

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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INVESTOR ADVISORY GROUP

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MEETING

+ + + + +

WEDNESDAY
SEPTEMBER 9, 2015

+ + + + +

The Advisory Group met in the Ballroom of the Army and Navy Club Building located at 901 17th Street, Northwest, Washington, D.C., at 9:00 a.m., Steven B. Harris, Chairman, presiding.

PRESENT

STEVEN B. HARRIS, Chairman
BRANDON BECKER
MERCER E. BULLARD
CURTIS L. BUSER
T. GRANT CALLERY
JOSEPH V. CARCELLO
NORMAN J. HARRISON
MICHAEL J. HEAD
PETER H. NACHTWEY
LAWRENCE M. SHOVER
DAMON A. SILVERS
TONY SONDHI
JUDGE STANLEY SPORKIN
ROBERT M. TAROLA
GARY G. WALSH

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SEC REPRESENTATIVES

MARY JO WHITE, Chair
BRIAN CROTEAU
JIM SCHNURR

PCAOB BOARD MEMBERS

JAMES R. DOTY, Chairman
JEANETTE M. FRANZEL
JAY D. HANSON

PCAOB STAFF

MARTIN F. BAUMANN
STEPHEN KROLL
HELEN A. MUNTER

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1 P-R-O-C-E-E-D-I-N-G-S

2 8:59 a.m.

3 CHAIRMAN HARRIS: Okay. Well, why don't we get
4 started. And at the outset, I want to thank everybody
5 for participating this morning, given the volatility in
6 the markets.

7 I know that a number of you are probably watching
8 it and a couple are predisposed toward, you know,
9 probably preferring to be there than here. So we very
10 much appreciate your attendance and your participation.

11 So welcome to the Sixth Annual Meeting of the
12 Investor Advisory Group of the Public Company Accounting
13 Oversight Board. And at the outset, I want to extend an
14 especially warm welcome to SEC Chair White for joining
15 us this morning.

16 Chair White, we thought was going to be leaving
17 at 10 o'clock, but she may try and extend her time a
18 little bit until the break. So whatever timeframe you
19 can be with us, that is very much appreciated.

20 And the fact that you would take time out of your
21 schedule to attend today's meeting is not only greatly
22 appreciated by all of us, but your advocacy on the part

1 of investors is also appreciated by the investor
2 representatives and community.

3 I also want to thank Jim Schnurr for attending,
4 the chief accountant at the Securities and Exchange
5 Commission and also Brian Croteau, who we work closely
6 with also from the Commission's Office of the Chief
7 Accountant, for attending today's meeting. So thank you
8 both.

9 To our participants, I know that all of you, as
10 I indicated, have extremely busy schedules. And we
11 appreciate the time you have taken to participate at
12 today's meeting.

13 In particular, I want to thank the members of
14 each of our working groups for the effort they have
15 devoted to topics that we will be discussing throughout
16 the day.

17 The purpose of the Investor Advisory Group is to
18 provide its views and advice to the Board on broad policy
19 issues and other matters that affect investors and are
20 related to the work of the Board. And that is why,
21 that's what you have done, that's what this group has
22 done in each of our previous sessions which is, as they

1 say, much appreciated.

2 I believe that today we will have another highly
3 productive meeting, and I commend you for the selection
4 of the topics that will be discussed.

5 Unlike other advisory groups, the goal of the
6 Board with respect to this group is to hear directly from
7 you and to listen carefully to the issues you feel should
8 be brought to our attention.

9 Going right to those topics and to the schedule
10 for the day, the Board will hear the results of a survey
11 relating to, amongst other issues, investor reliance on
12 audit opinion, audit firm independence, the importance
13 of potential audit quality indicators and whether audit
14 committees adequately represent the interests of
15 investors.

16 Next, the auditors' evaluation of going concern
17 will be discussed. This will be followed by a discussion
18 of current publications including Auditing Accounting
19 Estimates and Fair Value Measurements, and the Audit
20 Quality Indicators and the Auditor's Use of the Work of
21 Specialists.

22 Then we will have a discussion of the

1 effectiveness of internal control over financial
2 reporting under Section 404 of the Sarbanes-Oxley Act in
3 response to a letter from the Chamber of Commerce. And
4 this discussion will begin with introductory remarks by
5 Chairman Doty, SEC Chief Accountant Jim Schnurr and Helen
6 Munter, the Board's Director of Registration and
7 Inspections.

8 We will close with a general discussion of the
9 issues each of our group members believe should be a top
10 priority for the board to consider in the future.

11 I want to thank PCAOB Chairman Doty and Board
12 Members Jeanette Franzel and Jay Hanson for participating
13 in today's discussion. Board Member Lou Ferguson
14 unfortunately was not able to attend, as he is on Board
15 business out of the country.

16 From the Board's senior staff joining us at the
17 table are Marty Baumann, the Board's Chief Auditor, Helen
18 Munter, the Director of Registration and Inspections, and
19 Steve Kroll from the Board's Office of Research and
20 Analysis. Topics that will be discussed throughout the
21 day bear directly on their responsibilities.

22 Under Board policy, we are required to make the

1 following disclaimer. The views we express today are our
2 own views and do not necessarily reflect the views of
3 other Board members or the staff of the Board. Since
4 today's meeting is being webcast, I would ask all
5 participants to please identify yourselves before you
6 speak throughout the day.

7 And now, I would like to turn to Chair White for
8 any comments she may wish to make. And then I will
9 recognize Chairman Doty for a brief overview of the
10 Board's activities and then turn to Jeanette Franzel and
11 Jay Hanson for any remarks they may wish to make.

12 And afterwards, as we have done in prior
13 meetings, I would like all the members at the table to
14 briefly introduce themselves. And then we will get on
15 with the day's program.

16 Chair White?

17 CHAIR WHITE: Thank you very much, Steve. I was
18 really very pleased I could join you for, I guess this
19 is your sixth annual meeting. I think I may have been
20 out of the country last year.

21 You know, you don't need anybody to tell you how
22 important the work is that you're doing. You can tell

1 from your agenda and just the work you've done in
2 general, you're covering a lot of very important issues
3 of significance to investors, work that obviously the
4 PCAOB Board, the SEC, FASB in some instances, you know,
5 is quite, quite interested in.

6 As Steve indicated, I think I will be here until
7 your break this morning. I'm here mostly to listen. I'm
8 obviously going to get a full report from Jim Schnurr and
9 Brian Croteau of really the whole day's events and the
10 feedback that you're going to be giving. Because I'm
11 really quite, quite interested in that.

12 I might just make a couple of remarks on a couple
13 of things and then, you know, get out of the way so you
14 can get on with your agenda.

15 First, I want to thank Chairman Doty for his
16 leadership and all of the members of the PCAOB Board as
17 well as the PCAOB staff for the tremendously important
18 work that you all are doing.

19 Auditors are obviously critical gatekeepers.
20 It's impossible, really, to overstate the significance
21 of their role in protecting investors and for our
22 markets.

1 I can report that I am very pleased with the
2 level of coordination between the Commission and the
3 PCAOB in advancing what I consider to be our shared
4 missions. Critical work really does occur every day in
5 both organizations to improve audit quality and the
6 integrity of financial reporting.

7 As you know and know well, the PCAOB recently
8 issued a concept release seeking public comment on the
9 content and possible uses of a group of potential audit
10 quality indicators, AQIs as noted by the PCAOB Board in
11 its release.

12 You know, some auditors and audit committees have
13 made progress, I think, on this front through the
14 voluntary use of AQIs. While this project is in its
15 early stages, I want to commend the PCAOB's outreach and
16 efforts to develop an issue, a very thoughtful concept
17 release focused on improving audit quality. And I'm
18 quite, quite interested in the feedback, you know, from
19 your group on this.

20 And I know, I read with great interest your
21 survey results, very interested in that conversation,
22 which AQIs you think would be most useful to whom, how

1 they should be distributed, how they can be used. Very
2 interested in all that feedback.

3 You know, the last time I did attend your annual
4 meeting, I believe I mentioned the possibility that the
5 Commission would issue a concept release on potentially
6 enhancing the audit committee report. We did issue that
7 release in July the day after the Board, I think, issued
8 your AQI and transparency releases.

9 The comment period on the SEC's audit committee
10 concept release just closed yesterday. And the comments
11 that, you know, we receive will obviously be very
12 carefully considered, very interested in receiving those.
13 I think there is a real opportunity there to provide more
14 meaningful, useful information to investors.

15 A word about the PCAOB's inspection program and
16 enforcement, I mean, clearly both play an integral role
17 in really strengthening and maintaining the integrity of
18 the auditing function.

19 At the SEC, we also continue to emphasize holding
20 auditors to the duties they assume through our
21 enforcement actions. Over the past year, I think we've
22 brought charges against over 30 individual auditors and

1 auditing firms. It will remain a focus.

2 And these are obviously against auditors and
3 auditing firms who failed in their duties. Expect to see
4 more cases like those going forward. And we work very
5 collaboratively, and will continue to do so, with PCAOB
6 enforcement to ensure that our respective enforcement
7 resources are used effectively.

8 So let me stop with those just, you know, couple
9 of remarks by extending just a couple more quick thank
10 yous, first and foremost to all of you, the members of
11 the IG for your time, and your effort and insights.

12 Investor input is critical to all of us, and I
13 appreciate the commitment you've made to assist, in
14 particular the PCAOB with its work. But it clearly
15 assists the Commission and lots of other constituencies
16 as well. So thank you for that.

17 And then Steve Harris, I want to specifically
18 thank you for your leadership of the IAG and your efforts
19 in seeking the views and the advice of the investor
20 community. So with that, I will thank you for inviting
21 me and wish you a very constructive meeting. Thank you.

22 CHAIRMAN HARRIS: Thank you, Chair White. Chair

1 Doty?

2 CHAIRMAN DOTY: Thank you, Steve, and thank you,
3 Chair White. It has meant a great deal to me over the
4 years to have known Chair Mary Jo White in this
5 professional capacity and to have had the benefit of her
6 support, her encouragement and her counsel.

7 And I have a special debt here, because I have
8 always been able to get lunch with Chair White when I
9 need lunch with Chair White. And believe it or not, that
10 happens from time to time.

11 The other thing that has happened for which I've
12 got to thank Chair White and the SEC is the recruitment
13 of Jim Schnurr. Jim has made an enormous difference in
14 the Chief Accountant's Office in the relations with the
15 PCAOB and our ability to coordinate the activities that
16 Chair White has alluded to.

17 And we'll be talking more with you later today
18 about things that we are doing and where I think there's
19 a great deal of alignment between how we are seeing
20 problems spin out and what we intend to do.

21 Brian Croteau has always been a great ally in
22 causes of public disclosure, and better auditing

1 practices and the things that we need to do at the PCAOB
2 to carry out the mission that Chair White alludes to.
3 And we will say more about that.

4 Steve has asked me to make a few remarks on where
5 we are and what we've done in the past year. And I think
6 that one should start with where Chair White left it.

7 Enforcement, terrific coordination between the
8 SEC and the PCAOB with the result that we've settled a
9 record number of enforcement actions against firms last
10 year and clearly an increase in areas of foreign activity
11 where we're seeing problems that need to be addressed.

12

13 Inspections, Helen will talk later with Jim and
14 myself, as Steve said, but we're well into the 2015
15 cycle. There are ten firms that issued reports on more
16 than 100 issuer clients, and we will inspect portions of
17 50 or 60 audits of those ten firms.

18 There are 145 firms that are part of the
19 triennial program, because they issued reports on fewer
20 than 100 issuers. Fifty of those are non-U.S. And 45
21 of those 50 were affiliates of the global network firms
22 and we have bilateral agreements with 19 nations in which

1 we will be launching inspections of those 45, members of
2 those 45 cohort firms.

3 The standard setting has been a focus of our work
4 with the SEC this year, as Chair White's remarks
5 indicate. The transparency project was the basis for a
6 June 30th Supplemental Request for Comments on Form AP
7 which would be the place in which we would contemplate
8 the disclosure of the engagement partner and other
9 participants would be made.

10 And we have had 45 comment letters on that
11 Supplemental Request for Comments. And the comment
12 period expired at the end of this month. So we are
13 moving right along in parallel, in conscious parallelism
14 with the SEC's own interest in this area.

15 And I have some hope that, with the continued
16 encouragement and support, we're on track to get this
17 done by the end of the year. I think Jim and Brian have
18 given us a lot of feedback and a lot of help on how we
19 might do this.

20 And if we did it, it would be something that we
21 would be able to look back on, I think, as an example of
22 SEC and PCAOB coordination. We would expect a new

1 proposal on the audit reporting level in the new year.
2 That's something, again, which I know this group has been
3 interested in and which I would hope we would get out for
4 your consideration and for the public's consideration.

5 We have existing projects for the supervision of
6 other auditors, the multi-jurisdictional audit. The
7 going concern issues that are part of today's program,
8 those again are the subject of very intense research, and
9 effort and dialogue between ourselves and the SEC. And
10 I think there will be progress on all those in the coming
11 months.

12 Consultation papers were issued on fair value and
13 estimates and on the supervision and the use of
14 specialists by auditors. We separated those topics, and
15 the comment came back from you and others that the two
16 were so interlinked that we should consider them as one
17 overarching project. And we're going to do that.

18 We are going to do a lot of research on where we
19 think the economic and other research needs to be,
20 looking for areas where we can see what needs to be
21 changed and where people tell us what needs to be
22 changed.

1 I'm advised by a wise commenter that there's a
2 difference between outreach and information gathering.
3 And in going concern, and in fair market value, and
4 estimates and the use of specialists, we intend to engage
5 in information gathering and to find out what we can
6 about that.

7 In May, as part of the focus on audit committees,
8 we issued an audit committee dialogue which was an effort
9 to start getting out, as we see it, patterns of conduct
10 that we think are of interest to audit committees and
11 managers about what we're seeing in the field.

12 I've got to double back and throw an additional
13 bouquet to Helen, because one of the effects of the past
14 years of work with this body and others has been an
15 enormous improvement, I think, in the timeliness and the
16 content of reporting. And that's an effort that goes on
17 with the encouragement of Brian Croteau and others. And
18 I think we can see more of it in the future. We're not
19 done with that aspect of our mission.

20 And on the standards group, I'm always impressed
21 by how hard they work to get it right and to get the
22 projects done that need to be done and how good they are

1 at identifying where you all have pointed us in areas of
2 audit practice and audit standards that we need to be
3 thinking about.

4 So I think this, in my view, has been an
5 extraordinary year of growth. There are some new growth
6 rings on the tree at the PCAOB. And they have been, I
7 think, very well regarded internally. And we're going
8 to continue to make improvements where we think
9 improvements are needed.

10 I have not disclosed to the Chair, to Chair
11 White, that I am a life-long Houston Astros fan.

12 CHAIR WHITE: Uh-oh.

13 CHAIRMAN DOTY: And --

14 CHAIR WHITE: I just like the Blue Jays.

15 CHAIRMAN DOTY: Well, this is something we'll
16 have to discuss. But I note that she has been kind
17 enough not to tax me with the fact that the Astros, in
18 a recent series in Yankee Stadium, came away with a
19 victory.

20 CHAIR WHITE: I was there.

21 CHAIRMAN DOTY: You were, that's -- right. So we
22 appreciate your being here. And, Jim, it's an

1 extraordinary thing to have you and Brian here for this
2 meeting. And as I say, the collaboration this year has
3 been essential to us, just essential. I think I'll stop
4 there.

5 CHAIRMAN HARRIS: Well, I'm glad we're not going
6 down the slippery slope of baseball. But I would like
7 to note the success of the New York Yankees whose,
8 probably, age limit is beyond that of all the other major
9 league teams. And they seem to be holding their own.
10 But let's, we'll get off that subject.

11 Board Member Franzel? Do you have any opening
12 comments you'd like to make?

13 BOARD MEMBER FRANZEL: Yes. Thanks, Steve. I
14 want to echo my thanks to all of you for being here and
15 for providing us with your valuable input, not only today
16 but during the course of the year through all the other
17 ways that you interact with us and provide us with
18 advice.

19 We very much value the advice from the investor
20 community as well as the other outreach that we do that
21 really gets to some of the tough questions we're dealing
22 with.

1 You can see from our workload that it's extremely
2 ambitious. We've got a lot of proposed rulemaking
3 projects, a lot of thought leadership types of projects.

4 And we're really trying to tackle the tough
5 questions dealing with the role of the auditor, and the
6 role of the audit and even the role of internal controls
7 over financial reporting in the audit of those internal
8 controls in supporting our capital markets and promoting
9 reliable financial reporting and promoting high quality
10 auditing. Because without that confidence, our economy
11 and our capital markets cannot function.

12 And so, again, I thank you for being here. I
13 look forward to going through the agenda. I had a chance
14 to preview some of the materials, and I look forward to
15 further discussion on the investor survey and your input
16 on some of our current, very important rule making
17 projects that do, in fact, get to the heart of some of
18 these very important questions. So again, thanks for
19 being here. And I look forward to the discussion.

20 CHAIRMAN HARRIS: And Board Member Hanson?

21 BOARD MEMBER HANSON: I just wanted to echo the
22 thanks and looking forward to the discussion. And I will

1 let the activities commence.

2 CHAIRMAN HARRIS: Thank you. And then why don't
3 we, as discussed, briefly introduce the membership
4 starting actually, Bob, with you. And then we'll get on
5 with the program.

6 MEMBER TAROLA: Good morning, Chair White, Chair
7 Doty, the Board, staff. I'll take that responsibility
8 for the whole group.

9 I'm Robert Tarola. My background, as relevant to
10 this group, is that I'm a former audit partner of one of
11 the large firms. I'm a former CFO of public companies,
12 public reporting companies I now advise, companies that
13 are in the public reporting area.

14 And I serve on the Board of Mutual Funds and two
15 operating companies. And I'm also on the Board of XBRL
16 International and see great things available for moving
17 the audit from paper to digits.

18 MEMBER HEAD: My name is Michael Head. And
19 similarly, I think the relevance that I bring to the
20 table is I am a former CFO, I'm a former public
21 accounting CPA auditor. But more recently, I was the
22 chief audit executive for TD Ameritrade through 2013.

1 And currently, I'm an accounting instructor at
2 Creighton University. And so I think I bring a lot of
3 different perspectives, especially the retail investor's
4 perspective from the 15 years I was at TD Ameritrade.

5 MEMBER CARCELLO: Good morning. I'm Joe
6 Carcello. I'm a professor at the University of
7 Tennessee. I've been involved with this group since its
8 inception.

9 As Chair White knows, I'm also on the SEC's
10 Investor Advisory Committee, had some years with the SAG,
11 teach accounting, and auditing and corporate governance,
12 do a lot of research on the effects of regulation, a
13 number of items that the Board is considering, as well
14 as some items that the SEC is considering. And I chair
15 a governmental audit committee. That's probably my
16 relevant background.

17 MEMBER SILVERS: Good morning. I'm Damon
18 Silvers. I'm the policy director of the AFL-CIO. I've
19 served on all the committees Joe has served on. And I
20 suppose my, beyond following Joe around, my
21 qualifications are that I represent Union members as
22 pension fund participants and individual investors in

1 capital markets policy discussion and have done so for
2 so long I'm embarrassed to admit it.

3 MEMBER SONDHI: Good morning. I'm Tony Sondhi.
4 I run a financial consulting and investment advisory
5 firm. I've also, like Joe, taught for many years,
6 primarily focusing on teaching the use of accounting
7 information in investment decision making. And I've
8 written books on the subject which have been used in the
9 CFA Institute's work over the last 25, more than 25 years
10 now.

11 I also currently serve and have served for more
12 than ten years on the Emerging Issues Task Force
13 representing, again, investors and financial analysts.
14 And I'm hoping and helping to improve financial
15 reporting.

16 MEMBER NACHTWEY: I'll echo Bob's good morning to
17 everybody. Pete Nachtwey, CFO at Legg Mason. In terms
18 of qualification to be here, I was with Deloitte, my
19 final role running the investment management practice for
20 a period of 27 years and have been the CFO, first of a
21 private company that's also represented in this room, you
22 know, much better by Curt Buser now than when I was at

1 Carlyle. But I've been with Legg Mason for the last five
2 years.

3 A few weeks ago, I would have said Legg Mason was
4 a \$700 billion in assets under management firm. I can't
5 tell you what that number is today. You'll find out
6 Friday, but it's probably a little bit less than it was
7 back in June. So thanks for being here.

8 MEMBER WALSH: Good morning. I'm Gary Walsh.
9 I'm a partner with Luther King Capital Management, a
10 registered investment advisory firm in Fort Worth, Texas.
11 In addition to portfolio management work, I'm a telecom
12 analyst there.

13 As far as relevant experience here, I'm not
14 really sure. I was an auditor in a former life and
15 chairman of the audit committee for a local Fort Worth
16 non-profit hospital. And I'm very involved with the CFA
17 Society in Dallas and look forward to what happens today.
18 Thank you.

19 MEMBER BULLARD: Hi, good morning. This is
20 Mercer Bullard. I'm a professor at the University of
21 Mississippi School of Law. And I run Fund Democracy
22 investor advocacy program. I also manage the Bullard

1 Account, and my advice to Legg Mason is just don't check
2 your balance. Works for me. I do a lot of investor
3 advocacy, testimony for Congress. I'm testifying
4 tomorrow on the DOL Proposal.

5 And I also teach accounting but not as an
6 accountant, which means I spend a lot of time trying to
7 explain to law students why accounting is important, with
8 a little bit of success but not much.

9 MEMBER CALLERY: I'm Grant Callery. And I was,
10 a long time ago, one of those law students who didn't
11 understand the importance of accounting. I spent most
12 of my career at FINRA, previously to that, NASD, retired
13 a couple of years ago as general counsel and have been
14 doing, so obviously, a lot of investor interest there.

15 And for the last couple of years, I've been doing
16 some consulting work in the higher ed governance area and
17 other corporate governance issues.

18 MEMBER SHOVER: Larry Shover. I've spent about
19 25 years as a derivatives trader. Since then, the last
20 ten years, I've been a commodity pool operator. I have
21 to be vaguely familiar with accounting standards in nine
22 different countries to where we allocate, so vaguely

1 familiar.

