be to  
5 give us a sense of what were the assumptions before the  
6 fact that we made that totally didn't pan out?

7           Some which were impossible to do anything about  
8 because it is such a unique transaction that, you know,  
9 that's it, you know, even future information is not going  
10 to help you in any way.

11           But where future information can let you know  
12 something about the modeling process, if that can help you  
13 learn how to model better, I think that's something we  
14 should absolutely, you know, keep the thing open, I mean  
15 that possibility.

16           And we work with management, and as a profession, we  
17 continue to get better at this. That's really the goal.

18           MR. BAUMANN: Thanks, Sri.

19           Maureen McNichols?

20           MS. MCNICHOLS: So your slides in the document refer  
21 to academic research that supported this preferential  
22 ordering, and I am just curious, I didn't see the citations

1 to those specific studies. They may be in an earlier  
2 document, but I'd be curious to look at those and also  
3 maybe hear just a few comments about the nature of those  
4 studies and how they led to that conclusion.

5 MS. VANICH: Let me respond because I know we're  
6 jumping ahead just a little bit, and actually, maybe what  
7 we could do is just advance the slides and start to cover  
8 this area, because I think people's comments are getting to  
9 this issue.

10 So a number of the alternatives that were included  
11 in the advance material in the slides with respect to how  
12 the staff could emphasize professional skepticism, it  
13 included an explicit requirement for the auditor to  
14 identify which of the assumptions used by management are  
15 significant when testing management's process.

16 That was included in the staff consultation paper,  
17 and commenters were generally acceptant of that  
18 requirement.

19 I'll just jump ahead to answer the question and then  
20 go back, but changing the order of the substantive  
21 approaches, and I think maybe a couple of the comments  
22 related to this. I didn't have the citations in the

1 materials, although we could certainly provide them, and I  
2 think it was at least more than one study, but we've also  
3 heard it talked about at some forums. One way of increasing  
4 skepticism without changing requirements is to present  
5 things in different orders, and I think this got to Bob's  
6 point where putting subsequent events first might not be  
7 the best alternative.

8 But to do this alternative would not involve  
9 increasing requirements, it was just the general  
10 presentation. So I don't know if anyone else has a view on  
11 that.

12 MR. HERZ: I think there is a good point there that  
13 the other comment brought up.

14 I mean, I think about the loss development triangles  
15 that are disclosed for insurance companies, which is kind  
16 of what, you know -- what it does, it does help you  
17 understand management's ability to model and forecast, you  
18 know, some of that at least. It does give you some of  
19 that.

20 But what it doesn't tell you exactly is whether the  
21 estimate at that point in time, you know, was the best  
22 number or not, because there is new information.

1           But I think they're related, but there's a slightly  
2 different purpose. Now that auditor skepticism, to kind of  
3 look at the track record, you know, their track record in  
4 predicting things and that, but you've got to be careful  
5 again because the world changes.

6           MR. BAUMANN: I agree with that point, but looking  
7 at track records is a valuable piece of information as  
8 well. But those are all good points.

9           Phil Santarelli?

10          MR. SANTARELLI: Thanks Marty.

11          I do -- I wanted, as an auditor, I wanted to react  
12 to Sri's comments just a bit, and I think it piggybacks on  
13 what Bob just said.

14          But the -- when I think about testing management's  
15 process, I don't think solely with respect to what's in the  
16 black box, if there is in fact a black box. What I think  
17 about is how management is dealing with the black box,  
18 because I believe that's a big part of internal control  
19 over financial reporting: how capable is management of  
20 knowing how the estimates are developed? I think Loretta,  
21 you spoke to this a little bit before.



1           And the concept of back-testing and backward-  
2 looking, we've used that for years, and a very common area  
3 is with respect to percentage of completion accounting,  
4 when you're auditing that.

5           The thing is that is a build-up of information about  
6 the capabilities of management and their estimation  
7 process. It is not necessarily a discrete piece of  
8 information within an audit period, and it takes time to  
9 build that up.

10          So you get a history, you get a confidence with a  
11 particular system and process that management is using. I  
12 think the standard should enable you to draw on that, much  
13 as you do in AS 5 and so forth, your knowledge of what they  
14 did in the past may inform your risk assessments, et  
15 cetera.

16          But because of the constraints of financial  
17 reporting, there is just, in many cases, it's impossible to  
18 do in a tight window. So it builds up over a period of time  
19 and you become more confident, with Bob's caveat that the  
20 world changes, including people changing and processes  
21 changing. It is up to the auditors to note that, you know,  
22 if something has happened.

1           And from the skepticism standpoint, a change in  
2 management's process has to -- has to put a red flag up,  
3 you know? You did it this way for five years, what  
4 happened? What happened in your world that caused you to  
5 question that methodology, because it in fact had been  
6 pretty effective?

7           So I think that's a skepticism-type thing, so -- .

8           MR. BAUMANN: Thanks, Phil.

9           Jouky Chang.

10          MR. CHANG: Thanks, Marty.

11          And I thought I'd share a little bit with the group  
12 here about how we, when we're engaged on valuation  
13 engagements, how we deal with sort of this question of  
14 doing the work post the actual transaction date, if you  
15 will.

16          Because a lot of what we do is beyond the date of --  
17 of the, you know, whether it's the transaction, the  
18 business combination that's happened, or we're doing a --  
19 for example, a goodwill impairment analysis, it's generally  
20 beyond the actual testing date.

21          So the question we always ask ourselves is, you  
22 know, what type of information is knowable or known as of

1 the date of our valuation, and what we end up assessing is,  
2 you know, if there is a subsequent confirming event,  
3 subsequent event that confirms the outcome while we're  
4 still performing our analysis, is should we have known that  
5 information? Should we have known about that, you know,  
6 how the value would have played out when we were doing our  
7 work?

8 So it allows us to sort of -- so we don't accept it  
9 blindly, right? Just because the trade happens two weeks  
10 after our valuation date, we don't accept that blindly and  
11 say hey, we should really be marking it 107 instead of 105.

12 We really look at was there even any transaction  
13 being contemplated? Was there negotiations, for example,  
14 for this sale as of the valuation date, such that we can  
15 then decide whether or not -- is it a change in market  
16 conditions that led the value to move, or is it merely  
17 information that we should have known, but it just wasn't  
18 really concretely set forth?

19 Another context of it is, for example, maybe take it  
20 to more of an intangible asset world, is we're trying to  
21 value -- one asset we value very frequently is customer  
22 relationships, right?

1           And as of the valuation date, the company may be  
2 engaged in substantive discussions with a customer on  
3 either renegotiating the terms or expanding or contracting  
4 the relationship that they have.

5           That's important information to filter into our  
6 analysis if it is known -- if it's completed, that  
7 negotiation or that discussion is completed, so that we're  
8 narrowing what the potential outcome might be, because that  
9 is relevant, rather than ignoring that just because it is  
10 done a couple weeks later, or a few -- or a month later.

