NOTICE: This is an unofficial transcript of the Public Company Accounting Oversight Board’s Standing Advisory Group meeting on October 2, 2014 on Auditing Accounting Estimates and Fair Value Measurements.

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The Standing Advisory Group convened in the FHI Building, 8th Floor, 1825 Connecticut Avenue, N.W., Washington, D.C. at 9:45 a.m., Martin Baumann, Standing Advisory Group Chairman, presiding.

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MR. BAUMANN: I'm going to take this opportunity of a certain silence to get the meeting started. Good morning, everybody. I'm Marty Baumann, PCAOB's Chief Auditor and Director of Professional Standards. It's my pleasure to welcome all of you here, both those here and on our webcast, to this special meeting of the PCAOB's Standing Advisory Group.

This meeting was not on the year's original plan for meetings of the SAG and was organized only relatively recently. Having said that, we're really delighted with the turnout and the willingness of SAG members and panelists that we've invited and other observers to adjust your calendars and be here today. So for us, we're delighted that so many of you are willing to participate in what we hope is a very valuable meeting and very informative meeting on this most important topic.

As you know, we benefit greatly at the PCAOB from the advice we get from the Standing Advisory Group on all of our various different issues and matters of standard
setting. And we look forward to these meetings and the contributions that we receive.

As I'm starting to talk, one of the things I should mention early on is our standard disclaimer. The views expressed today by each of the panelists and presenters during today's meetings are their own personal views and are not necessarily those of the PCAOB, members of the Board, or the PCAOB staff. And those include views of the staff. Our own views are not necessarily the views of the Board or the organization.

Today's meeting is a bit unique compared to some of our previous SAG meetings where we've covered a variety of topics. Today, we're really focused on one topic, one topic but one very important topic, and that is the Staff Consultation Paper issued on August 19th pertaining to auditing accounting estimates, including fair value measurements. When you look at a set of financial statements, it really boils down to a bunch of accounting estimates and fair value measurements, so this is really an important area of accounting and auditing that needs the focus of our attention in making sure we get this right in standard setting.
We've distributed the agenda, along with a copy of the consultation paper, in advance of the meeting. But these items are also included in the folder in front of you. Hopefully, you've also all had a chance to read the paper.

Also, in your folders in front of you are biographies for all of the participants, SAG members, and panelists, and a seating chart to help you navigate and locate people around this intimate table. For those viewing via the PCAOB website, the agenda and Staff Consultation Paper are both available on the website.

The consultation paper solicits public comment on a number of issues relating to auditing, accounting estimates, and fair value measurements. We strongly encourage everyone to submit a comment letter by the November 3rd comment deadline in response to the specific questions or in response to any other matter that commenters feel they want to raise in such a letter.

However, we also wanted to hold this meeting to explore deeply the matters raised in the paper and engage in a meaningful dialogue with this group on the need for standard setting in this area, any new audit practices.
that might be evolving around auditing estimates and fair value measurements and a possible standard-setting approach to respond to the need identified in the paper. In developing responses to the paper, hopefully commenters can take into account the various views expressed around this table today to further inform their thinking on the comments.

So to that end, we've organized a structured meeting today with several panels, as noted on your agenda. Panels are led by your SAG colleagues and other distinguished guests, and these panels will delve deeply into various different topics all relevant to the auditing estimates and fair value measures. The panels will address these issues from different perspectives, but each of these perspectives should inform us about auditing estimates and fair values and further our thinking about a possible new auditing standard.

Now, this is important. As always, notwithstanding the panel structure, we encourage SAG members throughout the meeting at any time, including during panelist presentations, to raise your tent card on its edge and we'll make sure that we call on you and...
get to your comments. So this is not about just hearing
presentations from the panels. It's a regular SAG
meeting. We want to make sure that SAG members have
input into the conversation at any time throughout the
day.

As many of you know, we've had this project on
our agenda for some time to consider recommending that
the Board replace or amend the existing standards on
auditing accounting estimates and fair value
measurements. During that time, the staff has issued
guidance on several occasions. We've performed research
and conducted outreach to inform the project,
particularly with respect to the use of third parties in
determining fair value measurements. Many of you
participated in the pricing sources task force.

However, before recommending to the Board a
specific standard-setting proposal, we're conducting this
additional outreach through the Staff Consultation Paper
and this meeting to obtain information and views beyond
what we've learned from our earlier outreach or from the
Board's oversight activities. The outreach conducted
through the Staff Consultation Paper, including
discussions at this meeting and comment letters we receive, should be invaluable in informing a potential proposal of a new auditing standard.

As I said earlier, I hope everyone has had the opportunity to read the consultation paper. At the same time, I thought a high-level overview of some of its key concepts could be useful to everyone here in setting the stage for the discussions.

So in that regard, let me make brief comments. In thinking about potential revisions to our standards, we've analyzed and continue to analyze a number of alternatives. The alternative the staff is currently presenting and discussing through the Staff Consultation Paper could replace, is a single auditing standard that could replace two existing standards entirely: AU 342, auditing accounting estimates; and AU 328, auditing fair value measures and disclosures; and replace certain or all of the requirements in a third standard: AU 332, auditing derivative instruments, hedging activities, and investments in securities. These standards were all written many years ago. As such, any new standard or requirements could be specifically structured to be
1 further aligned with the Board's risk assessment standards, auditing standard 8 through 15, which the Board adopted in 2010.

4 Let me say why, in my view, it's so meaningful to align any new standard with those risk assessment standards. AS 12, identifying and assessing risk to material misstatement, and AS 13, the auditors' responses to the risks of material misstatement describe the auditor's responsibility for identifying risks of material misstatement related to the reporting of estimates and fair values and require an appropriate audit response to address those risks, including significant risks.

14 AS 15 requires the auditor to obtain sufficient appropriate audit evidence to form a reasonable basis for the auditor's conclusions and sets forth procedures for obtaining audit evidence. The existing auditing standards that I mentioned could be replaced are not specifically aligned with the risk assessment standards because those existing standards were created long before the risk standards.

22 As such, any new standard on estimates and fair
values could first be closely linked to the risk assessment standards, which clearly direct the auditor to properly identify and address these risks; and then, second, set out further specific requirements unique to the risks around accounting estimates and fair value measures.

The Staff Consultation Paper sets out the specific possible requirements, which include, among others, possible tests of controls and substantive procedures. There's quite a focus on the substantive procedures in the Staff Consultation Paper. And among those substantive procedures addressed in the paper are the auditors' testing of the company's process in determining the estimate, which includes evaluating the methods and models used, including significant assumptions, or the auditor developing his or her own independent estimate.

I must point out that these two substantive procedures are in the existing standards today. But the Staff Consultation Paper explores possible improvements to them and addresses more specifically the role of specialists and evidence obtained from third-party
sources. Most importantly, the paper seeks comment on these procedures and asks are there alternative procedures for the auditors to apply that we haven't considered in this consultation paper?

So as I said earlier, you will hear various views relating to auditing estimates and fair values from various perspectives throughout the day. Toward the end of the day, Barbara Vanich, on my left, leading this project, will summarize key points made throughout the day and key issues in the paper not otherwise discussed.

We look forward to a robust dialogue with active participation from all that will contribute to our thinking in developing a new standard for auditing estimates and fair value measures, critical to aspects of mostly all audits.

So unless there are questions or comments at this particular time, I'd like to introduce our first panel. And I see that a card has gone up already, and that's Arnold Schilder from the, chair of the IAASB.

MR. SCHILDER: Thank you, Marty. As the IAASB's work in this area is mentioned in your paper, let me briefly update the SAG where we might be moving. We have
1 a long history with this subject matter, certainly the
2 last ten years. And in 2007, the IAASB approved ISA 540,
3 and it's mentioned in your paper, auditing accounting
4 estimates, including fair value accounting estimates and
5 related disclosures.
6 Actually, that was a combination of two older
7 ISAs, one on estimates and the other one fair value
8 measurements. So we also took an approach of let's have
9 it all together.
10 That was 2007. Thereafter, we had to focus more
11 clearly on financial instruments, and that culminated in
12 the release of the so-called International Auditing
13 Practice Note 1000, Special Considerations in Auditing
14 Financial Instruments. That was 2011, and I know that
15 Greg Fletcher of the PCAOB participated in its task force
16 and reflect some potential enhancements to ISA 540,
17 certainly in the area of pricing services.
18 But in light of our other priorities and also the
19 upcoming project at the PCAOB will put us, at the moment,
20 on hold. We now will start a new period of new studies
21 and workplan, and so we've consulted on what we should
22 do and what our priorities should be. And there
1 certainly will be a project particularly relating to financial institutions. That's an area of focus, of course, for financial regulators but also other respondents. So many have encouraged us to engage in such a project.

That project on financial institutions will basically have three parts, three components. One is banking industry issues, not only clarifying relationships between banking supervisors and the bank's external auditors but also to address issues of particular significance in the audits of banks or other depository or investment institutions.

Second, insurance industry issues, also areas closely related to this topic and we will take that onboard, as well. And then other 540 issues we will consider there, the issues relating to ISA 540 that we already would have identified as a result of work regarding financial institutions and also more broadly applicable to other entities. Such issues might include application of professional skepticism, so how auditors obtain evidence and challenge assumptions by management; work on accounting estimates and fair values that have
1 not been identified already as significant risks; fraud
2 and, certainly, also the implications of the use of
3 third-party pricing sources.
4 And that project, therefore, may result in
5 amendments to ISA 540, other ISAs, and maybe a new IAPN,
6 as well, practice note. And our first discussion in the
7 Board may be Q1 next year.
8 Now, just listening to this, it's easy to see
9 that there can be many areas of overlap between your
10 project, as identified in your excellent Staff
11 Consultation Paper, and our project, certainly a good
12 example is the area of third-party sources of audit
13 evidence. And, accordingly, the IAASB will be very
14 interested in exploring possible cooperation with the
15 PCAOB, and that can, of course, be done at various
16 levels.
17 We have some positive experience with that on the
18 auditor reporting project, and let me conclude with that,
19 given also the previous interest in the SAG, how the
20 IAASB was moving with audit reporting. I can report to
21 you, and it has not so much yet become public, that two
22 weeks ago the IAASB approved unanimously the new revised
1 audit reporting standards. And after the expected 2 approval by our public interest oversight board in 3 December, it will go public early next year and will 4 become mandated for 2016 audits.

5 You talk about cooperation and dialogue, I have 6 expressed our sincere thanks to the PCAOB for the very 7 constructive collaboration. So with that in mind, 8 certainly future collaboration in the area of 540 9 accounting estimates, fair values, etcetera, will be 10 great. And let me stop there. Thank you.

11 MR. BAUMANN: Arnold, thanks for those comments. 12 They're very useful to know that the IAASB will be 13 looking at some of the same issues that we're addressing 14 in this paper. And I share Arnold's view that we did 15 spend a lot of time together over the last couple of 16 years talking about the potential changes to the audit 17 reporting model, and we're happy to continue a dialogue 18 in the area of auditing estimates and fair value. So 19 thank you very much for that.

20 I don't see any other cards up at this point, so 21 do we -- okay. So with that in mind, let's turn to the 22 first panel which deals with PCAOB and global inspection
The Staff Consultation Paper notes that audit deficiencies in these areas have been noted not only through the PCAOB oversight activities but also by inspections conducted by other audit regulators around the world. Our first panel will discuss in a bit more detail PCAOB and global inspection findings in this area, as well as the results of the past two surveys by the International Forum of Independent Audit Regulators, IFIAR.

So our panelists to discuss inspections and inspection findings include Helen Munter, the Director of the PCAOB's Division of Registration and Inspections. Helen leads this division, which conducts regular periodic inspections of hundreds of registered public accounting firms located all over the world.

Joining her, we have two representatives of the Canadian Public Accountability Board, CPAB. Brian Hunt is the founding director and chief executive of CPAB and serves on the advisory council of IFIAR. Brian is also the chair of IFIAR's global public policy working group.

Next to Brian, we have Jeremy Justin. Jeremy is
a senior director and leads audit inspections of CPAB registered firms. He is also a member of IFIAR's standards coordinating working group.

Last but not least, we have Liza McAndrew Moberg who serves as a counsel to the Director of the PCAOB's Office of International Affairs. Liza also leads IFIAR's efforts for its annual global survey on audit inspection findings.

Helen?

MS. MUNTER: Great. Thank you, Marty. I think we are here today, the inspections results panel, perhaps to answer the question is there a problem. And based on, you know, ten years of doing inspections, we've had the opportunity to look a lot at audit work done around fair value and around estimates. Clearly, these areas are complex, and significant management judgment has gone into them. They involve uncertainty and great ranges of possibilities. They're also, generally, areas with very big balances, accounts that are very material to the issuers' financial statements and accounts where we, in general, see that the auditor has devoted attention, the auditor has thought about how to address these specific
accounts and, yet, has stumbled. And we have had numerous findings in these areas.

We look at this account very, very frequently when we are doing inspections. Our inspections are risk-based, and so we tend to focus our attention on things like hard-to-value financial instruments, goodwill, long-lived assets. All of these accounts are subject to a very high frequency of inspection testing. And over the years, we've had findings. We've seen some improvements, but the findings do recur and we've really come to a point where, in spite of very, very significant remedial action on the part of many firms and some positive trends in terms of what we actually see auditors doing, we still come across auditors who are just missing it in a variety of different ways.

I wanted to highlight a few of the different areas that are pretty diverse in terms of the affected accounts. But I think it tells a lot about what is being done.

And the first area that I would highlight is with respect to hard-to-value financial instruments and, in particular, audit work done on Level 2 securities, where
we have seen auditors struggle in their testing of these
securities, and their approaches might have been to take
a look at what the pricing service provided to the
issuer, compare that to the recorded balance and see that
they were close, and say that was good. However, the
auditor failed to understand the specific methods and
assumptions that have been used by the issuers' pricing
service in developing that fair value estimate; and,
therefore, that work was found to be deficient.

We've also seen instances, again focused a lot on
Level 2 securities, where the auditor engaged a different
pricing service and perhaps multiple pricing services and
got a range of prices. However, that range might have
been very, very large, and the auditor selected a price
that was close to the price that the issuer had used and
said, okay, that's good. But the auditor failed to do
anything with respect to the other prices that the
auditor had obtained, failed to understand why those
prices were so different than what the issuer had
recorded, were so different from each other, and whether
that was reasonable with respect to what was recorded in
the accounts of the issuer. And, therefore, that work
was found to be deficient.

I think it's very interesting, in focusing on these hard-to-value financial instruments, that we have had -- I think the first years that we had this problem, it happened all the time, very high rate of occurrence. We have seen some improvements, definitely seen some improvements in this area, definitely seen much more effort to understand the specific methods and assumptions that a specialist uses in coming up to their, in coming up to their fair value.

Level 3 securities, which are inherently more difficult to value, the auditor, I think, tends to focus more time and attention on. But we still have problems in those areas, and I think a lot of the problems in those areas have to do with some of the inherent complexities of fair value.

Changing a little bit midstream here, accounts receivable and the allowance for doubtful accounts. It affects many, many, many operating companies, and this is an area where we have also seen problems. One of the problems that we've seen, and we've seen it occur with some frequency, is with respect to the testing done on
the general reserve. And we've seen where the auditor might focus their testing on a mechanical exercise of proving that the general reserve percentage applied to the aging buckets equates in a reserve balance that is close to what is recorded.

However, the auditor might have failed to test the accuracy of the aging itself. And the auditor might have failed to test the assumptions that went into those general reserve percentages, in spite of the fact that the general reserve was more than half of the total reserve and that the general reserve was very material in and of itself.

So this was really a situation, and we've seen it occur on more than one occasion, where the auditor is deferring to what management has done and some perhaps high-level view of this general reserve percentage is consistent and, therefore, good. But that is not enough. They need to understand and test that general reserve percentage, as well as test the accuracy of the underlying information used in the model that the issuer has to come up with this reserve percentage. And testing the underlying data that goes into some of these complex
calculations is a very important part of what the auditor does, and it ties in also with some of the testing of the computer-generated and IT type controls that are associated with it.

I think that having a healthy sense of professional skepticism is particularly important when it comes to audit work around the estimates. We have seen times where an auditor had, in their own work papers, evidence that was contradictory to some of the significant assumptions included in various estimates; and, yet, that evidence, although it was included in the work papers, was not linked to or considered in conjunction with the actual reserve balances or good will valuation that was recorded in the financial statements, and that has proven problematic.

We've also seen situations where auditors have collected information in order to support the estimate reported by management, rather than developing truly, their intention, what they set forth to do was to develop an independent estimate. But what they were actually doing was only considering information that was supportive of what was recorded by management. And that,
of course, was problematic.

And in the next category that I think links both professional skepticism and some lack of understanding with respect to what is required by the standards is where we might see, in particular in the complex areas, an auditor deferring to a specialist. And an auditor relying inappropriately on what a specialist has done with some idea that the specialist is well known and expert in an area; and, therefore, that assumption, which is critical to a significant estimate included in the financial statements, is okay, is good, and they're going forward with their testing.

So all of those things have contributed to a view that, you know, I think that there are real problems that we continue to identify in this area. We focused on root cause. We talked about that. I spoke about that a little bit at our last SAG meeting. And we've been focused on some of the times where we see auditors getting it right, and two of the things that really stand out are the sequencing of the work, the project management type aspects where an auditor, an audit team is doing the work at appropriate intervals in order to
1 be able to truly consider all the contrary evidence and
2 assess whether they are gathering enough information to
3 support their work and adequate supervision and review
4 where there is active and early engagement by the partner
5 in the work that is being done, appropriate coaching and
6 mentoring going on with respect to the audit work being
7 performed, in particular, in these very complex areas.
8 So, Jeremy, Brian, I think you guys have seen
9 some similar type of things, and I know you're working
10 on some other projects in this area. Let me turn it to
11 you.
12 MR. HUNT: I'm going to turn it mostly to Jeremy,
13 but this is clearly an area of great interest to us, both
14 from an audit deficiency point of view from our
15 inspections but also one of the things we've been working
16 on in Canada is greater guidance around 540 in terms of
17 how that standard needs to be implemented. We're working
18 with the standard-setters in Canada and the profession
19 to drive that forward.
20 So with that, Jeremy has worked extensively on
21 this, and I think he's the best to speak to that. So
22 it's a pleasure to be here, but I think Jeremy is our
MR. JUSTIN: Thanks. And I think what we found very much echoes what Helen had talked about. We certainly look at audit estimates pretty frequently, and we look at the focus areas from our inspections, certainly the same areas that Helen had talked about around estimates related to fair value, estimates around impairment, good will, intangibles, certainly some areas that we see quite frequently. As we see more and more of the standards focusing more on fair values, we see a lot more in a revenue recognition perspective. Long-term contracts, fair values of multiple element arrangements. So we're seeing it more and more. And as we focus more on it, I think we're certainly seeing a number of areas where the audit work has been done very well but also still seeing a lack of consistency across all the inspections we're looking at, as far as some audit teams that are still having challenge and still struggling in these areas.

So just to focus on a couple of the areas we're seeing. I think, certainly, professional skepticism is an area that Helen had talked about and it's across a
number of the different standards we look at and is 2 certainly a key area around evaluating conflicting 3 evidence, making sure that the auditor is not just 4 looking for information that supports what the management 5 has done but also having a dependent view.

The work as specialists, we've certainly seen 7 that where the firm is using valuators. Usually, it's 8 an evaluator perspective. And I think we certainly see 9 challenges sometimes in coordinating the work between the 10 audit engagement team and the specialist. A common area 11 that we certainly see is evaluating the data, the 12 information. I think the specialist evaluators do a good 13 job in evaluating the models, making sure the model is 14 an appropriate model. And some of the assumptions, 15 usually the discount rates but we certainly see 16 challenges sometimes in the other information, it's a 17 little more difficult to evaluate the future growth rates 18 where the cash flows. In some of these impairment 19 models, that, in a lot of cases, neither the evaluator 20 or the specialist or the engagement team is really 21 focused on. So I think it's sometimes areas that kind 22 of fall through the cracks, and I think that's an area
from more of an application perspective that teams are having challenges with.

As Brian indicated, in Canada, since 2010, we've applied the international auditing standards, so ISA 540 is an area that we're inspecting against in the vast majority of our inspections. And as I said, we've seen a lot of good examples but also some examples where there's challenges in applying 540. And we've been working with the Canadian standard-setter and providing our comments around areas where we've seen challenges but also working directly with Arnold and his team around providing input both from the Canadian perspective but also through the IFIAR working group to try and get comments around areas we think things can improve in that standard.

So the areas that we've kind of focused on are kind of three main areas. The first one, obvious professional skepticism around the evaluating evidence, contradictory evidence specifically. The next one is an area that Marty talked about was understanding management's process and management's key assumptions. I think we certainly see challenges still with audit
teams not getting a deeper understanding around how management is making their estimates, and I think it's an area that we think there could be some assistance, more application guidance that auditors can use to help them to evaluate management's processes and their key assumptions.

And the last one is also around the area around significant risks. ISA 540 has specific additional requirements around, if something is considered a significant risk, there's additional work that needs to be done. And I think it's very useful to have those procedures done, but I think we still seem to have auditors challenged with determining when an estimate is a significant risk, when is there significant estimation uncertainty that leads to a significant risk. So I think we have encouraged to have more guidance out there to help auditors evaluate when something is a significant risk or not, and that helps to drive what procedures, from a risk assessment perspective, in driving all the procedures that they're performing. So I think that's an area that we certainly think needs some improvement.
With that, I'll turn it over to Liza.

MR. BAUMANN: Before you do, keeping with my promise to acknowledge cards that come up at any time, I just wanted to check with Kevin and Kevin Reilly and Bob Guido. Did you want to express your comments now, or did you want to wait until Liza is finished?

MR. REILLY: Now is fine. I'll shoot now. Maybe a question for Helen and just maybe a naive thought on cause and effect. But, obviously, there are challenges in inspection activities. I've seen both PCAOB results, as well as the IFIAR accumulation. But do you think there's something fundamentally wrong with the existing standards that, if those issues were addressed, inspection results would improve? I'm just a little, it's not really seeing the link between what the SAG is charged with looking at today and commenting on by the November 3rd date in terms of the expectation of improving the standards, changing the standards, and what effect that might have on inspection results.

MS. MUNTER: I think I would link to something that Marty said, which was wanting to link a new standard to our risk assessment standards. And I think that that
is very important and would represent an improvement that could drive an improvement in result in a higher-quality audit.

I also think that, at times, there is confusion on the part of the auditor as to which standard they are choosing to follow and trying to apply, and that confusion that we see out there is another factor that makes me think that this project could have a very, very positive impact.

MR. BAUMANN: Just one further thought, in terms of its response to your question, which is a very good one, Kevin, and one we're certainly thinking through to make sure that standard-setting can help improve auditor performance here. One of the things I heard from both Helen and Jeremy was too often auditors, finding a piece of evidence that supports what management has as its estimate but not sufficiently thinking about or addressing potential other evidence that might be contrary to have the auditor explore further, is management's estimate truly reasonable or is there another number that is a better estimate? And it sounds like maybe standards could more clearly direct the
1 auditor to focus on contrary evidence, as well as 2 evidence that merely identifies or supports what 3 management has presented. So that's just one thought of 4 what I heard in terms of accepting one piece when other 5 pieces might be out there.

6 MR. GUIDO: Thanks, Marty. You know, I was kind 7 of reflecting, as Helen and the team went through some 8 of these observations, what's changed? I mean, we've 9 been auditing, I've been auditing in my old life since 10 the 60s. What's changed in these findings? And the only 11 thing I noted that was new that I jotted down was I'm not 12 sure in the 60s and 70s we called it Level 2 and 3 on 13 fair value of instruments, so that's the only thing that 14 I noticed that changed.

15 But, seriously, I was wondering what are we 16 attacking here? Are we attacking a problem with the 17 existing standards, or are we attacking a design flaw 18 within the firm's methodologies, or are we attacking the 19 execution of those methodologies? And that's what I'm 20 struggling with right now is to what is really the root 21 cause here of these findings? Because these findings 22 have been here forever, and I'm very disappointed when
I hear professional skepticism because that's embedded in what we do every day or we should be doing. So, you know, is it the educational programs, is it the design of the methodologies that we need to -- or is it we need to re-focus the execution of those methodologies?

MS. MUNTER: You know, I think that firms have taken significant remedial actions and have shown improvement in these areas. But that improvement isn't consistent, isn't across the board, and hasn't been able to impact every engagement team, and every firm certainly, at this point. And in my view, that fact is what drives a lot of support for this in terms of a standard-setting initiative.

You know, there's been increased guidance. There's been better templates to use. There's some good hand-holding that is going on. And, yet, not everyone gets it. And that fact I think makes us say don't we need to do something more? Don't we need to make a more fundamental change, rather than continuing to reinforce guidance, continuing to have trainings. As remedial actions, those have been effective in driving some
improvements, and those are the kinds of things, some of the things that we have seen quite a bit of in, you know, assessing a firm's remedial action in the 12-month period following their inspection report.

But you reach a point where doing that again isn't going to work. And I think, you know, in some cases, we've reached that point.

MR. BAUMANN: Brian Croteau?

MR. CROTEAU: Thanks, Marty. And good morning. Let me start just by providing my standard that the views are always my own and not as commission or other staff. And with 60 people here, I'll try not to say too much today and listen. But I thought I would just comment now on a couple of things.

One, certainly there is a range of performance in what we see today as a recipient of PCAOB inspection reports also through our own activities relative to the involvement we have in our own enforcement investigations. It probably should go without saying, but our current chair, as well as multiple prior chair and multiple commissioners, have pointed this out as an area where they'd like to see the PCAOB, over many years
now, make some progress in updating standards. I'm really happy to see a starting today with the discussion of the inspection results. I think that's an important place to start. It's probably a good time to also congratulate Helen and the PCAOB for the great work they've done to do something new in the inspection reports.

If you haven't seen it in some of the large firm reports that have come out, there's a specific appendix that references specific aspects of standards that haven't been complied with for every single finding. And, certainly, before I came today, I analyzed that relative to which paragraphs of the standards aren't being complied with. And as we think about the issues that have been raised today, I can't help but already here some of the comments and think that an important place to start is understanding what are the root causes of non-compliance with some of those paragraphs of the standards. And that may sound like it's in the weeds, but if we're really going to solve problems here, I think that's a place to start because I don't think there's one root cause. I think there are multiple root causes, and
it varies depending on a particular engagement. And from what we can see so far, I think that's the case. I can probably rattle off a few but will let others talk about that today.

I certainly encourage the PCAOB, in their efforts relative to drilling into the aspects of the standards that aren't being complied with and then thinking about the root causes, and the firms have an important role to play relative to that, as well.

I know that IFIAR, Lew Ferguson, Board Member Ferguson who chairs IFIAR and Brian Hunt who's involved has done a lot of great work, which Liza is, I think, about to talk about, relative to the inspection findings. And Liza has done a lot of the work, as well. Improving the taxonomy there is going to be an important thing to do as time goes on, as we try to aggregate findings around the world and think about what are the causes. But it's encouraging to see the discussion, from my perspective, start with the inspection results today and have a robust dialogue around what kinds of things can be done to improve the standards. And it is at least my personal hope that we'll make some real progress in the
1 very short term on this effort.

2 MR. BAUMANN: Thanks, Brian. Before I get to the
3 other cards, since Brian mentioned Liza, maybe, Liza, you
4 could just briefly summarize and maybe probably put an
5 exclamation point, I guess, on some of the comments
6 already made. But why don't you do that, and we'll take
7 the other cards that I see up. Bill Platt, Philip
8 Johnson, and then Sri Ramamoorti.

9 MS. MOBERG: Absolutely. Thanks, Marty. And
10 I'll try to keep it short because it looks like there is
11 much interest in starting the conversation. I guess
12 maybe I'll start with the punch line. The punch line is
13 that, as Marty said at the beginning and as was included
14 in the staff consultation, this truly is something that
15 is seen globally by audit inspectors. It's not just in
16 the U.S. It's not just in Canada.

17 And how do I conclude that? Well, at IFIAR --
18 IFIAR is the International Forum of Independent Audit
19 Regulators. It's currently chaired by Lew Ferguson,
20 PCAOB board member. They conducted a survey which
21 indicated just that.

22 In order to be a member of IFIAR -- we have 50
members. They cover the globe. Not all 50 of our members but members covering the globe contribute to our survey.

Back in 2012, the Financial Stability Board, which was taking a keen interest in some of the complexities of bank audits, challenges presented in the financial crisis in bank audits, asked IFIAR if they would explain a bit more what the challenges are that we, as audit regulators, are seeing from the audits. THE FSB's interest continues in this and, in fact, I think, going forward, we will, their most recent press release indicates that we'll keep talking about accounting for financial instruments and, especially as new standards roll out on loan loss provisioning, with a lot more area of judgment, a lot more fair value measurement. This conversation isn't coming to an end any time soon.