2 I also run a liquid alternatives mutual fund
3 which has been a dirty word the last couple of weeks, but
4 so be it. I'm also on the board of a turnkey asset
5 management program that caters to professional baseball
6 players. So that's it.

7 MEMBER BUSER: Good morning. My name is Curt
8 Buser. For the past 11 years, I've been with the Carlyle
9 Group, and most recently as its chief financial officer.
10 Prior to that time, I was an auditor partner in two of
11 the large public accounting firms.

12 MEMBER BECKER: Brandon Becker, I was formerly
13 director of what's now called the Division of Trading and
14 Markets at the SEC where I was responsible for various
15 programs involving the oversight of financial
16 institutions and their derivatives books.

17 But most recently, and most significantly, I was
18 the executive vice president and chief legal officer of
19 TIAA-CREF. I think they still manage over \$800 billion.
20 And with respect to that, we are consumers of the audit
21 information and rely upon it to a great degree. So I'm
22 very happy to be here today.

1 MEMBER HARRISON: Good morning, my name is Norman
2 Harrison. I'm the senior managing director at FTI
3 Consulting here in Washington, D.C.

4 In various aspects of my career as a practicing
5 attorney, as an investment banker and investment fund co-
6 founder, and more recently as a consultant, I have done
7 work on both sides of the table, if you will. I've
8 advised audit committees on internal investigations
9 involving financial fraud. I served on independent
10 monitoring or compliance consulting teams in the
11 aftermath of a fraud.

12 My more recent work involves working with
13 investment funds on a wide range of issues relating to
14 operations and compliance. I'm delighted to be here, to
15 have made the cut for another year, consciously aware of
16 the fact that we serve at the pleasure of the Board. So
17 I'm glad to be here again today.

18 And thank you, Chair White. It's always a
19 pleasure to see you and hear from you.

20 CHAIRMAN HARRIS: And I would note that, Chair
21 White, we are committed to diversity. Looking around the
22 room, I would note that Ann Yerger has done a terrific

1 job for our group. She went on to Ernst and Young where
2 we wish her nothing but the very best. Anne Simpson
3 could not be with us today, and another member of our
4 group has health issues which will not allow him to be
5 here otherwise.

6 But diversity is important to the PCAOB. And I
7 don't want you to get the wrong impression just because
8 all of us look quite the same in looking around the room.

9 CHAIR WHITE: I didn't know that until you just
10 told me now --

11 CHAIRMAN HARRIS: Now, having said that, I would
12 add --

13 CHAIR WHITE: Kidding.

14 CHAIRMAN HARRIS: I'd be surprised if you didn't.
15 I would ask that each working group lead introduce their
16 group and then briefly summarize your findings, starting
17 first with Joe Carcello, who will discuss his group's
18 survey's findings, and then Grant Callery and Tony
19 Sondhi.

20 And in terms of your comments, I would also ask
21 that you briefly note the need for the project you have
22 undertaken, the problem that you are seeking to address.

1 So with that, Joe, why don't we start with you. Thank
2 you.

3 MEMBER CARCELLO: Steve, I'm going to be very,
4 very brief here, since I'm going to be able to present
5 our results while Chair White is still here. I think in
6 fairness to the other two groups, I'm not going to take
7 very long.

8 The main thing I would point out, Chair White and
9 Board Members, is that these results are based on
10 investor responses and assets on the management by the
11 people who responded to the survey. It's over \$13
12 trillion.

13 So at least in my mind, that's a very, very
14 significant amount of assets under management. And I
15 would say, given the mission of both the SEC and the
16 PCAOB, at least from my point of view, and I think people
17 on my sub-group would agree, the perspective of investors
18 should be first among equals.

19 CHAIRMAN HARRIS: Grant?

20 MEMBER CALLERY: Yes. The, what we call the
21 going concern working group was a late addition to the
22 agenda. And so we've only been working together for a

1 couple of weeks. And the group includes Joe, Pete, Anne
2 Simpson who's not here today, Tony Sondhi and Lynn Turner
3 who is also not here.

4 Basically, what we were looking at, this was
5 generated by some comments that have come out relating,
6 and some media relating to FASB's ASU 2014-15 talking
7 about the standards for the going concern. And the going
8 concern reporting has its basis in the Exchange Act.

9 The IAG took a look at this issue two years ago,
10 I think it was, in 2012. And Pete will talk about that
11 group a little when we get to our report. But a couple
12 of points that have sort of come to the fore is that the
13 going concern issue has not been necessarily a good early
14 warning system for major bankruptcies. And whether it
15 should or should not be, there are differing views. But
16 that's an issue to talk about.

17 The ASU '14-15 requires management going concern
18 determinations and gives some guidance in that area. And
19 I think everybody seems to think that that's a very
20 positive thing to make those obligations, which I think
21 have always been there sort of more subtly but to give
22 some guidance.

1 But the thresholds that have been put forward in
2 there using a probability standard, there is some concern
3 that maybe it is not exactly the same threshold that has
4 been used by auditors in the past.

5 And there's an effective date coming up in 2016
6 in that at least those issues need to be looked at and
7 determined whether there is some reconciliation that is
8 necessary. And those are the issues that we want to get
9 this group to talk about today.

10 CHAIRMAN HARRIS: Tony?

11 MEMBER SONDHI: Thank you, Steve. Our group
12 wanted to report on and talk about these different
13 publications that we've mentioned, that have been
14 mentioned before.

15 Principally, we were talking about the two staff
16 consultation papers, one on accounting estimates and fair
17 value measurements and the other on the use of
18 specialists. And the third publication is the concept
19 release on the audit quality indicators.

20 The group includes Mercer Bullard, Norman
21 Harrison, Larry Shover, Lynn Turner, Gary Walsh and Bob
22 Tarola, of course.

1 The rationale and the need for this is really,
2 primarily stems from the growing complexity of financial
3 reporting, the inclusion and the increase in the number
4 of new business models, the emphasis on licensing the
5 different types of intellectual property that different
6 companies have these days. And the changing financial
7 reporting requirements are rather significant. And they
8 have increased the need for these.

9 The other problem, to some extent, is the fact
10 that we've had a rather, we've had a rather significant
11 increase in the different types of reporting requirements
12 that we see. So if you take a look at, if you take a
13 look at some of the requirements, let's focus, say, on
14 the estimates and the fair value measurements.

15 I go back many years to look at the guidance that
16 we have. The guidance hasn't been changed in many years
17 for many of these issues.

18 In 2008, I served on the expert advisory panel on
19 measuring the fair value of illiquid securities. And the
20 problem there is rather significant these days. It
21 remains a significant problem. And now we have a new
22 batch, in a sense, of illiquid securities, a new class

1 of them, the investments in firms that are owned largely
2 by private equity, firms that are not public.

3 These investments are now in mutual funds. And
4 the estimates of those values have become critical. And
5 certainly the SEC and other regulatory agencies have
6 focused on them. And that's why we wanted to talk about
7 these issues here today.

8 Let me just briefly mention some of the major
9 issues that we've noted. With respect to estimates and
10 fair value measurements, I think, and the working group
11 feels that there is a need for more information on two
12 fronts, primarily.

13 One is the area of additional information that
14 would enable users of financial statements, those who use
15 this information for investment decision making, it would
16 enable them to perform sensitivity analysis to better
17 understand where those estimates are coming from and
18 whether they apply.

19 Another aspect of the estimates is that it would
20 be very helpful if it was required, if auditors were
21 required to actually use independent external data to
22 perform tests on these estimates, compare them to the

1 actual results and then report on those, discuss that
2 with the audit committee.

3 With respect to the audit quality indicators, the
4 need is fairly obvious. It's been mentioned before, so
5 I won't go into that. We emphasize a few other
6 indicators. In part, those indicators that we're going
7 to talk about come from the 2013 meeting of the PCAOB and
8 the IAG where we discussed the audit quality indicators.

9 And our emphasis there was on a slightly
10 different set. And that was based on the outcome of the
11 audits. And we think those ought to be emphasized. We
12 also believe it's critical that we get quite a bit more
13 information on the governance structure, on the
14 regulatory actions against the audit firms as well as
15 their investments in technology and training.

16 The third section of our work today deals with
17 the staff consultation paper on the use of specialists.
18 And as I noted before, given the growing complexity of
19 both business models and the accounting standards that
20 we have, the need for the use of specialists certainly
21 has increased.

22 There again, the staff consultation paper

1 actually does a very good job of pointing out what some
2 of the problem areas are, what some of the deficiencies
3 are. And what we'd like to see is more information about
4 the use of employed versus engaged specialists. The
5 emphasis there ought to be on how that affects the
6 objectivity and the integrity of the financial
7 statements.

8 In addition to that, we think that, with respect
9 to the use of specialists, there has to be more guidance,
10 more very specific and rigorous guidance on how you plan
11 for, what the handoff issues are, that is areas where
12 there are disagreements between the auditor and the
13 specialist, how those are resolved.

14 We think it's essential that that be communicated
15 to the audit committees and to investors. So we
16 appreciate the opportunity to talk about all of these
17 issues and hope to provide more detail later on in the
18 day.

19 CHAIRMAN HARRIS: Tony, thank you very much.
20 And, Joe, it's now on to you and your group.

21 MEMBER CARCELLO: I'm going to stand for just a
22 moment. I spent 22 years doing it when I talk with a big

1 group.

2 So again, thank you for the opportunity to be
3 here, I appreciate it. To the Board members, and Chair
4 White, and Jim, it's an honor to be here.

5 So let's see here. This is the group, the sub-
6 group that worked on this. And I'll kind of lay out a
7 little bit about how we went forward. I want to thank
8 one of my students, Patrick Whalen. There was a lot of
9 work that went into this, and his help was invaluable.

10 So let me first talk about it a little bit, even
11 if you're reading this, why do we even do this? If you
12 were here last year, you remember toward the end of the
13 meeting there was some discussion -- did I do something
14 wrong?

15 (Laughter.)

16 MEMBER CARCELLO: All right. Now I'm miked.
17 Okay. So if you were here last year, you remember at the
18 end of the meeting there was some discussion about how
19 we had done a survey a few years ago on the audit report.

20 And that seemed to be very well received by both
21 the group and the people who were listening and some
22 sense that maybe it was time to go back to investors and

1 do a survey. That was really the direction we got,
2 nothing more specific than that.

3 So the survey initially was developed by me and
4 Ann Yerger. And then Ann left. And the thinking was,
5 a couple of things, one it needed to be short. Getting
6 investors to engage on anything, Chair White, I'm sure
7 you understand this, I mean, literally, well, I'll show
8 you the response rate here in a second. But initially
9 it wasn't even as good as it ended up being. And it
10 still was, I wish it was higher.

11 So I had one of my students, I'm not
12 exaggerating, for three weeks spend four hours a day
13 calling people on our list, begging them to respond. So
14 trying to get investors to engage, even on a short
15 survey, is quite difficult. And so we figured a long
16 survey, we had almost no chance. So we knew we had to
17 have it short. We knew we needed it to be very high
18 level.

19 And we also, there was a lot of concern on the
20 committee that we would only ask questions that they
21 really had the ability and knowledge to answer. And a
22 lot of times, we want to get into real granular kinds of

1 things. But often, the people we're sending this to
2 really don't have the background or the expertise to
3 respond to that.

4 So Ann and I took a first shot. The survey was
5 heavily revised multiple times, based on feedback from
6 our group. And the survey was mailed to the database
7 that the Council of Institutional investors has.

8 Ann sent that out before she left for Ernst and
9 Young. And then I have my own database that I've
10 developed over the years of institutional investors.
11 There's about 500 entries in that database. It's mutual
12 funds, public and Union pension funds, endowments and
13 foundations, hedge funds and private equity. So that's
14 who it was sent to.

15 So why a survey, you know, kind of why the issue?
16 At least in my mind the SEC, as the Chair knows well, we
17 are the investors' advocate. On the PCAOB's website it
18 says protecting investors through audit oversight. To
19 me those words suggest that the missions of those two
20 agencies should be heavily influenced by the needs and
21 wants of investors. And so what we're trying to do is
22 get high level views of investors on issues that affect

1 audit oversight.

2 So who responded? I had a response, 51, so less
3 than ten percent when you consider the two databases.
4 Now I'm sure there was overlap, probably a heavy, heavy
5 overlap between my database and Ann's database. But
6 still, response rate was not overwhelming. But it was
7 random.

8 And you can see who responded here in terms of
9 endowments, and mutual funds and public pension funds
10 being the most heavily represented but I think a pretty
11 nice cross section of different types of investor groups.

12 Obviously, these are all institutions. We didn't
13 reach out to individuals. Organizational type, in terms
14 of assets under management, again, a pretty nice
15 distribution, I think, in terms of size there.

16 As I said earlier, as cumulative assets under
17 management approximately \$13 trillion, very significant,
18 at least in my view, pretty significant sum of money.

19 Job position of the people who filled out the
20 instrument, chief investment officer, almost 20 percent,
21 so obviously a very, very senior person. Governance
22 officer, almost 20 percent, senior analysts heavily

1 represented.

2 If you look toward the bottom of the slide there,
3 you see accounting, auditing, treasury operating
4 officers, eight, and chief financial officers, five. So
5 that's 13.

6 So we actually, and you'll see this as I go
7 through, analyzed the results overall. And then we broke
8 it out by what I would call everybody else other than
9 these 13, which is 38.

10 And then what I'm calling management, so people
11 like my friend Pete here and my friend Curt over there,
12 these are folks who have accounting type jobs, right?
13 They're CFOs, but they work for institutional investors.
14 So these two guys I know, and I know their heart.

15 But you don't know if you have a CFO responding
16 from an institutional investor. Are they responding from
17 the perspective of an investor focus, or are they
18 responding from the perspective of a management focus?
19 You're never really sure. And so that's why we did the
20 analysis both ways.

21 Knowledge about external audits and audit
22 process, as you could see, at least pretty much everybody

1 self-assessed as moderate or higher, although the modal
2 response was moderate. So this is not a bunch of FASB
3 or PCAOB people, right. These are users. And they're
4 not claiming very high or high level.

5 But the questions we asked, I think, are
6 questions that even a moderate level of knowledge, they'd
7 be well positioned to answer. So, you know, a very basic
8 question, the kind of a question that would suggest, Mary
9 Jo and Jim, you should still have a job. And that is
10 does this matter to anybody?

11 Sometimes, you know, in being involved in these
12 groups over the years, when it's so hard to get investors
13 to engage sometimes I do scratch my head and say, "Am I
14 wasting my time? Should I just be back at the University
15 and teaching people?" Because it's very hard to get
16 investors to engage.

17 But 94 percent of the respondents say they rely
18 on the GAAP financial statement audit either a good bit
19 or extensively. So I thought that was actually a quite
20 encouraging response.

21 We asked them to, if they wanted, give us their
22 own words around a lot of these questions. Obviously

1 have way too much to use in a presentation today, so I
2 picked what I thought were some of the better responses.

3 Financial statements would be worthless, systems
4 built on trust, it matters a lot if the auditor qualifies
5 a report. It's a powerful signaling device.

6 Less supportive, as you'll see here, the less
7 supportive wasn't that much less supportive, right.
8 There's only six percent who even fell in this bucket.

9 Audit opinions are very important, but we use
10 other things. Well, yes, of course they use other
11 things. And you can't necessarily trust the statements
12 with an auditor sign-off. But you clearly can't trust
13 them without one. So a little bit tepid support, but
14 still it's not exactly a negative.

15 Then we went to ICFR, internal control over
16 financial reporting, not quite as strong here, 72
17 percent, either a good bit or extensively in terms of
18 reliance. So clearly, the numbers seem to matter more,
19 at least to the people who filled this out. But I would
20 say the controls and the opinion on controls is a pretty
21 significant percentage, 72 percent.

22 Supportive, this is a huge red flag, presumably

1 an adverse opinion on ICFR, somebody who's an analyst on
2 financial institutions saying it's an excellent
3 innovation and forces companies to invest more in risk
4 management and compliance systems. So maybe not so much
5 the opinion but the change in behavior that the regime
6 introduces.

7 Less supportive, experience shows that most red
8 flags are discovered ex-post. And a surprising number
9 of firms have material weaknesses, but many of them, in
10 this person's opinion, don't imply significant risk.
11 It's important but not necessarily a driver of
12 investment. I know the Chamber letter is on the agenda
13 for later, so some of these things may surface again.

14 Differences between the investor group, again,
15 remember that's the 38 people who are not CFOs, and
16 Treasury people and so forth. And the management group,
17 all but one of the management respondents relied on the
18 ICFR opinion either a good bit or extensively.

19 The investor group responses were more evenly
20 split. So this is, actually, I found a little counter-
21 intuitive. In that management, the body who's actually
22 responsible for the controls seems to rely on the opinion

1 by the auditor more than investors which I thought was
2 a little interesting, at least to me, maybe to no one
3 else but to me.

4 Effect on confidence, there's been some
5 discussion. Some have floated the idea of maybe we
6 should just eliminate mandatory financial statement
7 auditing and let the market determine whether companies
8 have financial statement auditing or not. Lynn's not
9 here today, but, you know, Lynn certainly has been
10 suggesting this and has reasons for it. It's not just
11 totally out of the blue.

12 But if we asked, you know, what would happen,
13 what would be the effect on confidence if mandatory
14 financial statement reporting was eliminated? And 80
15 percent said substantially reduced. That's a pretty
16 strong response, in my view. And if you add in a good
17 bit, it's 94 percent. So a pretty strong mandate, I
18 would say, at least from this group of respondents, that
19 let's not go that route.

20 In terms of words, we wouldn't invest if there
21 was an audit. The system can't work without audits, the
22 higher risk of fraud. I thought the short-seller comment

1 was interesting. It actually went the other direction,
2 right, without audits, short-sellers could say anything
3 they want.

4 And there'd be no independent check to basically
5 say, no, these numbers are okay. The increase of fraud
6 would be exponential, stock market collapse, we certainly
7 don't want that. While most firms would uphold high
8 standards, some wouldn't. And it would taint the entire
9 market, the classic in economics problem of lemons
10 argument.

11 GAAP is complex, companies make errors without an
12 audit, higher likelihood of errors. Non-GAAP results may
13 be used a lot, but they are based off of GAAP results.
14 So kind of, it's the foundation even for non-GAAP
15 reporting.

16 Less supportive, market would self-regulate by
17 applying a discount to public companies that didn't have
18 audited. So even the less supportive person seemed to
19 be saying, even if it wasn't mandatory, it would be
20 there. Because the market would force it.

21 A question we asked, this is kind of an
22 abbreviation of the actual question, is do you believe

1 there are adequate regulatory safeguards to protect audit
2 firm independence as it relates to the provision of non-
3 audit services?

4 And as you can see there, I would say this is
5 somewhat of a split, in my mind. The neutral kind of
6 doesn't say a whole lot. Thirty-six percent think there
7 are adequate regulatory safeguards, 24 percent think
8 there are not. You know, different people interpret that
9 differently. But, you know, I'll let each person in the
10 room make their own judgement.

11 And in terms of differences between groups, 29
12 percent of the investor respondents either disagree or
13 strongly disagree that adequate safeguards are there so,
14 you know, about 30 percent. Only eight percent of
15 management felt that way. So I would say that's a
16 noticeable difference between those two groups.

17 Another question we asked is do you have enough
18 information to even make this assessment? And if you add
19 most of the information and all of the information, you
20 had 47 percent. If you take some and none, you're at 53.

21 So again, that's not an overwhelming mandate or
22 an overwhelming response that the information to even

1 assess this exists, so probably something worth thinking
2 about.

3 Agree that there is enough information, existing
4 fee disclosures are sufficiently robust, others felt
5 differently. Disclosure on non-audit work is not
6 sufficiently granular for us to understand the effects
7 on independence.

8 I'd like better disclosure of auditing firms'
9 conflict policies and also detailed financial statements.
10 There's some of this in Europe, I think less of it here
11 in the United States.

12 Audit firm tenure in the name of the lead audit
13 partner should be disclosed. Obviously some of these
14 things are already being discussed by both the PCAOB and
15 the SEC.

16 If we, again, break out by groups, the modal
17 response from the investor group was I have some of the
18 information I need. That was the most common answer.
19 The modal response from the management group was I have
20 most of the information. Again, so a different
21 perspective between these two groups.

22 We asked about the scope of the audit. There's

1 some conversation should the scope of the audit be
2 expanded. Probably the thing that's been talked about
3 the most is an opinion on MD&A or at least part of MD&A.

4 Most of the respondents seemed to think, at least
5 right now, the audit scope's about right, three and four.
6 But if you're going to go in either direction, it clearly
7 is to expand, not to reduce.

8 Sufficient scope of the audits that I observed,
9 balance I think is about right. If anything should be
10 reduced, I have a situation where management is signing
11 rep letters that limit auditor scope and responsibility
12 anyway.

13 Those who think it's not sufficient get more than
14 a pass/fail, given the money that is spent on audits.
15 This is going to the audit report issue which Jim said
16 is coming soon.

17 I think it would be useful if audits were
18 expanded to include more tests for fraud. You'll see
19 later, fraud is just so important to this group. Near
20 and dear to your heart, right, Chairman? I think
21 management and -- what's that?

22 CHAIR WHITE: The absence of it, yes.

1 MEMBER CARCELLO: Yes, yes. Right, obviously not
2 fraud. I think management in a typically self-selected
3 board should not hire auditors, not as worried about the
4 scope, worried about auditors focusing on what matters
5 to investors.

6 Again, differences between the groups, all but
7 one of the 11 respondents that said the scope should be
8 expanded were investors. So basically, to the extent
9 there's, you know, that quarter percent that said expand,
10 it was basically all from investors.

11 Do you have enough -- then we went to audit
12 quality, and we talked this morning about the AQI
13 project. I don't know if Greg Jonas is here, but -- oh,
14 Steve's representing the group. Okay.

15 We talked this morning about the AQI project.
16 And so this is obviously a major project. I know the SEC
17 cares about it as well. And so do you have enough
18 information to even assess the quality of the external
19 auditor?