11           So I just wanted to share that with you on that.

12           And in the other context of when we're -- for  
13 example, when we're assisting, you know, private equity  
14 firms and hedge funds on the marking of their quarterly  
15 investment portfolio, that -- the whole back-testing and  
16 calibrating our models, that certainly happens all the  
17 time, right?

18           So when there is a trade that happens after the  
19 quarter ends -- after that year ends, we do look at it and  
20 say how can we improve our model, how can we -- you know,  
21 what -- does it confirm the model that we're using or the  
22 input that we're using, and if it doesn't, why not?

1           And we look, and we then apply that prospectively.

2           MR. BAUMANN: Sri, is your card back up?

3           MR. RAMAMOORTI: Yes. All right. Jouky's comments  
4 reminded me of February 12th, 2002, when former Secretary  
5 of Defense Donald Rumsfeld waxed poetic and gave us the  
6 beautiful known knowns, known unknowns, and unknown  
7 unknowns logic, which I just find very impressive, and it  
8 is, because the Boeing Corporation uses the unknown  
9 unknowns, calling it unk-unks.

10           So this is actually not a bad way for us to perhaps  
11 get auditors thinking about variables that are there,  
12 aren't there, should be there, and, you know, how do you go  
13 about modeling them, and how do you think about it?

14           So it is a nice methodology, so it sounds silly, but  
15 it actually is profound.

16           MS. VANICH: I don't see any more tent cards up, so  
17 I do want to back up just a little bit because I don't want  
18 to slight some of the alternatives that we'd like to get  
19 your input on.

20           So with respect to emphasizing professional  
21 skepticism in a new standard, as I mentioned, one of the  
22 ideas put forth in the staff consultation paper was to have

1 the auditor identify when the auditor has decided to test  
2 management's process of the assumptions used by management  
3 which are significant for testing.

4 It wouldn't require the auditor to identify  
5 assumptions not used by management, but rather just to  
6 start with management's assumptions to determine what the  
7 auditor would test.

8 Another alternative, and I think with respect to the  
9 alternatives we're going to talk about for skepticism,  
10 these alternatives could be done all in a new standard, and  
11 in some other places where we'll talk about alternatives,  
12 one alternative might replace another, but these would be  
13 things that would be relatively easy to do and work  
14 together.

15 A point we heard, and I believe this was discussed  
16 back in the October SAG, was to revise terminology to  
17 establish a mindset of professional skepticism, and that  
18 would include removing, for example, words like  
19 "corroborating management's estimate." It wouldn't change  
20 the requirement, but we'd just use a word that might lend  
21 itself more to being skeptical, like "to evaluate against  
22 management's estimate."

1           The staff has also considered including reminders in  
2 a new standard about the auditor's existing responsibility  
3 to exercise skepticism. It wouldn't seek to change the  
4 auditor's responsibility for exercising skepticism, but  
5 rather to reference those requirements to add emphasis, and  
6 I think that may be consistent with the comment we heard  
7 earlier that that often carries some weight.

8           Let me go through these last three, and then I am  
9 going to open it again for comment.

10           Another alternative that we're looking at is to  
11 emphasize the auditor's existing responsibility to consider  
12 relevant audit evidence, whether it corroborates or  
13 contradicts management's assertions. The risk assessment  
14 standards already require the auditor to consider the audit  
15 evidence obtained, whether it corroborates or contradicts  
16 management's assertions, so again, this is not suggesting a  
17 new requirement but would remind the auditor of the  
18 existing requirements.

19           We've also thought about extending the requirements  
20 for the fraud discussion in the risk assessment standards  
21 to more specifically address estimates and fair value  
22 measurements. Auditing Standard Number 12 includes

1 requirements related to having a discussion from a -- with  
2 the key engagement team members about the potential for  
3 material misstatements due to fraud, sometimes referred to  
4 as a brainstorming session.

5 This discussion could often likely include a  
6 discussion that relates to estimates and fair value  
7 measurements. However, the staff is considering whether it  
8 would be beneficial to just more specifically identify  
9 measurements and -- fair value measurements and estimates  
10 as something that would be important to consider in that  
11 discussion.

12 And then the last alternative that we included in  
13 the materials was something I think we've already covered,  
14 just related to this concept of preferential ordering.

15 And so, again, I do see some tent cards, so I am  
16 going to open back up the floor for any comments on these  
17 alternatives, also any other alternatives you might think  
18 that we could consider about skepticism. Also interested  
19 in whether any of the auditors have a view on maybe any  
20 issues in practice that would arise as a result of the  
21 alternatives we talked about.



1 MR. BAUMANN: I think this really was a pervasive  
2 comment in October from the -- when we had the full-day  
3 meeting on this standard about the need to really build  
4 professional skepticism into this particular standard when  
5 you're talking about estimates and fair value measures, so  
6 this is an important discussion for us about how to do  
7 that, and your comments about whether or not you think we  
8 have it right here, or there are other things we should be  
9 doing, are very important to us.

10 So Jon Lukomnik?

11 MR. LUKOMNIK: Thank you.

12 I think it's a -- it's a wonderful list. I do have  
13 one question.

14 As you point out, your requirement is for the  
15 auditor to identify which of the assumptions used by  
16 management, and you specifically said we're not asking them  
17 to consider assumptions not used by management, and I go  
18 back to sort of what Jouky said earlier about why do you do  
19 things as well, because if you start with what's already on  
20 the paper, you may miss the most significant assumptions.

21 So for instance, on financial instruments, there is  
22 virtually always the assumption that there is liquidity in

1 the marketplace, right? Usually, that is what gets people  
2 into problems, but it is not one that would be an explicit  
3 management assumption.

4 When you talk this way, I assume what you mean are  
5 the inputs that go into it, not the contextual assumptions  
6 that matter, and so my question would be -- and if you're  
7 talking about legal reserves, you're assuming that current  
8 case law doesn't change between the time of the estimate  
9 and the time of the report.

10 Having valued those things, it often does change for  
11 active cases. There are intermediate judicial rulings.

12 So my question is why would you specifically exclude  
13 sort of the context in which the assumptions are made which  
14 allow the assumptions to work?

15 MS. VANICH: All right, that's an excellent point,  
16 and sometimes it's difficult to talk about these  
17 alternatives without using too many words.

18 But as I mentioned earlier, the staff would seek to  
19 retain the three existing approaches, one of which includes  
20 testing management's process.

21 So in the case where the auditor has decided to test  
22 management's process, the staff asked questions about

1 whether the auditor should look to assumptions other than  
2 the ones used by management or start with the ones used by  
3 management with the auditor selecting which ones to test.

4 The staff, based on review of the comments and I  
5 think other outreach, felt that to go beyond what  
6 management used in an estimate when testing management's  
7 process probably started to feel like you weren't testing  
8 management's process.

9 When we get to talking about measurement  
10 uncertainty, we do have some suggestions that would -- that  
11 could potentially require the auditor to look at  
12 management's process for how management has considered  
13 alternative assumptions.