So the response to the FSB inquiry in 2014 was to do this survey of all of IFIAR members not just on financial institutions but on all aspects of audit. And I'll quickly summarize the result of our most recent survey. Our second survey was published in April of this
past year. It was on 2013 inspection findings. You can
find it online at ifiar.org.

Thirty of our members, again globally, contributed to our study. And what we found was the most, the area -- we had 16 different areas that, based on our collective experience, were most frequently cited in inspection reports. Of those 16 categories, the one that had the highest number of findings was, indeed, fair value measurement. Two places down from that, you have revenue recognition, which is another area, obviously, with a lot of judgment involved. So our survey actually covered 989 public company audits conducted on audits of 113 firms so quite expansive.

Interestingly, in the category of financial institutions, the area with the highest level of findings was the audit of the allowance of loan losses and loan impairments. The third highest was valuation of investments and securities. And the fourth highest was insufficient challenge and testing of management's judgments and estimates. So all very relevant to the conversation we're having today.

There are limitations to the survey. The survey
certainly is not an end on to itself. It doesn't tell
us that audit quality has gone up, down, or sideways.
What it does is it helps us identify what are audit
regulators seeing around the world and are we having the
right conversations nationally and together collectively
with the firms on these areas?

A couple of times Brian's working group, the GPPC
working group of IFIAR, has been mentioned. We are
trying to align what we're doing in the survey with what
Brian and his team are talking to the largest firms about
about their internal inspection findings. We're trying
to go to a deeper level of granularity because, of
course, all fair value measurement findings are not the
same. So we're trying to understand more, getting to the
root cause points that were mentioned, what types of fair
value measurement problems are we finding, what are the
root causes, and what needs to be done.

So, again, if I were to reiterate, while the
survey is not an end on to itself, it is actually a good
point of reference to tell us what we need to be focusing
on. And from the results to date, it's clearly
indicating that fair value measurement is up there.
We are currently in the process of conducting our 2014 survey, and we hope to have that improved and refined and informative next year. Helen?

Mr. Baumann: Thanks very much, Liza. Bill Platt?

Mr. Platt: Thank you, Marty. And let me apologize in advance if some of what I say at least picks up on themes that we've already heard in some of the discussion around this topic. But first I would say that I think the panelists, Helen, Jeremy, and Liza, have done an excellent job at summarizing a very complex topic and done a good job of laying out, you know, really the key issues you're seeing from an inspection perspective in the U.S., Canada, and then globally.

I want to follow up on, though, the causal factors or the root cause. And sort of, as I heard, Helen, you talking, and Jeremy, you know, three items sort of came top of mind to me as you went through that. Professional skepticism; project management, which dealt also with the sequencing of procedures; and then, lastly, supervision of review, I think you indicated were the causal factors of high quality in this area as you looked
1 at it.

2 So as we look at that and we think about if you
3 were going to then drive solutions that improve in those
4 three areas, rather than just a particular deficiency in
5 a particular estimate. And the other interesting part
6 is estimates are, there's a wide range of different types
7 of estimates. As you've noted, they're very complex.
8 There's probably not a one-size-fits-all solution. You
9 can't audit an allowance for loan loss the same way that
10 you would audit a fair value measurement, a Level 3 fair
11 value measurement. So there's some to this that's going
12 to be judgment and art as you design appropriate audit
13 procedures.
14 But I'd just be interested is am I missing
15 something, or is there more to kind of the causal factor
16 analysis? And then how would we best design standards
17 that would address causal factors instead of the
18 manifestation of the problem that they cause, which is
19 deficiencies in this area?
20 MS. MUNTER: When I was talking about the things
21 that we have seen in terms of what drives high-quality
22 audit work, that conversation is at a pretty high level:
project management, supervision in review, good involvement of the partner, sort of some of the intangible characteristics -- well, project management is pretty tangible -- that apply to a particular engagement team and drive the work that is done throughout the accounts. And I think, as we are looking at this problem, it's going to be focused at a much, much, much more detailed level of what specifically was able to drive a team to do good work with respect to a significant estimate. And that is work that is in process at many firms. That's work that is in process for us.

It's extremely complex to get to that. And I think it's extremely complex to get to that at the level of a specific audit standard, a specific, as Brian pointed out, paragraph of an audit standard. And that's the way we are looking at our findings.

So there's quite a bit more work to be done, but I do think that looking at the causal factors and where we have had deficiencies will progress. And I think firms are driving that progression at that paragraph-level of specific findings because that can be very
1 actionable in the short term, and that, of course, is
2 necessary from a remedial perspective, certainly given
3 our regulatory relationship.
4 MR. PLATT: Thank you, Helen. And I'm glad to
5 hear that, in order to really develop a standard in this
6 area, more work is needed and more insight. And I think
7 that I would encourage the staff and the firms to
8 continue to work on that to improve this project as it
9 goes forward.
10 MR. BAUMANN: And, Bill, we look forward to your
11 comment letter to lay out your thoughts. You've sort of
12 summarized some but lay out other thoughts in terms of
13 our potential standard in this area that we'd certainly
14 like to issue. Philip?
15 MR. JOHNSON: Thank you, Marty. It's a
16 reflection on what has been said, and other people have
17 touched on it. I'll make an overall comment to start off
18 with. I am supportive of bringing things, the standard
19 into one standard. I think it is important. There's no
20 doubt that a lot of the findings are failures to apply
21 or fully understand the requirements of the current
22 standards. But I think the world has gotten more complex
over the ten years that the existing standard has been in place, and I think it's useful to refresh the standards.

As Arnold mentioned about ISA 540, it was issued in 2007, and it's now being looked at again. I think in this complex world, looking at complex situations and probably some of the largest balances, as Helen mentioned, in the financial statements, we should do that. And I think it will focus the mind more by bringing it into one standard.

With regard to the inspection findings, some of the comments were made, not challenging management, not challenging management process and key assumptions, I did actually do a word check on the paper, and I didn't find challenging management in the paper. There was a lot of focus on third-party evidence, the use of experts. But it was silent on challenging management, and I think that, you know, we've had the words of professional skepticism. I think it is so important that the auditor does actually exert that skepticism and does challenge management.

It might be my computer that has not picked up
the words, but I hope that, going forward, it is very high in focus with regard to any potential new standard because, ultimately, that is where the main focus should always be.

MS. VANICH: If I could just respond briefly. I mean, I think that was an excellent comment and, as part of the team that drafted the paper, certainly interested in others' views. I would say that that word "professional skepticism" or "challenging management," whichever way you choose to refer to it, is something that we would view as inherent throughout the auditing standards and the basis for the audit. So point taken, but I think that would be why it wasn't referred to more directly in the paper.

MR. JOHNSON: I understand that. I was really reflecting on what Helen was saying and also Jeremy, that it's coming out as a theme. So if the auditors aren't getting it, then they really do need to have a -- and I'm a former auditor, so I think we need to spell it out if it's not being addressed, and that's coming out as some of the key findings.

MR. BAUMANN: Yes, I share Barbara's point that
I think a couple of you brought out that point. It's maybe that estimates and fair value measures are so challenging that, even though some of these concepts are rooted in the fundamentals of auditing standards, they need to be restated and emphasized in a fair value estimates paper of the importance of challenging management, the importance of skepticism in these particular areas. So maybe it's really putting that front and center in front of everybody in our standards and firm our methodologies in these critical areas.

I want to take the tent cards that are up. And then we want to get to the next panel, and we'll continue the dialogue. But I know a lot of people had important messages they wanted to get out right away, and I think that's very valuable. So Sri Ramamoorti, Rick Murray, Wayne Kolins, and Harrison Greene, and then I'd like to move to the next panel.

MR. RAMAMOORTI: Marty, I want to pick up on an earlier comment you made which I think goes to the crux of the issue. There is now an established body of work in the psychology of judgment and decision making about what's called a confirmation bias. So human beings have
1 a tendency to look for confirming evidence. So auditors
2 are no exception to that. I guess we all agree we are
3 human beings first before we are auditors. So we show
4 the tendency, and it actually can become very problematic
5 because you even engage in selective perception. You
6 look for what you want to see. And as a result, you have
7 this tendency to look for confirming evidence, rather
8 than disconfirming evidence. So that's just a natural
9 thing for human beings.
10 But with respect to auditors, I guess we need to
11 have some kind of intervention strategies to make them
12 question what they're doing, and that's part of this
13 whole, you know, professional skepticism conversation
14 that we are having.
15 I'll make one more comment, which is language is
16 extremely important in terms of standards. So a couple
17 of thoughts here. One, we tend to say that auditors
18 gather evidence to support their professional opinion on
19 financial statements. Well, we used the word "support."
20 We didn't use the word "challenge." So that's a
21 linguistic matter. And we'll say auditors should look
22 for misstatements in the financial statements. Well,
what about omissions? A misstatement by definition says just that it's a statement. But an omission is not in the statement. So we need to worry about the use of language. And whenever these kind of words are used, maybe there should be a footnote that there is a converse to this which will, hopefully, highlight for the auditor that there is something else that maybe going on here that has to get attention.

MR. BAUMANN: Thanks for those very valuable comments. Rick Murray?

MR. MURRAY: Marty, in light of the time and the very good discussion that's going on, I'll defer until later.

MR. BAUMANN: Thanks, Rick. Wayne Kolins?

MR. KOLINS: Yes, I have a quick question for Helen. Helen, in the root cause analysis process that the inspections is going through now, are you also considering looking at engagements with positive findings for audits where the issue had complex financial instruments, for example?

MS. MUNTER: Yes, we have begun to do that. It
is on a -- we have begun that process. It's on a more limited basis, but we have and firms have.

MR. BAUMANN: Thanks, Wayne. Harrison Greene, you get the final word on this panel.

MR. GREENE: Similar to Brian, anything I say my agency will disavow, so they're strictly my thoughts.

MR. CROTEAU: I didn't exactly say that.

MR. GREENE: But I was wondering, Helen, if there's any correlation as you're doing your inspections between the quality of the underlying records, accounting records, at the clients and how that might impact audit quality. And is there a correlation in translating that to internal control over financial reporting the deficiencies that you might see from that?

MS. MUNTER: Well, the short answer is yes. Yes, and a strong correlation. I mean, it's a lot easier to do a good audit when management has done an excellent job of documenting their processes, documenting the risks, the flows, and they have a well-reasoned and very well-supported basis for what they've recorded in the first place.

That makes the auditor's job much easier. The
1 auditor knows that. The auditor understands that. And
2 you can see that documented, I think, in the files. You
3 can see that documented in the client acceptance and
4 retention process that the firms go through, you know,
5 every year with respect to their clients.
6 So, yes, the issuer plays an important role. But
7 the strengths of the issuer, I would say, is not
8 determinative of the quality of the audit work that is
9 done. At times, you know, there could be a tendency to
10 say the issuer is so great at this, you know. The issuer
11 has all of these extremely high-qualified, high-quality
12 individuals who are doing the preparation of the
13 accounts, so I don't need to do much work because they're
14 much smarter, et cetera. So high quality in financial
15 reporting is fundamental.
16 MR. BAUMANN: And I think that's, we talked
17 earlier about the current standards not being linked to
18 the risk assessment standards, and a future standard,
19 Harrison, would be linked to them, could be linked to
20 them, and that's an important aspect of risk assessment:
21 the quality of the financial reporting, the valuation
22 group at a particular company and the controls there in
1 assessing those risks, the extent to which the company
2 itself challenges complex estimates and fair values. So
3 those are important aspects of linking risk assessment
4 into any auditing standard.

That was a great discussion by the first panel.
6 Thank you very much. And, SAG members, thanks very much
7 for your valuable contributions which is a great start.
8 And that will continue throughout the day, but I'd like
9 to turn to the next panel on investor perspectives and
10 related considerations.

This is an area, of course, very important to
12 investors, obviously. As we've all mentioned, fair value
13 measurements and accounting estimates are dominant in
14 their importance in any set of financial statements.

So on this panel, we have Tom Selling, who is
16 President of Grove Technologies and author of "The
17 Accounting Onion" blog. Tom is a SAG member. He's also
18 professor emeritus at Thunderbird School of Global
19 Management.

Our next panelist then would be Sandra Peters.
21 Sandy leads the financial reporting policy group at CFA
22 Institute and serves as a spokesperson for the CFA
Institute to various financial reporting standard-setters and regulators. She's also a member of the IFRS interpretations committee.

And then rounding out the panel is Jeff Mahoney, who's also a SAG member and serves as general counsel for the Council of Institutional Investors. Jeff's responsible for developing and communicating the Council's public response to proposed regulations, rules, and standards that may affect the Council's members.

To start the discussion, we'll turn to Tom.

MR. SELLING: Good morning. And thank you, Marty. I appreciate the invitation to be on this panel for this very important discussion today. But before I begin with my planned remarks, I just want to quickly react to some of the great conversation that happened in the previous panel.

I, too, am happy to see that we started with inspection reports. That's a great place to start for setting the stage, and I think the panel did a great job. Also interesting to note, I think relevant to what I'll be saying, is that the highest number of findings was, indeed, in fair value measurement.
And a number of people have asked what's the problem that we're trying to solve? Is it with the existing standards, or is it in design flaws with the way in audit programs, with the way those standards are applied? It's going to be my contention today that there are longstanding auditing standards that are no longer suitable in the current financial reporting environment.

So with that in mind, I'd like to begin by sharing my perspective on investors' perspectives. The major challenge for regulators in dealing with differences between what investors say they want and what others think that investors should want is something to keep in mind. Both perspectives are important, and I've decided to assign myself the role of discussing today what investors should want.

But, fortunately, I don't need to say a lot about how someone thinks about what investors should want because the question that we're dealing with today is very specific, and, in my opinion, there's little controversy about the answer. The question is when a judgment is required to arrive at a number in a financial statement, how should investors want that judgment to be
made? And the answer is, I think, an investor should want the judgment to be made in an unbiased manner.

Now, before providing my thoughts on how that could be accomplished, I first want to share my perspective on challenges to auditing numbers that have a judgmental component. Going back to the 1930s when verification was the driver of audit quality and attesting to the reasonableness of estimates was less of a factor, the SEC concluded from its perhaps first investigation of auditors in the McKesson fraud that auditors needed to be explicitly told something that today we take as second nature, that it's not okay to issue an audit report without having examined inventory and receivables.

These were the beginnings of some of the fundamental rules of audit engagements. But today the balance between verification and attesting to the reasonableness of estimates has shifted dramatically, and I want to ask whether the evolution of those fundamental rules of audit engagements have been responsive to that shift.

Basically, AU 342.03 says that management is
1 responsible for the judgmental components of financial
2 statement numbers and what management chooses to consider
3 when forming those judgments is a matter of management
4 judgment itself. This longstanding foundational rule,
5 which, to the best of my knowledge, has no direct basis
6 in the securities laws, may have worked well enough in
7 the past, but perhaps this is what needs to be
8 reexamined. Does it promote the unbiased judgments that
9 investors should want, or does it hinder it?
10 Let me ask the question in a different way.
11 Imagine that accounting professor X, and I'm sitting next
12 to two other accounting professors over here. And I
13 apologize in advance for using the pronoun "she" in my
14 remarks.
15 Imagine that professor X permitted students to
16 grade their own exams. In determining one's grade, the
17 student may take into account its intention to learn the
18 material better during the coming months while studying
19 for the CPA exam. Professor X understands that she must
20 reign in unreasonably high grades, but that's not as easy
21 as it sounds. All of the students are giving themselves
22 the benefit of the doubt, so to speak.
Under these rules of engagement, professor X certainly can't and does not wish to confront every student and remove the bias from every grade. Despite these obvious flaws, though, professor X must like her system. We know that because she's the one who wrote the rules into the course syllabus. Whatever the costs and whomever bears them, professor X has fewer confrontations with students over grades than any other professor, and the students think that she's really cool.

So here's my question. You are a future employer of professor X's students, and you're going to rely on those grades to identify her best students. Are you being well served by the rules of engagement for her class? What if the entire university system permitted students to grade their own exams?

My point is that AU Section 342.03, however it came into existence, from an investor perspective, looks like a standard created by auditors to benefit auditors. And management, like professor X's students, is happy to play along. But the system does a disservice to investors because it deprives them of unbiased judgments and even more so as accounting standards increase in
To summarize, this section is a foundational rule of engagement and it is not conducive to unbiased judgments. Even the most highly-qualified and intentioned auditors can be put between a rock and a hard place. Consequently, the best that an auditor can do is subjectively evaluate for itself whether management has an appropriate or some would say reasonable basis for its estimate. When the present doesn't look much like the past, this can be a big problem.

Personally, I found it most concerning that these rules of engagements enable inappropriate wealth transfers from investors to managers. Investors should not be content with a system by which management is essentially permitted to grade its own exam.

Along these lines, I wanted to share this anecdote with you. Please take a moment to read the slide. Basically, as you're reading, let me just say that that's Walter Schuetze telling a story from his experience. He's one of the original members of the FASB, a long-time KPMG partner, former SEC chief accountant. And I think, as you read this story, it
indicates that he's one of the most plain-spoken individuals you'll ever meet.

MR. BAUMANN: By the way, if anybody is having trouble reading that up there, you should these in your folders, as well, just in case you didn't know that.

MR. SELLING: Oh, that's okay. And in terms of plainspokenness, what he said is earnings management is like dirt, it's everywhere. You should keep in mind that Walter grew up on a farm.

But his story is the most straightforward way I can think of to explain why we are discussing audits of estimates today and why we have come to the point where I believe a fundamental shift in approach is needed.

To this point, I hope I persuaded you, if you already didn't know, that AU 342.03 has some fundamental limitations. But for decades, policy makers have acted as if it could not be changed. But that presumption, I believe, now seems to be challenged, and that's what I would encourage the PCAOB and the SEC to do.

On this slide, slide eight, I have barely outlined the start of an iterative process to gradually change how estimates are built into financial statements.
We've already talked about Level 2 or 3 estimates today, and, initially, we could scope in only financial instruments for which Level 2 or 3 fair values are already being reported by large financial institutions. These financial institutions would engage independent appraisers to estimate the fair value of those financial instruments.

The auditor, however, would still have a very key role, but it would be engaged for this purpose only to verify certain facts. With respect to the work of the appraiser, auditors would verify that factual information provided by management to the appraiser is accurate and complete, that the appraiser met specific independent standards, that the appraiser performed the work in accordance with GAAP and in accordance with their engagement letter with the issuer, and that the appraiser's calculations were accurately made.

If only this first iteration were to be implemented, that would be substantial progress indeed. But I also want to look ahead to the logical end point: to purge financial statements of all judgment bias, most likely by replacing management's judgments with market-
based drivers of value to be estimated by independent
experts. Let's see where that would lead us.

First, both auditing and U.S. GAAP would be much
less complex, a goal I think we all share, and much less
fraught with risk of restatement and litigation. Second,
it would take auditing back to its roots, but it would
also create new opportunities for audit firms. Since
auditors will no longer have to second guess management
in order to have a reasonable basis for its opinion, it
should be possible to reconsider things like the degree
to which non-audit services for clients are constrained.

Allow me to conclude with an acknowledgment and
a caveat. I want to acknowledge first that a 2003 speech
by Walter Schuetze to the New York State Society of CPAs
touches on many of these topics that I've discussed
today. For additional background and perspective, I
encourage you to read that.

And, finally, the caveat. In my brief time, I've
provided you with only the barest outline of a new path
forward. We will not be able to resolve even a few of
the questions that we all have regarding implementation
and practicability, but that doesn't mean there aren't
solutions. I can't think of any good reasons why practical solutions would not exist and why financial reporting regulators would not want to look for them. Thank you.

MR. BAUMANN: Thanks, Tom, for those provocative thoughts. Sandy Peters.

MS. PETERS: Okay. I thought I would start my -- oh, I need the clicker. Can you hear me? Okay.

I thought I'd start with a little bit of our perspective on why we think estimates are important and what we think are the challenges. I sort of had to pull myself back, having been a former auditor, from going into this in too great of detail because investors would be very challenged to look at auditing standards such as this and really understand what they do for them. So there's a little bit of a challenge in that. They understand what they ultimately want, but how this actually works I think is a challenge.

We care about auditing estimates and fair value because, the CFA Institute, our members are major consumers of estimates and fair value measurements. But we also care about it because we have members who sit
within the big four firms who are consultants who work as specialists to the audit engagement team. I've recently participated in some conversations amongst the firms and valuation organizations about how, in fact, we can improve valuation specialists in the quality of work and the identifying credentials associated with them to improve the work that's actually done by valuation specialists.

We have about 1500 members of our 123 members that sit within the firms. But also interesting as I went through this is that there are only about 500 members of our organizations sitting within the firms globally that actually do the work of accounting and auditing, and that's, to my mind, a very small number who have valuation and analytical experience that we perceive might be necessary to do this sort of work.

I used to fit within that category. As I said, I was an audit partner. As my bio says, I was an audit partner. I was also a controller of an insurance company, and I audited insurance companies, so I was very familiar with estimates and hung around with a lot of actuaries who, as many of you may know, can estimate
1 anything. So I'm not certain to the point of someone
2 else made of what's changed because we've been making in
3 the insurance industry these estimates for a very long
4 time.
5 I can recall during the financial crisis, the CFO
6 at the time of the organization I worked for saying, "I
7 don't know why these people are so exercised about Level
8 3 assets. Have they looked on the liability side?
9 They're all Level 3." And so I'm not certain what's
10 changed, per se, because we've been doing this or we
11 perceive there have been estimates in the financial
12 statements for a long time. Certainly, some have
13 changed, and I'll talk about those in a minute. But
14 we're interested in it from a variety of perspectives.
15 Just here is a little bit about how we supported
16 over time. Things have changed a bit in what's in some
17 items have incorporated more estimates, and CFA
18 Institute, as many of you know, is a big supporter of
19 increasing uses of estimates and particularly fair value
20 for the last 20 years. We've supported 115, 133, 128,
21 changes in pension rules, et cetera, et cetera, because,
22 as someone pointed out, the past doesn't look like the
future. And in making investment decisions, you care more about the future than the past, so we care about forward-looking estimates of value, not necessarily amortized cost estimates or verifying amortized costs, which is yesterday's perceptions of value.

But we're also, the challenge for investors in looking at estimates and fair value measurements in the financial statements is that there are very few disclosures associated with them. There are more than there have been in the past but very little information on the inputs and assumptions. Certainly, on fair value, there have been more over time. But on some of the others, it's still this is the number and some very generic language with respect to how, in fact, this estimate was arrived at. And that's challenging for investors who want to invoke some market discipline on these items.

But also challenging to investors, and what struck me as I read this proposal was, obviously challenging to auditors, is that there's such a variety of different estimates. Some joke that we have our favorite estimate, which is fair value. But when you
1 look at the financial statements, there's just so many
2 different types of estimates that have been made, and
3 there are compromises that have been negotiated over time
4 in revenue recognition, in the impairment of financial
5 instruments, as we see it playing out in the impairment
6 of financial instruments and impairment of intangibles
7 and long-life assets and, certainly, as we look at the
8 insurance liabilities project.
9    So the challenge for investors is what do these
10 estimates, what's actually behind them? They don't know
11 the accounting rules. They know cash, and they know fair
12 value, and what do these estimates actually mean? How
13 are they derived? What do they mean economically?
14    But as I look at some of the auditing standards
15 and some of the conversations, I sort of wonder if the
16 audit challenge, at times, isn't what are we auditing and
17 what do these numbers mean? And so how do we actually
18 employ audit procedures that are meaningful when we don't
19 know actually what this number can represent. So I
20 think, as I read this, I think that investors and
21 auditors might share some of those challenges.
22    Just in reading through the proposal, as I said
1 before, I found myself drawn to the details of the risk 
2 assessment versus the substantive procedures, and I tried 
3 to step away from the substantive procedures a little bit 
4 because I'm not certain, as I said at the beginning, that 
5 investors would necessarily know how those actually 
6 produce what they want at times. Certainly, some they 
7 would get, but how this proposal is changing things I 
8 think is a bit challenging. A shift's chart that shows 
9 how all this would be merged and what the significant 
10 changes would be and how they would address the root 
11 causes that investors hear about but they're not certain 
12 why they exist at times would be actually useful. 
13 I know I looked at the IFIAR survey, and I 
14 certainly can see those categories. But I was left with 
15 and why did they happen? And in the PCAOB findings, I 
16 recall reading one finding, and it was about inventory 
17 being the same last period versus this period and nobody 
18 did anything to say, hey, maybe it's not impaired. But 
19 I think the standard, actually, would have covered that. 
20 I think some of it may have been in the execution of the 
21 standard. 
22 So investors are interested in the root causes
in, you know, which many people have talked about here
today already, which is do these things that you're
adding fix the things that we keep hearing about? And
I think for them to actually comment meaningfully on
that, I think that that's something that they need. They
need a bit of translation.

But as I talk with my committee about the
proposal, I think everyone was in favor of an integration
of the proposal, sort of addition without subtraction is
I think how one person put it, because they thought that
it might help integrate thinking about estimates and
valuation more totally and more completely. I think
someone said we don't know what standard we're in, and
we view fair value as just one special case of estimate
and we don't think that it should be -- a more integrated
approach may be helpful in knowing how to audit them.

But also, as I step back from the proposal, I
thought that, from an investor perspective, the two most
important things to consider were a robust risk
assessment and an understanding of the current economic
context. And as I read the risk assessment standard and
I looked at the changes in AS 12 and AS 13, I thought
that they were useful. But I did wonder if it is really about, as I said before, the execution as opposed to the particular standard.

I think, you know, having remembered myself as a younger audit partner, I had some very challenging first-year engagements with all of these sorts of issues. There was one particular engagement where just stepping back and understanding the pressures that management was under would have been more helpful to all of the audit procedures we were actually performing.

But I think also that sometimes I think auditors are so busy doing the work that there's a necessary aspect of sort of stepping back from things. I can recall somewhere between QE 1 and 2 and infinity, sitting with a bunch of insurance auditors and regulators and them talking about why insurance companies were trading at 60 percent of book value, and they didn't really understand that, and I was shocked by that because the knowledge of the low-interest rate environment should have been incorporated into all of the estimates and assumptions that were going into the financial statements at that time.
And so sort of that step back. The market was recognizing something maybe before the auditors and regulators were. And that's something that, certainly, when I look at AS 12, there's words, but I think translating those words and having the education and experience to translate that into practice is, you know, one of our perceptions with respect to a root cause.

Also, as I've been in this role for five years, one of the things I've recognized and come up against is that many times people don't understand why we're advocating for these valuations. Some people certainly understand why we want them, and they don't like them, and for good reason. Some people, though, don't really understand why we want them. And it occurred to us that maybe we should look at accounting education and how it's evolved over the last 20 years or where it sits today relative to the evolution of some of these standards that have incorporated more valuation concepts over the last 20 years.

So we've undertaken a project over the summer to look at that. And given that valuation is one of the six audit assertions, and I can that it's only modestly
1 included, from what we can tell, in some of that education, which is concerning to us with it being one of the six audit assertions.

So, overall, we'll include our comments on the substantive procedures in our comment letter. To touch on something that Tom said and someone else said, you know, we think that you should start with management's estimate because they're supposed to be management's financial statements, and we want to see their cards. But we also believe that you should have an independent estimate. There is confirmatory bias. Certainly, that exists in the investment profession, as well, in looking for evidence that supports your valuation or your rating or whatever. And the auditors can do an independent estimate or the auditors should do an independent estimate is one of the questions we might ask.

As I said, we think there's commonality, sufficient commonality to merge. It's hard for us, as investor and investor group, to assess whether this is economically worthwhile because we need to know it's solving the problems, as investors are the people who will ultimately pay the bill. But, again, it's really,
for us, looking at the root causes. Is there sufficient
translation of education and knowledge and experience of
these auditing standards to what's actually getting
applied?
You know, as I read through some of the things,
as I said before, is this going to fix things, or is it
really about people having the ability to take those and
use them in the way and in the context that they need to
be used?
Investors as a group, as we've said, as I'm
certain my colleagues have said here before, want more
disclosures about these estimates and they want auditors
to tell them more about what they've done. And that's
really about the fact that they don't have a lot of
transparency over them.
So those are our thoughts on the importance of
the standard.
MR. BAUMANN: Sandy, thanks for those comments.
And I just want to ask you about one more thing. If I
got this right, early on, you said something else that's
not on this final slide, but you were pointing out the
number of CFAs who are actually auditors. And I think
you were pointing out it's a relatively low number.