20 And again, a real split in my mind, right, about
21 55 percent said they have either most or all of the
22 information they need. But 45 percent said they don't --

1 that's not again, that wouldn't give me warm and fuzzies
2 if I was evaluating this -- agree it's hard to audit the
3 auditor. But I believe processes he followed are
4 adequate.

5 As a private equity firm, we either sit on the
6 board or control the company, therefore we have
7 sufficient information. Well, that's not really, I don't
8 think, the mandate of the SEC and PCAOB.

9 Don't agree, greater transparency into audit
10 quality through the use of audit quality indicators give
11 investors more information. Need to know the name of the
12 partner, talked about that, and how much work of other
13 firms are used, especially in other countries like China.

14 No inspection, probably a problem, probably need
15 to know that. The audits are pass/fail. That provides
16 little information, so there is reliance on auditor
17 reputation, again, getting back to this pass/fail.

18 Maybe it would help to see a scorecard of what
19 percentage of the audits turned out to be materially
20 wrong over time. This is getting at some of those output
21 measures of AQIs.

22 Do you have enough information to make this

1 assessment? Eighty-five percent of the management group
2 felt they either had all the information they need or
3 most. Only 45 percent of the investor group felt that
4 way. Guys, that's a big difference. That's a big
5 difference.

6 All right. AQIs, I didn't pick all of them,
7 Steve, that Greg and your team had in your document, just
8 too many. So some of this was a decision on the part of
9 the working group as to which ones. So we picked,
10 obviously, the ones we thought mattered more. So there's
11 a little bit of our judgement here.

12 What I've put in yellow are the ones within each
13 of the three buckets, the buckets being input measures
14 of AQI, process measures of AQI, output measures of AQI.
15 I put in yellow the ones that seemed to be most important
16 within each of those buckets.

17 So in terms of input measures, what seems to
18 matter is the partner, right, partner matters a lot.
19 Industry experience of the partner, loaded most heavily.
20 Professional experience of the partner, partner matters,
21 partner matters an awful lot. Hardly surprising, right.

22 Audit team turnover, staff workload, you know, if

1 you're working your people to 2:00 a.m. every night,
2 probably not getting the greatest audit.

3 Process measures of AQIs, the ones that seemed to
4 load the most heavily, firm tone at the top, terribly
5 important, hard to measure. Supervision and review,
6 focus on audit quality, and evaluation and compensation.

7 In terms of output measures, the two that loaded
8 most heavily, in fact, the one that loaded most heavily
9 in everything is fraud. If there's fraud, and the
10 auditors miss it, that just matters so much, at least to
11 this investor sample. Less so, but still the second most
12 heavily weighted in the output, is restatements where the
13 auditor missed it.

14 The last question, and this is really more for
15 you, Chair White, and Jim and Brian than for Doty, Mr.
16 Doty and the rest of the Board, is about the audit
17 committee, right. Because they don't have the direct
18 responsibility you do. And that is do audit committees
19 adequately represent the interests of investors?

20 And it's an interesting result here, I thought.
21 If you, again, add the completely and a good bit, you're
22 at 65 percent. If you weigh it a little and not at all,

1 you're at 35 percent.

2 Again, I think this is in the eye of the
3 beholder. I guess if I was, if I was the NACD, I'd
4 probably say, hey, look, they're doing a good job. And
5 investors think so. I'd probably say, geez, if 35
6 percent of my students didn't think I cared about their
7 success, I would view myself as an abysmal failure. So
8 eye of the beholder, like a lot of things in life.

9 Agree, I believe they act independently to review
10 external auditors, Sarbanes-Oxley Act strengthened the
11 independence and expertise of audit committees. Don't
12 agree, hard to determine, since these committees are not
13 very transparent. Jim and Brian are going to fix that,
14 right, guys?

15 Audit committees are often nominated by
16 management. We believe directors on the audit committee
17 should only be allowed to be nominated by investors.
18 Difference, oh, still more don't agree.

19 Audit committees tend to defer to management when
20 negotiating audit fees. I do think this is an issue.
21 Anecdotally, I've heard this a lot from senior partners
22 in firms. They can't say this too loudly, but it's an

1 issue.

2 Corporate boards in general are weak, directors
3 are chosen based on relationships and reputation. Most
4 directors are conscientious, but they do not have deep
5 industry subject expertise, not in a position to
6 challenge management.

7 If we break it out separately, 77 percent of the
8 management group are either a good bit or completely
9 confident that audit committees represent the interest
10 of investors. Sixty-one percent of the investors group
11 feel that way. But that means 40 percent don't. So
12 again, whether that's good or bad, we'll let you guys
13 decide.

14 Questions? Wow, I get more questions from my
15 juniors. Jim?

16 CHAIRMAN DOTY: What does the, there's a question
17 that was not asked.

18 MEMBER CARCELLO: Yes. There's a lot of
19 questions not asked, Jim.

20 CHAIRMAN DOTY: But in terms of what we should be
21 following up on --

22 MEMBER CARCELLO: Yes.

1 CHAIRMAN DOTY: -- and going to Page 9 in the
2 investor survey and the effect on confidence, the
3 elimination of mandatory financial statement auditing,
4 does that suggest that we should be asking what if the
5 integrated audit, ICFR, and the registration with the
6 PCAOB, what if that became optional? How would that
7 affect the confidence and the credibility of the audit
8 in the eye of a sample group like this?

9 MEMBER CARCELLO: Yes.

10 CHAIRMAN DOTY: We've got some research going in
11 the Center that would suggest that having a PCAOB audit
12 and having an integrated audit does favorably impact
13 access to capital and the premium capital. But maybe we
14 ought to do some more scrubbing in that area.

15 MEMBER CARCELLO: Obviously, we didn't ask that,
16 Jim. And so I'd be speculating. And I'll wait for the
17 full group discussion for me to speculate on that. Okay.
18 I guess, let's throw it open then --

19 MEMBER BULLARD: I have one.

20 MEMBER CARCELLO: Yes?

21 MEMBER BULLARD: Do you have any insight on how
22 these answers might apply in the context of the 404

1 exemptions?

2 MEMBER CARCELLO: So, let me paraphrase what I
3 think you're asking me. So how would these answers
4 matter if we were only asking people who were investing
5 --

6 MEMBER BULLARD: Why might their views differ if
7 they were to be commenting, giving answers based on 404
8 compliant as opposed to 404 non-compliant?

9 MEMBER CARCELLO: Yes. I think that's a little
10 bit of what you were getting at, Jim, right?

11 CHAIRMAN DOTY: Yes. Would you have regression
12 or would you have a continuance, maintenance of
13 standards, something to worry about.

14 MEMBER CARCELLO: Yes.

15 CHAIRMAN DOTY: And I think our -- I would have
16 to say, personally, I'm skeptical that you would have
17 maintenance of standards without it.

18 MEMBER CARCELLO: Yes. It's a good question,
19 Mercer. Again, it would be complete speculation on my
20 part. Because we didn't ask that. Tony?

21 CHAIRMAN HARRIS: Please identify yourself.

22 MEMBER SONDHI: This is Tony Sondhi. Joe, I'm

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1 just wondering. I think you did a great job with the,
2 you know, identification of the extent of knowledge the
3 respondents have.

4 MEMBER CARCELLO: Yes.

5 MEMBER SONDHI: One of the things that I think,
6 at least I have always believed makes a difference in
7 here, it's not so much an issue of what their knowledge
8 is. The question is whether the models they use use
9 accounting information in making investment decisions.

10 MEMBER CARCELLO: Yes.

11 MEMBER SONDHI: I mean, you can have, you're
12 definitely going to have, I mean, if you call up Curt,
13 you know, and obviously he knows accounting --

14 MEMBER CARCELLO: Right.

15 MEMBER SONDHI: So when he says, you know, that
16 this matters or if this has a CFO as one of the
17 respondents on this, he knows what he's doing.

18 MEMBER CARCELLO: Right.

19 MEMBER SONDHI: But the point is, you know, if he
20 doesn't, you know, if he's running a mutual fund, but
21 it's based on either technical indicators, or he's
22 running a hedge fund where they're doing it on something

1 totally different --

2 MEMBER CARCELLO: Yes.

3 MEMBER SONDHI: -- the responses are going to be
4 quite different to each of these issues you've raised.

5 MEMBER CARCELLO: Yes, yes. I think one of the
6 things, and we've talked about this as groups before, is
7 we talk about investors as if they're some homogenous
8 group. And clearly they're not.

9 There's tremendous variation across investors,
10 Tony, right. And there's tremendous variation in how
11 they make decisions, and there's tremendous variation in
12 how they use the information.

13 So in some sense, they may be using forward
14 looking information to make decisions. But that's often
15 built off of this foundation. In other cases, they're
16 using GAAP information as a retrospective check.

17 And in a lot of cases, that seems to be, like in
18 talking to people like Anne Simpson and others, often
19 they use this really from a governance perspective to
20 evaluate stewardship.

21 We always talk about that the GAAP statements are
22 going to drive decisions, and they may be the foundation

1 for information that drives decisions. But a lot of this
2 whole process around reporting is really a stewardship
3 and governance role. And that's why we tried to include
4 lots of different people in who completed the survey.
5 Chair White?

6 CHAIR WHITE: Just, I mean, it's a more
7 methodology question a little bit. But in terms of who
8 responded to the survey, obviously different categories
9 of folks did.

10 MEMBER CARCELLO: Right.

11 CHAIR WHITE: Was there any direction with your
12 survey as to who that ought to be, you know, whether an
13 analyst, a CFO, just curious about that. And then I
14 guess sort of the follow-up question is to ask --

15 MEMBER CARCELLO: Yes.

16 CHAIR WHITE: -- up front is, well, in some of
17 the results on expanding the scope of the independence
18 auditor which related to reviewing independence
19 assessment of the audit committee, any sense of whether
20 that's coming from, you know, mostly from sort of
21 different types of responders who may have more or less
22 knowledge of the field? Just curious as to your sense

1 of that.

2 MEMBER CARCELLO: Yes. Great questions. So in
3 terms of the first, because there's two questions there.
4 In terms of the first question, any direction from us as
5 to who should respond, so at least the database I have,
6 the database that Ann used, I'm not as sure. But the
7 database that I have, what we tried to do when we built
8 the database was get the name of the chief investment
9 officer. That's what we tried to do.

10 We were not always successful, because it's not
11 always very obvious who he or she is. So if we couldn't
12 get the chief investment officer, often we would get the
13 chief executive officer, you know, basically the highest
14 level person we could get disclosed if the chief
15 investment officer was not disclosed.

16 Now, what we found with the telephone calls is,
17 when we got through to people, they often would say,
18 okay, again, what are you doing? Why are you doing this?
19 And then they would, inside the company, so let's say the
20 AA for the person who it was sent to, he or she would
21 direct, based on that person's judgement, Chair White,
22 as to who they thought was best positioned to respond

1 within their organization.

2 So we didn't really control that, as in a perfect
3 world, the way maybe you'd want. That's why we asked.
4 The best we could do is say, well, at least tell us who
5 you are.

6 In terms of the second question, which is on some
7 of these if we were to cut separately by respondent group
8 would our takeaways be different? I think you mentioned
9 a couple of items, the audit committee, and I think it
10 was maybe one other. We did not do that.

11 If that's something that you, or Jim, or Brian or
12 others are interested in, just send me an email. We have
13 the data, we can cut it, okay. All right, I'm going to
14 sit down and open it up, Steve, I think --

15 CHAIRMAN HARRIS: Well, Joe, let me ask you a
16 question which is, you know, apart from the methodology.
17 It gets to a little bit of the substance on the issue of
18 independence.

19 Forty-one percent of those surveyed were neutral
20 as to whether they were out of the regulatory safeguards.
21 You point that out.

22 MEMBER CARCELLO: Yes.

1 CHAIRMAN HARRIS: And I was wondering whether you
2 could tell us a little bit more with respect to your
3 findings here and what were some of their concerns. Or,
4 you know, what are some of the working group's concerns
5 on this one?

6 And then a related question dealt with another
7 slide which commentator indicated I would like better
8 disclosure of auditing firm's conflicts policy and also
9 detailed financial statements including profit earned by
10 division, tax consulting and audit.

11 And the questions on both of these, do you have
12 any idea what types of conflicts he or she might be
13 referring to or the independence issues that you referred
14 to? And assuming you just have a result without the
15 granularity, I'm wondering whether or not the working
16 group has any views on those issues.

17 MEMBER CARCELLO: Yes. Steve, I think this is
18 the slide --

19 CHAIRMAN HARRIS: I wanted Slide 21.

20 MEMBER CARCELLO: Twenty-one.

21 CHAIRMAN HARRIS: I think.

22 MEMBER CARCELLO: Okay. Yes. So that's the base

1 results. And these are some of the differences. This
2 was not a question that we asked them to give us three
3 comments on. Maybe that, you know, with the benefit of
4 hindsight, maybe we should have. We asked for three
5 responses on do you have enough information to make this
6 assessment. But we did not ask for three responses on
7 what specifically they're concerned about. So, you know,
8 we obviously can have that discussion among the broader
9 group.

10 I know some of the things that I've heard
11 discussed, and you're starting to see this in the
12 academic literature as well, is significant growth that's
13 still allowable in non-audit services.

14 So, you know, there's a long list that, Chair
15 White, in one of your rules, obviously pre-dates you, of
16 why it's prohibited. And the firms, to their credit, I'm
17 not criticizing them, are very creative in finding
18 services that there's a market need for. And they
19 provide those services.

20 There's also the concern of more rapid growth on
21 the consulting side than in the audit and tax side. And
22 at a certain point, are the organizations, the culture

1 of the organizations, essentially a different culture.
2 So I think that's probably best for the group to discuss.
3 Brian?

4 MR. CRATEAU: So if I could just, on that same
5 point, I had a similar question. And as someone who
6 spends a fair amount of time on other independents every
7 day, we're very interested if you are hearing of examples
8 of new, emerging services that you think might be
9 troubling or the group thinks might be troubling. We're
10 always interested in hearing that so we can think about
11 them and address the. Most of what we see tends to be
12 growth of non-audit services to non-audit clients.

13 MEMBER CARCELLO: Right.

14 MR. CRATEAU: Which might create different
15 questions for you. But if certainly you're seeing the
16 growth of non-audit services, of the types of services
17 that aren't on the prohibited list but yet, for some
18 reason, cause some degree of concern, certainly we'd be
19 interested in hearing about those.

20 But it does sound like perhaps the questions
21 didn't allow for that kind of feedback. But certainly,
22 even if anecdotally, you're hearing about that, you know,

1 certainly I'm always interested.

2 MEMBER CARCELLO: Okay. Thank you, Brian.
3 Mercer?

4 MEMBER BULLARD: I just wanted to add, I think it
5 was last year that we, I think I did the presentation on
6 disclosure of the financial statements. And that
7 obviously implicates the profitability of the non-audit
8 services. I think Chair White was at that meeting. So
9 I think that really directly ties into your findings.

10 MEMBER CARCELLO: Yes. Steve, I'm going to sit
11 down so we can have our conversation. You know, I don't
12 want it to be my opinion beyond just presenting the
13 results. And so let me go ahead and sit down. And then
14 let's see what the group has to say.

15 BOARD MEMBER FRANZEL: Joe, I have one more
16 follow-up question on the methodology.

17 MEMBER CARCELLO: Yes.

18 BOARD MEMBER FRANZEL: Some of your results are
19 presented, you know, for the two different groups,
20 management versus everybody else. And we see some big
21 differences, which is not surprising. Management is
22 closer to the audit --

1 MEMBER CARCELLO: Right.

2 BOARD MEMBER FRANZEL: -- and may feel like they
3 have more information about the audit. Did you run all
4 of the results separately, you know --

5 MEMBER CARCELLO: Yes.

6 BOARD MEMBER FRANZEL: Okay. So you only
7 presented to us the ones where there were major
8 differences?

9 MEMBER CARCELLO: Yes. The ones that you don't
10 see a slide, Jeanette, that's basically saying, at least
11 in my judgement -- and I'm happy if you want more
12 granularity, to send it to you. Just send me an email,
13 because I have all of these. I have pages and pages of
14 stuff. But on the ones that I don't, at least in my
15 judgement, they were close enough that, in a 30 minute
16 presentation, probably it wasn't worth highlighting.

17 BOARD MEMBER FRANZEL: Okay, thank you.

18 MEMBER CARCELLO: Thank you.

19 CHAIRMAN HARRIS: Bob?

20 MEMBER TAROLA: Joe, as usual a wonderful job.
21 Thanks to you and your group. My takeaways on this are
22 mostly positive, that the audit seems to be a base for

1 all other financial analysis, at least at some point in
2 the process of analyzing companies and one investment
3 over another.

4 What's a bit disappointing is that the audit
5 committee's role in that supply chain of information was
6 somewhat mixed as to whether or not it's adding a quality
7 factor.

8 MEMBER CARCELLO: Right.

9 MEMBER TAROLA: What I would like to see us do as
10 a group maybe going forward is what would they have liked
11 from the auditor or audit process, both in information
12 as well as in how they get the information and then how
13 timely they get information?

14 So is the audit a once a year, three months after
15 the fact, exercise as a bedrock of everything else? Or
16 can it also be beneficial to investors as a more real
17 time exercise? As they consume information, can the
18 audit be with it as a way to provide more indications of
19 quality of the information as it's being consumed, often
20 daily but certainly at least quarterly?

21 MEMBER CARCELLO: Bob, it's a good suggestion.
22 And as you know, this group has often struggled with

1 what's our mandate, if any, around audit committees. And
2 it's not clear, because the PCAOB does not have direct
3 oversight, and we're an advisory group to the PCAOB. But
4 clearly, audit committees do affect the audit process,
5 so it gets a bit uncertain.

6

7 For the benefit of Chair White, I have tried to
8 get the IAAC to engage on this. We'll see if I can
9 convince Roy to take this up in Invest Arizona.

10 MEMBER HEAD: This is Mike Head. And first, Joe,
11 I'd like to thank your group. Because I think this adds
12 a lot of insight and a lot of hard work. And I know,
13 from doing things like this, these slides don't just come
14 without a lot of effort. So thank you, guys.

15 And less of a question than a couple of
16 observations. And we all know when we see data at least
17 our human nature is we look for things that reinforce
18 what we already believe. And we ignore things that don't
19 reinforce what we already believe. And so my statements
20 may fall into that category unintentionally.

21 But it made me feel better than what I thought I
22 was going to, before I saw the information, about what

1 seems to be the financial statements are serving as the
2 foundation for the investment community and the
3 investors, that they want to use a lot of other tools,
4 but they're just assuming table stakes are there that
5 you're going to get auditor financial statements.

6 And they are expecting that they're going to have
7 a clean opinion on those financial statements and the
8 internal controls over financial reporting and that if
9 those weren't there, that would be concerning to them
10 enough that they would change their investment behaviors.
11 At least that's what I heard and saw in that. And I
12 think that's a very, very, very positive outcome.

13 Where I'm concerned, and it happens to be on the
14 slide, and I've been concerned all the way back to when
15 we first came out with the independence rules, because
16 I thought we chickened out originally by not just
17 mandating you can't provide any other services other than
18 the audit to your client. There's no such thing as
19 allowable or acceptable non-audit services.

20 And if we would have started there and stayed
21 there, we wouldn't be revisiting this issue today in the
22 format that we are. And I think that's where we should

1 go.

2 I think that's where we should have went
3 originally. I think that if you just mandate to the
4 firms, it doesn't matter, the dollars is what matter, not
5 what the types service is. They're creative, they're
6 going to find out ways to make money, and they're going
7 to try to maximize that amount that they make.

8 And as long as you leave that window open,
9 they're going to find a way to get through that window,
10 no matter if we think those services create conflict or
11 not. The dollars create conflict, not the type of
12 service that you're providing.

13 MEMBER CARCELLO: Mike, let me just briefly
14 respond before we go to Norman on that. And I'll
15 probably be in a minority, I think, on this issue. And
16 I think the group knows me well enough that when the
17 major firms fail, I'm not hesitant to criticize them.

18 But I think this issue is, at least in my view,
19 a little more nuanced than you made that out to be in the
20 sense that financial statements and financial reporting
21 has become so complex and requires so many different
22 skill sets that having skill sets, in the area of

1 valuation, and in the area of systems, and in the area
2 of actuarial and in many of the areas that the firms have
3 built significant skill sets, is needed to do a good
4 audit.

5 And, you know, I know the argument that many
6 would make, you would probably make as well, is the firm
7 can just hire these people, and they're essentially just
8 100 percent audit support.

9 I'm skeptical. I know the firms say, without any
10 doubt, that people wouldn't do it. I don't know if their
11 blanket statements are 100 percent accurate.

12 But I do think that the high level people that
13 you want inside the organizations doing this work, if all
14 they were going to do was essentially audit support, I
15 do question whether or not the best people or even very
16 good people would be willing to do that.

17 So I do think, I actually think this is a very
18 hard policy issue for the SEC and the PCAOB to grapple
19 with.

20 MEMBER HEAD: I don't disagree with you. I just
21 don't think that they continue to get utilized and keep
22 those services current on consulting services with their

1 audit clients. They do that with their non-audit
2 clients. And then they provide that same expertise as
3 support for the audit. But they can't do those services,
4 none of them, zero, for their audit clients.

5 MEMBER CARCELLO: I got you, now I got you.

6 MEMBER NACHTWEY: Great thanks. And I didn't
7 mean to jump ahead of you, Norm. Hopefully, you -- okay.
8 But again, add the kudos to, even though my name's on the
9 front page of this thing, in the interest of full
10 disclosure, Joe and Ann did the lion's share of the work,
11 well, and I'm sure some of the students at the University
12 of Tennessee. But great job.

13 Because I do understand how difficult it is to
14 get people to respond to this. And I'm guessing most of
15 us around the table all could make careers out of
16 responding to surveys we get almost daily. We just
17 couldn't make a living at it. But we could make a career
18 of it.

19 But I like the way you stratified the
20 respondents, and I think, as we think about going
21 forward, whether there's a way to do these in an even
22 more targeted way.