14 When developing an independent estimate, though, the  
15 auditor would certainly be able to consider developing  
16 their own assumptions. I hope that answers your question.

17 MR. LUKOMNIK: It does, and it's perfectly  
18 reasonable.

19 I'll just go back to something that Bill Platt said  
20 earlier that we sometimes look at things siloed, and that I  
21 would hope that as you wordsmith this, because that's  
22 really what we're talking about, this doesn't come to be

1        seen as an overall limitation, because clearly, those are  
2        the places usually -- or often are places where people get  
3        into trouble, where the -- the methodology for the  
4        estimation doesn't work anymore because the oxygen that  
5        enables it to breathe has somehow been taken away.

6                So I thank you, it makes perfect sense the way you  
7        explained it, but I would hope you'd look at it  
8        holistically as you write the entire standard.

9                MR. BAUMANN: Did you have a follow-on to that?

10               MR. HERZ: Yeah. I think in this area of  
11        professional skepticism, just kind of as an audit committee  
12        member, I always ask the auditors about consistency, you  
13        know, in the approaches used by management over time, or if  
14        they change, you know, why did it change, and, you know, is  
15        there a good reason for changing that?

16               And in terms of the inputs and ranges of inputs,  
17        that there is no overt bias from period to period, you  
18        know, the kind of similar place in the fairway each time.

19               MR. BAUMANN: And sometimes, if it didn't change,  
20        why didn't it change, right?

21               Guy Jubb? I am sorry -- Tom -- well, Tom Selling  
22        and Guy Jubb.

1           MR. SELLING: I want to briefly follow up on Sri's  
2 observation about unknown unknowns, because I think it  
3 really helps to make the point I was trying to make earlier  
4 to this highly resistant audience.

5           (Laughter.)

6           MR. SELLING: Unk-unks are factors that are present  
7 in a great many audit estimates. How good are management  
8 or anyone's forecasts of the negotiations between the EU  
9 and the Greek government going to turn out? What if the  
10 Greek government goes off the Euro?

11           What about estimates of future technologies? And  
12 very close to home now, what about lifetime estimates of  
13 credit losses as of the date that a loan is originated?

14           These are often the most critical accounting  
15 estimates we would make, yet I would submit they are  
16 inherently un-auditable. And yet auditors have to  
17 eventually conclude, according to the standards, that  
18 somehow these estimates, these unk-unks, are somehow  
19 reasonably made, and they have to associate themselves with  
20 those estimates, just as they associate themselves with the  
21 verification of inventory quantities.

1           It's -- you know, it strikes me as very -- very  
2 unbalanced.

3           And it's a frightening prospect when the unk-unk  
4 actually occurs. It doesn't reflect well on auditors. It  
5 doesn't reflect well on regulators or accounting standards  
6 setters.

7           I think we have enough history to know that this is  
8 a scenario that we as a group in the PCAOB should be  
9 working to avoid, and I don't believe that incremental  
10 changes to audit procedures to help auditors get more  
11 comfortable with the reasonableness of unk-unk estimates is  
12 going to help.

13           MR. BAUMANN: I think that's an excellent comment.  
14 Certainly there has been some research and studies from The  
15 American Assembly over time that talked about the fact that  
16 there is variable assurance, if you will, on cash compared  
17 to inventory quantities compared to some of these estimates  
18 that are hopefully auditable that have a great degree of  
19 estimation uncertainty, and there isn't a clear  
20 distinguishment in terms of the audit report in terms of  
21 that.

1 I do hope that critical audit matters communications  
2 can help in that regard, and I think the U.K. experience is  
3 indicating that auditors can communicate it through an  
4 audit report with CAMs, those more difficult, subjective,  
5 complex matters with greater risk of material misstatement,  
6 and give differential reporting through the audit report.

7 At the end of the day, they have to make sure that  
8 they're giving an opinion that they include in the  
9 financial statements, present fairly, but the CAM is going  
10 to at least give the reader that yeah, there was different  
11 risks of material misstatement in the various elements to  
12 which you were talking about and with respect to these  
13 various different estimates, so I appreciate that point.

14 Bill, did you have a follow-on to that? It looked  
15 like your card jumped up --

16 MR. PLATT: Yeah, I just had a follow-on that, you  
17 know, I think you have to take a step back and say what are  
18 we trying to measure in the financial statements?

19 So you take the example you have about what is going  
20 to happen with Greece and the EU and Greek debt and  
21 everything else, and I don't think that accounting is -- is

1 to predict exactly what is going to happen and then reflect  
2 that in your financial statements today.

3 What the accounting today in measuring something is  
4 what are the current market participants thinking about  
5 that situation?

6 So for example, if market participants said, you  
7 know what, there should be a 30 percent discount, you know,  
8 it should be valued at 70 percent on the dollar, but you  
9 really were perfect in predicting, and say you know, this  
10 thing is all going to get worked out, we think it's really  
11 worth 95 cents, even though you're perfect in your  
12 prediction, you would not be justified in recording at 95  
13 cents even if you can prove to me that you were right and  
14 market participants were wrong today.

15 So I think it's a little misleading to think about  
16 we're always trying to predict the future with certainty.  
17 What we're trying to do is to assess what do market  
18 participants today believe about the future, how they  
19 reflect that in their valuations?

20 MR. SELLING: I agree with that 100 percent, and  
21 that is why I support current value estimates, because I



1 think that is the only aspect of what market participants  
2 are thinking that we are capable of -- of estimating.

3 MR. BAUMANN: Thanks.

4 Guy Jubb?

5 MR. JUBB: I welcome the move away from the word  
6 "corroborate," and you mentioned, Barbara, the substitution  
7 perhaps of the word to "evaluate."

8 And that is a small and useful step in the right  
9 direction, but I do, as an investor, suggest that it  
10 probably doesn't go far enough in terms of what  
11 shareholders are expecting of auditors.

12 And I would like to see the word to evaluate and  
13 challenge. We have had, we have referred to it several  
14 times today, the benefit of the enhanced auditor reporting  
15 in the United Kingdom, and it is very interesting when  
16 reading these, and it may be therefore a source of some  
17 information for the PCAOB, to look at the words which are  
18 used by the individual audit firms.

19 I mentioned Royal Dutch Shell earlier today in a  
20 particular light, but in relation to estimation of  
21 decommissioning provisions, they say, this is the auditors,  
22 "We critically appraised management's account appraisal."

1           And that has a degree of granularity that goes  
2 beyond just valuation, and as shareholders, I think that  
3 consideration of just adding those -- something beyond  
4 valuation would be a very, very useful step.

5           Thank you.

6           MR. BAUMANN: Thank you, Guy.

7           Phil Santarelli?

8           MR. SANTARELLI: Yeah, just briefly.

9           I wanted to, as an auditor, say that we would agree  
10 with enhanced guidance as far as auditor skepticism. I  
11 think that's appropriate to put into the standards in more  
12 than one spot.