But it sounds like maybe what you're saying is we need to reinforce in our standards, in our quality control and other standards or maybe need to be enhanced in our standards that audit work, especially in these complex areas around fair values and complex estimates for product liability or allowance for doubtful accounts, but audit work should be assigned only to partners and staff who have the necessary experience and expertise to perform that audit work. And while that's a fundamental statement in the quality control standards, really emphasizing that, that maybe, in some of these areas, the people doing the work don't have the necessary experience and expertise to challenge some of these complex assumptions and models and methods that go into these calculations. And so maybe that's a more explicit requirement that's needed.

MS. PETERS: Yes. And I think also that they may not have the expertise to engage a specialist or evaluate the work of a specialist either because you can't really audit what you may not understand. And I don't mean that in a -- I mean, I can look back at my younger audit self
and say I wish I understood that better. But I think it's really hard to do the work if you don't understand valuation concepts, you don't understand how cash flows are derived, and you don't understand how discount rates, or you don't understand in doing the good will impairment tests the difference between a relative and a fundamental valuation approach. I think it's challenging.

MR. BAUMANN: So Tom put his card back up and then Steve Buller.

MR. SELLING: Just a quick comment in reaction to Sandy's remarks. I'm happy, more like ecstatic, to hear that CFA Institute thinks that estimates should be from independent sources. And I also hear and appreciate the comment that analysts want to hear from management. For me, that's the purpose of MD&A, to see the company through the eyes of management. We do have a financial reporting system that enables us to get both if we want both.

MR. BAUMANN: Thanks. Steve?

MR. BULLER: Thank you. I guess I'd just like some clarification on, you know, this thought experiment of an independent appraisal of all assets because,
obviously, companies want an efficient audit and quite often companies have information which may be pertinent in the evaluation process than you may be able to obtain from outside sources. So in performing an independent appraisal or assessment, it seems to me that it still would require the use of information that management may have in order to ensure that you're considering all facts and potentially information which may be more accurate and relevant than you can get from third parties. I guess on extent to which you would consider management data and that process and also the extent to which in performing an independent assessment, that you would still rely upon understanding a company's internal controls and processes as part of determining where the risk is in that process and the extent to which you can rely upon management's determinations in making that independent estimate.

MS. PETERS: Is that for me or Tom? Okay. I mean, we do want to, we do think it's important to look at management's estimates. We just think -- and the internal controls and the processes. And, certainly, as you said, there are types of estimates where only
management will have certain information about their particular product or the like.

But we think that that should be supplemented by a very -- you know, we've used the term skepticism. But I might go a little bit further and say independence completely of mindset in how you do these. I mean, I think one of the comments I think Helen made was that people, you know, ticked and tied things that were there. But really stepping back and say is what's there makes sense, or, if you have different pricing services, why are they different, where are they sourcing this from, and trying to at least explain why there might be a difference. I mean, I just think an independence of mind but not saying that we should be completely devoid of what management has said. You know, if you talked to many investors, they want to know what management thinks because they believe management has more detailed information.

MR. SELLING: There's no question that independent appraisers require the use of information that management has. But I envision that the information that management would provide to independent appraisers
would be fact based, would be factual, and that the estimates, therefore, that appraisers would make would be strictly market-based.

Earlier today, somebody observed, I think it was Bob Platt -- and I certainly don't want to put words in your mouth, Bob -- but you said that there was a fundamental difference between auditing fair values and auditing the allowance for doubtful accounts. And I agree with that. I would say that auditing the allowance for doubtful accounts, even though more fundamental, is actually harder because it incorporates management's future intentions.

Even if you didn't want to report a market-based measure of accounts receivable, like fair value, I still would prefer to see a market-based estimate of ADA, the allowance for doubtful accounts. And I think that's possible, and I think that's something someone that's independent of management could judge and do themselves, so long as they have fact-based information provided by the issuer.

MR. BAUMANN: Kevin Reilly?

MR. REILLY: Yes, thanks, Marty. Tom and Sandy,
you threw out this notion of independent appraisals, and I'll just give you the benefit of some of my experiences over the years. The big challenge is pushing back on appraisals I've seen that were not independent at all.

And so in your minds, who is it that would regulate these independent appraisals to make sure that what they're delivering, in fact, was independent, was objective, fact-based, and wasn't skewed towards the desires of the folks who had hired them to begin with?

MR. SELLING: A couple of quick observations. If you go back to the 1930s, I think there were similar -- the McKesson case even illustrates that there were similar problems with the independence of auditors. The SEC had to tell auditors what independence means, and the auditors do a great job of complying with Article 2 of Regulation S-X.

I believe that a starting point -- I mentioned in my talk that I want the PCAOB and the SEC to look at this because I don't see this as being just siloed with the PCAOB. I think the SEC, as a starting point, would have to do something similar to Article 2 of Regulation S-X that describes what independent appraisers are.
Furthermore, I don't necessarily see that independent appraisers are non-audit firms. Many of them would be non-audit firms, but it could be that your firm is the auditor and Bob's firm is the independent appraiser. I don't have a problem with that. You guys know how to be independent on engagements.

MR. REILLY: I appreciate your suggestion here, but one of your suggestions is the appraiser, that the auditors are responsible for the appraiser meeting specific independence requirements. I know you know this, that independence, in many respects, is, in fact, a state of mind, and that is a critical component of the analysis. And just building this type of program into a standard without the full scale involvement of the SEC with a regulatory oversight committee in terms of what goes on from an independent appraisal and what constitutes an independent appraisal, I just don't think is being practical under the circumstances.

MR. SELLING: I guess I disagree. I think that it is something we could look forward to in the future. I forget his name. It escapes me right now. Former Arthur Andersen partner, former FASB member, and
1 University of Illinois professor. Art Wyatt. Thank you very much.

Art Wyatt 20 years ago said that auditing is a business, and he recognized that as a reality of practice. What that meant to me was, one of the things it meant to me is the best we can do as regulators is to regulate independence in fact, independence in appearance. Excuse me. Regulate independence in appearance. And we have to rely, to some extent, on reputation and other factors so that independence in fact will actually occur.

I don't see why that cannot occur within the appraisal profession as well as it has occurred in the audit profession.

MR. BAUMANN: Okay. I'd like to -- I appreciate that dialogue, but maybe we can move on to some other comments and questions outside of the moving the management responsibility elsewhere. I think we've covered that, I hope, and maybe get back to some of the issues on the auditing standard. Philip?

MR. JOHNSON: Thanks, Marty. It's really picking up on Sandra's last point and the last point on this
1 slide. I know we're here to talk about estimates and 2 fair values and not audits and reporting. But from my 3 experience in Europe, I think auditor reporting, changes 4 in auditor reporting has actually, is actually closely 5 linked with a change in auditor behavior. And what we're 6 talking about here are estimates in fair value are key 7 balances and key risks within the financial statements, 8 and as auditors are being asked in Europe to provide more 9 information as to what they have done, what their 10 findings are, and how that impacts on the financial 11 statements.

12 KPMG have just done a very good report on looking 13 at the last 12 months of the behavioral change and the 14 things that have been reported in the space of just one 15 year and how that's changed and how that's changed 16 behaviors. And they made auditors more challenging and 17 more focused. Personally, as an audit committee chair, 18 I've seen it in practice, and it does make a difference. 19 And I think the two are linked when you're actually 20 looking at these key risk areas.

21 MR. BAUMANN: Thanks. We feel that's an 22 important area, as well, in addition to the, as Arnold
indicated, they've come out with an auditor reporting standard, and certainly the UK has had one in advance of that, and it's an active project of ours. I think your observation is a good one, as Sandy pointed out, too.

I think Loretta Cangialosi and then Bob Guido. And we do have to get to Jeff, so after those two comments we get to Jeff.

MS. CANGIALOSI: Okay. I'll try to be quick. I just want to come back a little bit on the notion of independent assessments being done by the auditors. And just to give you my experience, we actually have lots of intangibles that we've acquired, and we are required to do fair values and we're required to test those on a regular basis for impairment, which we do. And I can tell you that it is very complex. We do not do it ourselves. We actually do hire someone to do it. We actually do sign in a rep letter that we have not influenced that person in any way, you know, because it doesn't serve me to influence that person.

Frankly, the things that go in there are -- remember that it was started out with the hypothetical market participant. So the hypothetical market
1 participant, in fact, doesn't have a bias if you've done
2 it right. And you take that information and you come up
3 with forecasts for the future, for 20 years in the
4 future, with growth rates for 20 years in the future.
5 Frankly, I don't know what our auditors could possibly
6 do to come up with that information by themselves,
7 knowing nothing about the product. And in particular,
8 when you're talking about things like in-process research
9 and development, you're talking about actually
10 assumptions around what's the probability of technical
11 success for a pharmaceutical drug? Not so easy. And,
12 again, I don't know how an independent auditor could come
13 up with such a valuation.
14 As far as having an independent valuation expert
15 for the auditor, I can tell you they use their own
16 specialists. I can tell you they go through and they ask
17 us lots and lots of questions about the assumptions,
18 which is exactly what I would expect them to do. In
19 fact, we do that before we give it to them.
20 Things come into us on the actual cash flows. We
21 go back to the people that created them and say, well,
22 this doesn't make sense or why would this happen? And
that's what you would expect management to do before they hand it off to the auditors.

The auditors certainly question discount rates, but there are a lot of things in there and uncertainties that there's no way for them to know better than anyone else. In fact, I am sure that, if you gave it to another pharmaceutical company, they'd come up with a different answer. That's probably the only thing I do know because, inherently, you know, there is no right answer. There is a reasonableness that you have to come to that's supported, okay? Supported reasonableness.

I did want to say one other thing on the valuation and the point Sandra made about having people study a little bit more valuation. I actually think that's an excellent point. The field of study, the things we do with valuation today are much more important. They're pervasive in the financial statements, and I think it's a great point on, you know, really it goes to the licensing people, people who are licensing CPAs. But given the amount of valuation that's out there and the complexity of it, even management, when you get to different levels of management, don't
1 understand what the differences between the valuation
2 they do for a financial statement or that occurs on a
3 financial statement and the valuation they do to assess
4 whether or not to buy a business. They are different.
5 The context is different, what drives them is different.
6 So I do think it's something that is important.
7 MR. BAUMANN: I think that gets back to that
8 point of the care that audit firms need to make in terms
9 of making sure that the people assigned to audits where
10 there are various types of differing complex estimates
11 and judgments have the necessary experience and expertise
12 with those types of complex estimates and judgments. So
13 thanks for those comments.
14 And I think I did say we have Bob to make some
15 comments, and then we turn back to panel.
16 MR. GUIDO: Thanks, Marty. Loretta, this was not
17 staged because I'll pick up from what you said. But I
18 think it all goes hand-in-hand.
19 A couple of observations. We have an
20 opportunity, and, as an audit committee chair, we have
21 an opportunity to continue to drive the COSO refresh
22 project through a lot of these issues that we're talking
about. And one of the things that I've asked my board, the management of the boards I sit on is to really take these judgment and estimate areas and really focus on upping the game in the documentation of the process and fully understanding of what management does to monitor and measure these particular real tough areas.

Having said that, I must say, and I'll thank the PCAOB for the communication standards required communications, we do, Sandra, on your last point, we sit extensively with our outside firms and we talk about these high-risk areas and what are the related audit work procedures. So that's being done now, I hope pretty extensively.

MS. PETERS: Yes, we're not saying that that's not being done. We're saying that we have no insight into it. So we have very little insight into the assumptions that go into these complex estimates. The language is very boilerplate. It's generally from the accounting standards themselves. This is the complaint that I hear all the time.

Investors are trying to re-do these valuations because they're trying to value the entirety of the
company, and they have little insight into them. Certainly, as someone who audited insurance companies and worked at one, I know that the only thing you know about an estimate is that it's wrong and that what you want to know later is why it was wrong and what changed. And so that's exactly what reasonable investors want to know. Was it because the market changed; oops, we used the wrong interest rate; those sorts of things. The problem is, and to Philip's point, there is no market discipline around that because there is no transparency around that. When you see impairment charges taken well before they're taken in the financial statements, it's because investors have valued the business based on their estimates of the cash flows and taken them. And it's almost ironic that we look to the market price to determine the impairment because it presupposes that the market has more information than management.

So we think that management's assumptions and the like are very important. We'd just like to know more about what they are and what auditors did around them. MR. GUIDO: And, again, I'll just repeat audit committee chairs and audit committees today, if they're
1 doing a great job, are doing exactly that. So just let
2 you know there is some oversight there going on.
3 MS. PETERS: No, I agree with that. I just think
4 that right now investors have a high degree of skepticism
5 about that, just what we hear from them.
6 MR. BAUMANN: Jeff?
7 MR. MAHONEY: Thank you and good morning. I
8 appreciate the opportunity to appear on this panel. As
9 a representative of institutional investors, I'm
10 obviously concerned about the PCAOB's observation that
11 there are "significant audit deficiencies" in the audits
12 of accounting estimates, including and in particular fair
13 value measurements.
14 My concern is heightened by several factors.
15 First, I believe fair value accounting with robust
16 disclosures provides investors with more useful
17 information than amounts that would be reported under
18 amortized costs or other alternative accounting
19 approaches. In 2008, during the height of the financial
20 crisis, the Council of Institutional Investors
21 commissioned a white paper for the purpose of educating
22 our members, policy makers, and the general public about
fair value accounting and its impact on investors. That white paper issued in July of 2008 was authored by and expressed the views of Stephen Ryan, who is the KPMG faculty fellow, professor of accounting, and the director of the accounting doctoral program at the Leonard N. Stern School of Business at New York University.

In that paper, Professor Ryan concluded that fair value accounting benefits investors for a whole variety of reasons, including it requires or permits companies to report amounts that are more accurate, timely, and comparable than the amounts that would be reported under existing alternative accounting approaches, even during extreme market conditions.

It also requires or permits companies to report amounts that are updated on a regular and ongoing basis. And it can limit companies' ability to manipulate their net income because gains and losses on assets are reported in the period they occur, not when realized as a result of a transaction. And, finally, gains and losses resulting from changes in fair value estimates indicate real economic events that companies and investors often find worthy of additional disclosure and...
In October 2008, following the release of that white paper, the Council participated in the issuance of a public joint statement with the CFA Institute and the Center for Audit Quality about fair value accounting. The joint statement opposed efforts that were underway at the time by financial institutions and some of their allies to force the Securities and Exchange Commission to suspend fair value accounting for certain companies. In our joint statement, we essentially adopted the views contained in the Council's white paper and concluded that "suspending fair value accounting during these challenging times would deprive investors of critical financial information when it is needed most."

In the six years since that statement was issued, our position on fair value accounting has not wavered. A second factor that heightens my concern about the significant audit deficiencies that the PCAOB paper has identified and which Sandra and Philip also mentioned is that investors appear to assign a high value to the auditors' testing and evaluation of accounting estimates. I believe that view is demonstrated many ways but
including by the broad support that the PCAOB has received from investors for pursuing improvements to the auditor's report, improvements that would include the auditor's assessment or insights on management's critical accounting estimates and judgments.

As one example, 79 percent of the institutional investors responding to a survey conducted by the PCAOB's own investor advisory group expressed their belief that the auditor's report should discuss the auditor's assessment of the accuracy of management's significant accounting estimates and judgments.

As an aside, I would note that elements of KPMG UK's February 2014 auditor's report for Rolls Royce is generally responsive to that investor demand, and I'm very hopeful that, over time, the auditing profession, the UK, Europe, and particularly the United States will conclude that it's in their best interests, financial and otherwise, to improve the auditor's report in a similar manner and be more responsive to the needs of the primary customer of those reports.

My bottom line is, to the extent that the PCAOB concludes that the significant audit deficiencies that
they've identified can be reduced, at least in part, by improving existing auditing standards in this area, then I'm very confident that many, if not most, institutional investors will be strong supporters of that project.

And, finally, just a footnote to Mr. Selling's interesting remarks on experimenting with independent appraisals for all assets. In this area, I would echo the comments on former SEC chief accountant Paul Beswick, who, on more than one occasion, expressed the view that the ability of the appraisal or valuation industry to fully serve the auditing profession and investors is somewhat inhibited by the industry's inability, at least to date, to become a true profession. More specifically, Mr. Beswick has suggested, and I agree, that, as a starting point, the valuation or appraisal industry should establish a single set of qualifications with respect to education level and work experience, with respect to continuing education, standards of practice and ethics, and a code of conduct for the profession.

With that final observation, that concludes my prepared remarks. Thank you again for inviting me to participate on this panel.
MR. BAUMANN: Thanks, as always, Jeff, for your contributions as a SAG member and particularly today as part of this panel. Guy Jubb's card and then Doug Maine.

MR. JUBB: Thank you. As a professional investor, I'd like to support many, if not most, of the comments made by this panel. In addition, I'd like to give emphasis to just two or three aspects which I believe the Board should consider in terms of its standards setting.

The first is the importance and significance of management incentives, particularly in the context of freedom from bias and issues around that. As investors, I look to auditors to take into considerations the metrics on which the management are incentivized and to, in terms of exercising their skepticism and planning their audit approach and testing, to take due consideration of that. The incentive to describe a half-empty bottle as a half-full bottle when, in reality, it's a three-quarters empty bottle is something we look to auditors to address.

The second is we look to auditors, I look to auditors to ensure that the clarity of explanation and
1 disclosure, which is something that Sandra mentioned in her comments, is clear. As an investor, I don't have the ability to get into the underlying documentation and the risks associated with particular instruments. And one of the aspects we learned from the financial crisis was that the items were often disclosed in some remote part of the financial statements or the financial institutions, so they were there. But they were not explained with sufficient clarity to enable a reader to form a conclusion as to what the risks and dynamics were associated with the fair value assumptions.

Finally, I'd like to endorse Jeff's last comments about the read across to the enhanced auditor reporting project. This is something in the UK where we're now one year into it and the issues around fair value accounting and the estimates as being key risks. The additional transparency that the auditors have provided has served to not only enable a better quality of understanding and engagement around those issues but has also led to an enhancement of the appreciation of the work the auditor has done and, thereby, the confidence in the financial statements arising. Thank you.
MR. BAUMANN: Guy, thanks a lot for those comments. I'd like to just address one. They were all good comments. The first point you made about management incentives and bias is a very important one, and I'd like to just share that, as part of our project, the Board adopted recently auditing standard number 18 on related parties and, at the same time, we made amendments to other standards regarding significant unusual transactions and financial relationships with executive officers. And so the risk assessment standards were amended to specifically require auditors to understand the financial relationships between the company and its executive officers for the very point you mentioned: to understand what incentives and biases could be there that could be affecting management's judgments and estimates. So that point is excellent and, again, another important reason for us to make a very clear and distinct linkage between some of those concepts in risk assessment with auditing fair values and estimates. So I echo and put an exclamation point on that.

Next was Doug Maine.

MR. MAINE: Thank you, Marty. I want to bring
the point of view of a former chief financial officer. And I can tell you that there's nothing more contentious than a challenge by my auditor to my fair value methodologies and assumptions. And the reason for that: because at the heart of it, you're challenging my judgment.

For that reason, hearing for the first time today Tom Selling's recommendations, they strike me as a prudent approach. Thank you.

MR. BAUMANN: Thanks very much, Doug. Phil Santarelli and then Jennifer Paquette, the two cards that are up. And then we should turn to our academic panel after that.

MR. SANTARELLI: Thank you, Marty. I just, I've been listening for quite a while, and the last comment from Jeff kind of brought this, that I think we should not lose sight of in this dialogue is, clearly, fair value and the fair value framework provides more relevant information for investors. But the tradeoff is that the reliability of those measurements goes down. It's just the fact of life.

And so I wonder whether or not there are certain
1 physical limitations that auditors are faced with with
2 respect to weighing in on the reliability of those
3 numbers. Now, I think disclosure could be improved.
4 Perhaps that would be the answer for the analyst
5 community. But that's a question for the accounting
6 standard setters or the SEC primarily, rather than the
7 auditors and the PCAOB.
8
9 And I get troubled when I hear the concept of
10 accuracy around a fair value measurement or an estimate
11 because, in fact, 24 hours after that number has been
12 marked, it's no longer relevant. It's not the number
13 anymore. So you're almost faced as an auditor with,
14 rather than trying to audit to the accuracy, in fact,
15 your auditing process is, in many respects, based on the
16 reasonableness and the integrity of management's process
17 in arriving at that estimate because there is no, per se,
18 right answer. There is a range. Unfortunately, balance
19 sheets have point estimates. Every number on it may be
20 even cash, I would often say every number, except cash,
21 is a range, not a point estimate.
22
23 So that's the physics of the dilemma that we
24 face. So I would hope with this standard-setting process
we can maybe address some of those physics and bake it into the standard setting. Thank you.

MR. BAUMANN: Thanks, Phil. Jennifer Paquette?

MS. PAQUETTE: Thank you. I want to go back to where we started the conversation earlier this morning. As an investor, I've been puzzled over the years why the findings around accounting estimates and fair value haven't produced more of an impact on how audits are conducted. Not being in the audit profession or being a preparer, I've been puzzled why there hasn't been more behavioral change as findings have come out regarding deficiencies. And that leads me to being very attracted to this proposal of trying to address it by combining into one standard and also by trying to draw in in a better alignment with the risk standards.

That being said, I think the contributions by auditors and preparers, for those who better understand the nuances of current standards and the proposal, certainly I would think that those comments could help staff in terms of where they take this proposal potentially.

From my perspective, it appears to provide better
alignment with the risk standards, as I said. I would hope that it would improve audit quality and provide more clarity for audit firms and enforcement staff by producing a standard that is better understood by all.

I thought Sandra Peters' comment about it being difficult for investors to understand the nuances of the current standards, as well as the proposal, in the staff paper are very important. It is difficult, I think, for the average investor to understand something that isn't really their field of expertise. That being said, as end users of the financial statements, I think this work is terribly important to investors. Pursuing areas for improvement where we have already identified weaknesses globally is very important for long-term investor confidence and improving investor confidence in the information that we are using to make important financial decisions.

Thank you.

MR. BAUMANN: Thanks, Jennifer, and thanks to the panel for your contribution and for all the SAG members for your valuable input to the panel discussion. I'm going to turn to the last panel for this
morning, which is made up of two notable members of the academic community who will discuss research conducted in the area of accounting estimates and fair value measurements and some related observations. So we're pleased to have with us today Lisa Gaynor, who is an associate professor at the University of South Florida and holds the Robert Keith professorship. Her major research examines the judgments and decisions of audit committee members, auditors, practitioners, and investors, and is focused on topics related to auditor and audit committee communications, independence, and the accounting for and auditing of fair values.

Joining Lisa is Jackie Hammersley, who is an associate professor of accounting at the University of Georgia. Jackie's current research focuses on the factors that affect auditor performance when auditing complex estimates and auditor and situational characteristics that affect auditor fraud detection.

Lisa?

MS. GAYNOR: Thank you very much. I first wanted to start by telling you how we approach, how Jackie and
I approached this topic when we were first called together and we worked together on it. We first looked at the consultation paper, and we looked at what the discussion questions were and we looked at what the academic research, both being very familiar with it, questions we thought we could address and then what questions we couldn't address. And we put it into a framework, and you can see the framework on the diagram in the PowerPoint slides. And we tried to put the literature in a way that we could understand what are the problems that we note in the academic literature or the academic literature has noted as problems related to the auditing of fair values and complex estimates. And then we thought we would look at why do we think we see those problems where the auditing literature has determined why those problems are occurring. And then we were hopeful that maybe we could use the academic literature to give us some fixes that we might also be able to address to help with the standard-setting process. So that's the approach that we're taking.

You can see that the topics that we're covering, I'm thrilled to say and hear from this morning, that it
1 seems like at least we're on the right track. As academics, we often get told that we don't know what's going on in the real world, and we seem to have some idea of what's going on in the real world because we're going to talk about the environment, the characteristics of estimates, the bias that is apparent in estimates, auditors' knowledge or perhaps their lack of knowledge on the auditing of estimates, how that affects their processing, use of specialists, as well as their risk assessments.

Okay. So first what I wanted to do is I wanted to give the terminology that at least we use in the academic literature where we talk about, when we talk about the characteristics of estimates and fair values, we use the term measurement uncertainty. And measurement uncertainty basically means that there are well-meaning experts that you can put into a room and they can disagree on valuation or even the best method of estimation, so it's a true estimation in that there are many different answers to this question as to what is the true number. There is no true number. It's an estimate, and we don't know exactly what that number would be.
There are a choice of models and assumptions with no clear winner. And there are macroeconomic risks that exist that, you know, observed crisis, may be inappropriate, subsequent that would happen that we would know that an estimate, an assumption that was made before the fact no longer is pertinent in those estimate processes.

We talk about how there are subjective inputs that are often based on unobservable inputs. And then the outcomes, we define those as often being imprecise in that they're not necessarily best characterized by a point but by a range of possible estimates.

So where we make a distinction with fair value measurements and complex estimates is that we're looking at a situation that we have inputs that are fed into a model on the output or the outcome, where you have complexity along the way, that inputs are surrounded by uncertainty, you have unobservable facts that are based on subjective assumptions. They go into a model where it's not just one model. It can be a number of models, whether it's Black-Scholes, lattice pricing models, or what we'll see is also a series of models, not just the
choice of one model, where management may use a weighting of different models. So it's not just even one model. It can be a number of models that management is using. And then the outcome is a range of possible reasonable estimates.

Then that gets determined into a point estimate that gets put on a balance sheet or income statement. Then the auditor is faced at taking that point estimate and comparing it to another estimate or, not estimate, materiality or the likelihood and putting that in place against a range or likely misstatement. So you have this estimation uncertainty that gets put into a point that gets compared to materiality.

So the next slide you see is this is a study that was put together by Cannon and Bedard, 2014. It's a working paper right now. What they did, it's important to see where these statistics come from and what this means. This was 80 senior managers and managers predominantly that were recruited by the CAQ for Cannon and Bedard and were asked to come up with their 99 most challenging experiences with a fair value measurement. And with those, this chart compares, this is what the
1 auditors responded was the number of instances where 2 materiality, the comparison in materiality and the range 3 of estimation uncertainty. In this case, their range of 4 estimation uncertainty, just as defined as the reasonably 5 possible range of values for the fair value measurement. 6 What you see is that in 70 percent, looking at 7 that last column, the 26.5, 16.3, 9.2, and the 19.4, 70 8 percent of those observances, the auditor stated that 9 estimation uncertainty was greater than materiality. And 10 in 19.4 percent of the times, estimation uncertainty was 11 stated to be five times greater than materiality. 12 The highest number or the biggest area where you 13 saw estimation uncertainty being larger than materiality 14 was in the area of asset impairments. The most cited 15 area that auditors chose as the most challenging area was 16 in the areas of financial instruments.
17 So the next slide that we're looking at is now, 18 considering that we have this estimation uncertainty, 19 where auditors are trying to bring this inputs, models, 20 and outcomes into a range, comparing it to materiality, 21 we look towards what are the bias in estimates. There's 22 been many academic studies that some of you are probably
familiar with that have documented bias in accounting estimates and fair values. Some are in terms of the timing, and some are in terms of the valuation. You see them in a number of accounts. Some of the studies report that it appears to be opportunistic bias in terms of earnings management, but most studies acknowledge at least that it may be unintentional in some ways.

Two studies that, just in terms if you're thinking about the inputs, the models, and the outcomes, that we see bias along the way in terms of the inputs and the models, we have Dechow, Myers, and Shakespeare, where they report use of lower discount rates when securitization losses, when there would be securitization losses then securitization gains, in effect lowering the losses that would be reported. Choice of models.

There's a paper that's forthcoming in one of our journals. Bratten, Jennings, and Schwab show that companies seem to choose the valuation model of Black-Scholes or flexible lattice pricing model when it would benefit them in terms of their compensation packages or stock option pricing.

So we look now, if we're assuming that we have
1 these estimation uncertainty that gets put into the
2 inputs, into the models, we have bias that go into the
3 inputs and into the models, giving us imprecise outcomes.
4 We also wanted to look at what is the market's response
5 to these estimates. Academic research has shown that
6 estimates that are more likely to be biased are less
7 value relevant than other financial statement items,
8 suggesting that as estimates become less reliable they
9 become less useful to capital market participants and the
10 market places lower values on Level 3 estimates. But to,
11 Bob, your point is that result seems to be less when
12 there is better corporate governance. So audit
13 committees do seem to be able to mitigate some concerns
14 by the market for bias in the estimates.
15
16 The importance that we want to make clear here,
17 though, is that these studies are using stock price data
18 from markets, capital market stock price data in most
19 cases. And so these are audited numbers. So regardless
20 of whether this is intentional or unintentional, there
21 appears to be bias in these numbers and these numbers are
22 getting through the auditors to some extent. And so we
23 need to understand why these numbers are in the audited
financial statements, to the extent that there may be bias in those numbers.