1 And also probably the investment relations
2 officer, well, that sounds like it's an investor. I'm
3 guessing there was probably investor relations. You know,
4 so I've got a guy, Curt's got somebody at his company,
5 you know, et cetera, that just talk to our shareholders.

6 But it's more, I almost call it a marketing
7 position. You know, they're really just trying to help
8 the investors understand this and what not.

9 But when I look at the two layers of people that
10 actually make investment decisions in this group that's
11 on Page 7, it really comes down to the portfolio managers
12 and the senior analysts.

13 The, you know, the CIOs are interesting, but
14 they're typically operating up at a 50,000 foot level,
15 they're setting macro-policies, looking at the overall
16 portfolio, other than that, down in the weeds. And I
17 think the director of investment operations is probably
18 similar.

19 So I think it's all good info, but the more, I
20 really liked the fact that you kind of carved out and
21 sort of certain people are going to bring a different
22 perspective that may not be, you know, exactly what we're

1 looking for.

2 And then the governance officers, I think a lot
3 of what this group's dealing with is what the governance
4 officers are focused on. And in a perfect world, they'd
5 be involved in making investment decisions. In reality,
6 I don't know of any firm that has the governance people
7 involved in making the initial investment decision. But
8 they certainly are involved in voting their shares.

9 And then, you know, potentially, if they see
10 somebody that's just kind of a bad actor, eventually
11 they're going to get that around to the investment guys
12 and say, hey, do we really want to continue the
13 investment here.

14 But I think, you know, that the governance
15 officer group is the one that's probably the most
16 informed about the kind of things that are important to
17 this group. So to figure out a way to hone in on them,
18 you know, in future surveys might make sense.

19 And again, since my name's on the cover, it'd
20 have been great if I'd come up with that idea earlier,
21 but better late than never, I guess.

22 And two other things going to Bob Tarola's point

1 on the audit committees, I think I absolutely applaud the
2 efforts that both the SEC has made and the Board have
3 made. Again, you'd have to spend some time with our
4 audit committee.

5 I just can't overemphasize the importance of that
6 dialogue, that I kind of, you know, view the macro role
7 that the PCAOB plays over all in the regulatory process,
8 but then where the rubber meets the road is what's the
9 quality of the audit committee.

10 And I think there's a dramatic difference between
11 audit committees. And sometimes it isn't just based on
12 size, although often it is. And, you know, how do we
13 just continue to up the game on audit committees? And
14 how do we make sure they have the right, you know, the
15 financial expert criteria is good, but people can be a
16 financial expert and know nothing about auditing.

17 So how do you make sure that the audit
18 committee's populated with folks that have some
19 background in audit, at least, you know, one or two of
20 the members of the audit committee?

21 And then last but not least, I thought it was
22 interesting on the Slide 31, the AQI, around audit team

1 turnover and that, you know, almost 70 percent of the
2 folks are saying that's very important.

3 I think that ought to be something we think about
4 as we start talking about audit firm rotation. Because
5 there's some things that are appealing intellectually
6 about audit firm rotation.

7 Where the rubber meets the road is do I have 100
8 percent turnover of the engagement team at all levels
9 globally when you rotate auditors. So it's interesting
10 how important, you know, investors find that statistic.
11 So again, great job. Thank you.

12 CHAIRMAN HARRIS: Norman?

13 MEMBER HARRISON: Thank you, Steve. I wanted to
14 return to the independence issue for just a minute,
15 follow-up on the recent discussion. You know,
16 independence obviously is one of the cornerstones of the
17 integrity of this whole process. And threats to it arise
18 in a number of different forms.

19 But we've talked about this in this group two or
20 three years ago. Three years ago, I think, there was a
21 working group devoted specifically to the subject. And
22 we had a good discussion about it at that time.

1 And I think, you know, we're well informed by the
2 views of our colleagues who have been partners in Big
3 Four firms or other large audit firms, have some
4 firsthand experience.

5 But I think for the rest of us, where we come
6 down on the continuum between Mike, and Joe or perhaps
7 a broader spectrum is largely uninformed by virtue of the
8 fact we don't have access to a lot of the information
9 we'd need to make an intelligent decision.

10 You know, a lot of firms are not required to
11 publish GAAP-compliant financial statements. We know
12 something about revenues by segments and perhaps other
13 high level attributes, but like any other business
14 enterprise, you know, resources and talent, I would
15 assume, in the Big Four follow the money.

16 And if there are, as I think many of us believe,
17 you know, higher margins on the work being done in the
18 advisory segment, I'm going to bet that that's where
19 priorities go for resources and technology.

20 And Bob referred earlier to the evolution of the
21 audit process from a paper base to a digital process.
22 You know, where are the firms investing in technology,

1 and resources and people? How are incentive compensation
2 models developed in those segments?

3 And a lot of information we would need to form
4 some judgements around this issue, I think, we simply
5 don't have access to. So it, you know, is there talent
6 flight from the audit segment to the advisory segment?

7 A lot of the skills are transferrable between
8 those two business segments. Is it happening and to what
9 degree? How many mid-level professionals who are being
10 groomed to be engagement partners jump over to the other
11 side, because there's more professional opportunity, more
12 advancement or more money to be made there?

13 I don't know, but I think they are fair
14 questions. And I think they should be looked at very
15 carefully. There's an opportunity, of course, to begin
16 to gather some information on that in the AQI initiative.
17 And we'll talk about that in a later panel discussion.
18 But I just wanted to get those issues on the table.
19 Because I think it's a very important question.

20 CHAIRMAN HARRIS: Grant, and then we'll get to
21 Steve Kroll, Grant Callery.

22 MEMBER CALLERY: Yes. Just very briefly, and

1 then sort of maybe piling on to what Norman was saying,
2 this issue, we did a group last year that looked at the
3 business models. And the issue just keeps coming up, and
4 coming up and coming up.

5 And somebody had circulated a couple of weeks ago
6 an FT article mostly based on UK and the same issue of
7 non-auditing services. And, you know, and then, Brian,
8 you raised, if you have examples, we'd like to see them.

9 I think somebody really needs to take a look at
10 it and try to get there. Because it's a confidence
11 issue, I think, from an investor's perspective.

12 And the answer may be probably somewhere between
13 Mike and Joe, that you've got to have some balance of
14 this. And do you get the right things, and did Sarbanes-
15 Oxley get it right? Or do we need to move forward from
16 there?

17

18 But I think it's important to really try to get
19 there, because it just seems like it's such a festering
20 issue that keeps raising its head, it keeps showing up
21 in the media. And we ought to be more comfortable with
22 where we are and have good answers that people don't look

1 at and say, well yes, that's just the firm, because the
2 firm wants to make more money, so they do this. And
3 obviously that's their answer, that Sarbanes-Oxley took
4 care of it.

5 So I think it's really worth something to take,
6 you know, in concert with the PCAOB, and the SEC or
7 whatever, but to have a good discussion. And try to get
8 as close to the bottom of it as possible and maybe make
9 some of this noise go away.

10 CHAIRMAN HARRIS: Steve Kroll?

11 BOARD MEMBER KROLL: No, it is me. Joe, I'd like
12 to ask you and anyone else who wants to comment or
13 question about Slide 21. There was one thing in Slide
14 21 that I found a little surprising.

15 MALE PARTICIPANT: Which slide is this?

16 BOARD MEMBER KROLL: It's your Investor Survey,
17 oh, 31, excuse me, 31. One of the things we've heard
18 from a lot of people, especially audit committee chairs,
19 is that when they drill down, they're concerned about
20 obviously the engagement partner but also about the
21 senior managers and managers who are the sergeants of the
22 audit.

1 Now, I'm not an auditor, so you can make all the
2 fun of me you want. But it just seemed, it surprised me.
3 Of course, you'd care about the partner's professional
4 experience and industry experience, but it surprised me
5 to see a, oh what is it, a 27 point swing.

6 Because, you know, if I was going to audit Wells
7 Fargo, I had the greatest bank engagement partner in the
8 country and a bunch of managers who last year audited
9 Best Buy, I might be a little worried about that.

10 And I just, I don't know, do you attribute that
11 to the fact that a lot of people just knew about as much
12 about auditing when they filled this out as I did before
13 Greg Jonas taught me everything I knew? I will admit
14 that now.

15 MEMBER CARCELLO: Obviously, it's speculation,
16 Steve. I think it could be a few things. I think it
17 could be what you said, they don't have enough detailed
18 knowledge of the way audits work and the importance of
19 managers and senior managers. It certainly could be
20 that.

21 It could be that we didn't give them enough
22 levels to choose from. There's always this tradeoff

1 between more granularity and then they look at the
2 questionnaire, and they say there's no way I'm going to
3 do this.

4 So we could have asked about the partner, or the
5 senior manager, or the manager, the senior and then the,
6 you know, the first two year staff. And I think we would
7 have gotten more nuanced responses, but then, you know,
8 you just balloon the survey.

9 It could also be that, you know, when I think
10 about my world I think people say do I feel good about
11 the dean? And if I feel good about the dean, I feel good
12 about the associate deans and the department heads. And
13 at the end of the day, the buck stops with him or her.
14 Because that person's responsible for their staff.

15 So if I feel pretty good about the engagement
16 partner, maybe I trust him or her to make sure that the
17 team is appropriate to execute the engagement that needs
18 to be done. And it could be any of those, or it could
19 be a combination of those.

20 BOARD MEMBER KROLL: Okay. Thank you, that's
21 very helpful.

22 CHAIRMAN HARRIS: Brandon?

1 MEMBER BECKER: Just two quick points, one to
2 echo again the terrific work that Joe and Ann did putting
3 this together and really very helpful information. And
4 we on the working group appreciate their work, as Pete
5 mentioned.

6 And then what Joe just highlighted, we do look to
7 the engagement partner as the person who's supposed to
8 lead the team. So where there is a follow-on effect or
9 a waterfall effect in terms of perhaps undue focus on
10 that leadership, but that is the leadership that we're
11 looking to to build the team that he or she can rely
12 upon.

13 CHAIRMAN HARRIS: Tony?

14 MEMBER SONDHI: Thank you, Steve. I just wanted
15 to actually just follow on to a couple of comments that
16 have been made, one Norman had made earlier about this
17 transfer or migration of the talent from the audit side
18 over to the advisory group.

19 And I serve as an advisor to a number of small,
20 you know, regional accounting firms, audit firms. And
21 it's certainly noticeable there. When they start losing,
22 they start developing their advisory group or portion of

1 the firm. They tend to lose that, and that creates a,
2 I think, it's a really serious vacuum.

3 And the second aspect of that is the training in
4 there. So we think about training at these different
5 larger firms. But training in the smaller and the
6 regional firms is a significant problem. So from that
7 perspective, I think it matters.

8 And then this issue of engagement partners, what
9 I've noticed in much of the work that I do these days is
10 in software, or Cloud computing, or some of the newer
11 social media type of companies and digital media, et
12 cetera.

13 And many of these firms are in places where you
14 don't have a concentration of those types of firms. And
15 there the engagement partner and the level of knowledge
16 they have of that industry becomes a very critical thing.
17 So the emphasis on the engagement partner, I think, is
18 really critical.

19 But the emphasis should also be on their
20 knowledge of what they're auditing. And that, I think,
21 is, it's going to come up a little bit later on as well.
22 But since it's been commented on here, I wanted to add

1 that.

2 CHAIRMAN HARRIS: Joe?

3 MEMBER CARCELLO: Steve, I just wanted to briefly
4 respond to something Norman said a little while ago. I
5 do agree with Norman that it would be helpful to have
6 more specificity around revenue and profit by service
7 line in terms of the consulting issue, which we clearly
8 don't have now.

9 I would say that I, up to probably three, four
10 years ago I agreed with Norman 100 percent. Certainly
11 the perception is that consulting is much more profitable
12 than auditing or tax. I think that's the perception.

13 Now in private conversations, obviously I'm not
14 going to mention the firm or the persons, at least some
15 of the firms claim that that is not the case, that in
16 fact audit and tax is at least as profitable, if not more
17 profitable, than consulting which seems counter
18 intuitive. But if you think about it, it's actually
19 plausible, right.

20 Because in audit and tax it's much more of a
21 levered model. And you have a higher level of relatively
22 low paid people working for each partner. And in

1 consulting, it's hard to justify that.

2 So I don't know if I've been given good
3 information or bad information. But I think we would
4 both agree we have a lack of information. So I think
5 that's a non-settled question. I don't think it's an
6 non-settled question as to the growth rates.

7 I think that's pretty clear that consulting is
8 growing much more rapidly than audit and tax. And that
9 definitely has an effect on where people want to go.
10 Because if you're going to work as hard as these
11 organizations make you work, you want to become a partner
12 faster.

13 I think the other issue which we haven't talked
14 about, Norman, but in my role now as department head, a
15 big part of my job is staying in contact with alums for
16 obvious, you know, development purposes.

17 And as I interact with these folks who have been
18 out four, five, six, seven years and further, a lot of
19 them have moved from the audit staff to the consulting
20 staff. It's quite common. And --

21 MEMBER HARRISON: Are they writing bigger checks?

22 MEMBER CARCELLO: No. That's --

1 MEMBER HARRISON: I'm just kidding, sorry.

2 MEMBER CARCELLO: That isn't the reason. That
3 may be true, but that isn't the reason they give me. The
4 reason they give me, I think, is a hard reason to solve.
5 They often find their consulting is just more
6 interesting, just more fun. And I don't know how to,
7 that's a hard issue to solve. But I don't think we
8 should ignore that issue.

9 CHAIRMAN HARRIS: But how do you retain audit
10 quality if that's happening?

11 MEMBER CARCELLO: Steve, I don't, it's easier to
12 suggest a problem than to find a solution, right?

13 CHAIRMAN HARRIS: Jeanette?

14 BOARD MEMBER FRANZEL: Yes. And some of this
15 discussion about audit services versus non-audit
16 services, I guess, I'd like to emphasize the need for
17 some information. And this is a question I think we need
18 to address going forward.

19 We rely on an oligopoly to provide these services
20 which, you know, are to lend competence to the market.
21 But in the absence of information, it seems that these
22 urban -- it's almost like urban mythology that starts

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1 floating around about assumptions about how the firms
2 operate and what the impacts might be.

3 And, you know, we have done some research at the
4 PCAOB when we hear some of this, because we want to
5 verify is this true or not. And so I think this is a
6 very important issue.

7 The lack of information can actually be
8 impacting, you know, people's confidence, especially when
9 different types of assertions do start floating around
10 out there in the market place.

11 So just something for maybe this group to think
12 about going forward, and for us at the PCAOB and
13 certainly for the firms. Because these are very
14 important questions that do impact confidence.

15 CHAIRMAN HARRIS: Yes. I couldn't agree with
16 that more. And, Mike, I'd be very interested at some
17 future point, or if you have it now or any comments of
18 others in terms of what you see as the conflicts and what
19 you see as the independence issues as you increase the
20 consulting and advisory activities of these firms.

21 I mean, it's easy for some of us to throw these
22 terms around, such as myself, but then the question is

1 what specific examples do we have of potential problems
2 out there?

3 MEMBER HEAD: Because I am a couple of years
4 removed from my chief audit executive role where I served
5 at TD Ameritrade as the coordinator for negotiation of
6 fees for the audit committee and the director of the
7 audit committee, some of this is anecdotal and not based
8 on real data to support it.

9 But there was always the question that the
10 engagement leadership partners would bring to the table
11 though, because we set the policy early on that we didn't
12 want to have to deal with the issue.

13 So the easiest way to deal with the issue was to
14 make sure the firm that was doing our auditing knew that
15 we were not going to allow them to bid on allowable non-
16 audit work. Not because it wasn't okay, but that was
17 just the audit committee's policy.

18 But constantly the partners would be coming back
19 and saying we have this talent, we have this skill set,
20 we have this ability that we could help your firm and we
21 would like to do that.

22 And our response was we're never against you

1 bringing someone in with subject matter expertise and
2 sharing that knowledge with us to help us get better.
3 We just aren't going to hire you to do it from a
4 consulting point of view.

5 And the number, and so this is anecdotal, so the
6 number of those subject matter experts that actually came
7 and did work in the firm to enhance that knowledge was
8 virtually non-existent, where they would have been there
9 all the time if we were paying fees for it.

10 So that's only anecdotal, and that's a sample of
11 one. And it was okay. You know, if we asked for them
12 to bring a subject matter expert in, they always did.
13 But it was then responding to a need that we requested
14 versus that proactive of we're going to bring all these
15 subject matter experts.

16 But I will say our audit quality was very, very
17 high. I think the audit committee was very comfortable.
18 And when there was a need on the audit engagement, they
19 brought that subject matter expertise to the table to do
20 the audit they needed.

21 So my evidence of why I have the opinion that I
22 have is I think I saw it on a sample of one work very

1 well in our case. And I think that model could work well
2 as long as those subject matter experts had other non-
3 audit engagements that would allow them to do that work
4 and maintain that subject matter expertise. Otherwise,
5 you're going to lose them to --

6 (Simultaneous speaking.)

7 MEMBER HEAD: Yes. You're going to lose them.
8 Yes.

9 CHAIRMAN HARRIS: Brandon?

10 MEMBER BECKER: I think it's probably true that
11 all of us in the client service business know that the
12 best way to develop new business is with existing clients
13 and that that momentum is there. But I don't think it's
14 appropriate to think that the Commission's rules have
15 been effective in the gatekeeping.

16 Sophisticated institutions know what those rules
17 are. They know how to follow them, which is not to
18 minimize the structural question. I just don't want it
19 to be framed as -- I don't think there's, subject to my
20 committee members' disapproval, a fraud conflict here.

21 There may be structural issues about talent, how
22 talent is developed, what some of the implicit

1 assumptions are. But I think folks are following the
2 rules, and following the gatekeeping, and getting the
3 audit committee approvals, and doing that and doing it
4 on a regular basis.

5 Whether structurally, incentive-wise we might
6 tighten it down is a different exercise, and one that is
7 very challenging and not unique to accounting, whether
8 it was broker-dealer, say, Glass-Steagall, Volcker, line
9 of business rules are tough to draw. And it is tough to
10 decide that you've made the right market microstructure
11 judgement about how you're going to develop that talent
12 over its years.

13 CHAIRMAN HARRIS: Gary Walsh?

14 MEMBER WALSH: I totally agree with Jeanette and
15 what she had to say about independence in the visibility
16 or lack thereof of information.

17 As investors, we don't have enough information to
18 really identify conflicts. But we also don't have enough
19 to make us feel comfortable that there aren't conflicts
20 out. So I would encourage more awareness of what's going
21 on in terms of disclosure at a minimum of the non-audit
22 activities.

1 And I guess I'm also very suspicious about the
2 ability to tease out the audit model versus the non-audit
3 model with these firms. Because the whole awareness of
4 what a firm is doing depends, I think, a lot on their
5 audit activities.

6 And so if you take out, let's call that awareness
7 a marketing type of element to their business model, if
8 you take that out, of course the profitability looks a
9 whole lot better on the consulting side.

10 So I think more work needs to be done to really
11 tease out those two models and what would happen. The
12 cost of an audit is not so significant that we can't make
13 that portion as important and meaningful as it is, make
14 that a profitable endeavor for audit firms without non-
15 audit work.

16 CHAIRMAN HARRIS: Tony, in your slides later on,
17 which Chair White won't be here to review, you raised the
18 issue of transparency throughout virtually all of them.

19 And one area of transparency that I think I
20 recall you raising is transparency with respect to
21 revenue sources and other types of financial information
22 of the firms.

1 ACAP recommended, or at least some members
2 recommended that there be audited financial statements
3 of the firms. And since we're dealing with four major
4 firms in an oligopoly, and since some believe,
5 notwithstanding the rhetoric that nobody's too big to
6 fail, some believe that these are systemically important
7 institutions that may not be allowed to fail,
8 notwithstanding, you know, the contrary view of those of
9 us who believe in America. Anybody ought to be allowed
10 to fail.

11 So I was wondering in terms of the disclosure of
12 financial types of information, why do you think that may
13 be necessary, and then secondly, whether or not you
14 believe that these firms ought to be required to have
15 audited financial statements?

16 MEMBER SONDHI: Thank you. And any other member
17 of the team can also, of course, contribute to this. I
18 think that it's critical simply because it would provide
19 information and effectively tell us and maybe even answer
20 some of these issues that we've been talking about as to,
21 you know, what the emphasis is.

22 Although I, for example, agree with Joe that one

1 of reasons people may be moving to consulting is because
2 it's interesting or more challenging. It certainly is.
3 But at the same time, the question, you know, I'm not so
4 convinced that it's not more profitable.

5 So it would be helpful to understand not only
6 where the resources for these firms are coming from, but
7 it would give us an insight, additional insight into how
8 those resources are being used.

9 So from that perspective, I think that the cross
10 subsidies, for example, if it provides or sheds light on
11 that, that sort of thing would become much more useful.

12 I think it would allow the PCAOB to manage
13 potential risk of those, the too big to fail type of
14 problem, or too few to fail if you want to think of it
15 that way, that perspective. I think it's very important
16 to understand where the risks are within these companies.

17 I've seen some articles and some write-ups about
18 some of the problems that they have with the funding of
19 their pension obligations, for example, and some other
20 aspects and how those are being done. So from all of
21 those perspectives, it would be important to understand.

22 But in addition to that we also ask, for example,

1 of their investments in technology, their investments in
2 training.

3 Earlier we were talking about this growing need
4 for various types of specialists. I think, for example,
5 when I look at the outcome of your work, the Board's work
6 on broker-dealers, for example, some of the problems that
7 we have with banks, some of the ongoing problems with the
8 areas of auditing securitizations and the different types
9 of instruments that are being used these days for
10 securitizations.

11 So the way the firm responds to these challenges,
12 what their business models are, all of this would, there
13 would be more light shed on it through these audits. So
14 I think those are at least some of my reasons for saying
15 that. And there are other members of my team and, well,
16 and there's Mercer maybe.

17 CHAIRMAN HARRIS: I'd like to go to SEC Chief
18 Accountant Jim Schnurr first.

19 MR. SCHNURR: Thanks, Steve. Just a couple of
20 observations about this topic. And I know last year at
21 this meeting we had a somewhat similar discussion around
22 independence.