13           With respect to the explicit requirements to  
14 identify which assumptions used by management are  
15 significant, I don't think we should take it to a situation  
16 where the auditors need to develop their own assumptions to  
17 match up against, but rather, have a process where they  
18 would inquire of management diligently as to assumptions  
19 that were considered and rejected and then try to, from the  
20 standpoint of skepticism, say why were they thrown out?

21           That's a little bit I think what Bob was getting at  
22 from that bias that comes into it, and where in fact they

1 had, you know, if you can get transparent enough, they had  
2 the, you know, point A and point B and split it or took B  
3 because it was higher, and that's part of bias, and we  
4 really need to evaluate that as part of the fraud  
5 assessments, so -- .

6 MR. BAUMANN: Good, I think that's -- I think that's  
7 where we're headed, and we appreciate that support.

8 Sri?

9 MR. RAMAMOORTI: Marty and Barbara, I am teaching a  
10 graduate course in forensic accounting this semester, so  
11 obviously, I have been looking at a lot of references.

12 So I came across one, don't know what's the formal  
13 procedure to introduce books and other references into this  
14 August discussion, but you folks are happy to take a look  
15 at it, it's called Fair Value Accounting Fraud, so I think  
16 it's highly relevant that, you know, you should at least  
17 take a look. I am happy to leave this copy with you, so --  
18 .

19 MS. VANICH: Okay. You'll notice that the topics  
20 don't get easier, but I know that everyone wants to leave  
21 on time, so I am sure that everybody is going to give us  
22 some great input.

1           The next topic that we want to talk about is  
2     addressing significant measurement uncertainty, and I think  
3     it also was discussed briefly earlier today, that you can't  
4     have a discussion about estimates and fair value  
5     measurements without talking about it.

6           Several commenters suggested that a new standard  
7     should further address significant measurement uncertainty,  
8     and the staff has carefully considered these comments along  
9     with some relevant academic research.

10          Significant measurement uncertainty is inherent in  
11     certain accounting estimates, including for example  
12     contingent liabilities, environmental remediation  
13     liabilities, Level 3 securities, the allowance for loan  
14     losses.

15          But with that said, and I think Marty has probably  
16     covered it earlier, the auditor's role is to determine  
17     whether there is a misstatement, not to eliminate  
18     measurement uncertainty, and there's certainly procedures  
19     that need to be performed, and the auditor needs to  
20     consider available evidence and evaluate whether there is a  
21     reasonable range and points on that range.

1           And so the staff is very carefully weighing what  
2 would be an appropriate response to include in a new  
3 standard that would increase audit quality and reduce the  
4 risk of material misstatement, but not increase maybe an  
5 expectations gap, like I think we heard earlier.

6           So the potential alternatives include, the first was  
7 discussed in the staff consultation paper, amending the  
8 risk assessment standards to include factors that may be  
9 relevant to evaluating the extent of measurement  
10 uncertainty and accounting estimates as discussed.

11           This would supplement and aid the auditor in  
12 determining when a significant risk exists because of  
13 measurement uncertainty.

14           Another alternative, and I briefly touched on this,  
15 was to include a requirement similar to a requirement in  
16 ISA 540, particularly paragraph 15 and 16, to require the  
17 auditor in the case of significant risk or of significant  
18 measurement uncertainty to evaluate how management  
19 considered alternative assumptions or outcomes.

20           Several commenters who raised this issue suggested  
21 including that requirement, and also then if management has  
22 not adequately addressed the effects of estimation

1       uncertainty, the auditor would then need to develop a range  
2       to evaluate the reasonableness of the estimate.

3               A few other alternatives which I think people may  
4       have already touched on would be requirements to test  
5       models when the complexity of the model is giving rise to  
6       the significant risk. I think we heard about today the  
7       black box. It's difficult, auditors may not have access to  
8       it. Those are some of the things we have heard.

9               But at the same time, the model can be very  
10       important to the development of an estimate, and I think we  
11       heard mixed views, so if -- but if people have new views to  
12       add or want to recap what they have said, we're very  
13       interested in hearing it.

14               A few commenters suggested a requirement for the  
15       auditor to perform a sensitivity analysis, but at the same  
16       time, some of those commenters acknowledged that that might  
17       be very difficult for the auditor to do.

18               And the last alternative that we included would be  
19       to require communication of estimates with significant  
20       measurement uncertainty as an audit committee  
21       communication.

1           What I'd say here is I would think that given the  
2 existing requirements to communicate matters to the audit  
3 committee that these estimates are likely already being  
4 discussed, probably in a very detailed way, so maybe when  
5 you give us your views, if there's some nuance that you  
6 think would be valuable to add, we certainly want to be  
7 prudent and aware of audit committee's time. It is  
8 valuable, and they already have a lot to get through, so  
9 not just looking to add requirements.

10           And the last alternative would be to take on some  
11 element of reporting in this standard that would address  
12 significant measurement uncertainty, having the auditor  
13 make some type of communication. This certainly could  
14 potentially overlap with our project on the auditor's  
15 reporting model.

16           And so with that, I'd again like to open the floor  
17 to SAG members. So Bruce?

18           MR. WEBB: Thank you, Barbara. That is quite a lot.

19           Clearly, I think, you know, amending AS 12 to  
20 include factors that might be relevant to weighing the  
21 extent of measurement uncertainty makes sense. Certainly,  
22 no objection to including a requirement to evaluate how

1 management considered alternative assumptions, similar to  
2 ISA 540.

3 I think when you move into some of the other  
4 specific proposals there, while I think, you know, in most  
5 cases, when you're talking about a significant estimate  
6 with significant measurement uncertainty, you're talking  
7 about a significant risk, and you're probably talking about  
8 a fraud risk.

9 So I would think that most auditors would do exactly  
10 what you're talking about here, yet to throw specific  
11 requirements in in all cases causes me some pause.

12 Similarly, I would think most of the time, those  
13 estimates would be already included in audit committee  
14 communications, and would therefore be a source for -- for  
15 critical audit matters that you're covering in the auditor  
16 reporting model project. I don't think I'd want to have a  
17 separate disclosure requirement in this standard, but would  
18 want that to be subsumed in CAM.

19 MR. BAUMANN: David Kane?

20 MR. KANE: Yeah, just a couple brief points.

21 I think even when the valuation guys are coming up  
22 with a corroborative or point estimate, sometimes they are



1 concluding that it's within a reasonable range, but they're  
2 not necessarily identifying what that entire range is.

3 So I think that is a subtle but important difference  
4 if this were to be required in terms of developing a range.  
5 That would require a little bit more work, I think, is one.

6 Two, I think in terms of the testing, it depends on  
7 what you mean by testing the model. So the points we  
8 talked about this morning in terms of the level of detail  
9 that you have to get into. Is it really the inputs? Is it  
10 looking at the model assumptions? Or is it really looking  
11 at the granularity within the model?

12 The last piece in just thinking about this and  
13 requiring a sensitivity analysis, I could see this becoming  
14 more challenging particularly when you test management's  
15 process.