So this is where we kind of go from the problem, what academic research has shown is the problem, to sort of understanding why we think it's a problem. So the first thing I'm going to do is I'm going to point to some academic research that has explained what auditors claim to be the most difficult factors that they face in auditing fair values. Again, this study was about fair values, not all complex estimates. Again, this is Cannon and Bedard. This is all about highly-challenging fair value, their fair value experiences.

What you see there is the top four responses as to what they felt were the factors that made it the most difficult for them to audit. The first one, number of significant and/or complex assumptions associated with the process, high degree of subjectivity associated with these assumptions and factors used in the process. The next two, high degree of uncertainty associated with a future occurrence or outcome of events and then the lack of objective data.

What I think is interesting is, when I'm looking
at this input, model, outcome process that I see is that
the first two relate to the inputs, that clearly they're
having trouble with the inputs, that there's too many
things, it's too complex, that they're having trouble
there. Then the next two, the last two on that four-
point bullet list, those really relate to the outcome or
their lack of ability to do the verification procedures
that, Tom, I think you had mentioned in the 30s it was
more about verification and now that blue bubble was
smaller in the red circle. And so that's more about just
a change in the environment and a lack of ability to go
to being able to verify the outcomes.

I also find it interesting that, at least in this
study, they didn't comment on the models or that the
models themselves were causing them trouble. Now, Jackie
is going to talk about other studies that they do know
that the models also give them trouble, but I think that
I'm going to start talking about knowledge in a little
bit and I think that's going to get to Sandra's point,
as well, about how knowledge, sometimes not knowing that
you don't know can also be a problem.

The areas that they said were most difficult,
were the most difficult to audit accounts were financial instruments. Again, this relates to that table that I had pointed to before, financial instruments that was 50 percent or approximately 50 percent of the times when they were asked what was the most challenging experience, 50 percent of those auditors said it was financial instruments, keeping in mind that the audit of financial instruments may be more common than the audits of other areas. But that was 50 percent responded that it was the most difficult to audit accounts. And then asset impairments was 30 percent, the next highest most difficult to audit accounts. Asset impairments, again, was the one that had the highest level of the estimation uncertainty to materiality.

Also, in this study, 18.2 percent of the sample or 18.2 percent of the 99 responses indicated that, regardless of these large estimation uncertainty to materiality differences or ranges, 18.2 of them proposed an adjustment. So that comes to about 19 of the 99 responses or 19 of the 98 responses there was an adjustment proposed. Now, this is a self-reported number. This isn't going through the work papers and
1 actually looking as to what happened. But Jackie is
2 going to talk a little bit more about some of the
3 decisions that are related here, but in this study the
4 auditors reported that the reason that the proposed
5 adjustments -- I’m not going to say few but that the
6 ratio, the reason for the proposed adjustment was less
7 due about satisfaction with the estimate but more to do
8 about estimation uncertainty or lack of observable data
9 and the inability to verify.
10 Going back to the model where we have the inputs,
11 the models, and the outputs, there's another study by
12 Jeremy Griffin out of Notre Dame, currently at Notre
13 Dame, that's soon to be published. It's actually
14 available right now on the Web. He looks at the
15 subjectivity of estimates where he's comparing Level 2,
16 this was with audit seniors to partners, in an
17 experimental setting, comparing the subjectivity of
18 estimates, Level 3 versus Level 2.
19 He finds that, in certain settings, as
20 subjectivity increases, auditors are more likely to
21 recommend an adjustment and also a greater adjustment
22 amount. He also finds, though, that when outcome is more
imprecise determined by the range, the reasonable range
that the estimate may be, auditors are more likely to
require an adjustment when an outcome is imprecise and
the inputs are highly subjective when they're not as
subjective.

The implication there, going through a lot of the
statistics, the implication is that auditors at least
seem to be focusing on the outcome, the dollar amount of
the misstatement, and then focusing on the inputs. When
I think about that, and this is my interpretation, it is
that we think about or I think about, if I'm auditing a
process, you go from the inputs, the model, to the
outcome. This almost seems to indicate if you're
starting with the outcome, because that's what you might
feel more comfortable with, that's the quantifiable
number that you can compare to materiality, they may be
going to outcomes and going backwards and never getting
to the inputs portion of it.

Interestingly, when managers, they also had
another condition in this experiment. When managers
include a footnote disclosure of the estimate, the
auditors require lower adjustments. I did want to say
1 to Philip I don't think this has anything to do with
2 critical audit matter paragraphs that some people might
3 jump on it. Basically, what this says is when managers
4 were required to put information about the range or the
5 estimation process, the assumptions that were used,
6 auditors were less likely to require an adjustment and
7 required smaller adjustment amounts. But that was what
8 managers were putting in the disclosures, not what
9 auditors were putting in the audit report.

10 One of the last couple of things I wanted to talk
11 about, and we've heard it today from Sandra and Loretta,
12 is auditor knowledge. And from an academic perspective,
13 this is clearly something that I think that I can say for
14 myself that, in academics, we don't do in most accounting
15 programs. Auditing of complex estimates and fair values
16 requires knowledge from areas including finance,
17 economics, product mix, management, statistics, and
18 markets, which are not a required part of the academic
19 or the accounting or auditing curriculum. Auditors are
20 trained in financial accounting and auditing, simply not
21 valuation and technical skills.

22 And I think it was somebody -- I apologize for
not remembering. It was either Loretta or Sandra. Even if this knowledge transferred, even if you were trained in, say, one area of valuation, it doesn't necessarily transfer, academic research, it doesn't necessarily transfer into a different area of valuation.

And so the implication here is that the use of specialists -- well, there are several implications. One is including this in academics or in the university setting may be a necessity, but also the use of specialists is clearly a necessity. But I think what it also comes down to is Jackie has a paper, Griffith et al., that when they were interviewing auditors, as well, and documenting the processes that auditors go through and auditors themselves self report that the testing of fair values is often conducted by staff inexperienced in valuations and is supervised by those who often lack the necessary knowledge to thoroughly understand management's models and estimates. That could lead to the implication, and I'm not going to put words into Jackie's mouth, that this lack of knowledge and experience could lead to, could contribute to the difficulty in validating and testing management's critical assumptions and
estimates and reduces the auditor's ability to identify and valuate or even communicate effectively concerns with management. It kind of goes back to that lack of knowing what you don't know and not being able to communicate it effectively.

Lastly, there's been some talk about professional skepticism today. There's a model by Nelson (2009) that talks about professional skepticism, and the first input in professional skepticism is knowledge. And so without a lack of knowledge, skepticism becomes difficult. It goes from knowledge to skeptical judgment, skeptical outcomes, and then evidential outcomes. And then that feedback mechanism feeds back into knowledge. Well, this knowledge and this recursive battle also talks about misstatement risk, that you need to have the knowledge and this feedback mechanism to be able to understand risks and proper risk assessments.

So the implication here is that this lack of valuation expertise, lack of valuation knowledge could be related to what, if you see PCAOB inspections, it may have said lack of professional skepticisms or observances where it really may be more about it's a lack of
understanding risk and a lack of understanding how the risk feeds back into the process.

From here, Jackie is going to continue and talk about auditor's process and talk about why we think we see some of the problems and then solutions.

MS. HAMMERSLEY: Thanks, Lisa. As Lisa said, I'm going to --

MR. BAUMANN: Jackie, could you move the microphone a little bit closer? Thanks. A little closer yet.

MS. HAMMERSLEY: A little closer yet? Is that better? All right. So I'm going to focus my comments on two areas of new research. The first focuses on how estimates are audited, and, from that, we've come to understand what the common problems are while auditing estimates, some of which we've heard this morning, with a focus on trying to understand what the root causes of those problems are. These studies have been conducted either by doing in-depth interviews with very experienced auditors who work in the area or by serving auditors who work in the area. And then there is a small stream of research that is just getting started that is looking at
ways to improve the audit of estimates.

This literature has been following up on some of the issues that have been identified in the interviews and surveys and is using experimental methods to examine ways to change the way auditors approach the audit of estimates in the way that you can in an experimental lab. So I'll touch on that briefly at the end.

First, we've started by trying to understand how auditors approach the audit of estimates. And what we've learned is that, while there are three approaches described by the standards as allowable, auditors overwhelmingly choose to audit management's process or model. And they do this by verifying or confirming each of management's assumptions, and they report doing this because it's more efficient than, say, choosing to perform an independent estimate. We heard repeatedly that if they prepare an independent estimate, they will invariably have differences between their assumptions and management's assumptions or their estimate and management's estimate, and they'll have to circle back at the end and figure out what all of those differences are. And in the end, they end up augmenting management's
process anyway. And so they cut to the chase and audit management's process.

As a result of choosing to verify management's assumptions, they end up using sort of a verification or confirmation mode that has implications that result in them verifying the estimate, verifying the assumptions, rather than stepping back sometimes and doing a critical evaluation of the estimate. They'll carve up the responsibility for the assumptions that form the basis for the estimate by assigning the economic and industry-based assumptions to the valuation specialist, usually an in-house valuation specialist. That specialist will also generally evaluate the reasonableness of the model that's used to generate the estimate. And engagement, the audit team will retain responsibility for any accounting-based assumptions.

Importantly, the auditors, the audit team will retain responsibility for evaluating the overall responsibility of the overall reasonableness of the estimate. I will note that for difficult to audit estimates, auditors do take advantage of the flexibility that is available in the standards and do report for
these difficult to audit estimates, that they will use multiple methods. They do seem to still overwhelmingly audit the process or model, but they will supplement by preparing independent estimates or using subsequent events and data.

Turning now to some of the problems that came out of this work, first, again, out of the Cannon and Bedard paper that asked auditors specifically about their most difficult to audit fair values. These auditors reported that their inherent risk assessments for these estimates or fair values didn't always reflect the underlying account risk. So more than one-third of the time on these accounts, the inherent risk for these accounts was assessed as low or moderate when estimation uncertainty exceeded materiality, and this is a little troubling.

The other finding they reported related to risk assessments was that control risk assessments and control testing often don't lead to reduced substantive testing, even for accelerated filers. And the reason given for this was that controls are not precise enough to address the specific risks related to the subjective assumptions. They did note that this varied by account type, so
1 controls were more likely to be relied upon for financial
2 instruments and pension plan assets than for asset
3 impairments, which may not be surprising given what Lisa
4 said earlier.

5 Related to assumptions, auditors have a number of
6 problems related to evaluating assumptions. Some are
7 related to relying on specialists, as we've noted. 8
8 Specialists are here to stay. Auditors need to rely on
9 specialists because they do not and cannot have the depth
10 of valuation knowledge that's needed to evaluate the
11 finance and economic-based assumptions that are embedded
12 in some of these models, but this creates difficulty
13 because the auditors still have to evaluate the effects
14 these assumptions have on the overall estimate. And the
15 lack of valuation knowledge means auditors often have
16 difficulty identifying the critical assumptions that
17 drive risk in the estimate and evaluating the
18 reasonableness of those assessments and then pushing back
19 both on the specialist and on their client about the
20 reasonableness of that assumption and how the changes in
21 that assumption change the estimate.

22 The reliance on choosing to audit management's
process can make auditors a bit myopic. So choosing to
verify the process means that auditors often adopt a
step-by-step process. That means they're verifying each
of the individual assumptions used in the model, rather
than critically evaluating the overall estimate. And in
doing this, they sometimes fail to consider whether the
assumptions fit together. So they may fail to notice
inconsistencies among the assumptions and other available
data. They may fail to notice that there's other data
available in work papers that contradicts some
information that's being used in the estimate. They may
overlook information that is not used in the estimate,
but it's not included in the model at all as an
assumption and perhaps should be or, again, contradictory
information.

This is an especially difficult problem to solve
because it's very difficult to specify in advance using
a checklist or a standard what information may be
relevant to an estimate. But this reliance on evaluating
management's process seems to exacerbate this problem.
There are other problems related to the use of
specialists, so the current standards related to the use
of internal valuation specialists treat these people as any other member of the engagement team, so AS 10 governs the inclusion of these people on the team. And when interviewed about how they use these people, how they use internal valuation specialists, auditors report that the lack of specific items about how they should use them means that they have adapted the practices from the guidance on using external specialists, but that guidance is pretty silent on what valuation specialists do, how they interact with auditors, and how they're findings should be incorporated into the audit.

And, further, in addition to the difficulty with evaluating assumptions that comes from the lack of knowledge, lack of understanding of their work also leads auditors to sometimes misunderstand the importance of what the specialists report in their memo, what their findings say. That sometimes leads them to dismiss their findings as unimportant, that they may fail to follow up on the issues that are identified, and they may be uncertain about the sufficiency of the evidence related to the specialist's examined assumptions.

The comments related to misstatement evaluation
1 come from a survey with very experienced audit partners
2 who were asked about auditing issues related to accounts
3 with extreme estimation uncertainty. And this is a
4 situation that these partners reported as occurring
5 frequently. One-third of these partners reported this
6 as happening frequently. I want to make clear I'm
7 talking about a situation where this estimation
8 uncertainty exists at the end of the audit, where they
9 have worked to reduce this estimation uncertainty using
10 all appropriate means, but the estimation uncertainty
11 remains.

12 So, for example, we could have a situation where,
13 after completing the audit, the auditors and the
14 specialists may agree that there's no single input within
15 a 20 basis point-range that's better than any other, but
16 that 20 basis point-range produces a reasonable range on
17 the estimate that is greater than materiality, perhaps
18 many times greater than materiality.

19 In this case, when management's estimate is
20 materially outside that reasonable range, that large
21 reasonable range, current standards require an adjustment
22 to the nearest end point of the range. But the range is
1 still very large.

2 When management's estimate is inside the range, current standards don't require an adjustment, even if the width of the range exceeds materiality or the difference from the point estimate to management's estimate exceeds materiality, as that picture shows.

3 So this can mean that the related uncertainty in net income or earnings per share, if an adjustment on this estimate would affect those accounts, is much greater than investors might understand. In these situations, the auditors noted it's difficult to determine whether they've reduced the estimate's reasonable range sufficiently, whether they have collected sufficient audit evidence, and how to determine whether a misstatement exists in the financial statement line item.

4 So now some good news. So we're just beginning to examine how to improve the audit of estimates. A few experiments have examined auditors' critical thinking about estimates and whether the resulting planned actions would be effective for improving audit outcomes. We think this is where the focus should be, rather than
merely on whether skepticism, as a nebulous concept, was increased about the estimate. And we see some promise here.

So there have been four studies that I cited on the first slide that have all focused, in one way or another, in changing the way auditors approach the audit of the estimate. I'll talk about one method, and it happens to be a study I'm a co-author on.

We look at changing auditor's focus to big-picture goals, why you do something, rather than, away from how you do something. And what we found is that changing that focus made auditors more likely to notice available information, information that was in the working papers, that contradicted assumptions that were being used to form the estimate. And, importantly, it did this without any increase in time or effort involved to complete the task. And this resulted in improved identification of the biased estimate. So the auditors rated this estimate as more biased and increased the urgency with which they wanted to follow up on this biased estimate and made them want to follow up on the right things.
So we think this change in focus holds a lot of promise. Of course, it's one study, and we know that, you know, we need a portfolio of research before we can really move forward. But it's a start.

All of this research that Lisa and I have talked about this morning suggests some standard-setting implications. So, first, we know from the literature that estimates contain bias especially those that require significant judgment to prepare. This suggests that an auditor presumption of bias might be needed for these accounts. And some guidance about where the estimates are vulnerable to bias and how to identify the presence of bias might be necessary.

Second, others have said this, auditors lack valuation knowledge. It's not realistic for them to have the depth of valuation knowledge that a valuation specialist has, but this lack of knowledge impedes, the lack of vocabulary impedes discussions with valuation specialists. And so some encouragement to obtain basic valuation training; and, as people move up in the firm, additional encouragement may be needed.

The current standards implicitly encourage a
1 step-by-step verification of management's process. The
2 standards currently provide much more guidance about how
3 to audit management's process than they do about how to
4 prepare an independent estimate or get evidence about
5 subsequent events data. And this may impede the
6 identification of missing or inconsistent assumptions,
7 so perhaps some guidance about how to effectively obtain
8 evidence from those other methods is in order.
9 Finally, the current standards on using
10 specialists don't provide a lot of guidance about using
11 internal valuation specialists. And so some guidance is
12 needed on when and how to use them and how to incorporate
13 their findings. And then, finally, the auditor's
14 responsibilities for accounts with extreme estimation
15 uncertainty are untenable. Clear guidance about the
16 audit evidence and procedures to address the risks that
17 are unique to estimates and fair value seems necessary.
18 Consolidating the standards would reduce uncertainty
19 about which standards apply. Guidance on how to reduce
20 the reasonable range in the presence of extreme
21 estimation uncertainty and what to do when it remains
22 after all options are exhausted would be beneficial.
When extreme estimation uncertainty remains, we have to consider whether investors have enough information about this uncertainty. And, finally, we need to consider whether it's reasonable for auditors to provide positive assurance about this point estimate.

So thanks for inviting us today.

MR. BAUMANN: Lisa and Jackie, thanks for those very, very valuable thoughts. We appreciate all your comments on the academic research in this area and your views and the standard-setting implications.

As I mentioned earlier, we really are looking for comment letters, and that's very, very important to us, in addition to the input we receive today. But it would be great if the comment letters really addressed some of these points that were made here. How should the auditor approach situations where measurement uncertainty exceeds by two to five times materiality, and how should auditors approach narrowing that gap in reporting? And that also does tie into the auditor reporting model project and what the auditor report could say about such situations where their report is based upon estimates that have measurement uncertainty greater than materiality and then...
also points about the skill set that the standards might require that auditors, again, need to have necessary appropriate experience and skills pertinent to the fair value measures and estimates that they're dealing with, as well as some of the bias issues and confirming versus disconfirming evidence requirements that maybe should be in the standard.

So a lot for all of us to chew on and a lot for all of us, hopefully, to hear from commenters in terms of ways for us to think about this in our standards setting.

We're running late, but we have a couple of cards up. I think Tom Selling, Sri Ramamoorti, and Wayne Kolins, and Rachel Polson. So we take those four comments, and then we'll break for lunch. Tom first.

MR. SELLING: Thanks. And I'm very sympathetic to the idea that we're running over, so I'll try to make this quickly. But I was truly fascinated by the presentation both for its breadth and also for the information.

A number of SAG members have expressed concerns about the problems of estimation range, so it's good to
see empirical data regarding the significance of that problem. But I also would like to encourage us to think about the relative significance of the problem of estimation uncertainty versus concerns about biases, again from an investor perspective.

Financial theory suggests that investors would be much more concerned about bias. Non-systematic investment risk due to estimation uncertainty can be reduced, if not eliminated, by holding a diversified portfolio. But bias cannot be diversified away. That's why, from an investor point, I think bias may be more important. But having said that, also estimation risk is important because it is a real risk to auditors.

Also, with respect to the criteria of value relevance, while it's important in understanding the economic significance of bias, and Lisa presented some data about how bias affects stock values, I think that, considered by itself, that actually understates the problem, even though this data was pretty dramatic. It doesn't directly address the corporate governance issues of wealth transfer engendered by earnings management. The statistical techniques that are used to measure value
relevance probably are not sensitive enough to pick up on that type of effect, but I think that's very important for the PCAOB to consider.

Third, when thinking about what auditors are trained to do as students, I'd also like to see research on management's preparedness to perform complex valuations. The financial statements are certified by CEOs. Yet, very often it's the case that management doesn't have specific education or background regarding valuation either. So this has important implications not just for the intentional biases that I may have been focusing on but also that could introduce unintentional biases.

And, finally, regarding reasonable ranges that exceed materiality and that discussion by Jackie, I want to note that biases permitted up to a materiality constraint can accumulate to very highly-material effects. To borrow a phrase, it's death by a thousand immaterial misstatements. So thanks.

MR. BAUMANN: Thanks, Tom. Wayne Kolins?

MR. KOLINS: Yes, I had one question. One of those slides mentions improving critical thinking, which
is a real fundamental behavioral trait. Do you think
that this is the kind of behavior that should be taught
at the undergraduate level, as early as possible before
the individual either goes into the accounting profession
or goes into private industry and is actually coming up
with the estimate?

MS. HAMMERSLEY: I think that this is something
that we all have an obligation to work on. So I think
that, certainly, at the undergraduate level it's
something that should be built into the curriculum. But
I think that at the, you know, staff senior level, tasks
that staff need to be clear about why they're doing what
they're doing and what the implications are for what
they're doing for the rest of the audit so that they can
recognize a problem when they see it and start to develop
those critical thinking skills in the context of the
audit is especially important, as well.

So there's a well-developed literature in the
fraud paradigm that is starting to move over to the
estimates literature that shows that auditors are pretty
good at knowing where there's risk. They're less good
at identifying what to do in response to that risk. And
most of these studies, I'll say, have been conducted on senior-level auditors. But these senior-level auditors are the ones in the field doing the work and making the first-line decisions and are the filter on what goes up the line, and so their judgments are critically important.

MS. GAYNOR: Also, what Jackie was talking about and some of the research that's starting, it sounds silly, and I don't want to use the word "infancy," but in the academic process, the publication process is a very long, sometimes way too long, process. So where we had difficulty trying to find the papers to necessarily give you a lot of data, but the literature that talks about critical thinking or ways to try improve is relatively new, but we can look towards some research that has been done before that we think will apply and the new research that's coming out. But a lot of it is trying to frame, put the auditor -- Jackie has a paper on mindset and there's a couple of papers on framing and how you get auditors -- you mentioned confirmation bias -- how you just get auditors to get out of the way they're usually searching for evidence or how they're
approaching the picture, construals, mindset, putting them into a different focus.

The other thing for academics, between the AAA and accreditation boards, critical thinking and analytics are becoming the biggest push that we have in academics to bring into our classrooms across the board. And I know that most of us are trying to incorporate more critical thinking and analytics into our classrooms at the undergraduate and graduate level.

MR. BAUMANN: Thanks. Sri Ramamoorti?

MR. RAMAMOORTI: First of all, I wanted to thank Lisa and Jackie for their presentation. I didn't know, Jackie, this is what you were up to lately. I've known her from my days at the University of Illinois.

To me, the key takeaway is the issue of auditors don't understand valuation, Sandra Peters' comment that you cannot audit what you don't understand. There's a general comment that when competence goes down, risk goes up. I think this whole area of valuation and auditing of fair values and estimates poses a competency threat to the auditing profession because students don't get courses in valuation. They're all mostly offered in the
finance department, not in the accounting department.

And I had a vivid demonstration of this in the late '90s when I was a member of the AICPA's financial instruments task force representing Andersen, and one of the big four firm partners, and I shall protect the innocent and not name the firm, but he basically stood up one day and he said, "Guys, I am departing from this committee. This whole discussion is getting very heavy for me. I think I understand now why I was an accounting major, not a finance major, in college."

So this is not good. We need to change that around, and it shouldn't be possible for accounting majors to graduate without a solid understanding of financial economics and how that plays into financial reporting and this whole area that, you know, we are now talking about.

MR. BAUMANN: Thanks, Sri. And, Rachel, you have the final word.

MS. POLSON: I just wanted to say, as being a practicing audit partner, a lot of the things that Lisa and Jackie said are very true and is what you see happening on this, you know, lack of knowledge of people
doing things. And I think a lot of it goes down to not only the audit partner but then the audit team being able to say I don't have the specialty and I shouldn't be working on this. And part of that goes to the firm's QA program. You know, they only assign partners that have the proper industry area. Well, that should also be going down the staff level to make sure that they can do the work because that's how a lot of things are going to get mitigated and they're going to be properly trained. So I agree with what you're saying there.

And then the other part is the one part I thought should be included in the standard is getting more of that independent expectations process worked into the audit procedures because I do think that that is good for the auditor to come up with what they think the answer should be and then comparing that back to what the company came up with to see are you on the same basis, are you coming up with the same kind of conclusion, and how far apart you are.

And then that part where you're talking about, Marty, of the whole piece of how would auditors then address that difference would be good to basically get
us there because that's the whole part is how else do we challenge and come up with the a company's estimates without coming up with what our own answer would be.

MR. BAUMANN: Good comments. Well, thanks again. This panel, obviously, intrigued us all, educated us all, and created great value, as well as the SAG member comments. So thanks to all of the panelists this morning and this last panel certainly, as well.

We are running a bit late. We have a busy afternoon ahead of us, so I'm going to make an estimate, and we know estimates are often inaccurate. But I'm going to estimate that we'll be back here about 1:20 so we can possibly get somewhat near to schedule. Lunch is upstairs for the people around the table, and let's do our best to try to make that estimate. Thank you very much.

(Whereupon, the above-referred to matter went off the record at 12:41 p.m. and went back on the record at 1:24 p.m.)

MR. BAUMANN: Great, welcome back. Nike, I think there's a slide you have to put up one more time to
1 remind everybody that the views expressed by each of our
2 panelists who presented are their own personal views and
3 not necessarily those of the PCAOB Board or PCAOB staff.
4 So, the next panel is dealing with developments
5 and valuation. The topic of this panel focuses on how
6 valuation is evolving, both in fair value measurements
7 and other accounting estimates and what that could
8 potentially mean with respect to auditing accounting
9 estimates and fair value measures.
10 Our panelists provide a diverse range of
11 expertise in this area and we look forward to hearing
12 from them.
13 First, we have Sir David Tweedie, who is Chairman
14 of the International Valuations Standards Council. Prior
15 to this role, David was President of the Institute of
16 Chartered Accountants of Scotland and has served as
17 Chairman of the IASB as well as CEO of the International
18 Financial Reporting Standards Foundation, among many
19 other matters.
20 We also have Matt Brodin who's Director of
21 Interactive Data Corp's Pricing and Reference Data's
22 Evaluation Services Group. Interactive Data Corp
provides financial market data including evaluation services, reference data and pricing services.

Matt's expertise is in the evaluation of mortgage-related and other fixed incomes securities.

And our last panelist is Alan Meder who's the Senior Managing Director and Chief Risk Officer at Duff & Phelps Investment Management Co. Alan is the Principle financial officer of four New York Stock Exchange listed investment companies and is the chair of each fund's valuation committee. He's also a member of FASB's advisory group FASAC.

With that, I'll turn to Sir David to kick off this panel.

MR. TWEEDIE: Well thank you, Marty.

I'm going to talk about the background to valuation as we see it from the International Valuation Standards Council for two reasons: there's been increasing focus on fair values, partly the broadening application of them in financial reporting and, of course, the 2008 financial crisis.

I first came across valuation when I was KPMG's UK International Technical Partner in the '80s and one
1 of our clients had bought the company that manufactured
2 Smirnoff vodka. And, in those days, the rules were that
3 we didn't have intangibles on balance sheets, so it was
4 classified as goodwill and the UK had a rather bizarre
5 accounting standard that wrote goodwill off against
6 reserves. The result of which, this company was going to
7 have no net worth.
8 After some deliberation, we decided we'd allow
9 them to put Smirnoff on balance sheet as a brand but only
10 if we actually worked out how they calculated the price
11 they paid for it and that turned out to be a DCF
12 technique. And what we did is, we set out the rules that
13 we were going to look at this cash flow as it happened,
14 compare it against the price that they paid for it and
15 that was going to form the impairment model.
16 And that, in fact, did begin the impairment model
17 that we eventually adopted in the United Kingdom for
18 goodwill in brands. It spread then to the international
19 arena and, of course, you use it in the United States as
20 well.
21 When we first introduced it into the
22 international accounting, I remember the then chief
1 accountant to the SEC was almost apoplectic and said that
2 the United States had discovered the accounting for
3 brands and goodwill some 30 years earlier and that was
4 to write them off over 40 years.
5 And as I pointed out to the gentleman -- in the
6 United Kingdom, we have brands such as Gordon's Gin and
7 Johnny Walker, they're actually older than the United
8 States and, in my humble opinion, have done more for the
9 sum of human happiness than the United States and,
10 personally, I'd write off America before I'd ever write
11 off Johnny Walker Blue Label.
12 But these sort of things laid on to others
13 because the company then wanted to bring on its homegrown
14 brands and we wouldn't let them because we didn't trust
15 the valuation techniques. And that still has persisted
16 in accounting. There are very few homegrown intangibles
17 that are allowed on to balance sheets.
18 And when Australia adopted international
19 standards, Rupert Murdoch had to remove all his mast
20 heads from his Australian accounts, hundreds of millions
21 of Australian dollars, simply because we didn't trust the
22 basis of the valuation.
Business valuation intangibles is a growing area in the valuation sphere, it's the younger area, the more mature one is real estate but the real problem lies with financial instruments.