1 First of all, I think it's important to
2 distinguish what problem you're trying to solve. There
3 are two very different issues on the table, I think.
4 First one is non-audit services to an audit client.

5 I think, with respect to that issue, if you look
6 at the limitations that were put in as a result of
7 Sarbanes-Oxley, you saw non-audit service fees go from,
8 in some cases, a multiple of audit to, the last couple
9 of years the information I've seen is it's roughly 20
10 percent of the audit fee.

11 So question is, you know, is that really
12 independence impairing at a 20 percent level. And you'd
13 have to get into the individual nature of those services.
14 But I think as a general practice, the issue that was
15 originally perceived has been relatively well addressed
16 by the limitation.

17 I think one of the problems you have right now is
18 you don't really have any transparency into what the
19 audit committee does to evaluate the non-audit services
20 on an individual basis.

21 The bigger issue that you're talking about is the
22 size of the consulting practice with relation to the

1 overall firm. That is a totally separate issue.

2 You're now dealing with the culture, tone at the
3 top. And to what extent does the audit firm have in
4 place, if you want to call it safeguards, that will
5 mitigate the negative influence on the audit practice?

6 So are there factors that are now, you know, to
7 the extent there is a disparity between profitability at
8 a partner level, does that somehow put pressure on the
9 audit function and the audit engagement team to do things
10 that are not supportive of improving audit quality.

11 The flip side of that, as you look at some of the
12 issues that have been, not issues but some of the
13 discussion around improving audits through the use of,
14 for example, big data and analytics, without the
15 consulting practice the firms wouldn't have that
16 expertise to explore these types of things.

17 So you've got to be very careful when you look at
18 this issue and be very mindful of what you're looking at.

19 I do think that there, you know, particularly
20 from a PCAOB standpoint, you know, one area that hasn't
21 been explored is around the quality control systems that
22 the firms have in place.

1 And I think that's an area that, quite frankly,
2 you know, should be explored in terms of improving those
3 standards around quality control, supervision and review.
4 Those I think, are very, you know, where it would be
5 important to look at.

6 CHAIRMAN HARRIS: Well, I absolutely think you
7 hit the nail on the head when you indicated that, your
8 question of whether or not the safeguards were in place.
9 I'm glad that you're focused on it. We're focused on it.
10 And I think it's something we should be working on
11 together. But I think that's a very significant issue.
12 Mercer?

13 MEMBER BULLARD: Thanks. I think, you know, Jim
14 kind of hit on a point I wanted to bring up which is when
15 you talk about the financial statements, at least it's
16 my understanding financial statements would not do that
17 separation between audit client non-audit services and
18 non-audit client audit services.

19 And in my mind, what I would like to see would
20 be, you know, a bar chart that simply showed the amount
21 of audit client non-audit services and the amount of
22 audit services to those clients.

1 And then let the market decide whether the
2 relative size of those bars is something that might
3 impact their conflicts of interest. Because I think
4 Brandon is exactly right. The best way to sell is to
5 cross-sell.

6 And I would think, even though it may be 20
7 percent of your audit fees, the job of the accounting
8 firm is to get that 20 to 25 and then get it to 30. And
9 the best way to do that is go to audit clients who are
10 already clients and try to do that.

11 So I think just a simple matter of economics, you
12 know, water runs downhill. And you will inevitably have
13 some degree of conflict affecting the judgement of
14 auditors. In my mind, the only question is how much.

15 But very clear disclosure of that particular
16 relationship, I think, would go a long way toward, you
17 know, putting in black and white the potential conflict.

18 CHAIRMAN HARRIS: Pete Nachtwey?

19 MEMBER NACHTWEY: Thanks, Steve. And this is
20 such a complicated area. I mean, at the 50,000 foot
21 level it would seem to be simple. But, you know, the
22 elephant in the room is the vast majority of large public

1 companies are paying their auditors tens of millions of
2 dollars anyway. So which dollar taints their
3 independence?

4 I think, you know, when you kind of start
5 thinking about it that way, either we're going to go to
6 a model where the government's going to pay for the
7 audits, and then the question will be can we hit SEC
8 deadlines, et cetera.

9 Not that there aren't a lot of great government
10 workers, but it's just a different model in terms of --
11 so once you've looked at that, I'd go back to something,
12 Jeanette, you said earlier about, you know, there's an
13 oligopoly now.

14 And I grew up in the industry going back to the
15 late '70s when there was a Big Eight and a Little Eight.
16 And frankly, none of the Big Eight were of significant
17 enough economic power to stand up to any significant
18 client, anybody in the Fortune 100. The financial
19 disparity was gigantic.

20 Now today, with the oligopoly, and again, no
21 perfect world, right, the glass is either half empty or
22 half full. It's never all full. With the oligopoly, you

1 now have four firms that can face off against some of the
2 largest companies from an economic standpoint and have
3 a tremendous amount to lose.

4 And I don't think, you know, the lesson of Arthur
5 Anderson is lost on anybody when they come in to work
6 every day of, well, you know, the value of a franchise
7 that's, you know, all these franchises almost centuries
8 old, a century old, that if we want to get that next
9 dollar of consulting or do we want to make sure we
10 protect the practice, protect our client relationships,
11 et cetera.

12 I think there's many, many incentives inside
13 these firms that sometimes don't get talked about in the
14 public forums. So what would be interesting to me is to
15 see, you know, what's happened over the course of the two
16 major changes that have impacted this.

17 One, the consolidation amongst the firms and the
18 fact that you no longer can have -- I mean, some would
19 say that one of the mistakes that Anderson made was not
20 doing a merger and continuing to -- they went from being
21 the largest firm to the fifth largest firm.

22 Whereas, the other firms had the scale to be able

1 to organize nationally around industries and around
2 functions. So the P&Ls got taken away from the local
3 offices. That never happened at Anderson.

4 And Enron, who was paying them reportedly \$50
5 million a year, might have been, I don't know, 25 percent
6 of the revenue base in that office. And all the partners
7 in that office would know that if anything happened to
8 Enron that was going to be really bad for the Houston
9 office.

10 But if the national audit partner, if the guy
11 that was in charge of national audits, the guy or gal in
12 Chicago at that time was looking at the overall P&L of
13 the audit practice of Anderson, Enron was important. But
14 it wasn't life or death.

15 So I think it's a very different dynamic that
16 we're dealing with today, the way the industry has
17 evolved. It's not all for the good. But I think we
18 ought to, again, we're not going to get to perfect.

19 So has it been better that we now have some
20 oligopolistic power? And has that benefitted investors?
21 Because there have been fewer audit failures to find,
22 broadly, bankruptcies, restatements, a number of, you

1 know, negative deficiency reports in the PCAOB? Has that
2 changed since the industry's changed? And has it
3 changed, you know, post Sarbanes-Oxley? So just one
4 man's view.

5 CHAIRMAN HARRIS: Tony Sondhi.

6 MEMBER SONDHI: Thank you, Steve? I just wanted
7 to get back to respond to two issues, one, Mercer had
8 raised. Mercer, my suggestion with respect to the audits
9 of these firms was clearly based on being able to
10 identify those distinctions. Otherwise, it's irrelevant.
11 I don't care, you know, if that's not done.

12 But I'm also mindful, having been part of the CFA
13 Institute's group that worked ages and ages ago on the
14 segment reporting and seeing how that works in practice.
15 So those definitions are going to be critical to the fact
16 that they get audited correctly.

17 It's also, and that definition gets enforced
18 would be critical. So if we don't get that information,
19 certainly it wouldn't be very helpful.

20 The other thing that I wanted to mention was
21 something Peter just said. It is certainly true that
22 these are large firms now, the Big Four. But there is

1 at least anecdotal evidence, and at least I have observed
2 it, that there are differences in the way in which these
3 firms question their small clients.

4 So I don't think that has gone away. It will be
5 great to find some good research on whether that is a
6 pervasive effect or not. But I see it in terms of the
7 kinds of conflicts that my clients have with their
8 auditors.

9 And I have both very large clients and very,
10 very small clients as well. And I see that distinction
11 every day. I just, I'm not aware of enough good
12 empirical research that tells me that it's a systematic
13 difference. So I don't know that. But I still there is
14 a very serious problem there.

15 CHAIRMAN HARRIS: Mercer?

16 MEMBER BULLARD: I'll just respond quickly.
17 Tony, as you pointed out, I wasn't really clear. You're
18 right. The issue, in my mind, was more that if you are
19 an accounting firm, if I were accounting firm, I'd make
20 the argument why am I spilling my entire financial
21 statements which they don't want to disclose at all,
22 right, when what you really want is to focus on this one

1 data point.

2 So you're right, I wasn't clear. What I would
3 suggest is that's an alternative that would be, in their
4 mind at least, not as onerous but would still get to the,
5 you know, the data disclosure point.

6 CHAIRMAN HARRIS: Joe, one of our respondents
7 indicated that, "I think it would be useful if audits
8 were expanded to include more tests for fraud." And this
9 issue of testing for fraud comes up all the time. Do you
10 have any idea what he had in mind or what any of the
11 group would have in mind with respect to what may be
12 meant by that?

13 MEMBER CARCELLO: Yes. You know, the quote,
14 Steve, is the full quote. I didn't truncate any quotes.
15 So I don't know exactly what he had in mind. So I'd
16 speculate a little.

17 As you know, there have been discussions in the
18 past, I think, if I remember right, I think it was in the
19 ACAP report, around periodic forensic procedures would
20 be introduced into audits. I'm trying to remember. I
21 think they said every, maybe every three years. But this
22 is from memory. It's been awhile since I read the

1 report.

2 So it could be that, you know, random forensic
3 procedures, whether it be on an every year basis at
4 aspects of the audit or maybe periodically, maybe every
5 third year, more extensive.

6 The challenge with this is fraud is a relatively
7 rare event. And forensic procedures done well are quite
8 expensive. And so is the cumulative cost, if you
9 introduced it across the entire population of public
10 companies, even if you did it once every three years,
11 does that meet a cost benefit test? And deep thinking
12 would have to go into that. That would not be a snap
13 judgement, obviously.

14 CHAIRMAN HARRIS: I have two final questions if
15 others don't. You know, one is in terms of your survey,
16 what do you consider to be your major takeaways from the
17 survey? And what would be your view, in terms of that
18 takeaway, what the PCAOB ought to do in response? And
19 second of all, related, what most surprised you about
20 your survey findings?

21 MEMBER CARCELLO: Well, Steve, I think you had
22 three or four questions in there. I'm not -- yes. I'm

1 not sure I'm going to remember all three or four
2 questions.

3 CHAIRMAN HARRIS: Multiple questions so, you
4 know, take whatever you want --

5 (Laughter.)

6 MEMBER CARCELLO: I think probably what most
7 surprised me is just how strong the response was as to
8 how important audited information is, both the GAAP
9 financials, and ICFR and what would happen if it went
10 away.

11 And the reason for that, Steve, as you and I have
12 talked about and as I talked about when I presented, as
13 the PCAOB, as the SEC sends out these concept releases,
14 and these proposed rules and these final rules,
15 overwhelming, who responds?

16 The accounting firms always respond. Well, they
17 have partners who do that. And they're quite well paid,
18 and they're quite good. And big corporations respond
19 sometimes, and trade groups respond. And sometimes audit
20 committee members respond, probably hire law firms to
21 write the response for them.

22 But investors generally don't. And it's the same

1 investors all the time, right. It's the council, it's
2 the AFL-CIO, it's CalPERS, it's CalSTRS. So you come
3 away thinking does anybody even care about all this
4 stuff, or is this just a mass of tax on the economy that
5 no one even values what we're doing.

6 And I think it came away clearly that there's
7 tremendous value. Maybe they don't send comment letters
8 in, for whatever reason, but they value it. So that, I
9 thought, was a positive. And it did surprise me a little
10 bit just how strong.

11 I think in terms of takeaways, in terms of
12 implications for the PCAOB or maybe even the SEC, in a
13 couple of cases, two or three at least, there did seem
14 to be some concern about inadequate disclosure for
15 decision making.

16 And, you know, I think the SEC would define
17 itself as a disclosure agency. And so clearly there does
18 seem to be some opportunities for improved disclosure,
19 certainly around audit committees, as I alluded to. Jim
20 and Brian and going to solve that problem. So we're
21 already moving forward on that.

22 Some of the others I don't think are on the

1 agenda, necessarily, of the SEC or the PCAOB right now.

2 But maybe it's worth conversation.

3 There did seem to be, in terms of takeaways, and
4 I only had excerpts here, Steve, but if I gave you the
5 full free responses there were a number of people who
6 commented on the audit report. You saw two or three of
7 them up there. And if I had shown you all the free
8 responses, you would have seen more.

9 I think there's general sense worldwide that the
10 existing audit report is inadequate. There's already
11 been movement in much of the rest of the world to deal
12 with that. We're lagging a little. But I think we'll
13 get there.

14 There did seem to be a number of people who
15 commented on the name of the engagement partner. This
16 is getting so old, I can't imagine we're still talking
17 about it. But I think we're getting close on that.

18 Clearly seemed to be value in the AQIs. I think
19 there's a validation that what you're working on is
20 useful. And probably not surprisingly, the output
21 measures mattered the most. This group previously
22 reported on that. I think this group said that. We see

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1 this in the survey.

2 They're probably also the most challenging to do
3 well. So that's the real juggling act, right. They're
4 the most important, but they're the hardest to do well.

5 So there's probably more if I thought about it
6 longer, but I think those would be some of them.

7 CHAIRMAN HARRIS: And then Pete, since I know
8 you're not going to be here at the end of the afternoon
9 for the general discussion -- and I've asked everybody
10 to list their number priority in terms of what they think
11 the Board ought to address and why -- you've already
12 touched upon it, but in terms of audit committees, if you
13 want to expand upon it, since you won't be here.

14 MEMBER NACHTWEY: Yes. I think, again,
15 recognizing this as, you know, a place that the PCAOB
16 doesn't directly have oversight for but, you know,
17 clearly rubs up against in terms of its mission, I think
18 there's a tremendous difference.

19 I can just speak from a 35 year career of dealing
20 with companies that have audit committees. There's a
21 tremendous quality disparity. And frankly, there's a lot
22 of soft guidance out there of what an audit committee

1 should be composed of, et cetera.

2 It really comes down to the tone at the top, and
3 the quality of the company and the nominating and
4 governance committee of that company as to what quality
5 of audit committee they have.

6 And, you know, figuring out how the work that
7 this group is doing, the PCAOB is doing around making
8 auditors better is incredibly important. But I think,
9 you know, getting the oversight and the activities of the
10 audit committee, you know, in sync as well with that
11 level of quality is important.

12 And I know it's not going to be an overnight
13 thing. It's not a clear, there's no clear place that,
14 again, the SEC has oversight of this, but in terms of,
15 you know, a clear body of expertise, and knowledge and
16 years best practices, et cetera, it's hard to find that.

17 So you know it when you see it. But in terms of
18 what I see is, you know, as Tony was indicating before,
19 a tremendous disparity between real quality audit and
20 the average one that exists out there today. So I think
21 that's worth putting effort into.

22 CHAIRMAN HARRIS: Well, thank you very much. And

1 if nobody has any further final comments, well, Judge
2 Sporkin?

3 JUDGE SPORKIN: What occurs to me is it seems to
4 me we're looking for the needle in the haystack. But
5 there's the haystack out there.

6 You take the Dewey Ballantine case. Is someone
7 looking at the auditors in that case as to how they got
8 conned? And look at all these debacles.

9 It seems to me that those would be the first, the
10 high priority cases to look at to find out what happened.
11 I mean, it's there. Somebody missed it. And it seems
12 to me that would be a top priority. If you're picking
13 your audit teams, maybe have specialized audit teams to
14 look at them, look at the bankruptcies.

15 And I know there's a question of where cases are
16 litigation, and we don't want to touch those. But you're
17 going to have to break through and touch them.

18 CHAIRMAN HARRIS: Well, you've been a strong
19 proponent, and I'll conclude this session, with respect
20 to the requirement of forensic accountants in certain
21 audits. Do you want to talk about that a little bit?

22 JUDGE SPORKIN: Well, again, as I say that the

1 first thing I would do, with limited resources, is to put
2 your forensics or have special groups to look at the --
3 you've got a big body of companies out there. And I
4 would get you to look into those as quickly as -- Have
5 autopsies. You know, you have a death, someone has an
6 autopsy. What you need is a financial autopsy in these
7 cases.

8 And don't be put off by someone telling you,
9 well, there's litigation, or this, that and the other
10 thing. Go right in there and say, okay, this failed.
11 Why? Why didn't -- it looked like, as I read the Dewey
12 Ballantine, it looks like they were being conned night
13 and day. And you find out why. Why were the auditors
14 being conned so much? Did they do, you know, should they
15 have done the next step? Should they have had a forensic
16 in there?

17 CHAIRMAN HARRIS: Well, Joe, I want to thank you
18 and your group for a most enlightening survey. And
19 Brandon, Bob Buettner, Grant, Norman Harrison, Pete,
20 Larry, Anne Simpson, Lynn Turner. I think you've added
21 significantly to the work that we're doing and to the
22 results that we have to take under consideration. So I

1 want to thank you and your team very much for this
2 presentation.

3 And with that, we'll take a break until 11:30.
4 Thank you. And Chair White, thank you very much for
5 joining us today.

6 CHAIR WHITE: Thank you for having me, and I
7 commend you on the work as well. Very, very useful
8 discussion for me as well. Thank you.

9 CHAIRMAN HARRIS: Thank you for coming.

10 (Whereupon, the above-entitled matter went off
11 the record at 11:09 a.m. and resumed at 11:33 a.m.)

12 CHAIRMAN HARRIS: All right let's get started on
13 the next working group presentation. The issue of going
14 concern has been before us for some period of time.

15 It was recommended that we discuss this issue by
16 a number of our group members. So I would ask first of
17 all that our Chief Auditor, Marty Baumann, gives us a
18 very brief overview in terms of the issue as it's being
19 currently considered by the PCAOB.

20 And then I would ask Grant Callery, who headed up
21 the working group, to lead us through the slides and then
22 we'll turn to the discussion.

1 So, Marty, thank you very much.

2 MR. BAUMANN: Thanks, Steve. So just a little
3 bit of background on the standards and reporting issue
4 we are facing right now.

5 By background, historically reporting on a
6 company's ability to continue as a going concern has been
7 the responsibility in the U.S. of the auditor.

8 It's rooted in the Exchange Act Section 10A and
9 the background of 10A really was a number of significant
10 company failures with no early warnings, no warnings
11 about that, and congressional concern in that regard.

12 Going back to the S&L crisis, for instance, then
13 Congressman Wyden saying auditors didn't cause the S&L
14 crisis, but couldn't there have been some warnings that
15 they saw it coming.

16 And that congressional concern led to the
17 creation of Section 10A of the Exchange Act, the
18 requirement that the auditor evaluate whether there is
19 substantial doubt about a company's ability to continue
20 as a going concern and a corresponding auditing standard
21 today, AU 341, which requires the auditor to make an
22 evaluation as to whether there is substantial doubt about

1 a company's ability to continue as a going concern and
2 if there is to report that in the auditor's opinion.

3 Under the auditing standard substantial doubt is
4 a qualitative assessment based upon the factors and
5 attributes that are listed in the standard for the
6 auditor to consider the conditions that might give rise
7 to that level of uncertainty.

8 Over time data has shown that reporting on going
9 concern has been very inconsistent.

10 There are many companies that receive going
11 concern opinions, literally for a number of years and
12 don't go into bankruptcy, recover, or get acquired or
13 whatever else.

14 On the other hand, many companies do go into
15 bankruptcy within a year of a clean opinion, so they go
16 into bankruptcy without any kind of early warning within
17 the next year, and that happens especially with large
18 issuers.

19 So there is clearly a need for some improvement
20 at a minimum in the auditor's reporting about going
21 concern to get more consistency.

22 FASB had a project for a number of years to

1 consider whether there should be management
2 responsibility for reporting on substantial doubt or
3 inability of a company to continue as a going concern.

4 In August 2014 they adopted a new accounting
5 standard that now will require management to make an
6 evaluation and then report in the financial statements
7 when there is substantial doubt, and they defined
8 substantial doubt using a likelihood-based threshold of
9 probable.

10 So management has to report in the financial
11 statements when it is probable that they will be unable
12 to pay their debts as they fall due in the next year and
13 then say that substantial doubt exists in that case.

14 They had proposed in addition to that level they
15 had proposed that there be another early warning signal
16 of when it was more likely than not that a company would
17 not be able to pay its debts in the foreseeable future.

18 They decided in the final adoption not to go
19 ahead with that more likely than not disclosure.

20 Many commenters indicated, well many supported
21 that, many said, and the auditors and others said the
22 more likely than not kind of rested on a 49, 51 percent,

1 49.9, 50.1 decision, very hard to justify, or hard to
2 make.

3 So FASB in August 2014 came out with that.
4 That's different than our standard, which is qualitative
5 based, so we came out immediately thereafter with a
6 practice alert and advised auditors that our existing
7 auditing standard is still in effect, and that is that
8 auditors should continue to report on substantial doubt
9 using the qualitative-based thresholds and attributes in
10 our auditing standard AU 341 and we said that we have a
11 project to continue to consider standard setting.

12 There was also one other wrinkle when you
13 consider the issue, and that is IFRS. PCAOB Standards
14 apply also to audits of foreign private issuers that are
15 done in accordance with international accounting
16 standards.

17 IFRS has a different definition of going concern
18 and that is that management has to report under IFRS when
19 there are material uncertainties relating to events or
20 conditions that may cast significant doubt upon the
21 entity's ability to continue as a going concern.

22 So in thinking of what our potential new standard

1 might be we have to think about both the gap threshold,
2 the IFRS threshold, and what threshold we should come up
3 with.

4 Typically our standards have been aligned with
5 the U.S. accounting, you know, so some might expect that
6 we would go to a growing concern threshold which would
7 be at the probable level.

8 Some of suggested, however, that there could be
9 a significant effect on auditor going concern reporting
10 if it was moved to the probable threshold, so it is
11 important that such matters not be prejudged.