16 So let's just say for example like the allowance for  
17 loan loss. Would the auditor be required to develop his or  
18 her own estimate of what that range might be?

19 And I think to Bill's point a little bit earlier,  
20 it's easier in a fair value construct when you're thinking  
21 of market participant assumptions, but it can be a little  
22 bit more challenging when you're thinking about

1 corroborative or contrary evidence, particularly where we  
2 may be going on certain estimates.

3 So let's say like the allowance for loan loss, where  
4 the FASB is going, in terms of the current estimate of  
5 credit losses. You might have one bank that thinks we're  
6 going to fall off a cliff, another bank that might think  
7 we're actually going to do well, and they could have the  
8 same loan but have very different estimates of what that  
9 allowance might look like and be considering, you know,  
10 whether corroborative or contrary.

11 So how would auditors be thinking about that when  
12 similarly trying to develop a sensitivity for a range?

13 MS. VANICH: Those were all excellent points, and if  
14 I could just respond because I would also be interested in  
15 views.

16 I mean, I think that what is valuable for us to hear  
17 in this -- in this discussion today is some of the  
18 practical issues that could arise if we were to move  
19 forward with recommending some of these alternatives.

20 I think that when we've heard about models, and I am  
21 looking forward to maybe hearing about this more when -- in  
22 the comment period for the specialist paper, but we've

1 heard in some cases, you know, auditors maybe considering  
2 controls or activities of a model validation process that  
3 issuers may have in place. In other cases, we have heard  
4 that people test the model by perhaps having management run  
5 alternative assumptions through the model, and then they  
6 see if the output behaves in a way that they expect it to  
7 behave.

8 I think we've also heard that another option is to  
9 run management's assumptions through maybe a similar, it  
10 might not be as sophisticated a model as management is  
11 using, but just to get a general idea of whether  
12 management's estimate is reasonable.

13 The other point, I think that when we talked about  
14 potential for including a requirement like ISA paragraphs  
15 15 and 16, I would be very interested if auditors have any  
16 views on how that has worked in practice. I think that by  
17 the -- of all the alternatives we've talked about, that one  
18 probably had the most support from commenters.

19 And I think Bill, you might be next?

20 MR. PLATT: Yeah, I just wanted to maybe ask a  
21 question, and maybe it's an observation in the form of a  
22 question.

1           But, you know, I think that this whole measurement  
2 uncertainty probably causes a lot of people to be confused  
3 or have concerns about the lack of precision of an amount  
4 in a set of statements, and I understand that.

5           But I guess before -- I have a hard time -- before  
6 jumping to what more should the auditor do, I'd really take  
7 a step back and say well what is the objective? What would  
8 you like to get out of an audit that's different than you  
9 get today around this, and then you could evaluate well  
10 what -- are there any procedures we can do that will help  
11 move us in that direction or achieve that objective?

12           But I have a hard time with -- you know, I think at  
13 times, and I realize the staff is not doing this, but I  
14 think at times people think that if we've got an estimate  
15 that has a wide range, even if the company is in the middle  
16 of it, that somehow, by auditing, we can make the range  
17 narrower, and in fact, somebody made a comment before about  
18 having a narrower range and a higher degree of confidence.  
19 I think that is generally not achievable because usually  
20 the higher the degree of confidence, the wider the range  
21 you would get, and vice versa.

1           So, you know, I guess I would -- I would just -- I  
2 don't know if you have an answer to that question now, or I  
3 would encourage you to address it as you go through the  
4 project.

5           MS. VANICH: No, I think that is a good question.

6           I mean, I think that commenters -- and I hate to  
7 speak on behalf of commenters, but maybe they're also  
8 feeling this angst, whether it's angst on the part of  
9 auditors, whether it's angst on behalf of investors, but I  
10 think that enough people raised the issue. In some cases,  
11 I think people would feel better if there were more  
12 disclosures. In other cases, people maybe thought that the  
13 disclosure framework that exists today is adequate, but  
14 really making sure that you're evaluating the disclosures  
15 to make sure that the disclosures adequately convey the  
16 measurement uncertainty.

17           But I think that that's a good question for the  
18 staff to continue to pursue, but interested in if anyone  
19 has any comments.

20           MR. BAUMANN: I'll just add onto that, again, many  
21 of the commenters did say that they -- first of all, we

1 don't -- we agree with you, auditors can't audit away  
2 measurement uncertainty. It is what it is.

3 So, but the question is what should auditors do  
4 about it? In the -- and we asked that question in the  
5 consultation paper.

6 Many commenters said this was not a problem that  
7 PCAOB could solve by itself, that this was a problem of the  
8 financial reporting system and that the PCAOB and SEC and  
9 FASB should work together, and maybe is there more  
10 reporting that can be done on behalf of management, with  
11 respect to estimation uncertainty, than exists today?

12 And so that came up a lot in comment letters.

13 But I think what we're trying to do at a minimum on  
14 our end is say -- and I think it goes back into tying into  
15 the point of Barbara's about changing language from  
16 "corroborate" to "critically evaluate," or whatever the  
17 terms might be.

18 If auditors today are corroborating an estimate,  
19 while there is a wide range of measurement uncertainty,  
20 then I don't think we're achieving the objectives of what  
21 we want the auditor to do. We want the auditor to  
22 understand whether or not there is a wide range of

1 measurement uncertainty, and then, with respect to that  
2 risk of material misstatement because of that wide range,  
3 address their auditing procedures around that considering  
4 how management addressed that wide range of measurement  
5 uncertainty and how it considered various alternatives and  
6 why they picked the assumptions they did pick as opposed --  
7 and reject other assumptions and come up with the answer  
8 they did.

9 So I think -- I think we're on the same page here,  
10 not auditing it away, but what are the right procedures to  
11 make sure the auditor considers all of the options around  
12 that measurement uncertainty.

13 MS. VANICH: Brian?

14 MR. CROTEAU: Actually, a lot of what I was going to  
15 say I think Marty has just said, and Bill as well, frankly,  
16 and I think it's very helpful.

17 Again, my own views here on this, but as you hear  
18 and think about -- well, first of all, maybe thinking about  
19 the fair value project when you think about specialists,  
20 when you think about the reporting model and CAMs, I think  
21 all of these things can have some interrelationship, but  
22 you know, as you think about reasonable assurance and you

1 think about uncertainty, levels of precision, these  
2 concepts I think are -- you need to think about them all  
3 carefully and in their compartments, and then how they  
4 interrelate.

5 And from at least my perspective, I think this is a  
6 good dialogue to be having as you're working on all of  
7 these projects, and I guess I would just encourage, as  
8 people are thinking about providing feedback, to step back  
9 and think about them and to give some consideration to  
10 making sure that we're not doing something that we're  
11 trying to solve, to Marty's point, something that could be  
12 a management disclosure issue through the auditing  
13 standards, and if we're thinking about something that  
14 belongs in the auditing standards, perhaps in the auditor's  
15 reporting model, what is that and why, and how does that  
16 relate to something that management may already have  
17 obligations for or not?