In international standards, IS 39 was the standard that dealt with financial instruments. It was an amalgam of several of the American standards. I often used to say, if you understood that standard, you hadn't read it properly.

We ended up in huge fights with French banks who did not like valuing derivatives and other things at fair value. And that persisted right through the crisis.

After the crisis, the IASB and the FASB changed how we accounted for financial instruments. We changed the disclosures, but comparatively little action was taken to deal with the valuation problems that were thrown up during that particular crisis.

I first came across them about three or four weeks after Lehman's collapsed when I was attending a Financial Stability Board meeting. And I can say that I have never smelled such fear in a room as I did that day. There was a general feeling that the whole
financial system would come crashing down.

And people were taking fire sales as the values. These were the only values that were out there at that time because the markets had completely frozen. Values were tumbling and the Financial Stability Board turned to me and said, and what's the accountants going to do about this? And our reaction was, you know, we're accountants, we take values, we don't create them. And it turned out, there was nobody creating the values out there.

So the IASB and Bob with FASB did the same. We had to set up a task force consisting of industry experts, bankers, auditors, et cetera -- regulators, to come out how you value in illiquid markets and that eventually -- we had a joint statement which we both added to our literature.

But it became highly political. Chancellor Merkel, Prime Minister Berlusconi, President Sarkozy and President Barroso spent half an hour discussing financial instrument accounting one day. Now I would have loved to have been a fly on the wall listening to that, but that's how serious it got. It got right to the top.
And in the heart of this, I remember being interviewed by the BBC World Service and the interviewer said, during this crisis, fingers are pointing and fingers are pointing at you. You're the man who caused the crisis.

And I said, they're right, it was me. I made banks give up their risk management techniques. I made them give loans to people who had no assets and no income. I made them take these mortgages, break them into tiny pieces, add them to tiny pieces of lots of other mortgages. I made them scatter them worldwide. I made the rating agencies give them AAA ratings. I made people buy them even they didn't know what was in them.

It was all my fault.

And there was a silence and then the interviewer said, for the benefit of overseas listeners, that was irony.

But it became a highly contentious issue. Companies, especially in Europe, were looking for ways to escape using fair value. And they found a little known line in the U.S. GAAP which said that in rare circumstances, you could switch from fair value to cost.
Now rare in practice, in the United States, meant never. But suddenly, we discovered that the European Commission was going to change the law to make it allowable despite what the standard said, to let people go to cost. And our first reaction was, let them do it. And then the SEC contacted us to say, you've got to step in because if they do it, they're not going to do it like the U.S. does, with the transfer of fair value, nor is there going to be any disclosure, they're just going to add back all their losses. The markets won't believe the numbers. The European markets will implode and that'll spread across the Atlantic.

So within a week, we had to make a change in accounting standards without any due process and we were torn apart for it. The alternative was to watch the markets blow up, so we felt we'd no option. Bob had similar problems with Congress -- a change that didn't put all the fair value changes through profit and loss account, it went to other comprehensive income. Europe instantly wanted that change as well, and probably the only thing that saved us was the fact that
they wanted us to copy exactly what the Americans would do in the future and when we mentioned that they were heading for full fair value, that shut them up completely.

And the U.S., as you know, did expose a full fair value model and I think the results were 6.5 billion against and 1 in favor and that was Bob's auntie.

But the sort of thing there -- it shows you the tension that was around at that time.

If we'd had marked the loan book of British banks to markets, the profits would have been much more volatile in the UK, 100 billion over the first five years of the decade, but in 2008, the hypothetical losses would have been 300 billion pounds and that peaked at 400 billion in 2009.

The total resources of the British banking system at that time was 280 billion, so the entire system would have been bankrupt on a fair value basis and that's one of the reasons we didn't go that far.

But what both us, FASB and ourselves, did was we required companies to show the fair value of these loan books and then that is an area that causes problems. We
often talk about the figures in the accounts, but the disclosure is important, too, because this was the check on whether these loan books should be impaired. And we had an example, just a couple of years back, with the Co-operative Bank which showed that their loan book was worth 37 million pounds more than the book value -- which was the figure in the account. After well known difficulties and their regulatory scrutiny, they changed that six months later to save -- well, actually, the fair value was 3.7 billion less than the book value. And that started showing you the unreliability of some of these numbers. Hong Kong Shanghai actually stated in their accounts in 2011 that comparisons of fair values between the entities may not be meaningful and users are advised to exercise caution when using the data. That was their disclosure information. There's been other worrying signs. Tests done by banking regulators last year internationally using hypothetical portfolios, which they gave to various financial institutions, yielded large valuation differences. We're not talking small ones, these were
And if somehow the more aggressive banks had used 
the more conservative measures, it was estimated that 
equity would probably have been wiped out.

So the problems are still there and that raises 
questions. We've got a lacuna in regulation. If these 
variations are so big, how well can we rely on the Basal 
liquidity buffers and capital buffers and what does this 
say for profit and loss accounts and balance sheets as 
we go forward?

It is very difficult for regulators and for 
auditors because where are the benchmarks that say, this 
is where they should be, when you've got this wide 
variation.

In the International Valuation Standards Council, 
we're doing two things. Our job is firstly to try and 
get agreed international standards and we've made 
progress in that by getting many of the valuation 
organizations signing up to the fact that we'll try and 
get to one set of standards internationally.

Secondly, and the point that Jeff made earlier, 
there is a problem about the valuation profession. Is
1 it a profession? And Jeff mentioned Paul Beswick's
2 comments.
3 So one of the things we're also doing is we're
4 setting out valuation professional standards, which deal
5 with entry requirements, exams, CPD, et cetera, as Jeff
6 mentioned. And perhaps even a common designation where
7 people will understand that these people aren't
8 qualified, like CPAs and things like that which have
9 universal recognition. But the qualifications at the
10 moment don't have that recognition at all. The idea is
11 let's identify the cowboys and those that are properly
12 trained.
13 There are various reasons for the differences in
14 financial instrument valuations. A lack of transparency
15 and poor disclosure about the purpose and basis, a lack
16 of precision around the language used to describe
17 valuations ---- it's often not clearly articulated when
18 it's commissioned, a lack of relevant market data or
19 market activity because the inherent features are the
20 product -- meaning there's no active market for it and
21 that is a particular problem within some of the banks
22 because the information is not in a public domain, it's
1 held proprietorially and it's very difficult to get
2 comparisons. And we're hearing that some audit firms are
3 even asked to sign confidentiality agreements not to
4 reveal this information.
5 Differences can be caused by inappropriate
6 models, errors in the way the model is calibrated -- such
7 as using price data for one range of products for another
8 range but without sufficient adjustments.
9 Relatively small differences in the inputs used
10 to construct a yield curve can lead to significant
11 differences in the value.
12 Different perceptions of the risk profile of
13 products. With more complex products, the greater number
14 of variables can lead to significantly different
15 perceptions of the risks.
16 And certainly when we look at things that are
17 traded -- are not capable of being traded to
18 third-parties, you end up having to construct hypotheses
19 and while the international and American standards set
20 the objective of a market exchange and stipulate that
21 unobservable inputs shall reflect the assumptions that
22 market participants would make, there remains scope for
different views on these assumed inputs with a resulting effect in value.

We're also discovering there's a lack of guidance on the judgment necessary when deciding whether something is a level two or a level three input. That doesn't necessarily affect the value that's show. But what it does do is lead to people thinking that one firm's assets are of less worth than another one who'd be showing a level two.

Valuation standards can help and we're moving into the area of financial instrument standards. We won't solve all the problems, what we're trying to do is narrow the variation. This won't come down to three decimal places of agreement, it's going to be a case of, can we narrow these rather large variations that exist?

Some have already been helped by better controls within the banks. Regulatory supervision has helped with that a lot, they don't just simply take traders numbers, they now have controls at the back.

But common standards will increase transparency and help those relying on the numbers better understand them, which in turn builds market confidence.
We can't make a hard to value asset easy to value but we can show better disclosures and highlight any material uncertainties.

Developing more detailed guidance will help the consistent application of fair value and while, for example, IFRS set required criteria for valuation measurements, they don't address how these criteria should be used.

And that's traditional. The accounting standard setter says when a value should be used and the form of that value. The valuation profession is to tell you how to get there and that is what we're trying to do now.

What we have to do is look at the strengths of various models, how they should be calibrated, what inputs should be selected and this, we hope, will be helpful to auditors in how we actually look at the fair value estimates that are being produced and help improve therefore, both the quality of the audit and the financial statements in general.

What we intend to do in the new year is to hold a roundtable where we get the industry together -- auditors, financial institutions, regulators, valuation
professionals, and can we agree to market consensus on what is unacceptable and what is acceptable.

Can we eliminate some models? Can we come to more common assumptions that can be used? Do you extrapolate when the data runs out or do you flatline it even, to make a big difference? Can we agree on these sort of things? And if we can, then the idea is to set up this task force and try and come forward with more robust fair value standards for the valuation profession.

A long way to go -- I sympathize with the auditors. I found their academic colleagues data very interesting and I fully sympathize with role that the PCAOB has in trying to narrow this down.

Thanks, Marty.

MR. BAUMANN: Thanks very much, Sir David.

I see a card up, Mike, did you want to make your point right now?

MR. GALLAGHER: Sure, Marty. I just want to applaud and associate myself with the comments made by Sir David.

And Jeff made the point earlier, about the importance of raising the game of the valuation
profession because, in all too many cases, given the wide range of professionalism and expertise, we do spend a lot of time in the audit profession fighting with so-called valuation experts that are not truly independent -- to Kevin's point earlier. Yet, they have, you know, the credibility of quote, unquote being valuation experts.

So, I think raising the level of performance, the minimum level of performance, and building the strength of that profession is a great thing.

A couple of other comments that I think -- you know, just the discussion we had earlier about root cause and kind of where we're going with the standard setting, Marty, I'm very supportive of standard setting.

I don't think there is a silver bullet here, but I think moving standard setting in the direction to minimize complexity or lessen complexity through one-stop shopping with a standard, and connecting it to the risk assessment standards, makes a lot of sense. So, I think that's a step in the right direction.

I also think that the point that a number of people have raised -- you know, because that addresses the execution in how the audits are performed today, but
it doesn't address the needs and wants of investors and
I think that there is a great opportunity through the
auditor's report and the expanded auditor's report to
deal with that element because I think these are areas
where we will definitely spend time speaking about them.

And then the last element, we had some discussion
earlier about a range of acceptable answers that goes
beyond the materiality. And we deal with that a lot in
the audit profession and one of the ways that, you know,
we deal with it is making sure that the processes are
consistent from period to period.

It's okay to be in a range, but a lot of times,
it's how you get there. And, you know, I've been
involved in situations where companies have said, well,
this is what -- this is how we're getting to the range
in this quarter.

And the question comes up, well, that's different
than where you were last quarter and why would you make
that change given the fact -- if it's more positive, the
only external evidence that would be ---- we would call
triggering events, seem to go negative. Why would you,
therefore, change it to be more positive?
So, it's a very complicated topic and I think there's a lot of moving parts in terms of disclosure, in terms of outside service providers that are, unfortunately, beyond the PCAOB's control but are very important to how we do our work.

But, at the end of the day, it's, you know, how we execute, how we challenge -- the degree of the professional skepticism. I love the point about reinforcing that in the standard.

So, hopefully, again, you know, collectively, the comments that were made this morning and then Sir David's point about lifting the level of performance in the valuation space is, I think, critical to the financial reporting as we move forward.

So, thank you.

MR. BAUMANN: Thanks, Mike, for those very helpful comments.

Thank you, Sir David, and let's move to Matt Brodin.

MR. BRODIN: Good afternoon, thank you for having me.

In terms of Interactive Data, you know, creating
evaluations, we create just about 2.7 million evaluations
each day globally. That represents about 135 different
countries and about 50 different currencies. With an
average of about just over 200 evaluation staff that
evaluate these securities.

And the years of experience where we speak about
understanding the securities, the years of experience --
20 years plus in the industry and just about nine years,
10 years experience creating evaluations, so these are
professionals that know the marketplace, know the
securities.

So, in terms of defining what our evaluation
represents. Our evaluation represents a good-faith
opinion, a sort hold or received narrowly transaction,
typically a institutionally-sized round lot under current
market conditions.

So within a fixed income world, the outstanding
debt. There's only about one percent that trades --
estimated one percent trades, in any given day. So our
processes, our procedures, our systems and our evaluators
are all geared around digesting that market information,
those inputs, and then taking that market information and
extrapolating it out to price securities with similar attributes. So, we look to maximize the use of relevant observable market information.

So, let's speak about the inputs that go into the evaluation process. You have trade information that gets reported publically —— both MSRB and TRACE for munis and corporates. You also have some structured trades that are starting to report in via FINRA, via TRACE.

There's still more to come on that.

Absent and retrade information -- there's a large amount of market information that's sent around the street as, you know, quotes, bids, offers, dealer inventories, results of bid wanted lists. These are all what we call price discovery points, so the securities aren't transacting, but their communication of prices for the securities that are in question or the securities that are out there in the marketplace.

So, Interactive Data over the last couple of years has really invested a lot of money and a lot of time into creating systems to help absorb this market information in a more efficient manner.

Right now, you know, we've rolled out some new
One of the biggest things we rolled out is putting governance around the use of market inputs. We created what we call inboxes, or market repository databases, where we're getting market information from the marketplace -- as I discussed earlier, the bids, the votes, the trades and so forth.

We have software in place that reads this market information, puts it into a database, wraps it up with some reference data or performance data or attribute data so you can do sophisticated searches through that market information, helping the evaluator do his job.

But then we also created controls around the use of that market information. Instead of the old paradigm where evaluators used to go looking for that information on the platforms or in their email boxes, now that the information is in our market repository databases, it gets pushed in front of them into their models.

And we're creating controls around the use of that market information, so we know when the evaluator is using it and when he's looking at it and how he's incorporating into his or her evaluation.

So there's been a lot of money over the last
1 couple of years in changing the workflow of the
2 evaluation and in managing the data that we used in the
3 evaluation process.

4 These systems, while we employ them, are really
5 there to design -- they're not as a model where the --
6 you know, where you're going to run Monte Carlo scenarios
7 or lattice projections. These models are really there
8 for tools to help us group the securities together by
9 similar attributes, all the asset classes have different
10 attributes that are going to be honed in on.

11 And once we've created those categories of
12 securities, now as we get that market information, we can
13 take it and extrapolate it out to price those securities
14 with similar attributes.

15 So, you know, the question always comes down is,
16 how do you valuate 2.7 million securities on, you know,
17 each day leveraging 200 evaluators? And that's the
18 efficiency of these systems.

19 A lot of times, the evaluators don't have to look
20 at each individual security because they just have to
21 look at an issue or curve, or a use of proceeds, or
22 sector curve for municipal bonds, or a specific category
1 within a structured arena in the MBS world.
2 So, there -- you know, therein lies a chance
3 where an evaluator can put this market information in,
4 create what we call an issuer curve and then price a
5 couple hundred bonds off of that curve and he doesn't
6 have to look at each individual bond.
7 There are instances where we do have to look at
8 each individual bond. High yield sectors is an example
9 of that, where each of those credits trade individually,
10 so we obtain market information for each one of those
11 bonds.
12 But where we can employ the efficiencies of
13 models and systems, we will do that to create the
14 evaluations in an efficient fashion. And that's what
15 we've been spending our time and money on over the last
16 couple of years, is putting governance around the
17 evaluation process ---- on the use of market information
18 in creating reports so that management can see what
19 market information the evaluator's obtaining, how he or
20 she is using that and whether he or she acknowledges that
21 information when they're creating their evaluation for
22 that day.
So, after -- you know, I'm not going to go through methodologies and how we do all the evaluations. I did that with the pricing task force a couple of years back. But part of the process of creating the evaluations is now from the audit side ---- and our preparer's side, on transparency into the evaluation process.

We have also spent a lot of time and money creating one of our tools -- what we call Vantage, in which we are disclosing reference data, assumption data and market information that was used by the evaluator to prepare that data. Where the information is public, TRACE or MSRB, you can see the actual trade, you can see the transactions, you can see whether it was dealer buy or dealer sell, you can see the size and so forth. It's public information, we can present that.

For the proprietary information, the quotes, the results of the bid wanteds, the offers that we see in the marketplace. That's information that's proprietary to us, we can't display that information but we aggregate it where we can, where we have a couple points for a particular security, a couple price discovery points,
we'll create a graph so our clients -- the auditors can see that that trade information or that quote information compared to the evaluation we've prepared for that day.

So over the last couple of years, as we've created this transparency tool, clients have adopted it and put it in as part of their workflow in terms of testing the evaluations each day when they receive them.

So, you know, they will look at this information, review it and then create controls around it and also demonstrate to their auditors and management that they have taken the evaluations from Interactive Data, reviewed it and have tested it.

Also, a part of ---- you know, over the last couple of years, you know, speaking about changes, we -- you know, clients engage us in what we call due diligence practices. They come in, they come into the floor, they come into Interactive Data, they look, they speak to the evaluators. And we go through, usually, an hour and a half, two hours of discussions, methodologies, how we do things, what we do, what our process and procedures are, what our controls are, what our QC efforts are. We speak about all that.
We also demonstrate to them and they sit with the evaluators, they get to see the models, how the models work, what controls they have in the models so they get a feel for what the evaluators are doing each day. We're spending more and more time educating clients on that because they have to understand, in the end, how we're creating our evaluations, what market data we're doing, how we're absorbing that market data, what kind of filters we use in the market data, because as I said earlier, we created institutional round lot evaluation.

There's a lot of trades that go out there, you know, off what we call odd lots, you know, got to make sure we have filters in there so we don't reflect some of that information.

Along with the due diligence meetings when clients come into us, they also spend -- the Boards are also spending more time with us. We're doing a lot more Board presentations over the last couple of years. Boards want to understand their third-party. How we're creating the evaluations -- you know, at a higher level, what controls we have in place, how does their pricing
committee interact with Interactive Data, what controls do we see from them?

So, we have been spending a lot of time educating both the Boards, both our clients and then also from the auditor's perspective.

Auditors come in for their annual due diligence. They usually spend a little bit more time with us. We roll up our sleeves, we go through the models, we go through the methodology. We go through showing them how we create our evaluations, they test some of our tests and some of our controls.

I'll stop right there and I'll also say we do have an SSAE 16 program in place around the evaluation process and we look to build on that in the future. So, you know, that's demonstrating some of the controls that we do have in place and they do get tested.

Also, part of the -- you know, with the auditors interaction, while they do come to us on an annual basis for due diligence, throughout the year we get questions as their doing audits. They're questioning the evaluations, they're questioning what market information we have. Sometimes they have market information that we
1 don't have, sometimes we can share market information.
2 So, there's a lot of interaction between us, between our clients, between our auditors in the end.
3 When I was asked to come here and present, it was really about what's happened over the last couple of years and, you know, that's some of the things that we've experienced on the Interactive Data side.
4 But the marketplace is evolving, it's evolving fast. It's probably evolved faster in the last three years than it has in the last 20 years I've been at Interactive Data.
5 Clients, the marketplace, everyone's using technology better, faster and categorizing the information and being able to demonstrate that they have the information for the evaluation to support the evaluation.
6 Also, transparency. As I said earlier, we created a tool getting this market information out to our clients. We have a web portal in which you can see the information but we've also created downloads, in which you can download this market information onto spreadsheets.
Clients and auditors are looking for as much information as possible when they're doing their -- when they're doing their reviews.

We also put in place, or we're starting to put in place a validation work pit so our clients can actually put controls in place when they receive our information, to look for outliers or look for securities -- you know, looking for exceptions within the data that they're receiving from us and putting a controlled environment around that.

So when they received the information in the past, a lot of times they would look at -- they would have spreadsheets and they would pass the spreadsheets around and now we're creating a platform which is auditable and if you go in there and change the information, they can see what actually happens with -- in the receipt of that market information.

So you can see, as we roll forward, as the market evolves, technology is being used more and more. Transparency is becoming more evident.

But within a fixed income world, it's an over the market counter place. As I said earlier, it's a hard and
it's a complex world. There's a lot of securities out there, a lot of times these securities have individual attributes and there's a lot of unique characteristics.

A lot of times, two securities, while they may look alike, they may have a little bit different attributes or different, you know, covenants around them, so they will not be exactly the same.

And as I said, within the fixed income world, just about one percent trades in any given day. So there's, you know, it's a fixed income world. It's the nature of the beast that these securities are buy and hold type assets. They don't trade often -- doesn't make them illiquid but they don't trade that often because they go into portfolios and they're part of a portfolio and they usually stay in those portfolios.

Some securities can go in portfolios and never trade. Some securities will trade, you know, as soon as they come out the prior market, they'll trade for the first couple of days, first couple of weeks, they'll find a home and they'll stay there for the rest of their lives and, you know, they'll just take out. So, just because a security doesn't trade doesn't mean it's not observable.
or illiquid.

But -- by the methods that we employ, by looking at the securities attributes and obtaining market information with similar attributes, we're able to price that 2.7 million securities off what that market information we do see, but we can't make market information up.

As transparency comes into the marketplace, as more structured securities are being released through FINRA. I believe spring of this year, some of the consumer ABS securities will start being posted, some of those trades will be available in the marketplace, there will be more transparency.

But it's a very big world, it's a very complex world and understanding that in conquering this -- you know, as we build transparency into the process, it's not like an equity, where you can go the exchange and you can see the security transact each day.

You've got to go do your homework. You've got to get as much information as you can find, have the expertise within the evaluation staff to understand how the marketplace works, have the systems in place and the
1 governance in place that you are getting this market
2 information, reviewing it and then, at the end of the
3 day, the quality control in looking at this information
4 and getting it out to our clients.

And then also the feedback from the clients --
5 that was another key point I want to make to the Board,
6 is there's a challenge process. It's an over the counter
7 marketplace. We can't say we see every trade out there.

As clients see market information, they will, you
9 know, alert to us to it sometimes via the challenge
10 process and challenge our evaluations. We'll take a look
11 at that market information. We'll validate that market
12 information, making sure that it is valid information,
13 and then we'll take an action. Whether we adjust the
14 security or we affirm the security, we'll get back to the
15 client with the reaction to that.

So, you know, that also is -- as a client is
18 taking this market information from us, they're testing
19 it with the information they're seeing. So it creates
20 that great feedback loop when we create these evaluations
21 each day, clients are looking at the information and more
22 and more, over the last couple of years, we're seeing a
lot more of that.

We're seeing the clients testing the evaluations, asking the questions, getting on phone calls, describing as we do things. So in the end, everybody is getting smarter -- there's still a long way to go, but everybody is getting smarter in using and receiving this market information.

MR. BAUMANN: Matt, thanks for those comments. They're very, very helpful.

Chairman Doty?

MR. DOTY: Matt, you're going to realize quickly that you're speaking to the lowest common denominator of understanding and intelligence in the room here. And we are, at the PCAOB, deeply interested in data.

Listening to it though I wonder if, in the effort to know whether the models you're building and the data as you're using it works ---- whether we're not in need of some check insight into your proprietorial process that is not yours.

I'm thinking of the drug industry. In other words, is there anything, or are we lacking in this, for the protection of audit committees and users and auditors
1 -- are we lacking in this some check by others who are
2 not interested in the sale of the models and the use of
3 the models, and have you thought of building that into
4 your industry, into your commercial model in a way that
5 can nevertheless protect the proprietorial nature of the
6 data?
7 What I'm hearing is a very sophisticated and
8 highly designed system that is going to resemble a black
9 box to many audit committees or even auditors who are as
10 uninitiated and unsophisticated as I am.
11 So, how do you get assurance that the model has
12 been adequately tested, that it works and someone is
13 asking questions of it who might find a contradiction in
14 it?
15 MR. BRODIN: So, in terms of the model, yes --
16 getting the idea that it's not a black box because
17 ultimately, the end game, we see this market information,
18 we observe market information, we know the range, we've
19 spoken about this earlier, we know the range of the
20 evaluation in which we want to get to.
21 So, it's not a circumstance where the security
22 we're looking at, we don't know what it's worth and we
run a whole bunch of net present value paths out and run
the different -- a bunch of interest rate paths then we
look to see what the effect is on those securities.

As we are a market to market evaluation service,
we know the market information, we see the market
information, we know the basic level or the range in
which we want to create the evaluation for.

So when we look at our evaluations and we're
creating them, the quality control check is around,
here's the observable market information, here's all the
securities that look like it. Are they priced close to
that observable market information? Are they within that
range? Is it relatively acceptable?

Because we know where we're going with these
evaluations because we see the observable information.

So, in terms of testing the models, I want to say
they get tested each day because as we're creating our
evaluations each night and each day, there's trades that
are going off and we're looking to see, as those trades
or as that market information comes in, is our model
performing to where that information is coming in at?

We also will do some back testing to see where,
1 historically, how has our processes performed as the trade information does come in. And it=s -- the numbers are relatively good, they're relatively high in terms of how the models perform.

But, as I said earlier, a lot of times, it's not a black box, we're running different kinds of interest rate scenarios and Black-Scholes models to value these securities. We do leverage it for our structured securities because you're going to want to see the structured securities' sensitivity to interest rate paths and prepayments, but we use it to group the securities together when we create the evaluations.

So we will run these paths and we'll look at the securities' sensitivity but ultimately, in the end, we know the security that traded here. We know what the security=s sensitivity is to interest rate paths. This security that we have in question that we haven't seen the market data on looks exactly like this one. Hey, that security's going to be priced relatively close to that.

So we do employ pretty sophisticated models but ultimately, in the end, we know the range of the
evaluation in which we're going to.

And clients can come in and they can see our models, they can look at our models. We'll run the calculations for them, we'll show how the evaluations are created, the spread information that we're using and so forth. So, we're pretty transparent in that.

If a client's going to want to come in and see the code and how the code is working, you know, that might be one step too far because I don't even understand that in terms of how the code was written and the true underlying mathematics.

But having a sense for how the model works and how the information is employed -- the inputs, how the information is employed and extrapolating out would be the great understanding -- would be the, you know, the understanding that the client should have.

MR. BAUMANN: My comment is going to be a little bit of a follow-on to Doty's question to you.

And that is ---- so we'd see up in our staff consultation paper the fact that we think that our standard would have to address third-party pricing sources, and we appreciate all of your participation in
that task force a while back and here today.

But given what you've just said that there's something like 2.7 million fixed income securities and only one percent trade on any given day, we're talking about a lot of level two securities where auditors can't see an active price, for purposes of audit procedures.

So therefore, in our staff consultation paper, we did ask for specifically for comment in this area. And so we'd love to hear from auditors and other users of pricing services about your ability to use these pricing sources, the transparency of the process to you, your ability to recalculate values based upon the information that's made available to you from the pricing sources, as well as the information that's not made available to you, which Matt just indicated some codes and certain things that are proprietary, and to what extent does that limit uses of these sources from actually really understanding how securities were valued.

So this is a very, very important area to us. Arnold indicated, as well, that the applicable ISA doesn't have guidance right now with respect to pricing services and this is just very important for us to get
in there. But we really need to hear from commenters about their view on the transparency and ability to recalculate values based upon that data.

MS. VANICH: And if could just add to Marty's remarks --- I mean if there's one thing I've learned about pricing providers over the last few years, it's that while there are similarities, there were certainly differences. And so we would also be interested in how you view, say the IDC model, versus challenges you face with maybe how others construct pricing.

MR. BAUMANN: Tom Selling?

MR. SELLING: Preliminary observation and a few questions. I have the same caveat as Jim, I hope I don't completely reveal my ignorance here. And also, I'm not even sure if the questions I'm asking aren't similar to what Marty has asked.

The observation is that the accounting standards have conceptualized current value as a non-distressed exit price. And as David Tweedie explained, this can create great problems for financial -- for valuation of financial instruments when markets are inactive because there are no willing buyers.
So my question for you, and again, I apologize if this is naive -- the valuations that you're describing, what do they represent? Do they represent -- do they meet the accounting definition of fair value? Do you ordinarily make a distinction between how much it would cost to buy versus how much or the price you would receive to sell? Or perhaps in the extreme -- in the absence of willing buyers, do your models actually perform?

MR. BRODIN: The evaluation represents an exit price -- so if it's arms length transaction, if you had to exit that position in the normal amount of time, that's what our evaluation represents, from the observable information we're seeing.

In thinly traded markets, if you roll back the calendar back in 2007, while liquidity did dry up and the securities -- especially in the structured world, there was less trading activity, we were still able to observe market information that we were able to create our evaluation process.

Ultimately, in the end, if there was an instance where there was no market information for us to build our
opinions of value, we would ---- you know, work with our clients, alert our clients but we would stop the evaluation process because we're always going to look to see from market information as we are a market to market evaluation service, we need the market information to support our evaluations and we're always going to look for that information.