12 So we have been laying the groundwork for a staff
13 consultation paper and performing a lot of additional
14 research and doing some outreach in that regard before
15 we issue the consultation paper.

16 The consultation paper will seek investor and
17 others input in terms of what kind of threshold our
18 auditing standards should be at, should the auditor
19 report based upon a qualitative threshold today or more
20 likely than not, or should it be the FASB probable
21 threshold, and, also, should there be improved auditor
22 performance requirements so that there is more consistent

1 auditor reporting on whatever threshold we use.

2 We also want to seek information on how important
3 is auditor going concern reporting to investors, what are
4 the factors that influence auditor going concern
5 reporting, why is it that there have been lack of going
6 concern in their reports and substantial doubt reports
7 when companies do go into bankruptcy in the next twelve
8 months, which has occurred in many cases with many large
9 companies.

10 So we will be seeking a lot of information in
11 this consultation paper that is currently been in the
12 works for some time and we continue to research to inform
13 it so we can put out a paper that will give meaningful
14 input for people to comment on.

15 With that, Steve, let me turn it over to your
16 working group.

17 CHAIRMAN HARRIS: Grant?

18 MEMBER CALLERY: Thank you, Marty. Okay, this is
19 the working group we have here and I'll talk a little bit
20 about the methodology we use, which is probably an
21 overused word for what was a relatively short timeframe
22 that we considered this, but this came up a few weeks ago

1 and we put the group together to try to frame the issues
2 a little bit, and Marty's done a very good job of doing
3 that.

4 But the IAG did have a working group in 2012, as
5 I mentioned before, that actually did a survey along the
6 lines of the one that Joe reported on this morning and
7 so we decided that we would try to leverage that as much
8 as possible here, and Pete Nachtwey, who was on that
9 group, will talk about what that working group did in
10 2012.

11 So we figured we'll use as much of that as we
12 can. The thing that they did not have available to them,
13 obviously, was the 2014 pronouncement that came out of
14 FASB and which I think changed some of the assumptions
15 that were probably thought about in that study.

16 And then the other thing we thought we should do
17 is try to come up with some ideas of what the PCAOB
18 should do because I think frequently, as people have
19 sometimes said in these meetings, it is nice to have all
20 these wonderful ideas, but you ought to really focus on
21 something that's within the jurisdictional boundaries of
22 the PCAOB so that they can actually take it from us and

1 do something.

2 And you'll see at the end I'll flip it to Pete on
3 the middle slides in here and then come back and part of
4 what Marty talked about is exactly what we are
5 recommending.

6 You know, we did note that the going concern
7 reporting structure has not been a good early warning
8 system, but that's a question as to is that the right way
9 to do early warnings.

10 The FASB, as Marty mentioned, did take a position
11 on that, that they should not set up an early warning
12 system, but I think that's something that the PCAOB ought
13 to continue to discuss and that we ought to talk about
14 today.

15 It does require that the management get actively
16 involved and do the assessment, which I think for the
17 most part everybody in the working group thought was a
18 good thing.

19 It does set up the standard that can be viewed as
20 being different from what auditors had been using and I
21 think that's probably the primary issue that they didn't
22 put from this group would be important on because there

1 are lots of things you can see as potential problems
2 where you have auditors using one set of standards for
3 making an analysis that management's using a different
4 set of standards for and that the PCAOB ought to look at
5 it very closely.

6 Obviously, there is a statutory basis in 10A that
7 the audit has to look at substantial doubt about the
8 ability of the issue or to continue as a going concern
9 during the ensuing fiscal year, and that's not going to
10 change.

11 That's got to be the basis, absent congressional
12 action, that will be the underlying basis, but the
13 definitions that go with that are what we need to talk
14 about.

15 The prior IAG review was in 2012 and I'll hand it
16 off to Pete and you can talk about that and if you want
17 me to flip through the slides just tell me and I'll push
18 the button.

19 MEMBER NACHTWEY: That would be great. Thanks,
20 Grant, and thanks also for your leadership because I
21 think it's a great metaphor that we're in the Army and
22 Navy Building because he did a great job at generalship,

1 going up and Steve Harris told him to take that hill and
2 we did it in two weeks.

3 Anyway, so we last looked at this as a group back
4 in March of 2012 and that working group consisted
5 actually of Damon Silvers, Anne Simpson, Lynn Turner, and
6 myself, so I guess I'm becoming a serial going concern
7 person at this stage, but hopefully that never applies
8 to an entity I am associated with.

9 But in any case, it was also interesting I think
10 that that meeting, March of 2012, marked the tenth
11 anniversary of Sarbanes- Oxley, and that just reminds me,
12 Steve, of how quickly time has passed since that
13 legislation was put into effect.

14 But just as a reminder in terms of the work that
15 we did in '12, first we did conduct an investor survey.
16 The results of that are included in the next several
17 slides, which we can look at.

18 We also looked at the history though of the
19 evolution of going concern and it goes back many, many
20 decades.

21 We chose to start with the Cohen Commission back
22 in the '70s and go all the way forward in terms of

1 various regulatory bodies and other groups that have
2 looked at going concern right up to what at that time was
3 the FASB's project on a going concern standard in
4 February of 2012.

5 The other thing we did was we looked at a list of
6 high profile bankruptcies since 2000, I'm going to that
7 in a second, but I'll point out before we get there only
8 three of the top ten bankruptcies had going concern
9 opinions.

10 So, you know, and that's since 2000, the top
11 bankruptcies since 2000. Actually, Grant, maybe we'll
12 fast forward a couple of slides. There is the list, a
13 picture is worth a thousand words.

14 If you keep going there is a list of -- There we
15 go. So those are the top ten bankruptcies since the
16 millennium and only three of them, as you can see, with
17 General Motors, Thornburg, down at the bottom, and PG&E
18 that had going concern opinions.

19 So, yes, on the one hand you'd say well
20 definitely it's not a very good leading indicator. I
21 think we'd all agree with that. On the other hand I also
22 looked at well what drove some of the other ones, and,

1 you know, WorldCom, Enron, maybe arguably MF Global, were
2 as much frauds as they were going concerns.

3 So, you know, with going concern, going concern,
4 really the thing we should be focused on, that might have
5 ended up just being part of the symptoms as the patient
6 was, you know, on its last legs.

7 And going back to Judge Sporkin's, you know,
8 comments about, you know, forensic accounting, et cetera,
9 you know, could there have been more done to ferret those
10 frauds out long before a going concern even would have
11 been relevant.

12 And then the last one, well the last one I'll
13 mention, but it's the first one up there, Lehman
14 Brothers, you know, clearly a phenomenal failure.

15 On the other hand was it all a failure of the
16 auditors or was it a failure of the whole environment in
17 our financial system that allowed a firm like that to
18 operate with 30:1 leverage for decades.

19 The, you know, flip side is the auditors are
20 inside that place, they absolutely should have been
21 understanding the risks.

22 So does that all feed into our audit opinion and,

1 you know, other things that the auditors could have been
2 disclosing along the way, again, long before a crisis put
3 them out of business, because one could argue if the
4 crisis did not happen they'd still be fat, dumb, and
5 happy making, you know, tons of money on Wall Street.

6 So anyway, I didn't pre-clear that with the
7 Committee, so, Grant, no one else is bound by those
8 editorial comments on my part as to what might have
9 caused those three.

10 But maybe we'll back up then a few slides on the
11 survey, because I think what you'll see is -- Okay, one
12 forward. So you can see it's very important, basically
13 two investors, and if we flip to the next one maybe,
14 Grant.

15 And then this one goes to a bit a crux of the
16 issue as, Marty, you've summarized that, you know, what
17 should the standard be. I mean basically, you know, of
18 the investors that were surveyed and, unfortunately, I
19 don't have the census data on that one.

20 Professor Carcello will knock me on my Ph.D.
21 thesis here that I didn't bring that info, but I think
22 it was a reasonably wide survey, and the vast majority

1 came back and said we ought to have a, well more likely
2 than not, or reasonably possible, you know.

3 Sixty-seven-and-a-half percent were lobbying for
4 a standard that's even lower than what's in either the
5 accounting or audit standards at the moment and then, you
6 know, 22.5 said substantial doubt.

7 So, again, that shouldn't necessarily be
8 definitive as far as this group deliberates because the
9 survey wasn't of, you know, savvy audit folks, but it was
10 of investors and what they would look for.

11 So in terms of recommendations that we came out
12 with at that point in time, and then I'll hand it back
13 to Grant, first was standard setters were at large to
14 strengthen the definition and better define the triggers.

15 That included a recommendation that management
16 had to have a role in this and, you know, bottom line is
17 that no management can decide what accounting regime they
18 are using until they've done a going concern analysis,
19 because if they are not a going concern they should be
20 using liquidation basis of accounting and not GAAP.

21 So hypothetically managements always have had to
22 make a decision on this, they just never had to disclose

1 it and didn't do it formally.

2 We also suggested that, you know, despite the
3 fact that management should get involved that the
4 independent auditor ultimately had to buy off on the
5 assessment.

6 We talked about some key performance indicators
7 and, you know, that disclosures of those could help
8 investors and users of financial statements to develop
9 their own view around going concern.

10 We talked about the audit committee role and then
11 some thoughts about regulators and mitigating risk. But
12 I think, you know, since that time the one key thing that
13 has happened is the FASB did issue a standard.

14 I think what we'll probably spend the rest of
15 this time debating a little bit is what confusion does
16 that, you know, does the standard help for, does it end
17 up dumbing down what already existed, or just simply
18 create confusion.

19 So, Grant, back to you.

20 MEMBER CALLERY: Thank you, Pete. Okay, yes. So
21 as Pete said the 2014/15 came out, it's effective for
22 periods ending after December 15th of next year, so, you

1 know, from a standpoint of, you know, what the PCAOB
2 should do about reconciling, coming to decisions on, you
3 know, whether they want to be at the same standard or
4 whatever, the lead time, given the way rulemaking and
5 promulgation of things work, is not very long and the
6 rule does permit early application for issuers on
7 previously unissued statements.

8 So that December of 2016 is not that far away and
9 could, in fact, be found to be used in earlier
10 timeframes.

11 As we've mentioned, the Board decided not to
12 pursue the early warning aspect of this and I think that,
13 you know, the early warning, whether it be in a context
14 of a going concern or somewhere else is an issue that we
15 ought to discuss.

16 They do provide guidance on management's
17 responsibility to evaluate the substantial doubt issue,
18 which previously had not been there.

19 So I think in the discussion, at least by our
20 group, everybody was very much of view that that was a
21 positive step forward because you don't want the, I mean
22 the idea of auditor go first as opposed to management go

1 first just logically doesn't make a lot of sense, at
2 least to someone who is a non-accountant and a non-
3 auditor, but could end up in, you know, some strange
4 situation.

5 So I think that piece of it is very positive.
6 The real question is this definition of substantial doubt
7 in the probability standard that was there, that is in
8 2014/15.

9 So as we looked at issues to talk about the first
10 is the threshold issue, what is the proper threshold,
11 substantial doubt in the statute is undefined but is
12 there and that their commentators have said, and there
13 have been a number of articles that have been published
14 in various different media talking about the fact that
15 probability would create either a higher threshold or a
16 lower standard than what auditors have been currently
17 using.

18 And as Pete said the 2012 discussion, in the
19 survey there was a lot of sentiment for going even below
20 what the current interpretation of what statutory
21 language might be and making it easier for a going
22 concern determination.

1 The second issue was to who goes first and that
2 this, as I've said, is consistent with the 2012, and is
3 this an important thing, what does this group think about
4 that.

5 As I've said the working group generally thought
6 it was a positive thing and that the thing, the to-do
7 list from the PCAOB standpoint would include the things
8 that Marty had mentioned, but, you know, amending the
9 current standards, addressing the potential differences,
10 decide which standard they want to go with.

11 I think the tendency in the group, or the feeling
12 in the group, was that a race to the bottom is not
13 exactly what we would like to see here.

14 And then the staff consultation, which Marty
15 mentioned, and, of course, that runs into sort of the
16 timing of the issue, can something get done to reconcile
17 things before the effective date of the FASB ruling and
18 if not is it feasible to look for a delay in the
19 implementation of the FASB ruling until the audit
20 standards can be ironed out and then what are the
21 implications if that does or doesn't happen.

22 So that was pretty much the discussion that the

1 group had had. I give Tony and Joe, who were the other
2 members of the working group, an opportunity to add
3 anything they might have before we open it to full group
4 discussion.

5 MEMBER CARCELLO: I'll just add a couple of
6 things. Grant, I had told you that I would try to give
7 you some, or try to add for the group some takeaways from
8 the academic literature and, unfortunately, I was trying
9 to finish the questionnaire, the survey results, so I
10 couldn't quite get it in time for the cutoff date to have
11 it in the slides, but let me go ahead and give you at
12 least some brief, two, three minutes here.

13 So there is actually a long body of -- And I have
14 focused primarily on the usefulness of this reporting to
15 investors, which I think is the litmus test of whatever
16 the Board decides to do.

17 So there is a long history going back to 1986,
18 Nick Dopuch and colleagues in the General Accounting and
19 Economics, Keller and Davidson in the Auditing Journal,
20 and that was 1983, more recently in 2010 by Krish Menon
21 and David Williams, find that the market reacts to going
22 concern opinions, most strongly, probably not

1 surprisingly, to unexpected going concern opinions.

2 The Menon and Williams paper observed negative
3 excess returns when the going concern opinion is
4 disclosed and the reaction is more negative if the going
5 concern opinion cites a problem with obtaining financing.

6 Also, in the same line in terms of this negative
7 reaction, papers in 1992, 1994, and 1996.

8 A paper in 2011 by Allen Blay finds that the way
9 the market values firms changes once a going concern
10 opinion is issued moves away from the valuation,
11 primarily being driven by the income statement and that
12 income to valuation being primarily driven by the balance
13 sheet and issues around assets and liabilities.

14 They conclude that going concern opinions provide
15 additional company-specific valuation information to the
16 market beyond the information that is already publicly
17 available.

18 A paper in 2011 by Willenborg and McKeown around
19 IPOs find that going concern opinions are positively
20 related to the likelihood of subsequent stock delisting
21 and that IPOs that have a going concern opinion before
22 IPO affects first-day pricing.

1 So a number, and this is not complete, but this
2 gives you a sense, I will tell you a very significant --
3 So sometimes when the Board is considering issues there
4 is actually very little research or the research that
5 exists is often not on point.

6 In the auditing space going concern reporting is
7 arguably one of the most researched areas that exists,
8 for obvious reasons, we have data.

9 And so, you know, as you talk about the, you
10 know, Christian and his group, Jim, is well aware of this
11 research, and so in terms of hard data and empirics to
12 support some of these decisions and clearly to provide
13 information on how useful these reports are to the market
14 and to investors there is a wealth of data that exists.

15 MEMBER CALLERY: Okay. Tony, thoughts?

16 MEMBER SONDHI: Thank you, Grant. Joe is right,
17 of course, in that, you know, what matters is the utility
18 of that particular signal to the investors and listening
19 to some of this and thinking about it before the meeting
20 I was struck that maybe, I wonder if we are asking, if
21 we are using the right questions over here as Jim had
22 said earlier in a different context.

1 See, for example, one of the issues that we
2 always seem to talk about with respect to going concern
3 is whether the bankruptcies that we have seen were
4 preceded by going concern opinions.

5 The problem is that bankruptcies are not the same
6 thing as negative market returns. Those negative returns
7 happen way before bankruptcies. Bankruptcies are
8 negotiated.

9 Marty, in your earlier preliminary remarks you
10 had made the comment that there are cases, many cases I
11 believe you said, where they received going concern
12 opinions but they never went bankrupt, they either got
13 bought out or something.

14 Now there two things strike me. One is, as Judge
15 Sporkin had said earlier, maybe we should do an analysis
16 of what happened to those where the going concern
17 opinions were there and were repeated and yet nothing,
18 they didn't declare bankruptcy.

19 So the fundamental question really is we should
20 be asking whether going concerns are a good indicator of
21 negative returns. That's more -- Because the bankruptcy
22 thing happens sometimes and sometimes you get bought out.

1 If you get bought out, you know, if you were
2 selling at \$100 and you get bought out at \$3 it's really
3 not a very good outcome for the investors. Presumably,
4 hopefully, they are already gone from there by then.

5 But that's something that I wanted to point out
6 and this, by the way, had been going on for a long time.

7 I remember almost 25 years ago seeing a study
8 from Harvard Business School where they looked at whether
9 cash flow-based ratios were better indicators of
10 bankruptcy than accrual-based ratios, right, so the
11 income statement or balance sheet versus the cash flow
12 statement.

13 And those authors had said the cash flow
14 statement ratios were wrong, which is probably along the
15 lines of what investors would have been focusing on, but
16 they said that they were wrong because three years before
17 Chrysler had problems the cash flow ratios told you there
18 were problems, well I can't see why that's wrong.

19 I know Chrysler did not declare bankruptcy, but
20 that's not the point, right, because you should ask some
21 of the investors in Chrysler what happened to them rather
22 than whether they declared bankruptcy or not.

1 So from that perspective I think it's very
2 important to ask the right questions. I also feel that
3 management should be, because after all they should be
4 the ones to be talking about this because after all it's
5 their representation, the financial statements, they
6 develop them, they put the numbers in there, and they are
7 the ones running, they're the stewards of the money
8 that's been provided to them by the investors.

9 Marty also did, I think, a very good job of
10 laying out the way this thing seems to have worked out.

11 On one side you had this qualitative standard in
12 the audit guidance and then along comes the FASB with the
13 probable or more likely than not, and then you have the
14 IFRS, which is on the material uncertainties.

15 So if you think of those and continually you have
16 to ask yourself where are these going to be, where are
17 they going to end up on a continuum, and the type of
18 definition that's being used, or I should say the types
19 of definitions being used in here are going to create
20 problems for investors because the level of judgment
21 involved makes it very difficult to say that this was
22 done at the right time or not.

1 So the question is what is it that we should be
2 looking at, how should we approach the question in this
3 particular issue. I think that's something that we are
4 missing here.

5 MEMBER CALLERY: Okay. I think we'll open it for
6 discussion from the group and, again, I guess the focus
7 being sort of the issue of the definitions, the
8 timeframe, how should the PCAOB best use the time between
9 now and the effective date and to make the most progress
10 to getting to the right resolution here.

11 CHAIRMAN HARRIS: And, Grant, maybe we can
12 recognize speakers as they raise their cards.

13 MEMBER CALLERY: Absolutely. Do you want to do
14 the recognizing or do you want me to?

15 CHAIRMAN HARRIS: No, No, I want you guys -- I'm
16 very happy, but I didn't know whether or not you see
17 Brian's card --

18 (Simultaneous speaking.)

19 CHAIRMAN HARRIS: -- a reference to the SEC
20 first.

21 MR. CROTEAU: Thanks, Steve, thanks, Grant, and
22 thanks for the presentation. It's probably a good time

1 just to remind that the standard disclaimer applies and
2 these are my own views and not to be attributed to
3 others.

4 Just -- I certainly would agree that utility of
5 the signal to investors is what is very important here
6 to be thinking about and while there is a wealth of data,
7 Joe, to your point, what we certainly have heard over the
8 years is that the way substantial doubt today is
9 interpreted is different to many people and there is
10 quite a range.

11 So I think that does at least cause some degree
12 of difficulty relative to thinking about the current
13 signal that one can get from the application of today's
14 standard.

15 Not to make this more complicated than you have
16 already described, but I think there are some other
17 issues to think about, just a couple factual points,
18 certainly that FASB extended the period of time that the
19 evaluation would occur and also included a quarterly
20 evaluation by management.

21 Those are probably important points to be
22 thinking about, particularly in the context of the slide

1 that you put up where there may be more quickly emerging
2 bankruptcies or rapidly emerging events that might not
3 otherwise be -- you know, coincide with the timing of the
4 year-end audit.

5 So I think the timing of an evaluation is as
6 important perhaps as the threshold that's used.

7 I wonder how much the group has thought about the
8 threshold that is being applied today, or probable
9 threshold or any other relative to the chart that was up
10 there, because I think, Pete, to some of your points
11 probably some reasonable questions would be raised as to
12 whether any threshold would result in, you know, a binary
13 conclusion of substantial doubt in some of those
14 circumstances.

15 The other point I guess I would just raise to be
16 -- to include in the mix as you are thinking about this
17 topic is the FASB in their basis for conclusion on
18 eliminating, or not implementing I guess I should say,
19 the disclosures at the more likely than not level
20 included consideration that all of those disclosures are
21 otherwise required, at least of management, in other
22 parts of the document. Risk factors, liquidity

1 disclosures, et cetera, and now there may be reasonable
2 questions to ask about the sufficiency of those
3 disclosures and I am certainly interested in that topic
4 as well.

5 So I just wanted to add, I guess, those few
6 points to the mix.

7 MEMBER CALLERY: Okay. Damon?

8 MEMBER SILVERS: Well, first, let me say how
9 pleased I am that PCAOB is taking this matter up.

10 I have I think spoken in one way or another about
11 this question at every meeting of this body and of the
12 SAG, when I was on the SAG, since 2008, and I think this
13 is extremely important work, and again, just pleased to
14 see it.

15 I think that the -- and I am pleased with what
16 the working group has done as well. I want to make a
17 couple of comments about sort of the conceptual approach
18 here and also some of what is now the historical backdrop
19 to this that motivated the fact that I have been sort of
20 like Cato the Elder on this question for a while.

21 The conceptual background, which I don't think --
22 which we haven't really touched upon because of an

1 understandable interest in kind of getting at investor
2 attitudes and investor desires in this space, the
3 conceptual backdrop here is that I think it's always been
4 understood that the ability of an auditor to issue an
5 opinion on the adequacy of the, on the -- now I've
6 forgotten the term of art, but the accuracy of the
7 financial statement is tied to the going concern
8 question, all right, that without this that if there was
9 a serious doubt as to the company's ability to continue
10 as a going concern that that means that the entire
11 financial statement has to be read differently, right.

12 And so the question of exactly how investors work
13 with that data is an important question but it's not the
14 core question from the perspective of the statute
15 Congress enacted or from the perspective of the way that
16 the public accounting system and the system of public
17 company audits works.