18 So I think these are very important concepts, and I  
19 wouldn't want to put Jim on the spot, but you know, I don't  
20 think from a IAASB perspective you know, the idea was  
21 certainly to have different levels of assurance or change  
22 the reasonable assurance models with KAMs as opposed to



1 CAMs, and I think that's critical to think about as you're  
2 -- as you're providing feedback on these projects.

3 MR. BAUMANN: Thanks, Brian.

4 Bob Dacey?

5 MR. DACEY: Thank you, and these are my personal  
6 views as well and not necessarily those of GAO.

7 But just observations. I guess I would have some  
8 concerns, as was mentioned before, about adding specific  
9 requirements when you have significant measurement  
10 uncertainty, but at the same time, I guess some of our work  
11 kind of crosses over with sensitivity analysis and trying  
12 to identify those assumptions or drivers of that range of  
13 uncertainty to help understand and focus attention on those  
14 areas to see if we have sufficient evidence to support that  
15 those are, you know, reasonably supported by sufficient  
16 appropriate evidence to really hone in on those key  
17 drivers.

18 Thanks.

19 MR. BAUMANN: Thanks, Bob.

20 Bob Herz?

21 MR. HERZ: Yeah. I guess it was this morning that  
22 Liz Murrall mentioned that in the U.K. auditor reporting,

1 they actually explicitly talk about the materiality level  
2 that they set, and I don't know whether you're thinking  
3 about that in our auditor reporting here in the U.S., but  
4 if you are, and I am starting to think about how all this  
5 would relate to that, and expectation gaps, and how that  
6 can be communicated appropriately, because, you know, we  
7 said here, you know, let's say for a particular audit they  
8 said it's five million dollars and there's particular  
9 estimates that individually are -- some individually, and  
10 certainly in the aggregate, are much more than, you know,  
11 an uncertainty range of five million dollars, and, you  
12 know, how that all gets related to that disclosure of the  
13 materiality.

14 It has got to be explained. Otherwise, I think it  
15 increases the -- it could increase the expectation gap.

16 MS. VANICH: Yeah, I think that some commenters did  
17 kind of specifically point out that some people dealt with  
18 this as when measurement uncertainty exceeded materiality,  
19 I think from the staff perspective we definitely thought  
20 that that would be incredibly challenging because unless  
21 you disclose materiality and just say it was larger than  
22 materiality, I would assume that as an investor I would

1 want to know whether it's a dollar more or a billion  
2 dollars more.

3 And then if people would be interested, maybe more  
4 in aggregate for the balance sheet, has measurement  
5 uncertainty exceeded materiality?

6 So those areas are certainly not without challenge.

7 I think Sri?

8 MR. RAMAMOORTI: Bob, thanks for so eloquently  
9 trying to, you know, communicate what I am going to try and  
10 say too.

11 I have very strong opinions on this one. I agree  
12 completely with Tom that we don't want to be in a position  
13 where the measurement uncertainty significantly exceeds the  
14 threshold in that it could even be a multiple of the  
15 materiality threshold because if that were true, the  
16 standard audit report language that the financial  
17 statements present fairly in all material respects, that is  
18 actually meaningless.

19 How could you even make that statement? Because  
20 these things are totally, you know, out of the, like,  
21 reservation, I guess. I mean, they are like so far out,  
22 you have no idea.

1           So I don't think you certainly cannot audit them  
2 away, we talked about that, but I think we can't even opine  
3 on these numbers, and if we do opine, the danger we put  
4 ourselves in is that we are now dignifying numbers about  
5 which we have no clue. We have no clue. We don't know  
6 where they've gone, but we're happy to I guess have our  
7 name associated with them. Why would we do that? That's  
8 not a very smart thing.

9           So my preference would be if there is some way to  
10 dissociate from this area by basically saying we are happy  
11 to look at management's process, and what kind of integrity  
12 did they show, what kind of diligence did they show in  
13 terms of coming up with what is admittedly a very  
14 challenging issue?

15           We sympathize, and we understand, so that would be  
16 my first preference, if you can do it.

17           However, I also understand how hard you folks have  
18 worked because I am totally impressed with all these  
19 alternatives that you have come up with, and to me, the  
20 last one, which is maybe lumping these as part of the  
21 critical audit matters, maybe roping in the audit committee  
22 in terms of formal communication, and most interestingly,

1 if you could disclose in the auditor's report that folks,  
2 this is way beyond, you know, our ability to meaningfully  
3 opine on, and it's basically putting the public on notice  
4 that we really shouldn't be relied upon to be opining very  
5 meaningfully, I think then we are protecting ourselves.

6 MR. BAUMANN: Well, I don't think we've teed up the  
7 latter one in this discussion, that the auditor would say  
8 that we can't opine on this because the measurement  
9 uncertainty is too wide.

10 But I -- as commented earlier, there certainly was  
11 various different groups in the past, as I mentioned The  
12 American Assembly, that talked about varying levels of  
13 assurance, that certain numbers are more capable of  
14 assurance than others.

15 So if auditors believe that these numbers were not  
16 auditable, or we believe that, I think we have to address  
17 that issue. I don't think we're at that state, but  
18 certainly that would be an important matter to take up.

19 I do think as long as they are auditable, the  
20 importance of this expanded audit report in critical audit  
21 matters helps tell investors the story that there are  
22 different sets of numbers here in the financial statements

1 and some have far greater risk of material misstatement and  
2 some have far greater measurement uncertainty, and that's  
3 important I think for investors to understand.

4 MS. VANICH: Okay, you know, I'm keenly aware that  
5 we're starting to lose people as they have to leave to  
6 catch their transportation.

7 Again, we've probably saved -- I don't know if this  
8 is a tougher issue than measurement uncertainty, certainly  
9 sometimes it feels like it is, but the last -- the last  
10 topic of the day is use of third parties, and there is a  
11 lot of overlap with what we talked about this morning, the  
12 content of the staff consultation paper on auditor  
13 specialists, and the area of auditing fair value  
14 measurements and estimates.

15 The first panel this morning, and not to slight the  
16 second panel, but the first panel, what you heard I think  
17 was really more closely related to something we were going  
18 to talk about today, which was management's use of the  
19 specialist.

20 But in the interest of time and because I would like  
21 to talk about the auditor's use of pricing services, if  
22 it's okay with everyone, I'd like to walk through what I

1 heard and kind of where I think -- how it affects this  
2 project, and certainly we would obviously wait for the  
3 comment period to close to make any kind of conclusion.

4 But I think one of the things we heard and heard  
5 relatively strongly was to consider retaining AU Section  
6 336, or have some other type of standard relating to the  
7 auditor using the work of management specialists.

8 The staff consultation paper had started to go down  
9 a path of having the auditor treat information from  
10 management specialists as if it were developed by  
11 management. I think that the specialist team benefitted  
12 from the comment that we've received that that might not be  
13 the best way to go about standard setting.