MR. SELLING: One of the other reasons I'm asking the question is because -- so it sounds like in an extreme case, exit prices ---- replacement cost actually might work better than exit prices because if there were no willing buyers, that doesn't mean that you couldn't go out and buy something yourself at some price. Am I making sense?

MR. BRODIN: I understand. But then, that wouldn't make -- there wouldn't be a marketplace at that stage of the game if there was no willing buyers or sellers, so we would consider that to be a locked market and that wouldn't be information for us to build our evaluations off of.

So, we're not going to fair value to an intrinsic value for what we think it's worth, we're always going
to need that market information to support our evaluation.

MR. SELLING: Okay, thanks.

MR. BAUMANN: Thanks. Wayne Kolins?

MR. KOLINS: Two thoughts. One, I think in the last few years, the transparency has increased substantially over what it was before.

We found that, in many instances though, the type of data that is provided is probably only understandable by specialists, or much more understandable by specialists. And quite often, the firms use their own specialists to come up with pricing that we compare with the pricing that the service -- that the issuer comes up with and explore variations, sometimes challenge the variation.

I was wondering, and this is a follow-on to Jim Doty's question, I think, that have you considered -- has your company considered issuing a report on the processes and controls, you know, a so-called service organization report, that could be publically available in the marketplace that I think could mitigate some of the concerns about transparency, in terms of auditors
understanding assumptions and needing to understand the assumptions and the inputs?

MR. BRODIN: As I said earlier, we do have an SSAE 16 available for some of our processes and procedures. We are building on that to cover more of our asset classes.

You know, you can put controls and service reports around the receipt of the market information, how you're incorporating it, but, ultimately, there's a judgment that comes into play and it'd be very hard for you to put boundaries on that judgment because it's a human intervention that's coming into making a decision how he or she is looking at the marketplace and interpreting it.

So, you can control the information coming in, you could put controls and tests around the receipt of the market information, and then on the outbound side, you could have controls in the tolerance about how those securities have changed and so forth. But there's that judgment piece in the middle that would be the hard part, the assessment.

You know, there have been attempts and are
attempts to use algorithms and use models to do that judgment piece with limited success.

Ultimately, in this very dynamic world that we're living in, it's very hard to create a model or teach a model fast enough to have the market -- to have the securities responding to different interest rate environments or, you know, if a government program kicks in, the model doesn't know that. You need a human in there and you need a person in there that knowing what's going to happen in the marketplace and knowing what, you know, what was just brought to the marketplace, how that's going to affect the securities.

So, yes, you can for the beginnings and the ends, but that judgment piece in the middle, you're going to have to leave that open.

But, ultimately, in the end, we've found, you know, with the work we're doing and the government's reporting around our evaluation process, as we're beginning more efficient in digesting this market information, the quality evaluations are getting better because we have controls around the inbound information and we have controls around -- the quality controls
around the outbound when we create the evaluations looking at securities with similar attributes and making sure we made the adjustment to the appropriate securities.

But, there's always that judgment piece in the middle that you can't wrap into any kind of service report.

MR. BAUMANN: There's a great degree of analogy to the rating agencies in terms of, you know, understanding the assurance that people are looking for from what's being done in your organizations, yours and others, so that people can be comfortable that the values they're getting are accurate and reliable. So, especially to the extent that there's some proprietary aspect to it.

There's great interest in this topic. Mike Gallagher has his card up, let's take Mike and then let's go on to Alan Meder.

MR. GALLAGHER: Thanks, Marty, and thank you, Matt.

And I had the pleasure of working with you on the pricing services taskforce and I have some recollection
1 of some of our meetings there, enough to ask a basic
2 question.
3 It's just capacity, depending on where standard
4 setting goes on this and your capacity to potentially to
5 go deep dive, how many deep dives can you, you know, will
6 you go on tilt if every auditor under the sun comes to
7 you and, you know, CUSIP number by CUSIP number in level
8 two, given all the securities that Marty had mentioned
9 earlier, I mean, where does your capacity -- do you have
10 any concerns about where standard setting will go
11 relative to your capacity to respond to the marketplace?
12 MR. BRODIN: You know, that question was asked
13 during the pricing taskforce, if we had to do a deep dive
14 for everyone of our 2.7 million securities each day, I
15 think it would be overwhelming for us to satisfy that
16 need.
17 In terms of our transparency and the tools that
18 we've created, we do have the ability to download
19 assumption data, download reference data and be able to
20 download some trade information for that particular
21 security.
22 And, you know, there are algorithms in place to
draw -- where we can actually have the security in question and have comparable securities where we see market information.

But, ultimately, in the end, the auditor, the preparer, they have to understand this. As we've been talking all along, some of this information, if you don't know the fixed income marketplace, you're not going to understand, you know, when we talk about prepayments being voluntary and involuntary, severities and all that and how that affects the security. You're going to need to understand that.

But, no, to the question on doing a deep dive on every security. But, we do have the ability to get you underlying assumption data and reference data off of the securities that we do create.

MR. BAUMANN: It would be great to have any written comments you want to submit, as well, for the record as we're doing in our standard setting, so, thanks a lot.

MR. BRODIN: We plan on submitting.

MR. BAUMANN: Thank you, thank you very much.

Alan?
MR. MEDER: Thanks, Marty.

Rather than give this presentation from the perspective of a preparer, for myself -- I'm a Chief Financial Officer of several investment companies -- or I could have given this presentation as a Chief Risk Officer.

I thought it would be more interesting for you all to look at this topic through the eyes of a financial analyst. And I have a number of internal developments that I want to highlight and then I'll move on and talk about some more board industry developments that I came across in my review of this material.

So, I'll start with just some brief comments on accounting estimates from the perspective of financial analysts.

Financial analysts really love accounting estimates. This is the closest thing they have to the Full Employment Act. And you can't really see it on the chart, but they're always looking behind the estimates, they're trying to see what management may be hiding, what gaps there may be between accounting impairment and economic impairment, as an example.
But for this discussion, I'm not trying to train you. These are training slides, we use them to train the young analysts who, some of which, want to become portfolio managers. They what to live with these risks and the valuation problems each and every day.

But, what's important to me is the parallel discussion that I seem to have with analysts, they'll point out that companies management teams control the estimates and then these estimates are quite unilateral and then what happens is that these very same analysts take these estimates and, in a unilateral fashion, adjust their model and while they'll point to management and say, there's not enough communication surrounding the estimates, they, themselves, share very little information about what they're changing in their models.

So, as I bring them onto the valuation committee work that they're called to do as part of their mentoring process, I try to stress that they're going to need to adjust their style a little bit.

So, I start with this chart and I start talking about what's the difference between estimates and, say, fair value? And I stress the bilateral nature of fair
1 value. I talk about how buyers demand matters and that's why we show here a classic demand graph.

But, what's even more important is that I start to stress to them that they're going to have to communicate if they're going to participate in a candid way on the valuation committee. They're going to have to address risk factors, very specific risk factors in specific terms. And they're going to have to do more than just merely adjust their model.

So, this is the first internal development that I wanted to highlight from the analyst perspective and I think it has equal applicability for the industry is that, there's more discussion than ever before, certainly more than when I got in the business 30 years ago. But, I think as I'm hearing from other panelists, there's even more that's needed.

Another thing we talk about from an analyst perspective is that it is difficult for an analyst, it's difficult for everyone, to take qualitative risk information and to convert that into some quantitative impact.

And to ease their fear, their burden, all I can
simply do is give them homework, give them education and the chance for ongoing education.

I bring here just one article. This is a Nobel Prize for economics article, but here's some 1970 research that tries to pull together qualitative factors and well as quantitative factors and I think that's what's important for us and it's the second development, internal development, but also industry wide development that I wanted to highlight and it's been discussed numerable times this morning.

Education, ongoing education really does matter. And this is a very difficult task, even for analysts.

I have one more slide here from the training deck, so to speak, and that's despite all the work we do to have analysts spend time thinking about relative prices and relative risks, very specific risks. You know, ultimately, it's very rare to find any two analysts agree on a point estimate.

Point estimates for us, and where we spend most of our time, is wondering where on the continuum, where in the probability distribution that's shown on that chart might this security price move today, tomorrow and
the next day and why.
And again, to keep encouraging the candid discussion and then I work -- I think about the work on the valuation committee, and what is the, perhaps, the point estimate that I'm always leery of that give us concern on a daily basis? And I would simply say, I would point to broker quotes.
I never get a broker quote that's a true commitment. I get broker quotes that, late in the day, I get whoever's on the desk that wants to give me a number and I really don't have a lot of confidence in them.
So, we spend a lot of time taking those inputs, applying, perhaps, old tools, tools that we have from third-parties such as performance attribution tools, and we take inputs from the market that we've built into, it's not big data, but data warehouses of some shape and size, and we use that data and we discuss that data and we try to come up with at least something that we can run and be skeptical with against the broker quote that we're receiving.
So, I would say that this is the third element
that I wanted to bring up as an internal development that
use. And it's the application of tools and data in a
consistent process. Maybe not a process that doesn't
change over time, depending on how market conditions are
changing, but a process nonetheless that we can really
discuss in a candid basis.

So, beyond these internal developments that we've
seen, I've also pulled together several broad, more
externally focused developments that I wanted to
highlight. Some of them have been already mentioned by
the panelists today.

One of those is that valuation matters are now
even reaching into the Board room. We had last year the
SEC accuse some fund directors of not exercising proper
oversight over a portfolio management team and some
subprime mortgage assets that they had in the portfolio
during the last crisis and those directors did settle
with the SEC.

Another external development is, I would say, the
providers, the price providers like IDC might be getting
larger and more integrated but there are more price
providers available than I've seen ever before.
Providers like Market, Harvest Investments, even Bloomberg's BVAL as an example. And then you have EMMA on the muni side, TRACE, there are a lot of tools that are available. And that creates in and of itself two more developments. One is, again mentioned by Matt, I think the providers in a large extent are becoming much more transparent.

And secondarily, the vendors are posing agency risk and that means you have to exercise a lot more due diligence. You have to really ask them a lot more questions and we do that regularly with all of our vendors. And we also get secondary prices every month end to check our work.

Just a few more comments on more broad external developments. Illiquidity is just pervasive and it certainly has gotten worse in the last few years and I think in the near term, it's just it's something we're going to live with on the sell side and the buy side.

When you lose Lehman Brothers and Bear Stearns, you have just less institutions selling and when you have the proprietary trading desks and bank investment pools and portfolios shrinking, again, you have fewer
participants in the market.

There's a lot of reasons for illiquidity. The quantity of assets matter, quantity of the market volume matters, security structure matters, all these enter into the illiquidity framework.

And then I'll make one last comment. As opposed to what Sandy said earlier, we might not have a lot of CFA Institute members today and I've been a person who's given a lot of time to CFA Institute over the last 25 years, but we have increasing numbers of candidates for the professional designation of the chartered financial analyst that are coming from folks in the valuation business from auditing firms and I think it's a very positive trend. And it certainly should help reduce the amount of incorrect, inappropriate, inconsistent assumptions, inappropriate models and just poor valuation methods in general.

So, I know we're behind so I'll stop there.

MR. BAUMANN: Alan, thanks a lot for those very insightful comments.

Seeing no cards up at this point in time, thanks to the panel. It was very, very informative on valuation
developments. I can see a great interest by all of us in that area as it's so fundamental to this auditing standard that we're dealing with.

Let me turn now to the next panel with respect to developments in financial reporting frameworks.

Obviously, we've heard a lot today already about the importance of accounting standards to the, you know, the auditing aspects of our project and a lot of discussion of measurement uncertainty and what should be disclosed and things of that nature.

So, we're really appreciative to have with us today Patrick Finnegan who's a Board Member with the International Accounting Standards Board. Pat is a former Director of the Financial Reporting Policy Group at CFA Institute and led a team responsible for providing user input into the standard setting activities of the IASB, FASB, and regulatory bodies. Thanks for being here, Pat.

And then also joining this panel is Larry Smith who regularly attends our SAG meetings and who's a Board Member at the FASB. Larry's had a long and distinguished career in accounting. Prior to his appointment to the
FASB Board, he served as FASB's Technical Director managing FASB's activities related to application and implementation issues and served as Chairman of its Emerging Issues Taskforce.

So, with that, Pat?

MR. FINNEGAN: Thank you, Marty. I'd like to say thanks to you and Barb for the opportunity to visit with the staff and the Board this afternoon.

And at this stage of the discussion, it's challenging to, I think, add anything terribly more illuminating or insightful about the discussion because I think a lot of the discussion so far has been quite good. So, in that spirit, I'll try to be incremental.

I tried to put myself in your shoes being a Board Member setting accounting standards and asked myself what is it I might want to hear and how it could be helpful in this process?

So, what I'm going to do is offer you a series of five very concrete recommendations as it relates to the consultation paper and then I'll relate some of those recommendations to a new accounting standard that the IASB published this summer, IFRS-9, which I'm sure many
of you are familiar with that deals with the financial
reporting for financial instruments. And in particular,
I'd like to touch on the impairment guidance that we
developed in IFRS-9 and related to your consultation.

So, my first recommendation is simply to say that
I strongly endorse the approach being considered by the
staff. I think that the creation of a single standard
that would align risk assessment standards and retain the
approach that you have right now for substantive testing
would be very beneficial.

And the reason I believe that is because I think
audit procedures need to be clear, they need to be
precise, they need to be comprehensive and anything that
you do to improve the understandability of these
procedures, I think, will be very well welcomed.

Now, that recommendation ties into my second
observation and recommendation for you and I think it's
borne out by the presence of the three gentlemen to my
right here. And that is one of the most significant
trends in the area of making estimates about fair value
measurements over the last decade is the introduction and
use of third-parties to develop those estimates.
And as we've heard this morning, complexity abounds in this area, particularly as it relates to the collection of data, the use of assumptions and then exercising judgment in applying that data and assumptions consistently, if you will, to various models.

So, what is the auditor need to do? I think it's very clear from Matt's comments, the auditor needs to have a clear understanding of what his organization does and that's no simple task.

There needs to be an emphasis on the evaluation of management bias. I think this is perhaps one of the most understated areas in the issue of coming up with fair value measurements and we've heard from Lisa and Jacqueline about the importance of this, and, obviously, evaluating data and assumptions consistently.

So, I strongly endorse the recommendations that the staff have on Pages 35, 40 and 41 without going into them in detail.

My third observation is a familiar one to all of us here around the table and I will entitle it the expectation gap and I think, Mike, you alluded to this and I think even Marty, you may have mentioned it.
By adopting a single set of principles and guidance in perhaps the most critical aspect of the auditor's work, I think the PCAOB will be sending a very strong signal to the marketplace that the accounting profession, that can help the accounting profession in two ways.

The first is with the recommendations I've just covered, improving understanding, clarity and consistency of audit work. But an equally important benefit here of adopting a single set of standards is to raise the level of awareness and understanding with managements to prepare the issuer community about their responsibility for coming up with estimates in financial statements.

Interestingly, you know, I continue to hear in my role as a standard setter, but in past roles as an analyst and as an auditor, the refrain from very, very experienced market professionals that the financial statements are the responsibility of Deloitte or PWC, not our responsibility. And I think these statements essentially reflect the lack of understanding and perhaps a gap in the understanding of what is, in fact, the role of the auditor.
So, if you proceed with, you know, this process of developing a consolidated standard, I would greatly recommend that you coordinate it with an announcement by the SEC, whether it's the Commission itself or the staff, to emphasize the content and the importance of shared responsibilities here to ensure that management understands that it is their estimate and not the auditor's estimate.

My fourth recommendation drills down a little bit more into the paper itself and it deals with Question 25. And here, the staff is asking whether there are enhancements to the existing requirements for testing data used by management to develop the accounting estimate that the staff should consider.

And I have a very specific recommendation here that I believe is critical to an auditor getting a clear and comprehensive understanding of how values are assigned, particularly to complex financial instruments. And this is based on my own experience as an auditor, but also in recent discussions I've had with people who are actually engaged in this process. And that is that the auditor should have access to and be
able to observe the investment committee process of any institution that is involved in assigning values to large numbers of financial instruments. So that would be insurance companies, banks, pension funds, endowment funds and what have you.

And they need to be able to observe management=s discussions and how they are evaluating and assigning valuations to these very complex instruments.

Now, the reality is, as I'm sure you know -- and I was in this position myself at one time -- that the task of looking at this process many times is assigned to somebody who's got anywhere from one month to maybe as many as five years of experience on the job. And they're reading a set of minutes about the investment process and they're being asked to evaluate and come to some conclusion about how robust it is and how consistent it is, et cetera.

And I think that process has to change. You need experienced people at the table watching the investment committee assign valuations.

My fifth recommendation deals with something that we've heard a lot and, Alan, you've touched on this this
morning and it has to deal with education and the experience of the auditor, and this is not a new issue but one I think that is taking on heightened importance. The recommendation is a reminder that there's a close nexus between the knowledge and skills that you have to have in the area of evaluating accounting estimates and judgments and the need to have a deep understanding both of an industry and the financial reporting framework in which an auditor is evaluating. And as I just said, we have to be honest, much of the work conducted in this area of evaluating very complex estimates is being conducted at a level on the audit, perhaps sometimes, with the least amount of professional experience and professional judgment. Although, many times, that's overridden by reviews by very senior people.

I believe in order to ensure that you have a high quality audit, you need people with significant amounts of experience. And if I'm correct and quoting Oscar Wilde who said that experience is nothing more than the name that we assign to the mistakes we make, unless you've made a number of mistakes in this area, you're
never going to get it right.

So, I would implore you to ensure that in order for this to be done right, you insist that it be done by people with the appropriate amount of responsibility and experience.

Now, I said I'd try to relate this to some of the work that we've done at the IASB in the area of assigning, or I should say, preparing guidance related to impairment of financial assets.

The model that we've adopted under IFRS-9 is what we'd like to refer to as a forward looking model. And one of the important changes that we've introduced into the accounting literature is the elimination of a threshold for the recognition of expected credit losses.

So, it's no longer necessary for management or an auditor to identify specific triggering event to say an impairment should be recognized.

And specifically, IFRS-9 requires an entity to base its measurement on expected credit losses using what we call all reasonable and supportable information based on past, current and expectations about what's likely to happen in the future. So, it imposed on management this
requirement to develop a forecast.

Now, I'm not going to go into or elaborate on the mechanics of exactly how IFRS-9 requires you to set an expected credit loss, but what I'd like to highlight here is that an auditor, in order for he or she to be effective in evaluating the judgments and estimates applied by management in the implementation and the ongoing application of the standard, there needs to be a significant amount of education. They're going to have to go to school in several areas.

The first area deals with just the core principles of credit analysis. In my opinion, this will involve developing a new set of skills to evaluate how credit risk has evolved and is trending by types of instruments, by credit class, by geography and collateral type, just to name a few parameters.

They'll also need to understand how credit risk changes in response to economic events as well as issuer specific events. And they will need to assess the quality of the systems used to monitor, to collect data and effective those systems are in capturing timely changes about credit quality.
So, as you can see, there's a wide range of judgments and estimates that are incumbent upon management and hence, the auditor, to evaluate the impairment allowance. And I think you can safely make the assertion whether the measurement attribute is either fair value or it's an entity specific measurement, significant judgment comes into play.

So, in the final analysis, I think the auditor will need to have a deep understanding of the amounts recognized, how they were determined, whether the assumptions applied have a sound basis considering the outlook for economic environment and the past history of existing and existing market prices.

So, that concludes my formal remarks and I'd be happy to take your questions.

MR. BAUMANN: Thanks a lot for those formal remarks. I have a great team that's supporting this effort over here, but we'd love to have you on our drafting team if you have any free time, all right?

And I'd certainly be interested in, again, the comment letters that come in from various parties about
how this expected loss model works with the different independent estimate or testing management's process and does this present unique challenges when we're dealing with something like this model of impairment on expected losses, which is quite different than where we are today. So, certainly want to hear about that as we're developing our auditing standard.

Steve Buller?

MR. BULLER: Thank you, Marty. Thank you, Pat, that was a very thoughtful discussion.

I just wanted to comment on one recommendation you made which was to observe the investment committee process. And, only because in any company, there are many decisions that are made, including not just the valuation of investments, but during a committee like that, for example, that are also discussing possible new investments. But, if you think about it, companies also have meetings on looking at loan loss reserves and tax reserves and contingencies and I'm not sure that it's appropriate to have the auditor involved in all those
discussions and if that's necessary to understand the internal controls and to perform an assessment of proper evaluation.

MR. FINNEGAN: When I made that recommendation, Steve, I actually had you in mind. I suspected that you might have that --

MR. BULLER: I'm not sure how to take that, Pat.

MR. FINNEGAN: --- you might have the reaction you did.

I think because it is such a sensitive area, it demonstrates the need for the auditor to be at the table.

MR. BAUMANN: Jeff Mahoney?

MR. MAHONEY: Thank you, Pat, just a question. Do you believe IFRS-9 makes the auditor's job more challenging or less challenging?

MR. FINNEGAN: I don't think it changes the job, to be quite honest with you, because I think if you're going to expect the auditor to opine on the amounts that are reported in the financial statements, you need to have accounting principles that are going to faithfully represent those amounts and drive towards that type of conclusion.
So, I think IFRS-9 advances the quality of financial reporting. Is it the model that I would have developed and chosen? You know very well that I'm a fair value proponent and would have a single measurement attribute if I were king, but that's not where we are. But the reality is, is I think IFRS-9 goes a long way to improving, I think, the financial reporting that will be made available principally by financial institutions in the, you know, next several years.

MR. BAUMANN: Larry Smith?

MR. SMITH: Thanks, Marty. I approach this a little bit differently. First of all, let me offer the normal disclaimer. These are my views.

And I looked at the staff consultation paper from the perspective of my former life as an auditor and in reading it, while I agree with Pat's recommendation that it makes it a lot of sense to pull together a lot of the different aspects of the auditing literature so that people can see it in one spot in when they're evaluating accounting estimates or coming up with estimates.

I also agree with Mike Gallagher's comment that I don't think there is a silver bullet out there because
I don't think that doing so really introduces a dramatic change in auditing.

You know, from a practical standpoint, the consultation paper deals with the fundamentals of auditing and that is how to audit estimates and that's what auditing is all about is all about in my mind.

And it caused me to question, you know, the extent to which accounting has changed over the years and whether that's causing a change, a required change in the auditing literature.

So, I spent about ten minutes, literally ten minutes, and I developed a list of accounting estimates and they are as follows. And this is not all inclusive.

Depreciable lives of PP&E and intangibles. Under the old rules before 141 goodwill life; valuation of stock options; allocation of purchase price to acquired assets and liabilities in a purchase biz-com; inventory capitalization of costs and absorption both what you absorb, what costs you absorb and how you absorb them; inventory obsolescence; percentage of completion accounting; impairment of PP&E intangibles and goodwill; assessment of going concern; insurance companies
liabilities; pension obligations; realizability of the deferred tax assets, other than temporary impairment of investments; accounts receivable allowance; loan loss provision for financial institutions; warranty reserves; prepaid card fees and breakage; revenue channel stuffing; revenue recognition from multi-element arrangements; loss contingencies both the probability of loss as well as the amount of a loss; evaluation of materiality; probability of correlation of a hedging instrument to a hedged item; residual values of leased equipments; salvaged values of PP&E; is an investee a VIE and if yes, who's the primary beneficiary and fair value estimates.

And then in terms of current standard setting activities, we have several topics on our agenda that might get into requiring accounting estimates.

One is financial instrument impairment, we're not finished like the IASB is; insurance target improvements to accounting for a long duration contracts both in terms of remeasurement of the liability and the discount rate; leases, if we decide to move from our current FAS 13 distinguishing characteristics or criteria to an IAS 17 model, that will cause more judgments and estimates;
1 clarifying the definition of a business; determining
2 whether a host contract and a hybrid is more akin to debt
3 or equity; and hedging.
4 So, it caused me to step back and ask questions, you know. Auditors have been auditing estimates forever
5 and what is it that's causing a need for a new auditing
6 standard today? Me defining that putting everything
7 together is not a fundamental change.
8 Or, is it fair value estimates only that's really
9 causing this demand? And if it is fair value estimates,
10 what is it about fair value estimates that causes us to
11 think that new auditing guidance is necessary?
12 Why are audit deficiencies so high? Are audit
13 deficiencies higher for all types of estimates or is it
14 just fair value?
15 And is it the accounting standards that are
16 influencing the rate of deficiencies and the perceived
17 need for a new auditing standard? Or, are there other
18 factors out there such as, increase in litigation or a
19 change in the regulatory environment, including the fear
20 of being second guessed?
21 And getting personal about it, from an accounting
standards setters perspective, if it's the latter concern in terms of the environment in which people are reporting and auditing, what implications does that have for setting accounting standards?

MR. BAUMANN: Are you sure that was an exhaustive list of estimates? I can think of one or two more, amortization of deferred acquisition costs and as you know it.

Thanks very much. Comments? Questions? Kevin?

MR. REILLY: Yes, Marty and Larry, thank you for that exhaustive list because I think it does demonstrate a very important point and Bill Platt touched on it earlier this morning, and that is the playing field here is quite wide.

And I read with interest the paper where the tentative thinking was to develop a single standard that will cover all estimates, including fair value measures.

And I just have major concerns that we're trying to take everything in that wide playing field and fit it into a single box where we're dealing with economic type fair valuation measurements along with non-economic measurements such as warranty reserves. And I'm just
1 fearful that we create a standard that will end up
2 crashing under its own weight.
3 So, I would ask that the staff and the Board
4 consider perhaps an approach that would articulate some
5 broader principles in the audit of estimates and fair
6 value measures but then really think about some type of
7 an approach where supplements are developed to deal with
8 the use of pricing services or the expected audit
9 procedures undertaken relative to revenue recognition
10 which is an issue was talked about at the last meeting.
11 So, rather than try to create the aircraft
12 carrier, let's try to deal with this in more digestible
13 pieces to help drive longer term clarity in the standards
14 and hope for improved audit performance.
15 MR. BAUMANN: Good points, thanks, Kevin. And
16 Guy Jubb?
17 MR. JUBB: In responding to the question of what
18 implications does it have for assessing accounting
19 standards, perhaps we should -- the right question to ask
20 is, what implications does it have for setting corporate
21 reporting standards?
22 Because many of the aspects that we have been
discussing today are seeking to finesse a figure in our financial statements which, as we all recognize, has many variables associated with it and is not rather than a science.

We investors are putting increasing emphasis upon narrative reporting, management, MD&A, management commentary, in IASB speak.

And one of the things that the Board may wish to reflect on, but it's possibly already within its standards, is the degree to which auditors should give assurance and consider the completeness and clarity of the explanations that can be provided by management in the MD&A which can provide transparency for shareholders, for investors about some of the inherent risks which cannot be communicated in just numbers but can be communicated in words otherwise.

So, it's really to extend some of the debate from audit into assurance that is given to shareholders.

MR. BAUMANN: And I've heard a lot of comments today about or maybe I just heard them, but what's the role of accounting standards setters in trying to solve some of the problems that we're trying to solve around
this table today?

Through your long list of estimates and fair value measures, most of them have a range of measurement uncertainty. But yet, they get portrayed on the financial statements as one single number that the auditor has to report on that it's fairly presented.

When, in fact, there's a range of reasonableness from which that number is picked and whether there's a need for improved disclosure standards that would have more information in the footnotes about that measurement uncertainty and the range of potential acceptable outcomes for any of those particular estimates that would make it clearer to users that, yes, the management has selected one, a number, and that's their view of the best number, but other possible alternatives include for an X to Y and whether that would be a better financial reporting framework. But that's just my view.

Philip?

MR. JOHNSON: Thanks, Marty. It's really to support what Kevin was saying because one of the concerns I have because of the far -- we've heard from Larry how broad the spectrum is. And we've got to be very careful
that we don't -- we're not too prescriptive in what the
auditor has to do because it is such a wide range and I
very much support what Kevin was saying that we shouldn't
move guidance into rules that have to be followed for
this very wide spectrum.

So, I just think we have to be cautious as to how
widely this proposed standard is drafted.

MR. BAUMANN: Walt Conn? We would like to hear
from you.

MR. CONN: Thanks. Just a couple of thoughts.

Can you hear me?

I very much support the effort to explore
standard setting in this area and I would echo Mike
Gallagher's comment that I think there is no silver
bullet and I would echo Kevin's sentiment that I think
you could bite off so much that it takes years and years
to develop a standard that then auditors take years and
years to absorb.