18 The core question is is that the whole notion of
19 an audited financial statement and an auditor's opinion
20 on that statement is incoherent without this going
21 concern component.

22 Secondly, the reason for, at least my really deep

1 concern about this, has to do with the failure, in my
2 view, of the auditors of our country's major financial
3 institutions to do a proper evaluation of these questions
4 in the context of the 2008 financial crisis.

5 And in particular the absence of a going concern
6 qualification on Citigroup and Bank of America's
7 financial statements as of year-end 2008.

8 And this raises -- this is tied to a conceptual
9 issue that I hope PCAOB is looking into, which is in my
10 experience when these issues are raised in smaller
11 companies auditors are particularly concerned when there
12 is a contingency that ties to the question of the going
13 concern, meaning that there was some circumstance outside
14 the company's control that which if it flips one way the
15 company will be out of cash.

16 In the case of the two firms I just mentioned
17 it's, I think, incontrovertibly true that as of the end
18 of 2008 that those companies as going concerns were
19 completely dependent on the goodwill of the federal
20 government and in a circumstance where that was a policy
21 decision and not a matter of -- and they had no legal
22 entitlement to that goodwill.

1 That circumstance seems to me to be completely
2 akin to the circumstances where auditors routinely will
3 issue a going concern qualification.

4 For example, where a public company's survival
5 during the coming year would be dependent on obtaining
6 a loan from a bank or being able to execute a public
7 offering.

8 Now, the -- so looking into that question I think
9 is critical to sort of executing this body of work, is
10 how do we understand the treatment of contingencies, that
11 is a subset I think of what the data in this nice little
12 presentation shows us, which is that to a large degree
13 this issue -- and this is squarely in the PCAOB's
14 wheelhouse, the issue here is not -- it may be in part
15 the question of what is the definition of going concern
16 by the FASB and potentially by the -- how does the PCAOB
17 structure that.

18 But as much as that it's an issue of how is this
19 being implemented and is there essentially a double
20 standard, one for large public companies and particularly
21 for "too big to fail" public companies, and another for
22 small to medium-sized enterprises.

1 There is I think a strong suggestion in the data
2 we have seen that there is such a double standard and
3 that this is something where auditors really are treating
4 different folks differently in a way that I think is
5 unacceptable from an investor perspective.

6 Finally, I would just note that because this
7 issue has its root in a statute, unlike a lot of what is
8 -- well, unlike a lot of the issues we find in financial
9 accounting and in auditing, Congress was quite specific
10 about this, the term substantial doubt is a statutory
11 term.

12 Now I don't know if there is some special gloss
13 that exists in the courts on this question, but as an
14 attorney I can tell you that substantial doubt does not
15 mean probable and I would be very concerned if I was on
16 the board of FASB, and I wonder whether anyone asked,
17 whether should a firm fail in the circumstance where the
18 firm and its auditor sought to rely on FASB's definition
19 to justify the failure to have a going concern -- an
20 expression of concern about, you know, a going concern,
21 language in the audit that they would be found liable,
22 nonetheless, and this particular FASB guidance would be

1 overturned by a court.

2 MEMBER CALLERY: Thank you. Mike?

3 MEMBER HEAD: This is Mike Head. I'm having a
4 little bit of deja vu because this feels a lot like our
5 discussion we had the last time, too, so I'm not going
6 to go there again even though I guess I have a hard time
7 not at least saying a couple of things, is I am not sure
8 a going concern creates problems for an investor and they
9 want to get out or if it creates a buying opportunity for
10 them to get in.

11 So, again, I have trouble, I always have, even
12 when I was a little baby auditor thinking the going
13 concern tells us much, because I audited early in my
14 career manufacturing firms that were small to medium that
15 always were struggling with cash, and this was before the
16 accelerated filing dates, so I'm really dating myself.

17 And so the partner would sit on the opinion until
18 they were close enough to knowing they were at the 12-
19 month period so that they knew they could give a clean
20 opinion and it was going to meet -- not meet the criteria
21 of a going concern because it was 12 months, and that's
22 how they wrote it up in the audit work papers was all we

1 have to do is get to such and such date and there is no
2 going opinion by definition.

3 So I struggle because I am a bottom dweller when
4 I invest. I look for blood and then I, like a shark, go
5 look at that company and make my own personal opinion and
6 I would've bought GM, I bought IBM way back when they got
7 bloodied up and lost 50 percent.

8 The last month in the market has been wonderful
9 for someone that wants to look for those investments.
10 You're not always going to be right, but a going concern
11 from an investor's point of view, I don't think it's
12 telling them to get out, I think it's telling them to get
13 in unless you can't assess the company as truly what's
14 going to be the disposal.

15 Now, again, as we always say, this is Mike Head's
16 opinion, but that's what you want. I think the critical
17 issue is getting all three definitions of what is
18 substantial doubt or the basis for giving the going
19 concern, they have to be the same, and it's not just AU
20 341 and ASU 214-15 unless the convergence project has
21 went away.

22 I don't even understand how FASB issued something

1 that didn't automatically reconcile with IFRS, so we must
2 have abandoned the goal of converging with IFRS because
3 they just created a difference that allows -- that
4 requires you to go back and now address it as a
5 convergent issue, you know, I just don't get it.

6 It seems like 101 you got to define it the same
7 otherwise I would assume there is going to be lawsuits,
8 there is going to be auditors not knowing what to do,
9 management not knowing what to do, let alone addressing
10 IFRS.

11 So that's a little bit of maybe just blowing off
12 steam, but going concerns since 1982 has never worked
13 when I did my first audit, okay. So I'll shut up.

14 MEMBER CALLERY: Brandon?

15 MEMBER BECKER: Just one question about the
16 bankruptcy chart. I would find it interesting, but this
17 may just be more curiosity on my part, to have another
18 set of data about what the rating agency said, what the
19 analyst said, what the short-sellers said, and what the
20 price movement is, because I'd really be curious whether
21 all those people who are paid a lot of money to make
22 these judgments got it any better than the accounting

1 firms that we are now asking to do it.

2 Second, Joe has nicely highlighted in a variety
3 of form that investors come in many shapes and forms and
4 is particularly interested in what portfolio managers
5 making decisions make.

6 Our portfolio managers do not think it's good
7 news to get a going concern, so those studies are
8 correct. They also don't think it's good news to have
9 that stock in their portfolio.

10 If anything, they think they've made a mistake
11 because they're going to get out of that company before
12 there is a going concern, in fact, before there is a
13 rating agency downgrade.

14 They are not looking to going concern judgments
15 to make judgments about negative returns. You know, if
16 you want to choose whether the Astros or the Yankees are
17 better you are not looking to your auditing firm to do
18 that for you.

19 You know, you are making judgments about those
20 returns based on the information. Now, yes, to the
21 extent going concern has the hint of fraud as opposed to
22 bad business judgment, are PCs coming back, you know,

1 those sorts of judgments where going concern has sort of
2 the salad oil in the barrel, that's a different concern.

3 You are looking to your auditing firm to validate
4 the integrity of those numbers, but not to make the
5 business judgments for you about potential excess returns
6 and whether or not that's a failure or not and whether
7 or not electric cars are the way of the future.

8 But I also acknowledge that's because we've got
9 a group of people who make their living doing that. I
10 am not talking about the retail investor where whether
11 it's a rating agency downgrade or a going concern it may
12 come as news to them in a much more dramatic way than it
13 would for an institutional investor.

14 So in that sense, I do think that this question
15 of the standard is one which just needs to be clarified.
16 I agree with Mike that you got to get that straight or
17 the courts, as Damon predicts, will get it straight for
18 somebody at some point.

19 And, finally, I think Damon and I have had this
20 conversation before, I don't think that looking to the
21 four accounting firms to decide whether a SIFI is going
22 to fail or not and whether or not they should announce

1 that a major bank is not a going concern is something
2 that we should look to the accounting industry to do.

3 And I suspect that there would be many
4 conversations with many parts of the federal government
5 if the accounting firm decided to say that about one of
6 the two largest banks in the United States.

7 MEMBER CALLERY: Okay. Bob?

8 MEMBER TAROLA: Thanks, Grant. I have a few
9 comments to make from a perspective of someone who has
10 rendered going concern opinions and someone who has been
11 on the side of disclosing going concern issues for an
12 issuer.

13 For the most part it's not the auditor that
14 identifies whether there is a going concern risk, it's
15 inside the company and generally it's been there for a
16 while, it doesn't just surprise you.

17 The surprise going concerns are often fraud
18 related or some sort of accounting mystique-related, but
19 the business going concerns are generally -- they
20 generally evolve and they generally evolve either because
21 of the market or because of what management is doing
22 within the company, whether it's a squeeze on cash,

1 whether it's some sort of structural profitability issue,
2 or whether it's a contingency that needs to be resolved.

3 Those are all well-known and more often than not
4 they are in the disclosure of the issuer's financial
5 reports one place or another. If not in the financials,
6 if not in the MDNA, they are in the risk factors.

7 So I actually think the term going concern is the
8 problem. It's a lightning rod and it makes auditors and
9 issuers come at odds with one another quite often.

10 The question of if you render one then I will --
11 then, of course, I'm going to go bankrupt. So what comes
12 first the business problem or the disclosure problem?

13 I would suggest to the PCAOB to come up with a
14 better way of highlighting this risk by the auditor so
15 that investors know the auditor is concerned about what's
16 embedded within the entire financial report without
17 having to say that the financials might be wrong, as
18 Damon pointed out, because they are based on some false
19 premise.

20 That's where I think it falls away from me, that
21 the financials might be wrong because they are based on
22 some false premise, just get the word out and emphasize

1 that.

2 MEMBER CALLERY: Okay. Okay, we've got seven
3 minutes, so I'm going to suggest that we go down, Joe,
4 Damon, and Tony, and be pretty concise because then I'd
5 like to give Marty a quick opportunity to say are there
6 things that you would've liked us to have talked about
7 that would help you as you look toward that December 2016
8 date and trying to get your consultation done, or,
9 obviously, any of the members of the Board, that we could
10 chime in on before we sign off on this.

11 MEMBER CARCELLO: So, Grant, who do you want to
12 go, me?

13 MEMBER CALLERY: Why don't you go first, okay.

14 MEMBER CARCELLO: Okay, all right. I'll try to
15 be reasonably succinct. There is a lot to say on this
16 topic so I'll do my best here.

17 I do agree with Ryan, it is an improvement to go
18 out essentially 15 months rather than 12, I think that's
19 the -- right, because it's a year from the date, so it's
20 essentially -- right, March 15th.

21 So it's essentially 15 months rather than 12, so
22 I think that's an improvement. I do think it's an

1 improvement to have this done quarterly rather than
2 annually. I think it would be hard to argue with that.

3 I am concerned when you put the responsibility
4 entirely on management if you remove the auditor and here
5 is why. Let me use an analogy that I think we could all
6 relate to.

7 So if we were sitting here with a person sitting
8 in front of us who weighed 400 pounds, who smoked three
9 packs of cigarettes a day, who never did any exercise,
10 and when we said what's your risk of a major
11 cardiovascular event in the next year I think it would
12 be very different than if we were asking a cardiologist.

13 And so the reality is it's hard I think for
14 management. You wouldn't get to be the CEO if you didn't
15 think you could turn things around. People don't get to
16 that role if they don't have that belief.

17 And I think for the CEO and the CFO to say we are
18 in a going concern situation it's more difficult than for
19 an outside observer to do it. I also think it's
20 important for the Board -- the going concern reporting
21 has been around for a very long time.

22 We have had SAS 59 since 1988, if I remember

1 correctly. Before that we had SAS 34, which was a
2 slightly different version, but close enough for at least
3 our discussion. And that's a long, long time, and to make
4 a major change in kind of the regime I think there needs
5 to be very strong evidence that it's necessary.

6 I also would encourage the Board, which I'm sure
7 they've done, to look very carefully at the dissents by
8 Mr. Linsmeier -- Dr. Linsmeier and by Mr. Smith, who I
9 thought were quite elegant in their dissents.

10 Dr. Linsmeier said too late to be a significant
11 benefit to users of the financial statements, probable,
12 typically already know about the uncertainty and Larry
13 Smith said decrease in the number of going concern
14 disclosures as compared to current practice.

15 I think it's hard to argue with that. I think
16 most people would say probables are a higher threshold
17 than what's been used before. Granted, that may not have
18 been consistent across auditors and auditing firms, and
19 maybe there is an issue there, but I think it is hard to
20 argue that this is not going to be a different threshold.

21 My prediction, we'll see if this is borne out, is
22 if all groups reconcile around probable and it's probable

1 for management, probable for the auditor, the number of
2 opinions will go down.

3 I'll be very surprised if there is any stock
4 market reaction to most, if any, of these. So then the
5 question becomes if you are requiring a disclosure that
6 no one cares about why are you even doing it exactly?

7 It's not even obvious to me why you are doing it.
8 So I think these are all things that the Board needs to
9 think about very, very carefully as it considers what the
10 right steps forward are.

11 MEMBER CALLERY: Damon?

12 MEMBER SILVERS: I think it's sort of bizarre to
13 suggest, as I think some have, I'm not saying Joe was
14 actually saying this, but that no one cares about this.
15 People care about this immensely.

16 Anyone who has ever been anywhere near or close
17 to this issue in real life in a firm, this is a huge deal
18 to the firm, to anyone who invests in it, this is a very,
19 very big issue, and so that's A.

20 B, I can't imagine why -- the notion that
21 management should have some obligation to say something
22 about this is, I think, a reasonable idea.

1 But the idea that management rather than the
2 auditor should say something about it is incoherent in
3 relationship to the role that this issue plays in the
4 structure of the audit function.

5 An auditor cannot, I think, issue an opinion
6 without having made the judgment about this question, all
7 right, it's not -- in the way that our financial system
8 works it's not possible to do that.

9 So you can't take it away from the auditor in my
10 view. And certainly I think you cannot do it consistent
11 with the statute that we saw earlier.

12 Thirdly, I really, I appreciate Brandon's comment
13 about the too big to fail issue because it puts it
14 clearly on the table, right, but I would just say that
15 we all need to pay attention to the way in which this is
16 put clearly on the table.

17 If, you know, the Securities Exchange Act, the
18 Securities Act, doesn't have an exception for too big to
19 fail firms nor do the Auditing Standards nor the
20 Financial Accounting Standards.

21 Until somebody is willing to write such an
22 exception I would suggest that this Board, the FASB, the

1 SEC, have an obligation to enforce the law as written.

2 You know, a world in which the stockholders of
3 large financial firms, or large firms in general as the
4 chart was put up there, so it might suggest, a world in
5 which those stockholders are immune from losses or immune
6 from financial distress, we could build such a world.

7 I don't think that the American public would
8 support doing so.

9 MEMBER CALLERY: Tony?

10 MEMBER SONDHI: I think that the FASB's decision
11 with respect to the early warning disclosures, given
12 their basis that these disclosures or something similar
13 exists elsewhere, for example, in risk factors, makes you
14 ask that question.

15 Has anybody noticed how often risk factors get
16 changed? You know, I mean I have seen stone tablets that
17 get changed more frequently than that.

18 And the other issue, of course, is one should
19 take a look at those risk factors and ask why is it that
20 a company that is in the business of, you know, say
21 selling something on the internet versus somebody who is
22 running a railroad have -- you know, to what extent

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1 should their risk factors be identical and how long
2 should they stay that way.

3 The other question with respect to whether the
4 IFRS and the FASB are doing things together, as Mike had
5 raised, in fact today I would argue that -- or I would
6 submit, rather, that over the last three years there have
7 been more instances of divergence than of convergence.

8 The number of places where divergence is coming
9 up is building up. The revenue standard, the leasing
10 standard, the insurance standard, the IFRS 9 on measuring
11 the bad debts in banks, the list of the differences is
12 enormous.

13 I just don't see the convergence there anymore.

14 MEMBER CALLERY: Jim?

15 CHAIRMAN DOTY: Reacting to a ruling discussion
16 I am tempted to ask some of you what you really think.

17 I do take note of the fact that you kicked the
18 hardest question to the Board originally, and that is to
19 determine whether probable as a threshold is in investor
20 interest.

21 Then going to the remarks, Bob, and Tony, and
22 Mike as well, to ask the right question and to think of

1 this in terms of the dynamic of what the audit does.

2 What is the right question? Is the right
3 question whether the threat of a going concern opinion
4 and recognizing that it is not a good indicator -- it's
5 not a good leading indicator of negative returns, but is
6 the threat of going concern an additional force that
7 provides better conduct, read Lehman, or does it provide
8 a change of direction in a corporate enterprise that it
9 needs, read Citi?

10 Because if it is then as a lawyer, and among
11 ourselves we talk often about the different views or the
12 different situations lawyers or auditors find themselves
13 in here.

14 But as a lawyer and having sat in some of those
15 discussions in which you try to change or amplify risk
16 factors to produce more transparency it seems to me that
17 one of the utilities of the auditor's threshold is simply
18 to create better conduct or a change of conduct.

19 And if that is the uniform rule and if that's
20 what SAB 99 was saying and if that's what the statute,
21 Exchange Act 10A was saying, then it may well be that it
22 doesn't matter whether the threshold comes down and it

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1 doesn't matter whether there is interpretive dissonance
2 between a FASB or an IFRS standard, but rather whether
3 in fact it is understood that the auditors and the
4 corporate counsel are in league to use the threat of
5 going concern to change conduct or to change corporate
6 policies or to get management earlier to focus on the
7 kind of negative return threats that Tony is talking
8 about.

9 Is that what we should be looking at or asking
10 after in a consultation paper when we are trying to
11 decide what we should do?

12 MEMBER CALLERY: Steve?

13 CHAIRMAN HARRIS: Yes. Damon, I just wanted to
14 follow up. You were talking about the conceptual
15 backdrop of going concern and you were also on a
16 committee as I recall studying the financial crisis.

17 We hear time and again that banks and financial
18 services ought to be treated differently and somehow or
19 other the going concern opinion may be applicable or
20 should be applicable to the manufacturing sector and all
21 the other sectors, but banking is based upon confidence
22 and, you know, banks can go belly up overnight.

1 I agree that, you know, one cannot ignore the
2 specific language of 10A, which requires auditors to
3 evaluate a going concern opinion, but how do you react
4 to what we hear time and again that somehow or other
5 banks ought to be somehow or other separated aside from
6 the normal going concern opinion?

7 MEMBER SILVERS: Steve, I would say a couple
8 things about this, and I was, you know, very deeply
9 involved in this in the Congressional Oversight Panel for
10 TARP and in the course of doing that at one particularly
11 tense moment in private Hank Paulson said to me just what
12 you just said.

13 He said, "You know, absent confidence they are
14 all dead". And there is -- I think there is deep truth
15 in that. I think that in the course of evaluating a
16 financial institution's status as a going concern, I
17 think an auditor is perfectly entitled to take into
18 consideration the unique circumstances of that business
19 just as any other business.

20 The reason why I have harped so much on the
21 specifics of what happened in 2008 was because in general
22 looking at these issues, and, for example, if you looked

1 at the companies that we have on the chart here, it's a
2 little difficult sometimes to second guess folks, right.

3 Look at, well Enron was a very unique case, but
4 if you look at a number of the companies up there you
5 have to have a lot of detailed information about who knew
6 what and when inside the firm, what was being -- what the
7 company's management was disclosing to the auditors, and
8 so on and so forth, hard to judge.

9 The case of Citigroup and Bank of America at the
10 end of 2008 is not one of those cases where you can't
11 figure it out, all right. We know, you can look in the
12 work of the committee I served on, you can look at the
13 Financial Crisis Inquiry Commission's work, you can look
14 at contemporaneous reporting.

15 We know that the management of Citigroup informed
16 the Treasury Department Thanksgiving week of 2008 that
17 absent extraordinary assistance from TARP they would be
18 insolvent within days.

19 And that extraordinary assistance was forthcoming
20 but it was not -- that assistance was not guaranteed,
21 right. There was no -- Citigroup had no right to that
22 assistance. It could've been withdrawn.

1 A new administration was coming into office. It
2 was a clear but-for situation, right, without the
3 continuation of that cash, but the confidence that came
4 with it, all right, Citigroup was insolvent.

5 And that happened to occur at the moment at which
6 the financial statement was assessing the state of
7 Citigroup's balance sheet. The same thing was true of
8 Bank of America.

9 Bank of America came to the Treasury Department
10 two weeks after the closing of its books at the end of
11 the year and said if we do not get extraordinary
12 assistance under TARP we will be insolvent.

13 And the insolvency both those institutions faced
14 was a cash related one having to do with a loss of
15 confidence, all right, but in those two circumstances it
16 does not require an insider's view of those two
17 institutions to be able to make the judgement that at the
18 time that the auditor's opinion was rendered, at the date
19 the auditor's opinion was rendered, they were dependent
20 on the goodwill of the federal government to be solvent.

21 And at the time the auditor's opinion was signed,
22 which I think was in March for those two institutions,

1 that same circumstance continued to be true.

2 And so, Steve, the answer I think to your
3 question is people come to you and say banks are
4 different are right, but they're no more different than
5 any other line of business.

6 Each type of business has its own indicia of
7 whether they are a going concern. I do not believe it
8 is true that if you consistently apply the rules around
9 going concern, either the ones that sort of seem to exist
10 today or any reasonable system that the PCAOB might
11 apply, I do not believe if you do so that you will be
12 forced into a position of saying that all banks are not
13 going concerns at all times.

14 That would seem to be kind of the implication of
15 what maybe some people have said to you. I don't think
16 that's true at all and I think it's pretty clear the
17 kinds of circumstances in which a bank is dependent upon
18 uncertain outside infusions of cash to survive.

19 Yes, I think that situation exists with those two
20 institutions at that time and, for example, I don't see
21 any evidence to suggest that it exists with any large
22 institution today.

1 CHAIRMAN HARRIS: Grant, I think if we go over
2 for five minutes I think that would be fine. I see that
3 Mike and Judge Sporkin have their cards up and then Marty
4 Baumann, so I don't think we ought to stick right smack
5 to the time schedule.