14 So with respect to management's use of a specialist,  
15 I think that we probably have some homework to do. I don't  
16 know if anyone disagrees with that view, you're welcome to  
17 get to -- to let us know.

18 But I don't want to close out the day, and so I  
19 assume this will be kind of our last discussion of the day  
20 that I want to get to is the auditor's use of a third  
21 party, and in particular, the approach that the staff had  
22 put forth when using a pricing service.

1           So the staff included in the staff consultation  
2 paper some example requirements that could apply when an  
3 auditor uses a pricing service, which in the staff's view  
4 is different than a traditional specialist. I think we  
5 heard part of that today, that pricing services provide a  
6 uniform product to subscribers for a fee. We heard from  
7 commenters that there is certainly less opportunity for  
8 management to bias that number, if any opportunity at all,  
9 maybe depending on the exact process.

10           Commenters generally agreed that the pricing  
11 services are different than specialists. Some suggested  
12 additional procedures or other procedures. Some commenters  
13 were unsure based on the consultation paper whether the  
14 staff was suggesting there would be procedures for each and  
15 every individual security in a portfolio, and some also  
16 suggested that for many easy-to-value securities, their  
17 first procedure is to look at exchanges or information  
18 that's in the public domain rather than to go to a pricing  
19 service.

20           So the first alternative that we wanted to talk  
21 about was whether it would be maybe more beneficial, and  
22 this is an either/or alternative, I should mention that, to



1 retain the approach discussed in the staff consultation  
2 paper largely as described, however to clarify the  
3 auditor's ability to group securities with similar  
4 characteristics and risk, and to also acknowledge, and I  
5 would say acknowledge because this was not inconsistent  
6 with the staff's view when we developed the paper, that for  
7 exchange-traded securities, acknowledging that evidence  
8 provided through quoted market prices that are readily  
9 available to the public through national exchanges would  
10 serve as audit evidence.

11 The other alternative, and this is really kind of a  
12 much broader alternative to what was discussed in the staff  
13 consultation paper, is to take a different approach and to  
14 address not only the pricing service used by the auditor,  
15 but to consider what -- whether the auditor could in some  
16 way use the work of management's pricing service. I think  
17 we certainly heard support today for retaining the  
18 auditor's ability to use management's specialists, so I  
19 think it would be reasonable for us to look into whether  
20 the auditor could use the work of management's pricing  
21 service, given we've heard that there is less chance of  
22 bias.

1 Under that approach, we also thought it would be  
2 beneficial to consider what other types of auditing  
3 requirements and guidance would be useful for financial  
4 instruments on a broader basis, and that could include  
5 considerations relevant for assessing risk with -- related  
6 to financial instruments, responding to risk, and  
7 addressing perhaps specific topics like impairment of  
8 financial instruments.

9 I know that is a lot to get through in a few  
10 minutes, but I really wanted to get your reaction to this  
11 alternative and discussion.

12 Larry?

13 MR. SMITH: So in reading the paper, I was a little  
14 disappointed that there was not something else on there  
15 that you were considering which has been mentioned  
16 previously today, so I am going to strongly encourage the  
17 PCAOB to listen to the sage advice provided by my former  
18 boss in terms of developing -- particularly for Level 2  
19 measurements, developing a SAS-70-type report in which an  
20 auditor of the pricing service provides a report on the  
21 internal control system and also provides a report  
22 summarizing the results of substantive tests in which, and

1 you pick it, the confidence level is x, that the error rate  
2 doesn't exceed y, and then allow other auditors of  
3 companies that are using that pricing service to rely on  
4 the results of that single audit and not do any other work  
5 on it.

6 I think that would take tremendous costs out of the  
7 system.

8 MS. VANICH: Jay?

9 MR. HANSON: I just wanted to express my support for  
10 Larry's comments and Bob's earlier comments that as I kind  
11 of pragmatically step back and think about it, and I am  
12 going to look at Jouky for a minute and say gee, there is  
13 probably nobody in this room who knows more about -- well,  
14 Jouky and Susie -- pricing financial instruments than the  
15 two people there, so either we could have everybody in the  
16 room without the skills to do it try to audit it, or have  
17 those two tell us the prices, and we test what they -- they  
18 told us, and all of us rely on it. I would vote for two  
19 experts determining the price, and the rest of us relying  
20 on it.

21 MR. BAUMANN: Larry's got your statement in, and  
22 you're walking out before I can get my response back there?

1 (Laughter.)

2 MR. BAUMANN: Make the comment and run.

3 Certainly I think that's a good comment. If there  
4 could be an audit of pricing services and a report on the  
5 pricing service that auditors could rely on where the test  
6 of the process and controls and test of the substantive  
7 tests of actual valuations of different types of categories  
8 and that type of report could be developed, I think that it  
9 would certainly help take costs out of the system and  
10 enable auditors to use pricing services more freely without  
11 performing maybe additional tests there in each case.

12 I think there's an authority question there in terms  
13 of the Board in terms of could we mandate that pricing  
14 services have to have these types of studies done? So, I  
15 mean, if they're done and pricing services engage somebody  
16 to do all these services, the question is we don't have  
17 authority over pricing services, we have authority over the  
18 audit of the issuer, so I think there's at least a question  
19 there as to what's the mechanism for that to take place.

20 I am happy to explore that, whatever that mechanism  
21 is, happy to hear more about it, but certainly, to the

1 extent that we're there, that's a dialogue we'd love to  
2 have further.

3 I think that without that mechanism, I think what  
4 we're looking at is, yeah, use the third-party pricing  
5 service and assess the extent to which they are  
6 independent, that their prices are widely used, that they  
7 have some processes and controls. I know the larger firms  
8 today are doing a lot of what was just said. Some of the  
9 larger firms are going into that pricing service one time,  
10 evaluating the controls around that, processes, their  
11 prices, doing substantive tests of different categories,  
12 and creating the ability to therefore -- so that all their  
13 engagement teams don't have to go in, they have gone in and  
14 made that valuation, and then the firm, I think the teams  
15 test selected prices along the way.

16 So I think that that is happening today to benefit  
17 the large firms. The smaller firms that can't do that  
18 don't have the same benefit, so I think this is an area  
19 that's continuing to evolve, and we're looking for ways to  
20 do what Larry said, to get costs out of the system and to  
21 get a benefit of an overall study of these pricing  
22 services.

1           So ideas in this area are certainly -- are valued,  
2 and I will look forward to more.

3           Brian Croteau, you have your card up.

4           MR. CROTEAU: Thanks Marty.

5           I was just going to add, that's what you'd say  
6 certainly from an authority perspective, some have asked me  
7 as well from time to time about the SEC, and without  
8 getting into that, I think a first question that some  
9 pricing services may have registration requirements with  
10 the SEC depending on the nature of the services they're  
11 offering, but that doesn't necessarily follow relative to  
12 authority to just mandate some type of audit.