So, I think a challenge that the Board and staff
and all of us collectively as we weigh in, should
consider is how to bite off some of the issues and
pieces.
And I thought Larry raised some really good questions. I thought he was going to answer them, but he didn't. And I think that the Board and staff and we collectively need to really pontificate on some of those questions and try to come up with answers to them to help inform the standard setting process.

MR. BAUMANN: Thanks for those comments, Walt. And, Tom Selling?

MR. SELLING: The first thing I thought of when Larry asked his list, was how many of these estimates do we really need?

And perhaps I should have kept that thought to myself but I raised my name card anyway because it does relate to our earlier discussions about the ability, you know, how do we get unbiased estimates and one way to get unbiased estimates is to focus on things that are drivers of market value or market drivers of valuations.

So, I took Larry's challenge and I made a quick list of things we don't need: impairment of goodwill, impairment of long lived assets, impairment of inventory, other than temporary impairment.

What is the functional currency? What is
probable? What is more likely than not? What is a constructive obligation? What is a cost that is eligible for deferral? What is a self-constructed asset and what is not? Is an arrangement a lease or something else? Who is a customer and who is not? What is significant influence?

So, anyway that's my list.

MR. BAUMANN: Thanks, and Pat and Larry, thank you very much for your contribution to today's meeting, to our thought process and for giving us a lot to chew on in terms of our process going forward on the standard. And thanks for SAG comments with respect to how that could play into our potential standard.

Let's take a 15 minute break. It's 3:00 or just about and let's be back at 3:15. Thanks.

(Whereupon, the above-entitled matter went off the record at 2:58 p.m. and went back on the record at 3:19 p.m.)

MR. BAUMANN: Well, we have a very interesting panel coming up now. We've talked about auditing all day from a variety of perspectives, but now let's talk -- you can hear from the Audit Committee and from the auditors.
Specifically in the panel today is going to be
Bob Herz, who's currently Executive-in-Residence at
Columbia Business School, Columbia University, and is
also a member of a number of very large boards.
Bob's extensive experience also includes serving
as past chairman of the FASB, past board member of the
IASB, and a past partner in a firm with me. We are
fortunate to have Bob as a member of the SAG.
We also have on our panel Tom Omberg. Tom is
Managing Partner of the professional practice at
Deloitte. He has served in a number of leadership roles
including leading the accounting, valuation, and
securitization advisory services. Tom, thanks for being
here.
And then we also have Jean Joy. Jean is the
Director of Professional Practice and Director of
Financial Institutions Practice at Wolf & Company. Jean
is also a SAG member and a member of the Professional
Practice Executive Committee of the Center for Audit
Quality.
So we greatly look forward to the perspectives
here now from the Audit Committee and the auditors on how
we should go about improving our standards in this area. So, Bob?

MR. HERZ: Okay, thanks Marty, and my thanks to the PCAOB and Marty, Greg, and Barb for organizing this. I think it is a very, very important topic in moving the whole reporting system forward towards better and more relevant and trustworthy reporting.

I'm not going to cover all of this because some of it's already been discussed. I'm not going to go back through the history of the fair value pronouncements, but Marty and Barb, when we were on the call planning this, said it would be really good if you could share any kind of lessons learned or take-aways from all this, particularly the financial crisis.

And, of course, just like Sir David there, it gives us a great opportunity to reminisce about such a pleasant period in time, not just standard setting but for -- for all of us a very challenging time.

If you think about -- in the development of the fair value standard, we spent a lot of time on developing the different levels in the hierarchy and within that on level three, level three inputs in particular, there was
1 a lot of debate and gaining understanding of what was
2 currently being done at that time by valuation experts,
3 by pricing services, and auditors and very importantly
4 by the issuers.
5 And one of the things I recollect from that time
6 was that a number of parties said gee, you know, when you
7 get to these unobservable inputs and hypothetical
8 markets, we understand the objective, but it's going to
9 be tough and we don't want people having to do a search
10 and destroy mission to come up with things that are
11 inherently going to be subjective and the like.
12 And so you'll see reflected in the actual
13 standard, it's actual Paragraph 30 of the original
14 standard; I'm not sure where it is in 820 anymore, but
15 it kind of reflects a view that okay, we understand that
16 and those situations by necessity management's going to
17 have to come up with its best estimates of what it thinks
18 market participants, hypothetical market participants,
19 would be thinking.
20 But then it goes on to say however, if there's
21 actual market data readily available or reasonably
22 available with undue costs and effort, you shouldn't
ignore it and try and make adjustments.

There's also wording in the standard the basic definition of fair value that says it's the price you would receive for selling an asset in an orderly transaction, which is not a for sale, distress sale, or a liquidation.

Those all made a lot of sense until the financial crisis hit because what happened, of course, was that we had whole swaths of asset-backed securities and derivatives complicated instruments that were written and tied to all that, probably trillions of dollars of this that went from -- a lot of them essentially from being level one for which there was -- you could get -- there was activity and there were pricing quotes all that.

People were using that to value it to all of the sudden the trading went way down. In some cases, it seemed almost inactive or if there was trading you didn't know who was involved because there were no clearing mechanisms, there wasn't a lot of transparency, and so you had to -- people had to figure out -- people who really, you know, were not ready for this.

Because the level three valuations previously had
largely been done on intangibles and some structured
long-dated type derivatives and the like for which there
wasn't -- that were tailored and that weren't traded
really.

But now you had these trillions of instruments
that had been traded, not -- no longer very active
trading, so that raised all the questions about well, is
this an order -- if we do get a price somewhere we can
find it. Is it an orderly transaction or was it a
distress sale? What's going -- who's involved? You
don't even know some of that.

Is the market sufficiently inactive now that we
should stop looking for quotes or actual transactions and
go more to a discounted cash flow type approach and try
and figure out how you would estimate those cash flows
and what interest rate you would take and the like.

And for some of these instruments because they
eranated from these very complicated asset-backed
securities trusts with all the waterfalls and all of
that, you really needed a lot of expertise to unravel
those.

And unlike for our corporate bond and equity
markets where we have put in periodic reporting to update things, there wasn't good current information on those things at all.

So, clearly, we were called upon to intervene there a number of times to provide kind of, you know, not only how-tos, but almost kind of safe harbors for it's okay in this circumstance to go to a discounted cash flow type valuation and here's kind of how you would do it and how you would pick the interest rate and things you would look for and all of that kind of thing.

So, from a standard setting point of view, one of my take-aways was that the wording counts and you've got to almost kind of think about unforeseen possibilities and the like.

I also think the definitions counted a lot in that, too. I think that there was a lot of stress in the system and you think about behavioral impact, so at the onset of the what was then called the credit crisis in late 2007, I remember the CAQ tried to put out a helpful white paper and it kind of dealt with this issue in Paragraph 30 that said yes, well, you just can't go automatically go to these management valuations.
There may be prices out there because the back end of the paragraph says you can't ignore information that's reasonably available and all that. Well, I remember I got lots of calls from CFOs, even CEOs, saying don't they understand how the market's not working now and all that and what is available and what isn't available and all of that.

But it was a very understandable behavioral reaction by the auditing profession who's put in that very difficult -- that difficult place in a difficult circumstance and the like.

And I think that was another kind of -- when I go beyond just whether it's the accounting literature or the auditing literature, if you think of the financial reporting system, it's like a supply chain. Lots of different people involved, the accounting standards, the auditing standards, obviously the companies, the audit committees, the investors and analysts and all that.

And you change something in one part of it and/or circumstances change, you get very interesting behavioral reactions and pressures on different parties in the system. Now, I think one of the hopefully good things
1 to come out of this from a systemic point of view is that
2 some of these things have been recognized, like the move
3 to provide better information, ongoing information about
4 asset-backed securities, to put more derivatives on
5 exchanges or through clearing mechanism may help with
6 some of this, but I don't think it's going to completely
7 take away those stresses and strains that occur either
8 in a crisis.
9
10 And just thinking about whenever there's a change
11 in circumstances within one leg of the reporting system,
12 whether it's change accounting standards or a new
13 auditing standard, that -- it kind of shifts kind of the
14 pressures and balances within the system.
15
16 Tom's going to talk about from the viewpoint of
17 some of the large firms some of the continuing challenges
18 and what they're doing around or have been doing around
19 that, and Jean's going to talk about from the small
20 auditing firms and their clients, the issuers, smaller
21 issuers, what some of the challenges are.
22
23 One point I'd make is that we talk about fair
24 value measures. Not all fair value measurements require
25 estimation. For level one, you know, quoted prices in
an active market, we accept the quoted price. It's a fairly mechanical exercise.

Even some level two things, even though, for example, there may not be heavy trading in any day in a municipal bond, I think for most municipal bonds the matrix pricing approach is fairly well established, could be back-tested, and the like.

Larry did a great job in his ten minutes of coming up with all the other types of estimates in inherent and in accrual accounting. I spent two minutes, got to the end of the page, and stopped there, but I think the point I was trying to make there is that they really do vary in nature and extent of estimation.

The period estimate of accrued liabilities, which are short-term types of things, how you do that is very different than how you do a level -- an ARO, for example. And I go back into standards -- accounting standards and when we set -- on AROs, there was a lot of tension on that. I said, gee, these are really long term and we don't know how or when we're going to fulfill this obligation.

It could be 200 years from now and there may be
1 different areas, methods, and the like, and in that
2 standard -- actually, in clarifying that standard in I
3 guess it was interpretation 47, we actually said you've
4 got a practicality exception if you can't really pinpoint
5 it with sufficient certainty.
6
7 You have to be able to kind of have a view of the
8 amounts and timing of how you're going to fulfill that
9 ARO.
10
11 Now let me take the other hat on here, the Audit
12 Committee perspective, and I'm on the audit committee of
13 two very major financial institutions -- Chair of the
14 audit committee of Morgan Stanley and I'm on the audit
15 committee of Fannie Mae, and we obviously -- fair value
16 and loan losses and all that kind of stuff are very, very
17 key to the whole financial statements and explaining our
18 financial position and our results.
19
20 And I would say both institutions prompted in
21 part by the regulators, we have put in what I regard as
22 pretty good governance processes and procedures and
23 detailed procedures of internal controls. We've got the
24 classic three lines of defense where somebody comes up
25 with the estimate.
There are separate groups to look at them carefully, to look at the models, to look at the assumptions, and then you have the internal auditors coming behind to look at that and what I look for over time is that less and less of the deficiencies are spotted by either the second or third line of defense, the separate valuation review group or by the internal auditors. You want to see the quality being built in at the front end.

The auditors, obviously, a key part of the planning exercise, and I think due to some of the PCAOB's recent changes, the discussion with audit committee members and planning the audits are now much more timely and I think much more detailed.

And these are the kind of things, what are you going to do around this? We talk about the changes in the environment, the changes in the business models, and the like and how are you going to respond to those kind of things.

I also like to get from the auditors each quarter if there are changes what were the big subjective things this quarter? Were there unusual changes or whatever?
I like to know all of that both from management and from the auditors. I like to know about -- somebody mentioned consistency. That is very important, and part of that, kind of that you didn't detect any overt management bias in the going about the valuations or the loan loss allowance or whatever complex and long-term estimate it might be.

It's important to understand that from a not only audit committee but a board perspective or a risk committee perspective, a lot of this also ties in with the basic -- the functions of risk management, the strategy, the operations of certainly a large financial institution.

Proper valuation, proper estimation are key to running the business. Absolutely. You can think about it in a risk management context and types of things, but understanding well, why are we having so much difficulty and challenge in this new thing and that?

What did we decide going in? What are the real challenges in it? We have, for example, at Fannie Mae under a mandate to systematically reduce what's called...
our retain portfolio of whole loans and asset mortgage-
backed securities.
And in order to decide what to sell when, we do a fair value based upon what we could get in the market at the time and we do what's called an intrinsic value, which is a management estimation of the cash flows discounted at a risk adjusted rate.
It's kind of a sell versus hold kind of decision, but it's being regularly done in order to figure out at what point should we make the sales and sometimes also in what form.
Are we going to just sell them outright or are we going to go into a securitization type thing where we transfer -- retain some of the risk but transfer some of it?
So, you've got to understand that, again, it's not only the audit committee. This is tied into good governance, both by management and by the board of directors.
Now, from the PCAOB's point of view, a lot of suggestions have been made. I'll give my own, but there's always the issue of the -- I'll call it the
1 Hippocratic oath of standard setting.
2 It's not exactly do no harm, but it's make sure
3 that you're going to do more good, a lot more good than
4 harm when you create new standards in that, and that
5 takes a lot of judgment.
6 But, you know, I see, for example, the old
7 standards at least in the fair value portion were written
8 before 157, 157 or 820, sorry, 820, introduced new
9 concepts in trying to come up with a single definition
10 of fair value.
11 Certainly, level two and three, not all level
12 two, as I said, but that's an issue. We've talked about
13 the use of pricing services. I'll have some thoughts
14 about that. Valuation specialists, as well.
15 On auditing other accounting, as I said, they
16 vary. Somebody said there's a lot of variety between
17 them and they're all over the place and is it all of them
18 or is it which ones, do you need different guidance for
19 different types? What's common guidance? What has to
20 be detailed specified guidance?
21 The disclosures as the investors said are very,
22 very important. They -- we constantly heard that the
disclosures are as important as the actual point measurements. And then, as I said, there are practicality exceptions. How do you decide whether that's a reasonable -- the company's taking a reasonable out there or not? Is there proper disclosure of it and the like.

I think there's other standard setting considerations which I mentioned before from my experience. When you get something as broad as this, you need clarity and scope and in definitions, and I kind of -- thinking about it, I came to a similar kind of conclusion as Kevin Reilly, that you probably -- you may want a broader standard with broader guidance, but then to specific situations, and I wouldn't provide detailed rules and things, but I've always found it helpful in standard setting is to take almost like mini case studies in an educational kind of way and go through them and here's kind of the things that we would expect of the auditor in those realistic situations.

Again, make sure you do consider the behavioral impacts of what you write. It's very difficult to do, but understand how people would react to specific wording.
and the like. I asked is ISA 540 a good starting point?
It may be. I think we heard from Arnold this morning
that it may need some refreshing and they're very eager
to understand what's going on here and the like.
And then finally, I think as a lot of this
discussion today pointed out that this is not just a
matter for improved auditing standards. It requires
broader continuous improvement. It may be some thinking
to of the box, too, and I realize that may be beyond the
sole purview of the PCAOB, but it's certainly within the
purview of the various groups within the financial
reporting system.
This is not a new issue. This tension between
increased usefulness, relevance, and the pressure it then
puts on the auditor, auditing standards, and the like.
Lots of solutions -- not solutions, ideas have been
forwarded over the years.
I remember back in the '90s, Commissioner Steve
Walman had his notion of the colorized financial
statements with different levels of information, which
in part would depend on degrees of measurement
uncertainty.
I recall about ten years ago -- I guess it was 11 years ago in November 2003 there was rather an eminent group convened by what was called the American Assembly of Columbia University, and I wasn't associated with Columbia at that point, but it was a group of -- there were, I think, four -- the current chair of the SEC, Bill Donaldson, was there. Bill McDonough and Charlie Neimeier was there. Ryan and Catherine Shipper were there, but there were senior people from the accounting firms, from the investor community, and the like, and it was really on the future of the accounting profession, and it was a wide-ranging discussion for three days. But we talked a lot about this whole issue of moving forward, the reporting to be more relevant but then how do you deal with that in education? How do you deal with it in auditing and auditing standards? And actually a number of us in the room were here. Not just me; I think Bob Guido was there. I think Jim Cox was there, and I think there was even a very eminent senior securities attorney from the firm of Baker and Botts, one Mr. James R. Doty, there that was part of
putting this whole report together.

It had a whole section on the need to change the auditing standards to kind of evolve into this new world we were kind of going in, and they basically at that point advocated that there would be different levels and types of attestation for different types of things in the financial statements, things that you could vouch directly, one, and things that required complex objective estimates that there would be other approaches.

They happened to advocate the approach of more the attestation around forecasting-type model. But that -- it was just, again, trying to think out of the box.

I do think as some have said that we have made some movement, both in the accounting and disclosure; probably not enough.

I know the standard setters are continuing to think about that, including other ways to present the information to give better ideas between what's kind of more hard and what's more subjective, long-term re-

And I do think, also, that the expanded order reporting, which other people have mentioned may provide
a vehicle for improving the communication around this
area and maybe reducing what some people refer to as
expectations gap. Thanks.

MR. OMBERG: Great. Thanks, Bob, and Marty,
thanks for organizing today. I think this has been a
great dialogue and a great conversation and I think that
as we got the opportunity to listen to those on the
panels that came before us, certainly a lot of good
things to consider.

As I got ready for today and thought about today
and worked with a number of my partners at Deloitte, we
really went back and looked and started with inspection
themes and inspection comments, and I know Helen provided
an update on that, but we sort of looked at what were the
themes as we thought about where we've been with
management estimates, but we also looked at the evolution
around how we've been thinking about management estimates
and what we've been doing around management estimates
over the last three to five years and just thinking about
the guidance.

And I know all of us on the audit side think
about guidance that we put out to our practitioners and
just looking at the guidance and the evolution of that
guidance around estimates and then I know there's been
a lot of focus here today around learning and just
looking at what we've been doing, not just about training
our internal specialists because we've been on a journey
and I think there have been some great comments that
certainly we'll take back around learning, but then what
we've been doing with our core audit professionals, as
well, just in the area of learning and trying to raise
the awareness and trying to increase the tools that we
provide to our professionals and also looking at
resources.

I think there's been a lot of dialogue here today
about resources, and I'll spend some time later talking
about the resources that we have and that we're trying
to deploy against estimates and against trying to make
sure that we're continually raising our game as it
relates to management estimates.

Helen had mentioned just sort of the inspection
themes and the inspection comments and clearly they would
reflect if there's challenges around auditing managing
estimates, and while we may have seen some improvement
1 recently, there's still areas for improvement. We've
2 still got a lot of things that we can look at and a lot
3 of things that we can do better at.
4 I think when we look at sort of where we are from
5 our perspective around this, there's a couple of themes
6 that come out. How we audit and how we use information
7 that comes from management specialists. That's an area
8 that I'll talk about because I think that's an area where
9 there are some things that we could probably improve
10 around how we use the information that comes from
11 management specialists.
12 And then how do we look at and how do we audit
13 and how do we document data and models, and I know
14 there's been some dialogue here around data and models
15 and the controls around the data that go into those
16 models. So, we'll spend some time talking about that.
17 It might be helpful just to spend a little bit of
18 time -- I know Matt provided some perspective around a
19 pricing service, so as we went back and sort of looked
20 at the evolution around how we think about fair value and
21 auditing fair value, clearly back right after the credit
22 crisis we stepped back and we looked at fair value and
we looked at how we were approaching the audits of fair value and I think the consultation paper makes reference of centralized valuation methods that some firms might use.

I know a number of the firms do that. We do that. We began centralizing all of our valuation resources and all of our valuation professionals with a view that the issues were too big. The resource pools were somewhat limited and so from a deployment, from a training, learning, development, and monitoring point of view, we did go to a centralized process for that.

And we also started looking at how we were using pricing services or vendors, and were we using those vendors in the right way, were we doing the things that we needed to do around due diligence to get comfortable with those vendors, and as Matt alluded, a number of the firms now do a fair amount of due diligence.

We do a lot of due diligence on a handful of vendors. We look at five vendors. We do onsite due diligence annually where we send in teams of audit and accounting professionals as well as our internal specialists around fair value to really do a deep dive
and to understand how the pricing services go about pricing, what information do they use, what quality control do they have.

And as a result of that, we've decided that for the five vendors that we look at, some of the asset classes that they provide pricing information on would be reliable. Now we make that determination based on what we find in the due diligence that we do, and as I said, we do that annually; we update it quarterly.

And in addition to that, we also do some fairly extensive walk-through where we price securities, we compare our pricing to the vendor's pricing, but we also understand is the method we're using independently consistent with the method that they've described to us that they use.

And just to sort of level set, I know Matt mentioned that there's 2.7 million or so CUSIPs that they price on a daily basis. When we look at the asset classes that we think were reliable from an audit perspective, and that's not to say that the other information is not reliable; we've just held a pretty high threshold around what we can rely on from the
pricing services, they tend to be asset classes like U.S. treasuries, asset classes like U.S. investment grade, corporate bonds, and municipal bonds, U.S. agencies, so Freddie, Fannie, Jennie notes that they issue off their own balance sheet as well as some of the MBSs that are guaranteed by those agencies but not all of them.

So, it's a fairly limited population. We wouldn't look at, for example, private label mortgage-backed securities or private label asset-backed securities. Again, it's not that we're not comfortable with the work that's being done at the pricing services, we just think there's too much variability within those asset classes and in some cases too much subjectivity and too much judgment.

I think Matt mentioned that they'll make a lot of information available to people who ask for it but perhaps they wouldn't make the code available. If we had to ask for the code, we probably wouldn't look at that asset class as being one that we could rely on from an audit point of view.

We're looking for transparency. We're looking for homogenous. We're looking for things that while they
may use models to value them, the models are relatively
standard market models that anyone could reasonably back
test on their own or reasonably reproduce on their own.

And so we do that, as I said, for five vendors.

We provide to engagement teams fairly extensive due
diligence memos that include the interviews that we've
had and the onsite meetings that we've had with the
vendors, as well as the work that we've done.

So, we provide the back testing that was done on
the securities, but then we also have realized that we've
got to connect that to the actual engagement. So, an
engagement team would then be required to actually not
just rely on the vendor but make sure that we're doing
some testing at the engagement level.

So we're looking at some of the securities that
are within those asset classes that are covered and we're
actually pricing those as well to do another level of
validation. So, we do a, for lack of a better word, a
macro due diligence but then we actually test at the
engagement level as well to ensure again that at that
engagement level the work that we've done in providing --
and due diligence with the vendor this corroborated all
the way down to the engagement level.

So we do a fair amount of work, and candidly, I think when we started the process we probably thought we would cover more asset classes at the vendors than we ended up covering. And so I do think that the process for us has really been good from an overall audit quality perspective and enhancing our understanding of actually what's happening at the vendors.

And again, it's not to say that the asset classes that we don't cover are not done in a high quality way by the pricing services. We still use that information to look for disconfirming information, so if a pricing service provided a price on something that we didn't think was reliable, we might still look at that just to make sure is there other information out there that we don't have that would either help us in confirming where the client's price is or disconfirm.

But if we were using it for confirming, we'd still have to do more information. We couldn't just rely on the vendor.

And so, I think there's other challenges that we have around management estimates and fair value. I think
use of third parties I talked about and we'll go into that in a little more detail, but the data in the models, and I think it's been talked about a lot here today, is just looking at illiquid, hard to value instruments, understanding and documenting, how do you get comfortable with an illiquid, hard to value?

And if we're using models, if we're using data, where is the data coming from, where are the models coming from, and how are we getting comfortable with that? I think when we can see the process from beginning to end, when we can develop our own assumptions, when we can use our own model, and we can see the output that comes from that, we generally feel pretty comfortable.

When there's a breakdown in one of those is where we generally run into challenges, and we see that a lot with specialists where we may see the input, we may see the output, but we won't necessarily see what happens in the middle.

And so when we don't have the model, and I do think this is something, Marty, that would be good to explore, is that when management is using a specialist, I think the consultation paper makes reference to the
1 auditor looking at that as if management had performed
2 the work.
3 And I think the challenge that we frequently see
4 is it's very hard for us to do that because it requires
5 us to actually have the model and to be able to go back
6 through the model and understand how the inputs get to
7 the output.
8 And so I do think that's a challenge that we see
9 frequently as auditors is that we don't necessarily see
10 what happens inside the black box, and many specialists
11 are not always willing to share that for proprietary
12 reasons.
13 The models can be very, very complicated, and are
14 not things that you can generally just push across in an
15 email, and so that is an area that I think we do need to
16 explore is just how do auditors get comfortable with the
17 work of a specialist because it's not always possible for
18 the auditor to go through as if management had done it.
19 And I think it's also useful to continue to
20 highlight what's management's responsibility, especially
21 when they're using a specialist around getting
22 comfortable with the work of the specialist.
They can obviously evaluate the specialist, get comfortable with the reputation, get comfortable with their qualifications and their credentials, but there still is the black box in the middle.

Specialists are usually willing to provide you with the assumptions that they use. They're always willing to provide the output, but it's what happens in the black box that becomes a bit of a challenge, and so management's got a responsibility to understand that and evaluate it, put their controls around it, and we obviously have that same responsibility, but it is a bit of a challenge because we don't always see what happens in the middle.

I mentioned resources, and I do think it's worth noting, and I know Jean's going to highlight on this as well, but we have a significant level of resources that we've committed to estimates. And if you just look at fair value estimates for a minute, we've probably got 500 professionals. They're not FTEs, but they're 500 professionals when in the firm they'd focus on valuation.

And so people have highlighted some very good points around how do you develop those resources, how do
you train those resources, how do you take somebody who
is a deep mathematician with a trading background and
help train them in auditing and accounting in addition
to the deep expertise that they bring to the table.

And so, we're not constrained because we're not
willing to invest. We're always willing to invest and
bring more specialists onboard. The constraint is just
around how do we integrate them, how do we make sure that
we give them the right training and the right
development.

We've got a fair amount of supervision and
review, but it's the training and the development of the
specialists and then making sure that we can connect
them. I think when you look at the background of many
of these specialists, I mean, many of them have advanced
math degrees. Many of them are Ph.D.s. Many of them
have prior experience as traders, as risk managers, as
regulators.

So, they're very, very knowledgeable about the
markets, but as has been the point that's been made many
times is they're not necessarily connected to accounting
and to auditing, so that's a challenge that we continue
1 to deal with.
2 There's also a significant infrastructure that needs to be put in place for specialists, in particular, for fair value. If you look at the investments that we make in data and the investments that we make in models and that's a continuous.

We've got to constantly be out getting data from Matt and from his competitors as well as other data that we use, but in addition, there's an extensive library of models that we -- some we build on our own, some we license and acquire from others -- that we've got to constantly be evaluating to make sure that those models are up-to-date and that the data that we're using for those models is reflective of the current market.

The only other thing before I pass it off to Jean just to mention is the distinction between a specialist and a data provider, and I think one of the things -- I know the paper talks a little bit about it -- one of the things that we look at and sometimes struggle with is can we do a better job of delineating a specialist versus an information provider.

And I think clearly we look at specialists and we
think of somebody who can provide information or can provide an estimate about a unique asset or a unique liability, and for example, somebody who's engaged to do evaluation of a mortgage servicing right, which requires deep understanding of mortgages, deep understanding of the models that you would have to do to value that.

That clearly would be a specialist versus a data provider, and I think we would look at IDC as a data provider. They're useful, they provide a lot of information, it's a service that is somewhat open providing you're willing to subscribe to it and pay for it.

They tend to provide data on assets that are fairly transparent and not necessarily unique. So we do think from an audit perspective it would be helpful if we could differentiate between the two, and then what are the responsibilities of an auditor when you're looking at a specialist versus when you're looking at a data provider.

So, with that, I think I'll pass it over to Jean, and she can provide some comments.

MR. BAUMANN: Before you do, I'll ask a question.
1 If there's some other cards that we'll see, as well.
2 But, Tom, you touched on a lot of really very important
3 topics that we set forth in the Consultation Paper, and
4 I'm glad you took them head on in your comments.
5 Certainly, we'd be very interested in comment
6 letters from you and from others that deal with the
7 question about the centralized approach, and as you said,
8 the macro due diligence that you did at five pricing
9 services, and then, how you communicate that to the
10 engagement teams, what the details and the levels of that
11 communication.
12 And then, I'm also glad to hear that that's
13 supplemented by additional testing at the engagement
14 level, and how you think that should be articulated in
15 your own guidance, maybe, but how it could be articulated
16 in an auditing standard, as well.
17 And then, at least, to the next major point that
18 I, you touched on a number of major points, but it's
19 clear that from earlier comments from the academics and
20 others that auditors tend to test management's process,
21 most of the time, to fall to that.
22 And you're right, we laid out in the Consultation
Paper that if management was relying on a specialist, that if the auditor was testing management's process, one possibility would be that the auditor would have to test that data from the specialist, as if it was prepared by management.

And now you've indicated, of course, that some of that data that was proprietary, and therefore that would present challenges. So I guess the question is then, you know, how could the auditor really test management's process, if part of that process is kind of hidden from the auditor, because it's proprietary?

And I recall a speech given about, going through management's responsibilities, Brian Croteau may recall the speech, also, about three years ago, from the SEC staff at the annual AICPA SEC PCAOB Conference that management certainly had a responsibility for their books and records responsibilities, to understand what management specialists did and couldn't just rely on that.

So to the extent they were using that as part of their process, they needed to understand the key aspects about that process, so they could take responsibility for
books and records, otherwise, I don't want to state incorrectly, Brian, but I think, one of your staff was pointing out they might have some issues, with respect to internal control over financial reporting, if management didn't understand that.