13           But then you get into the question of the standards  
14 against which the audit would be performed, and the  
15 questions that in fact I think Larry is raising about  
16 precision, essentially, and level of confidence that one  
17 would need to think about relative to the potential than an  
18 individual company has one individual security that could  
19 be hugely material that may, you know -- that needs to be  
20 thought about in the context of the overall audit of a  
21 pricing service if that kind of an approach were even  
22 market-driven.

1           So I think to Marty's points, it's an interesting  
2 area to really give a lot of thought to, but I think, you  
3 know, there's a lot of issues to think about when doing  
4 that, and not just authority questions: what the auditing  
5 standards would be around it, would it be market driven,  
6 would the precision levels stand the test of thinking about  
7 the example I gave of one security being hugely material?

8           I am not raising these issues to say we shouldn't  
9 think about it, I am raising them to add to what Marty has  
10 described. I think it's worthy of thinking about, but, you  
11 know, thinking about all these issues as we do so.

12           MS. VANICH: If I could add onto -- if I --

13           MR. HERZ: I was thinking much more of a market-  
14 driven thing, not that you -- I don't think you have that  
15 authority, but something that if, you know, they got, you  
16 know, a service bureau's SOC 1 Report, and kind of an  
17 equivalent in this area to maybe what Larry said, but if  
18 that occurs and it's -- it meets those standards, then, you  
19 know, for those pricing services, that, you know, that  
20 would be another way to go.

1 MS. VANICH: If I could -- if I could add to that,  
2 though, there is one point that I think that's particularly  
3 relevant.

4 Based on the staff's outreach, it would be  
5 interesting if anyone has any views or data on how this  
6 would take costs out of the system.

7 As Marty mentioned, the large firms have in-house  
8 expertise that does a lot of work with pricing services.  
9 We don't hear from enough small firms, but from some of the  
10 smaller firms we heard from, they don't extensively use  
11 pricing services. It's just not part of their business  
12 model to pay for an ongoing subscription or to have a  
13 relationship. Because their issuers may or may not have  
14 very many securities, they may be more likely to test  
15 management's process or to go to a specialist, so I think  
16 that we would have a lot of questions to ask around whether  
17 it really would, on the audit side of the house, take costs  
18 out of the system.

19 MR. BAUMANN: Bruce Webb.

20 MR. WEBB: Thank you, Marty and Barbara.

21 I just, you know, I think Larry's idea is an  
22 intriguing one. Just a couple of points.



1 I mean, first of all, pricing services I believe in  
2 some cases are a service organization, in other cases maybe  
3 a specialist. It depends on -- on how they determine the  
4 value of a security.

5 So, you know, today, we do have -- we do have the  
6 SOC 1 approach for internal controls that they're  
7 considered to be a service organization, they could elect  
8 to issue a service organization report and have a service  
9 auditor report on their internal controls.

10 That gets you partway there, but, you know, you  
11 can't rely solely on tests of controls, so some substantive  
12 procedures still need to be performed, and I think what  
13 Larry was proposing is some sort of a combined  
14 controls/substantive audit of a service organization that  
15 would, I think, require some sort of new standards setting  
16 because there's not a standard today that would enable that  
17 sort of approach to allow an auditor to rely on that as  
18 audit evidence without doing their own work.

19 MR. BAUMANN: I think to maybe Bob's point, if there  
20 is a lot of cost in the system, you'd think it would be a  
21 market-driven event to say -- for this report and this  
22 study to happen, because the market would say that would be

1 an efficient use of pricing services, and would standards  
2 setters, you know, permit auditors to reduce the scope of  
3 their work if this type of report, this type of both  
4 internal control and substantive testing of prices in  
5 different categories, took place, much as what I think the  
6 large firms are actually doing for their own teams?

7 And I don't know if any of the large firms want to  
8 comment on that or it's proprietary, but so speaking  
9 generically then of large firms.

10 Well, good. So I think -- Jean Joy, and I also  
11 would be interested, James, if you think this is something  
12 that is being discussed at the -- at the IAASB, but let me  
13 -- I don't want to put you on the spot in that regard, but  
14 in the meantime, Jean.

15 MR. GUNN: No, thank you very much, I had -- I just  
16 -- general comments from today's discussion, and first of  
17 all, I'd like to state the obvious: I think the PCAOB and  
18 staff's efforts of looking at these performance standards  
19 both on specialists and fair values is the right place to  
20 be, so much support from the Board and the IAASB staff for  
21 your continued efforts on the two topics that you've raised  
22 today.

1           We are -- we do not have a particular project on  
2 third-party pricing sources, and we're not in the state of  
3 reviewing ISA 620 at the moment.

4           However, we've -- we've undertaken an exercise, and  
5 I think we started off on the premise of financial  
6 institutions because that area has many issues in terms of  
7 fair value estimations, modeling, use of experts internally  
8 and externally, and so forth.

9           And so we've taken away the industry factor, and I  
10 think we are going to be focusing more around the IFRS 9  
11 issues, loan loss provisions and the implications of that  
12 relative to the auditor's work in modeling, testing, and so  
13 forth.

14           We do know that this is an area, third-party pricing  
15 sources, where there could be further enhancements within  
16 the standards, so we -- we look to monitoring your  
17 activities and considerations quite closely to inform our  
18 future activities.

19           MR. BAUMANN: Thanks, James.

20           Now Jean? And Jean, it looks like, unless anybody  
21 else wants to put a card up on this subject, you get the  
22 last word, but I'll monitor the table on this.

1 MS. JOY: It's never a good position to be in.

2 I'll make this very brief since you asked about the  
3 small-firm perspectives and cost in the system.

4 And I would just continue to suggest that there --  
5 there be more attention paid to the risk assessment and the  
6 -- the banning, if you will, of testing back to a client's  
7 pricing service, to me, is still sometimes ineffective or  
8 just not warranted, meaning if you have really assessed the  
9 risk of a portfolio and you're talking about, you know,  
10 Level 2 securities for the most part, at least  
11 understanding the nature of those securities, and are you  
12 really gaining further audit evidence that would have any  
13 material impact on the financial statements by -- by having  
14 to test to a second source?

15 So I'm always troubled by -- that is adding cost to  
16 the system because we don't have pricing specialists, and  
17 we are paying an additional service to test back to pricing  
18 sources that are deemed to be very reputable, so to see a  
19 ban on that without an appropriate risk assessment, I think  
20 I'm troubled by the fact that we keep getting away from  
21 that, but I'd still like to see some focus on when the risk

1        assessment is appropriate, that you don't have to go to a  
2        second source.

And I think anything we can do to get the credentials, if you will, of the service provider more transparent so that they can be relied upon by many firms, I think that that would be a tremendous step forward.

MS. VANICH: Well, I think that everyone has done a great job, and I appreciate all the effort you put into preparing for today, and so to -- we're going to end on time, but again, I want to thank you for -- for your time and helpful comments.

MR. BAUMANN: Thanks, thanks Barbara.