So we laid out this issue in the Paper. Very glad you brought it up. We'd love to get comments about if management is using a specialist, as part of their process, but yet, some of that information isn't transparent to either management, or the auditor, what should the audit procedures be then, in that regard? So very important factors for us to hear more about.

MR. CROTEAU: Just, credit where credit's due, it was Jason Plourde's speech, who worked in our office at the time. Certainly, I associate myself with his remarks and we continue to think that the remarks made are grounded in existing rules. So it was really just laying out management's responsibilities, as they existed and still exist today.

MR. BAUMANN: Jean.

MS. JOY: Thank you. And I'd also like to thank the PCAOB for the opportunity to participate today,
1 because the conversations have certainly been enlightening and clarify that this is not an easy issue to deal with.

4 For those of you that are not familiar with Wolf, I thought it might be helpful just to put it in perspective the size firm that we are. We have about 210 employees, 18 partners, and we have 20 to 25 issuer clients that we deal with, you know, depending on the year that we may be looking at.

10 And we're a full service firm. We have a niche that focuses on community banking, and we also deal with investment advisors, broker-dealers, and several other industries, as well. But the financial niche, I think, is important to this particular topic that we're speaking of today.

16 And I thought that I would focus on, really, three major categories. One dealing with what are those estimates and fair values that are common to the smaller issuers? I'll speak a bit about risk assessment and judgment, which is really the foundation for the auditor's response. And then talk a bit about the resource challenges and how that relates to specialists.
and third party pricing services with smaller issuers and their auditors.

As we know, accounting estimates and fair value measurements are certainly not unique to larger institutions. And I, as well, have a list here, but I will save you the trouble of going through that list.

However, I just wanted to focus on the fact that there are certain estimates that are requiring a lot of attention today, for different reasons. Business combinations continue to be a significant focus for us. Activity is increasing as the economy recovers. And there are business expansion opportunities and pervasive reasons, on both the buy and sell side, to effect a business combination today.

We're dealing with investment portfolios that have both Level 1 and Level 2 investments in them, which we believe, and in our practices, may be much more readily available in terms of fair values and pricing.

We also deal with Level 3 securities and alternative investments in assessing the challenges related to fair values.

In terms of other estimates, pension and post-
1 retirement obligations, stock-based compensation are very
2 prevalent in the smaller issuers, companies of all sizes. 
3 And with regard to asset impairment issues, 
4 because of our community banking clientele, we deal very 
5 often with allowances for loan losses and the resultant 
6 challenges that that estimate provides, as well as 
7 goodwill impairment issues. 
8 We thought about the support for, you know, 
9 should there be a single standard that is addressing the 
10 estimates and fair value measurements? And, you know, 
11 I think the conclusions are mixed. 
12 We would be in favor, on one hand, of combining 
13 into a standard, as long as that standard could be 
14 principles-based. And I think that's the challenge that 
15 we were hearing today. And the comments that I heard 
16 today, as well, were actually changing my focus a bit. 
17 We do think that the standard needs to tie in closely to 
18 the risk assessment standards. And if it is to be 
19 principles-based, right now we have the standards that 
20 continue to have lists, lists of prescribed procedures. 
21 And is that really heading in the right direction? 
22 We heard this morning about critical thinking and
whether or not something like that is really enhancing the ability for critical thinking, and where that needs to move might be more of a challenge. So I think being very careful as to how these issues are compartmentalized without a broad brush, but staying risk-based focused, I think, is really helpful, and principles-based focused.

In terms of risk assessment, AS 12 provides guidance for the auditor's assessment of the risk of material misstatement, as we know. The concepts in AS 12 are well-defined. And the key to the auditor's audit plan is really a well-founded risk assessment that's grounded in the standard. And that requires that the quantitative and qualitative considerations be appropriately addressed.

To the extent that we can do that, and adequately document that, that forms the basis for the entire audit response. There is less questioning, in terms of what is the risk assessment, if we have grounded it in the standard and appropriately documented that risk assessment.

In terms of the appropriate audit response, and once we have done, hopefully, an appropriate risk
1 assessment, we deal with all three of the approaches
2 here. Testing management's process. It's often used for
3 estimates other than fair value. I think you'll find in
4 the smaller entities that fair value determinations are
5 typically not done with a management process, although
6 they may outsource that, or engage a specialist to do so.
7 But the estimates, typically, such as an allowance for
8 loan losses, would be based on management's process.
9
10 I think we also see, when we look at developing
11 an independent estimate, that there could be elements in
12 testing management's process that relate to somewhat of
13 an independent estimate, if you're actually looking at
14 independently assessing certain of the assumptions. And
15 you may independently estimate what you think certain
16 inputs should be, not necessarily the whole process. So
17 we also see some overlap there.
18
19 Developing an independent estimate is less
20 utilized for the smaller issuers and it's generally not
21 necessary for the non-complex estimates. That's where
22 I was indicating that if there was a complex estimate,
23 management would normally be engaging the specialists in
24 that regard.
In terms of reviewing subsequent events or transactions, life would be so much simpler if we had more ability to do that. But very few estimates are actually resolved within the period subsequent to the audit date and prior to the audit release.

So as much as that could be helpful, it generally is not available. And then, if it is available, in terms of a fair value situation, as we've heard today, you have many issues relating to, what are the elements that change the fair value between the report A and the subsequent event A that provide typical challenges?

We've also noted here regulatory influences. And looking at that mainly in terms of recognizing the impact that that may have on a couple of things. One is in the risk assessment. Because if you're working in a highly regulated industry, risk assessment really should at least identify what the regulatory influences may be in assessing that risk. Whether they're subject to examination, or review, or testing, should all be part of the risk assessment.

And also in relation to management's bias that relates to an estimate, because there may be regulatory
requirements that management has an expected bias for, and an auditor has to at least understand what those influences may be.

Also, in considering the internal control environment, any regulatory influences on the internal control environment are important to understand, either from a monitoring perspective, or tone at the top.

Resources challenges. I'm envious of Tom's 500 or so valuation professionals that he has access to, or the firm has access to. But, obviously, that's not the case with the smaller entities. We, as a firm, do not have any internal valuation specialists.

So when we look at the limited model design expertise that is within our client base, and some limitations on that in terms of, certainly, our own internal capabilities, that really results in the greater use of specialists and third-party pricing sources.

When we think about specialists, the auditing standard for the work of a specialist we think is fundamental to the audit process, and is really required, particularly when you're looking at smaller entities and possibly smaller firms.
Because what we heard today is the complexity is so different today than maybe it was in years past, but that specialist becomes even that much more significant. To test any of the assumptions in data to the level that we would be testing management's assessment, as Tom indicated, would provide significant challenges, because of the availability of the information and what we can see and not see, and frankly, what level of expertise we would have, or the client would have, to question some of the detailed assumptions, which is the purpose for engaging the specialists. So we do see challenges there. I like what I heard today about raising the bar, in terms of what other credentials that specialists require and how we might make that more consistent and assessable to the auditors and in their evaluation.

Third-party pricing. Many clients, most clients use third-party pricing services. Sometimes there's a limited number of those pricing services that are available, particularly, if you look at the cost benefit. So I think, based on what we've heard today, if there is a way that we could test to the same source with reliability, that would always be very helpful to the
smaller issuers and their auditors. But providing a means to determining the reliability of that third-party service provider, and relating that very specifically to the risk assessment, these investments that are just not difficult to price, combining that would be very helpful in terms of executing the audit.

We've indicated here that specialists are typically engaged by the issuer. So knowledge of what constitutes reasonable assumptions also is a challenge for the client. Tom commented on that, as well.

And we've acknowledged here that there will be continued emphasis on education, and there should be. The client and the auditors have a responsibility to at least gather sufficient technical expertise to be able to deal with the industry, or the estimates, or to sufficiently challenge the inputs and estimates that we're dealing with.

And we think that this will continue to be more complex going forward. It will present challenges, so the timing of this topic is very timely, and these issues will continue to challenge the smaller issuers and their auditors, particularly in relation to complex GAAP and
We talked about the allowance for loan losses and the expected credit loss model, revenue recognition. It will not be any easier going forward, so we appreciate the dialog today. Thank you.

MR. BAUMANN: And we appreciate your comments. And I do have some follow-up, but I do see a number of cards up first. So, Jeff Mahoney.

MR. MAHONEY: Thank you. Tom and Jean, you both talked about the use of specialists. I could say the PCAOB has a separate agenda project now on specialists. So just a couple of basic questions. One, how commonly are specialists being used with respect to significant estimates, including fair value measurements?

Second, what's the percentage of internal versus external specialists that are used? And then, third, if you were to make one change to the existing auditing standards with respect to the management and the evaluation of specialists, what would it be?

MR. OMBERG: I mean, I would say a couple of things. I mean, specialists, we don't see them every day, but I would say, over the course of the year, you
1 know, we have a fairly significant number of clients who
2 use specialists. And they could be, you know,
3 specialists to value a, you know, particular asset or a
4 liability, you know, that they have. But it's not
5 something that I would say is pervasive, but I think it's
6 something that when we see it, becomes an area that
7 consumes potentially a fair amount of time.
8 So if we could change something, I mean, you
9 know, I think I would say this, you know, I said in my
10 comments, having the auditor look at it as if management,
11 you know, prepared it is a challenge. I mean, I think,
12 frankly, the best thing for us to do is actually to have
13 a more meaningful conversation, bring preparers to the
14 table, bring some specialists to the table, and have a
15 more meaningful dialogue around, how is it that an
16 auditor can get comfortable with a, you know, with a
17 specialist? And I think management probably needs to
18 have more responsibility and more ownership around a
19 specialist. I think maybe specialists need to be a
20 little more forthcoming.
21 I can appreciate the competitive issues and some
22 of the challenges they have around providing things that
they think are proprietary. But I don't think it's something that we're going to solve just with auditors, I do think we're going to need specialists and preparers to the table to have a conversation.

MS. JOY: And I would say that we see specialists being used particularly with pension and other post-retirement obligations that might require some type of actuarial considerations. And assets and liabilities acquired in a business combination, very often, particularly with a financial institution, specialists are being engaged to value intangibles, to value loan portfolios, to value some contingencies.

We see real estate appraisals, and Level 3 investments is generally where we would also see specialists in the investment portfolio. And, I think, up until I said Level 3 investments, we can get reasonably comfortable with the work of the specialists and the qualifications of the specialists.

What's probably most troubling these days is that you can talk to different valuation specialists regarding Level 3 investments, and you can have a wide variety. So where that bar is, in terms of assessing the
qualifications of the specialists, many of these specialists are very well-qualified, but they still have different views as to what fair value is. And that presents issues for auditors, as well as clients, in terms of trying to reconcile what is the value that will be reflected in the financial statements.

MR. BAUMANN: Bob.

MR. HERZ: At least my experience is that the large financial institutions, for the ongoing operations involving financial instruments, more and more of it's in-house, you know, with highly specialized people, both at the initial valuation and the second line, so to speak, the separate valuation review function, as well.

So I think where you see it more, as people said, is actuarial valuations, insurance reserves and business combinations and impairment, you know, the annual impairment reviews.

And, you know, I kind of, you know, again, thinking out of the box, I kind of like what Tom Omberg said. Because part of the problem now is, as I see it, you know, is when the valuation folks come in, and there are varying levels of professionalism and work that they
1 do, but it's not always clear exactly how much they did
to obtain comfort with management's, you know, tying them
to the factual information, or maybe the projected
factual information, so to speak.

And I could see Tom's model, or some variation of
it almost where, you know, somebody would be willing, and
it might be the large accounting firms, over time, to
say, you know, we're ready to become, you know,
independent, certified financial statement valuers, where
you do not only the valuation, but you also do the
auditing, so to speak, or get enough comfort on the --
and not complete reliance by the audit team, but, you
know, more reliance than now where they're just kind of,
I don't know, so it's kind of a grey zone.

And sometimes, my perception, having been in a
client side, you know, it's a little bit of a war zone.
And that's very disquieting to, you know, when you're
sitting there and they're kind of, you know, there
doesn't seem to be any coordination, or the things are
not aligned properly. And I can see that happening.
And, you know, you think a regulatory point of
view, I mean, the UK hasn't quite gotten that far. But
1 if you remember, the FRC, as I remember, took over
2 oversight of the actuarial profession a few years ago,
3 as well, realizing how important those were to pensions,
4 insurance reserves, and the like.
5 So I think this kind of holistic system kind of
6 thinking about how do we really -- you know, the real
7 objective is to get more useful, more trustworthy
8 reporting in the hands of investors, you know, that's the
9 real objective.
10 MR. BAUMANN: Just one follow-up to Jeff's
11 question, if I may? Tom, I guess, in your firm, you
12 basically have specialists assigned -- you employ
13 specialists more than engage them, I think that was part
14 of his question, how you talked about management's
15 specialists. But with respect to your own, when you use
16 a specialist for your work, they're probably employed
17 rather than somebody you engage, is that fair?
18 MR. OMBERG: Yeah, I think they're all employees,
19 and we view them to be a part of the engagement, right.
20 So we do the, you know, training with them where we would
21 view them to be a part of the engagement team. If
22 they're being asked to do valuation work, or something
else, they're doing it as part of the engagement team.

MR. BAUMANN: Right. And at smaller firms, Jean, probably more engaging specialists to review the work of management specialists, is that fair?

MS. JOY: I would say, more often than not, management is engaging the specialists. And that is often determined up-front with the risk assessment and planning process. And occasionally we will engage our own, but more often, management.

MR. BAUMANN: Steve Harris.

MR. HARRIS: Jean and Bob, you both refer to Level 3, and you kind of danced around it, in terms of valuing it. And, Bob, you talked about trustworthy reporting in the hands of investors.

If you can't value it, why don't you just say so? I mean, why are we going through this effort of valuing something which nobody can value, other than in a hugely significant range?

And if it is a hugely significant range, where should that be noted for the investor? Should it be in the audit report, should it be otherwise? How do you approach that?
We talked about Level 1, we talked about Level 2, we talked about the valuation, the difficulty of it. But when it gets to Level 3, I haven't heard anybody here say that that can be valued, how it should be valued, or, if it can't be valued, where should that be noted? Should it be noted in a footnote, should it be noted in the report, how do you go about solving that?

MR. HERZ: Well, I think that, you know, some of that's already kind of been dealt with, but probably not systematically and comprehensively enough.

I mean, first, and again, as I said, with the accounting standard setting, you know, there was a lot of discussion as to whether or not we should, you know, whether Level 3 fair values were the right information to provide.

And, remember, 157 doesn't tell you where to use fair value. That's another decision, project-by-project, on specific topics that the accounting standard setters then decide that. But they say, if they make the decision that it should be used, then look to Section 820, now 157, there.

I mean, I think the thinking has been, and guided
by a lot of input from investors, is that directionally correct information is more useful than precise but irrelevant, non-useful information. And, you know, you could debate that, but it causes a lot of discomfort in the system.

You know, the work of the American Assembly, it's an interesting report, if you go back to it, it suggested that, you know, we actually, in the financials, acknowledge that. And not just for Level 3, but there's a lot of other estimates that have ranges. We saw them on the academic screens there, you know, that were beyond materiality. It just wasn't Level 3 fair values, it was a lot of other estimates that involved long-term projections of the future.

That the financials, you know, be reformatted, even for those things that have ranges. Now, whether that's societally and from a systemic point of view acceptable in a world that likes earnings per share, single number, likes all those kinds of things, is a broader question. But that would be one presentation alternative it the financial statements.

The accounting standard setters have been
thinking about a presentation that shows what are called "re-measurements" in a separate column and the like. But then you get to the auditing. And what kind of auditing assurance can and should the auditor provide? Is it, you know, do we be much more explicit about what that is and what can be provided, and it be explicitly recognized that there are different forms and levels of assurance for different forms, you know, of things in the financial statements?

And we introduce complexity into the model, but it's probably a more representationally faithful depiction of actually what is going on and can be achieved.

MR. BAUMANN: Bob, I don't question the fact that it's good financial reporting. It's better to have relevant information, even if it's somewhere down on the reliability tract for purposes of investors.

But that's different than the auditing. And if the auditors are saying, at the end of the day I have to rely on some specialist, management specialist who has a black box that I really can't get into, then I think the question being posed there is, should be audit report
1 say, we did an audit of the financial statements, except
2 with respect to X Y Z aspects, we relied on somebody
3 else, and the report reflect that we relied on another
4 party and we can't take responsibility for that?
5        MR. HERZ:  Well, that's a possibility. In the
6 old days, in auditing, like in venture capital funds,
7 that's kind of what we did.
8        MR. BAUMANN:  Did you want to make a comment,
9 Larry?
10        MR. SMITH:  I was just going to add that -- and
11 this doesn't relate to the audit, but the accounting --
12 you know, 157, or 820, as Bob said, also requires not
13 only disclosure of the amount that's valued at Level 3,
14 but also what the significant inputs are, so that the
15 investor can see what the significant inputs are.
16        Now, the real question on the table that Marty
17 teed up previously was, well, should there also be some
18 disclosure of the degree of uncertainty that's embedded
19 in that Level 3 measurement? And that's a different
20 issue and it's an issue that people might raise to the
21 FASB.
22        MR. BAUMANN:  Well, we have a lot of cards up,
and we have a 4:45 break time, and we still have to hear from Barbara. So Barbara's summary may be very brief, because we've probably summarized greatly. But I have Professor Cox, Sridhar Ramamoorti, and Bruce Webb as the first three.

MR. COX: So, Bob's two minute list and then, Larry's ten minute list, just reminds us that one of the exciting parts of accounting is it's just riddled with account, you know, assumptions and judgments and estimates. It's always been the auditor's role to kind of be the referee of that process against the rule book. And my take on it is that fair value accounting has made just a quantum change, I mean, a big change in scale, and that's why we're talking about it now.

And I think that intuition was supported by what we heard in the first panel today, that the category where we're finding the most problems in the inspections are areas of making these valuation judgments. And I want to associate myself with what Kevin said earlier and that is that, if you work on a standard that's going to be really big, it's going to be an
1 aircraft carrier. And we all remember what happened to
2 the aircraft carrier release at the SEC sometime ago, it
3 never gets launched, and in fact, it started listing
4 before it even got near the water.
5
6 And at the same time, I don't think you don't
7 want to have a flotilla of the canoes, because they're
8 inherently unstable, to continue the metaphor.
9
10 So I think the way out of this process goes to
11 something that Bob just got through saying, and that we
12 have to make, at least when it comes to fair value
13 accounting, we have to make some judgment and some
14 decision about what is the role of the auditor in this
15 entire process. That's going to be our North Star here,
16 and with a North Star, I think it'll lead us.
17
18 And so I think we're always going to be
19 interested in problems of measurement. I mean, that's
20 what accounting statements are supposed to do, and that's
21 an inherent process. But I think we don't want to just
22 get tied up in looking at the measurements, because I
23 think that's going to lead us down the wrong path.
24
25 I believe that what you want to do, measurements
26 are important, but there has to be the forest that
everybody keeps an eye on, and that is what Tom was saying earlier, that there were questions about whether these measurements biases are bias. That is, are they systematic? And that should make the alarm bells going off.

And in that process of evaluating the measurements -- it's a process, the governance process that was mentioned earlier -- I also believe that it's important in that process that this is not what we learn about in corporate law and law schools, about the business judgment rule, where you can have some screwy school of thought that will support what management is actually doing, even though their counter-weighting and compelling reasons are the other directions. That to look at to see whether these statements are providing a fair statement of the economic position and performance of the firm, there needs to be much more than just a razor-thin basis for thinking what the valuation model is.

And the role of this North Star that I'm supporting here would be that there has to be not only a governance standard, but it's got to be a well-accepted
method of valuation and the metrics have to support that. And then just a final point I'll point out is that when you read the cases that have been coming out of the 2008 crisis, whether those cases survived a motion for summary judgment, or didn't survive a motion for summary judgment on the plaintiff's side, overall the standards that were being used were not really good governance standards.

So I think the North Star that we'd be looking for as we move forward is more going to be process-oriented, it's going to require a lot of evaluation and judgment on the part of the auditors about whether there's methods for determining the fair value of these assets.

MR. BAUMANN: Thanks, Jim. Brian.

MR. CROTEAU: Thanks. I just wanted to -- I'm just following-up on the discussion of whether something can be valued, and Larry will keep me honest if I get off track here.

But, you know, I think there's a difference in the discussion of what was being discussed and what Bob said what might be possible, relative to a scope...
1 limitation. And then we might get into questions as to
2 whether that satisfies an issuer's filing obligations.
3 But I don't think, what I was hearing today
4 before, that was a suggestion that things can't be
5 valued. If there's a black box issue, we should be
6 talking about that and dealing with that.
7 But, today, I'm not so sure management, at least,
8 of public companies, can satisfy their filing obligations
9 with a scope exception of that nature. So I just wanted
10 to be sure that that wasn't left unsaid.
11 MR. BAUMANN: Sri and Bruce Webb and then Rick
12 Murray.
13 MR. RAMAMOORTI: You know, in a conversation
14 around financial reporting involving complex valuations
15 in foreign jurisdictions, I recall reading that, for a
16 small country, or relatively small country like, let's
17 say, Sri Lanka, there might be just one specialist in
18 that marketplace. That's it, just one.
19 And so while there may be no questions about the
20 competence of that specialist, I think certainly
21 questions about, you know, that specialist's independence
22 come up, particularly if they might be on, potentially,
1 both sides of a transaction.
2 And so I'm thinking, after hearing Jean's
3 comments, that for small issuers and small auditing
4 firms, this could also be a problem, in terms of the
5 large specialist firms perhaps being unaffordable, so
6 they have to go to, maybe, a smaller specialist firm.
7 And there aren't too many of them, and so you're stuck
8 with, pretty much, you know, just one firm. So, I don't
9 know, does that raise questions about, you know, what's
10 the quality of these, you know, estimates and pricing
11 information that you're getting?
12 
13 MR. BAUMANN: Bruce.
14 
15 MR. WEBB: I just wanted to respond a little bit
16 to Jeff Mahoney's observation and question. The
17 observation was that the PCAOB also had a project on the
18 use of specialist. And the question was, how often are
19 they used, internally and externally, and if one change
20 would be made in that area, what would it be?
21 And, I guess, I think specialists are used very
22 frequently, both by issuers and by auditors. And
23 whenever you're dealing with a fair value measurement,
24 whether that be a financial instrument, or a tangible,
intangible asset.

And I think the larger issuers tend to have internal specialists, the smaller issuers tend to engage external specialists, similarly with the firms. And in the case of our firm, we're sort of a middle market firm and I would say we're almost exclusively internal specialists for supporting our audit teams, although we do reach outside, occasionally. And, Jean, on the other hand, whenever they need that kind of help they would go outside. So I think you're going to find it sort of runs the gamut, and it depends, to a larger extent, on the size of the issuer and the size of the audit firm.

In terms of the one change that maybe should be considered is the Auditing Standards Board has separated the requirements when using a specialist as an auditor specialist from how you audit it when it's management specialist. And I believe the ISB has done so, as well. With that in mind, although the projects aren't -- I don't know if you would combine the projects. My sense is that use of a specialist is so intertwined with accounting estimates that I would very much like to see
those two projects at least be on a parallel path.

MR. BAUMANN: Good. Thanks. And it's consistent with the view of our Board, who recently asked for us to put a Staff Consultation Paper out with respect to specialists and it's on our recent standard setting agenda.

Rick Murray, and then I'm really going to, just given time, try to turn it over to Barbara to kind of wrap up the events here. Rick.

MR. MURRAY: Thank you, Marty. I'll try to clear the decks for Barbara quickly. First, my thanks to the staff and the Board for a day that I think has developed a lot of extremely erudite thought and valuable movement.

My perspective, from a 40-year view, is that despite the enormous growth in the size and the speed of the measurement devil, we're no further behind now than we were in the '70s. And I kind of find that encouraging.

It seems to me, Marty, that we started the day with a centralizing set of themes. One was that the valuation issues are homogenized, the values and estimates are broadly in the same category of activity
1 and can be looked at in a spotlight.

Second, that it was a problem because the frequency and severity with which outcomes differed from booked values was unfair to the investor community.

Next, that the reason for that was primarily, or at least significantly influenced by insufficient audit attention observed through the inspection processes, warranting at least a significant response in the form of new and more prescriptive regulatory initiatives to address that issue.

By noon, it seems to me, we had pretty well developed a premise that there is no silver bullet. By now, I think it's clear, there is no silver target and we've got a crowd of problems and they influence and need attention by virtually every component of the financial reporting process.

And that some of the things that weren't fully on the table at the outset, I think, have been valuable, that the basic problem is valuation problem. That the first recourse to deal with it is probably at the issuer level. And I'm sharing here my view, rather than trying to summarize.
And that the end of the day, there will be some degree of unfair difficulty for the investment community because it is the disorderly reality we live in today.

With that, I strongly encourage proceeding with a regulatory initiative by the PCAOB, because there is clearly a lot that can be done with that. But that is a step, not a solution.

MR. BAUMANN: Agreed. And thanks for those comments.

Given the hour, and I do know people have planes to catch, et cetera, I do want to turn it over to Barbara. Barbara will try to bring together some of the key thoughts today, and where we're headed from here. So, Barbara.

MS. VANICH: All right. Thank you, Marty. So I just want to acknowledge that we went into today with a very aggressive agenda. And it was aggressively purposefully, since we all benefit so much from your views.

While we had a closing session scheduled to talk about the paper more specifically, technically, since you've all read the paper, you've already heard that
It could be challenging to summarize any meeting, but it's certainly more challenging to summarize what I would characterize as just a great meeting full of insightful, thoughtful views from all the participants. During the meeting I summarized the comments more broadly, but also more narrowly, just focusing on the single standard approach discussed in the paper. And in the interest of time, I'd like to go through those quickly before we wrap up.

So, overall, I heard support from several participants on support for one standard. We heard that the standard might need to emphasize challenging management, or maybe termed in another way, emphasizing skepticism by the auditor, of bringing people to the table that have the right skill set for auditing accounting estimates or fair value measurements. And also about the importance of a robust risk assessment, which includes a thorough understanding of both the estimate and fair value, but also of external factors that could affect the valuation.

We heard that for a standard, it would be helpful
to have guidance for how to consider measurement uncertainty and inherent and certain complex estimates, even when that measurement uncertainty far might exceed materiality.

We had some good discussion about bias, where estimates are vulnerable to bias, and how to identify bias and how an auditor can address it.

We were also told to be cautious, given the breadth of estimates and fair value measurements that we seek to address and discuss in the Staff Consultation Paper.

We heard several comments relating to a more principles-based standard with maybe guidance or requirements that would address more specific estimates and fair value measurements. And it may not be evident from the Paper, but that's certainly part of the staff's preliminary views on the direction a single standard would set forth.

When you think about principles-based, I would be very interested in comments on how specifically the view that's discussed in the paper could be made to be more principles-based, if your view is that it is not
principles-based enough.

We had some comments on how to consider what the
behavioral reaction would be to a new single standard.
And we had some good discussion on resource challenges
and how this can be involved, especially with
specialists, hearing how some of those difficulties could
be resolved would also be of great interest to us in your
comment letters.

Before I let Marty close the meeting, I want to
thank you for your input and time, on behalf of my team.
We certainly will benefit from it and we'll spend quite
some time going back through your remarks. So, thank
you.

MR. BAUMANN: And before I do close the meeting,
I will acknowledge one more card that's still up, Doug
Maine, one of our SAG members and seeing none after that,
Doug, you're going to get the last word.

MR. MAINE: I'll be quick. This is an
enlightened suggestion. Given that there's no regulatory
oversight for these very important specialists that we've
talked about all day, it seems to me an easy first step
would be for someone to issue some guidelines for
specialists in terms of certifications, experienced background, and so forth, and let your humble audit committees serve as the first line of defense to make sure that the specialists that are engaged have the right capability.

MR. BAUMANN: Thank you very much for that comment. I, too, as Barbara just did, want to thank all of the panelists for joining us today.

I thank all the SAG members for active participation throughout the day and valuable input, and everybody around the table for participating in this meeting.

I also want to thank my staff, led by Barbara, who pulled together what I think is a very outstanding discussion on a very, very important topic.

With that, I think we're about to leave, unless anybody has any further words. And thank you very much for great day. Have a good trip.

(Whereupon, the meeting in the above-entitled matter was concluded at 4:43 p.m.)
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In the matter of: Standing Advisory Group

Before: PCAOB

Date: 10-02-14

Place: Washington, DC

was duly recorded and accurately transcribed under my direction; further, that said transcript is a true and accurate record of the proceedings.

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Court Reporter