6 MEMBER CALLERY: Okay. Marty, do you want to go
7 first?

8 MR. BAUMANN: Well I thought, as you said, at the
9 end if you wanted me to wrap up I would, but I am happy
10 to go first if you want.

11 MEMBER CALLERY: Well --

12 MR. BAUMANN: I'm happy to hear what Judge has to
13 say and Mike Head and then why don't I comment then.

14 MEMBER CALLERY: Okay. Stanley?

15 JUDGE SPORKIN: In listening to this it seems
16 that we are looking for a magic bullet here to tell us
17 when we can issue such an opinion.

18 And I think what just was said makes more sense
19 is let's break it down. Suppose the auditor and
20 management say look, for this thing, for this company to
21 exist next year it's going to require certain things.

22 We got to have certain financing that has to be

1 available, that the product has to be still received by
2 the public.

3 In other words it seems to me that we can break
4 down the elements of going concern and that the
5 management can certainly issue its views as well as the
6 auditor as to whether there is going to be financing,
7 whether the product is going to be there, whether the
8 patents that have expired, and if those things are said
9 I think that the public can make up its mind as to what's
10 going on and I gather that the more severe the situation
11 is I think that has to be stated.

12 In other words what you are doing is you are
13 opening the screen for the public to have the same kind
14 of information, not in the same degree as the discussions
15 that have been going on in the company when they look at
16 say what are we going to do for next year.

17 MEMBER CALLERY: Mike?

18 MEMBER HEAD: I'll just be real brief that based
19 on what I just heard from Damon, and I was the partner
20 on Citibank and Bank of America, under the current
21 guidelines I would not have given them a going concern
22 because I would have said that government support is

1 meeting the probable threshold and as an auditor under
2 AU 341 I would've met with my management and I would've
3 had the discussions and I would've come to the conclusion
4 not to give them a going concern because of the strong
5 argument you just made that the government obviously
6 evidenced they were going to, therefore, the threshold
7 of probable is so low, unless you change it to an early
8 warning you are eliminating that as being a going concern
9 not making it a going concern.

10 MEMBER CALLERY: Marty?

11 MR. BAUMANN: Well, Grant, your first question to
12 me was have you all given us valuable input for our
13 consideration as part of the consultation paper and the
14 answer to that is absolutely yes.

15 So thank you very much to you and to your group
16 and then to the entire Investor Advisory Group for the
17 input you have given us for further thought as we
18 progress, hopefully promptly, on a staff consultation
19 paper to lay out the issues and lay out possible
20 solutions and get that feedback.

21 One or two points I'd like to make. A good point
22 was made. I think it was Bob, and we have been thinking

1 about this as part of that, that the word going concern
2 is a lightning rod and can there be disclosures that, and
3 can we have emphasis paragraphs that describe a situation
4 where there's problems where there isn't that going
5 concern lightning rod word as well.

6 That doesn't mean you get rid of going concern,
7 but can you have the disclosures at a level that would
8 not use the lightning rod word but would still get
9 information out there to investors. So that's one thing
10 and certainly something for us to think about.

11 Secondly, another one to think about is 10A is an
12 audit responsibility. So FASB required management to
13 make new disclosures but they didn't do anything about
14 10A which is an audit responsibility.

15 That still exists. The auditor still has -- so
16 there's new accounting disclosures that weren't there
17 before, but FASB didn't touch 10A. 10A deals with this
18 is what has to happen in their audit, this is what an
19 auditor has to do, and an auditor has to make certain
20 evaluations and disclosures.

21 It is now up to us and the Board, with them
22 working with us together, to determine how do we make

1 sure this continues to be done properly and how do we
2 reconcile that with the new management disclosures.

3 The management disclosures doesn't make 10A go
4 away in any fashion, it doesn't make the audit
5 responsibilities go away in any fashion, or the auditor's
6 responsibility to comment when there is going concern
7 concerns about that in the audit report.

8 The issue is the reconciliation of these
9 different terminologies for us and what the reporting is
10 on our end, so we have a lot to chew on.

11 And I guess the last comment I will make is, and
12 someone else said this earlier, not being a going concern
13 does not equal going into bankruptcy, I agree with that
14 comment.

15 It means you are going to go through some sort of
16 restructuring, some sort of significant change.
17 Conditions aren't what they were before, but bankruptcy
18 isn't the only outcome of that and that's an important
19 thing to remember when we look at the research and other
20 things.

21 Joe, we are aware of the significant amount of
22 academic research and we have been studying that and it

1 will be laid out in the paper.

2 So we've got a lot from this discussion and I
3 appreciate it very much. Thanks, everybody.

4 CHAIRMAN HARRIS: Grant, thank you very much. I
5 thought that was an enlightening discussion. Lunch is in
6 the Arnold and Washington room and we will reconvene at
7 1:45.

8 (Whereupon, the above-entitled matter went off
9 the record at 12:47 p.m. and resumed at 1:43 p.m.)

10 CHAIRMAN HARRIS: Okay, Tony, why don't we get
11 started with the working group on PCAOB publications.
12 And at the outset I know this has involved a terrific
13 amount of work.

14 I've read some of the email traffic back and
15 forth so I know you've had to, you know, put together a
16 number of divergent viewpoints in terms of your
17 presentation, so I obviously want to thank you and your
18 group for all the effort that you've put into this.

19 So with that please go ahead.

20 MEMBER SONDHI: Thank you, Steve. And all right,
21 let's get started on this. So I just want to mention
22 that this is something that we had decided to take a look

1 at and asked to do so.

2 Wanted to look at these two consultation papers,
3 the one on Auditing Accounting Estimates and Fair Value
4 Measurements and the second on the Auditor's Use of the
5 Work of Specialists, and also third is the concepts
6 release on Audit Quality Indicators now.

7 I know that we've discussed audit quality
8 indicators before in this forum and it's also come up a
9 few times earlier today, but we're going to take a
10 slightly different look at it this time around.

11 So let's begin then, and let's take a look. In
12 terms of just an introduction I wanted to point out that
13 estimates, fair value measurements, the use of
14 specialists and the audit quality indicators are all
15 critical because to investors, from our perspective, the
16 issue in essence is the integrity of the financial
17 statements. There is a growing use of estimates.

18 Now obviously most people, if not everybody over
19 here, knows estimates are sort of pervasive in financial
20 reporting, and the larger the company, you know, the more
21 you're going to see those estimates.

22 And some of them are as mundane as the ones you

1 and I have seen for ages, such as the bad debt expense
2 or the number of returns, and some of them are as complex
3 as the fair value measurements which go into the Level
4 3 type of assets. For example, are the ones that don't
5 have the kinds of markets that we need for either Level
6 1 or Level 2 measurements of fair value.

7 And it is certainly getting more and more complex
8 because of the introduction of many of these different
9 kinds of businesses. And it's not limited to the
10 Facebooks and the LinkedIns and the Zyngas of the world,
11 but companies like Tableau Software, Splunk and so on,
12 the ones that do huge data analytics and so on.

13 The kinds of analyses they use, the kinds of
14 estimates they use, those are very critical. The number
15 of intellectual property assets that companies have and
16 the ways in which they use them and the number of
17 different acquisitions and divestitures of patents and
18 those assets that occur, these are all creating and
19 putting on additional layers of complexity.

20 Financial reporting is something that has also
21 contributed. And, you know, I won't get into whether the
22 standards are becoming more complex, or contracting and

1 transactions are becoming more complex and that's why the
2 standards need to follow them, but whichever it is the
3 result is that we have more complicated financial
4 statements.

5 And so by the way I do want to point out that
6 that last bullet point there is an error. What I wanted
7 to say there was we wanted to provide this prospective
8 rather than anybody else asking us to do that. So
9 please, I do apologize for that. Okay.

10 Let me now give you sort of just a quick look at
11 the major recommendations that we have for each of the
12 three publications that we looked at. Beginning with
13 Auditing Accounting Estimates and Fair Value
14 Measurements, I think it's very important that we as
15 investors get additional disclosures that enhance the
16 transparency and enable sensitivity analyses of the
17 estimates that are used in financial statements.

18 It's very important to understand, for example,
19 how a particular estimate goes from where it was at the
20 end of the previous period to where it is today.

21 Roll-forward disclosures are being required more
22 frequently, and I can tell you that as a member of, and

1 currently chair, of the CFA Institute committee that
2 responds to all the initiatives -- the FASB proposals,
3 the IASB, we also write to the SEC and often and at times
4 to you as well and I've served in that committee for more
5 than 25 years now -- I can tell you that we've been
6 focusing more and more on roll-forwards because that's
7 what we need in order to understand what's going on in
8 financial statements and it helps with that sort of
9 incremental transparency that results.

10 Currently the standards make it optional to
11 develop an expectation of estimates, and we really think
12 that that ought to be mandatory. The auditors should be
13 required to use external or objective or independently
14 obtained data in order to audit the estimates, and then
15 they should be required to compare management-provided
16 estimates to the actual and report on those results over
17 time. It's very helpful to understand how well those are
18 performing.

19 We also recommend audits of the internal controls
20 of the process that management uses to generate those
21 estimates and fair value measures.

22 Now with respect to the audit quality indicators,

1 our perspective, as I pointed out, sort of adds on to
2 what has already been proposed at 28 different indicators
3 that are in the concepts release. What we felt we need
4 a little bit more, quite a bit more information on, I
5 should say, is on firm leadership and the governance
6 structure.

7 In essence, we need to understand how it's being
8 operated and what's -- you know, this is sort of an
9 attempt to get a better sense of the tone at the top as
10 we discussed earlier today.

11 We also think that it's important to get a sense,
12 a very good sense of the regulatory enforcement actions
13 against the audit firm, any violations of auditor
14 independence, disciplinary actions and so on.

15 And then, finally, our focus, the third kind of
16 focus is on additional information about where the firm's
17 revenues are coming from, the different business
18 segments, get a better sense of the cross-subsidies, and
19 effectively how those resources have been used and
20 primarily in terms of their investment in technology and
21 in training.

22 And this, it's very important that this

1 information be provided both within the audit practice
2 specifically and firm-wide, so that if there is other
3 work that you're doing like the advisory and so on, how
4 that contributes would be a critical component of this
5 disclosure.

6 The second consultation paper and our third topic
7 is the issue of the use of the work of specialists. Now
8 I want to start off here, I will get into this in some
9 more detail, but I want to point out that I think this
10 consultation paper was really well done. It's very
11 comprehensive and it gave me a very, very good sense of
12 where things are. And in using the information in that
13 consultation paper, we wanted to emphasize the following
14 issues.

15 So first we think we should strengthen the
16 guidance of and require incremental disclosure on the
17 auditor's use of employed and engaged specialists. So
18 an employed specialist is one that has been hired by the
19 auditor, the engaged specialist is one who doesn't work
20 for the auditor but may actually work for the firm that
21 they're auditing, right.

22 And that's something that I think is very

1 important because it obviously affects the integrity and
2 the objectivity of the work of the specialist. And again
3 as the consultation makes it very clear, the current
4 guidance and the supervision of the work of the
5 specialist is, you know, just isn't very good. It needs
6 to be stronger. It needs to be more specific.

7 I think that the auditor-audit committee
8 communication with respect to the work of the specialist
9 is very critical, and this is again in addition to the
10 audit committee. I think the investors need to be
11 informed of where and how they're going to be used, and
12 I think there ought to be additional disclosure for the
13 investors of the use and the audit of the work of the
14 specialists, and I think that is currently one of the
15 missing components.

16 So now let's take a look at the issues in some
17 detail. Estimates are often difficult. And by the way,
18 I can tell you that the estimates that will be required
19 under the new revenue standard are going to pose some
20 very interesting problems.

21 In addition to the new revenue standard, both the
22 Boards, the IASB and the FASB, have been working on

1 standards with respect to bad debt measurement by
2 financial institutions, they've been working on new
3 standards for the insurance industry. The estimates
4 that'll be needed there are going to require
5 significantly greater levels of expertise than we have
6 today.

7 So I understand, and we understand, I should say,
8 that fair values and these kinds of measures are
9 difficult to develop, they're difficult to audit, but at
10 the same time reliability is a critical characteristic
11 that we need, and therefore it's important to emphasize
12 that.

13 The primary sources of financial statement
14 errors, in essence, I think one is there is a management
15 bias, and it's critical that auditors exercise
16 professional skepticism on that. It reminds me of what
17 is probably the first line in my book on the analysis and
18 use of financial statements, because one of my co-authors
19 very strongly believes as I do in this, and we say in
20 there that it's very important to be cynical and
21 skeptical in order to be a good analyst. Because if
22 you're merely going to take what management gives you,

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1 then it's a different profession than that of an analyst.

2 And I think the same holds for auditors. It's
3 very critical that they be skeptical, so management bias
4 is something that you have to fight. Auditors often
5 audit to those estimates and don't pay enough attention
6 -- or let me make it positive. I think it's important
7 that they should pay more attention to what management
8 assertions are, what data management is used, and that
9 should be assessed, should be challenged.

10 And the second point there is that the auditor
11 really should develop independent estimates and have
12 recourse to external data in order to develop those
13 estimates.

14 And then, finally, it's very important to have a
15 much, much better improved understanding of the client's
16 business, the economic rationale underlying those
17 transactions and the control environment at the client.
18 And very often, you know, it's the engagement partner who
19 needs to have this understanding, and then it should
20 extend to the team as well.

21 The KPMG comment letter to the staff consultation
22 paper does a very good job of talking about the utility

1 of external data and the evaluation of management
2 estimates. And as a financial analyst this is something
3 that I do routinely, because we take the numbers that
4 management provides, we look at the financial statements,
5 and then we ask is there other information that tells us
6 something different, and we're developing our own
7 estimates, and we're always checking these.

8 The 2013 CFA Institute comment letter to the
9 Board on the auditor's reporting model had already -- has
10 cited consistent findings over many surveys over many
11 years of the importance that investors place on the audit
12 report, and the survey results also highlight the call
13 for more information on the basis of the auditor's
14 opinion.

15 And that's what I would extend to their audits of
16 estimates and fair value measures. I think we definitely
17 need more information there. Investors have long noted
18 that the audit team and the leader should have sufficient
19 knowledge and experience in the industry, the business
20 model and the transaction types that are employed by the
21 company that they're auditing.

22 The financial reporting framework that applies to

1 that entity is critical, and we need documentation for
2 those transactions and framework and a good understanding
3 of the internal controls framework that would apply to
4 that particular economic or business model that the firm
5 is using.

6 And auditors also should develop a better
7 understanding of how investors use financial statement
8 data in investment decisions. I've often heard that, you
9 know, one of the most common things is the cash flow
10 statement is not relevant, or the footnote disclosures
11 on deferred taxes are not critical.

12 Well, when the IASB had proposed a new standard
13 on taxes, the CFA Institute sent them a comment letter
14 and talked about this, and they said we -- the board
15 wrote back to us and said we don't understand why you're
16 talking about this, so we sent them an explanation of how
17 investors, analysts use different taxes.

18 And I still have the letter from the board that
19 says that we're very grateful because we now actually
20 know why this matters to people. So it's very important
21 that one understands how the information is being used.

22 I think in terms of recommendations I would add

1 to the comment that I made at the start that we need to
2 enhance transparency to enable sensitive analysis. One
3 relevant area would be range and dispersion measures,
4 write up observations that are used to derive estimates.
5 So what is the basis of that estimate? Because having
6 a single number in a financial statement doesn't
7 necessarily help evaluate how well it reflects what's
8 going on.

9 We need additional information on the assumptions
10 that are significant or material to different estimates
11 in the financial statements. And then there's very often
12 information that is material to an estimate or a fair
13 value measurement, but at the same time, it's not
14 otherwise required by any standards. So none of the
15 guidance requires it, but it has become more important,
16 and that information is a critical piece of the basis for
17 saying that this estimate works or doesn't work.

18 And then, finally, on this slide I think it's
19 important to highlight the financial statement,
20 particularly the income statement consequences of the
21 non-cash adjustments to reserves and other balances in
22 a performance standard.

1 At times, you know, I'm surprised by the way the
2 FASB proposes certain things. A very recent one, for
3 example, was where they were talking about a roll-
4 forward, it's in the new revenue standard, a roll-forward
5 for certain costs that will be deferred.

6 But one of the most important things that affects
7 it very often is if you have foreign operations. Then
8 the exchange rate effect has an impact on the movement
9 from the beginning to the ending balance as well, and if
10 you don't have that, you're not going to understand how
11 it got there, or you're going to have an incorrect
12 assessment of how you got there.

13 And then I mentioned earlier the current optional
14 development of expectation of estimates by the auditors
15 should be made mandatory, and I've given you the auditing
16 standards that deal with that. I think management should
17 provide auditors with more information underlying the
18 models that they've used that would then help the
19 auditors to evaluate the level and the accuracy of those
20 prior estimates.

21 And then, finally, auditors should be required to
22 critically judge management estimates by using

1 independent source data. So this is the external data
2 argument that I have made earlier.

3 The audit partner and the team, I think, needs
4 sufficient expertise in the economics underlying the
5 business models. I think there's a need for more
6 rigorous testing of the internal controls and that
7 surround the development of those estimates.

8 And then, and I think that the, you know, it's
9 very important that the PCAOB require the use of
10 objective or external data in audits of estimates, so
11 that ought to be sort of the linchpin of those tests.

12 Auditors should be also required to obtain the
13 evidence needed to audit those disclosures and that
14 assessment should then should be reported separately.
15 And then the PCAOB, I think, should, we believe should
16 develop audit standards using these requirements, but
17 it's also important to work with the SEC to ensure
18 enforcement.

19 And then there's a level or a stage at which this
20 needs to go in, and that is to work with the FASB and the
21 IASB when they're developing these standards to ensure
22 that we don't get to a point where we don't have

1 something that can be managed.

2 Okay, I'm sorry. Jump to the slide there, I
3 believe. For the audit quality indicators, as I said
4 earlier, I think most of these things are really well
5 known. But they're critical, largely, I think, very
6 importantly, because they help us measure and manage
7 audits, and they would help investors and audit
8 committees then compare audit quality.

9 They would provide much needed data for the
10 selection of audit firms and then, finally, obviously,
11 it would help in terms of your monitoring risks.

12 The three areas in which that we talked about the
13 audit quality indicators, I think with respect to firm
14 leadership it's, you know, how it is selected. A much
15 more comprehensive discussion of the governance structure
16 is needed, so we need audit quality indicators of that.
17 And then third, a ratio of audit staff to partners.

18 And, you know, this can't be sort of a firm-wide
19 thing. It has to be by different business segments and
20 so on in order to make it to be of any value.

21 With respect to other information about the audit
22 firm, qualified reports on their internal controls, any

1 enforcement actions, disclosure of violation of auditor
2 independence, and then also percentage of audit reports
3 and internal controls that have reported material
4 weaknesses.

5 And you can combine this with some of the other
6 issues that we've talked about earlier. You know, some
7 of the comments that we've discussed or issues that we've
8 discussed that relate to going concern come to mind when
9 talking about this particular requirement here.

10 And then, finally, a three-year moving average of
11 practice protection costs related to the audit practice
12 that would be a useful indicator as well.

13 Within the audit practice specifically and firm-
14 wide, I think it would be important to understand where
15 the revenue comes from disaggregated by business line,
16 what profit sharing and subsidies are provided by
17 specific business lines to others, and then, finally, the
18 percentage of the firm's revenues that are invested in
19 technology and in training.

20 And again, you know, if these are provided at a
21 high level they're not going to help. It's important to
22 understand some details about this.

1 Then our third category, of course, is the
2 auditor's use of the work of specialists. And I've
3 pointed out this issue of the increasing complexity, so
4 I won't go back into it. Effectively as I said, it's
5 complexity in contracting, it's complexity in business
6 models, and then third, this new class of intangible or
7 intellectual property assets and the ways in which
8 they're being used.

9 Those are some of the reasons why we need more
10 specialists these days in audits. The auditors' use of
11 specialists certainly raises critical questions about the
12 objectivity and the transparency in and the reliability
13 of the financial statements.

14 Now the current standards require that the
15 employed specialists be independent of the entity being
16 audited, however, the auditor's engaged specialist is not
17 required to be independent. And I think that's a
18 significant issue there. We encourage the staff's
19 efforts to learn more about audits of the clients'
20 proprietary valuation models.

21 See, the problem with these types of models is
22 that you really can't get a lot of information about

1 them, so the way the audit gets conducted, we really need
2 to rethink that. We need to work on that and come up
3 with some more specific recommendations on how to change
4 that.

5 But as I pointed out, this was discussed in the
6 staff consultation paper, and I think they've done a very
7 good job of this aspect of it as well.

8 Other PCAOB staff observations in that paper
9 which I think are important, fair value measurements are
10 often audited, they note, by testing significant
11 assumptions that are used by the company and its employed
12 or engaged specialists. They also test the valuation
13 models that the company uses as well as the underlying
14 data.

15 The question is whether they should stop there,
16 of course. You know, what kind of independent assessment
17 do you need to ensure that this works?

18 Hand-off issues. There are times when auditors
19 and the specialists may have disagreements with respect
20 to the scope of their work or the auditor may not
21 adequately assess the work done by the specialist or at
22 times may not have the expertise to do so.

1 And then, finally, you have this, you resolve the
2 discrepancies and differences that are reported by the
3 specialists. The PCAOB consultation paper also notes
4 that multiple specialists, as many as five, if I remember
5 correctly, were used in the majority of audits of large,
6 global accounting firms, and those specialists often
7 provide help to the auditors on more than one area of
8 expertise. I believe the average there was two.

9 And then it appears as if the scale of the
10 problem is lower in audits by smaller firms, but you'd
11 expect that because the more complex problems are likely
12 to exist at the larger firms.

13 Some more background. Currently 328 requires the
14 auditor to evaluate the reasonableness of the company's
15 specialist. Now standards in the supervision of the
16 audit engagement, however, don't have specific guidance
17 on the use of the work of the specialist. And there
18 again, with the exception of that one footnote, there's
19 little guidance on hand-off issues.

20 The 2013 IAASB post-implementation review also
21 pointed out how difficult this exercise is. And then the
22 paper also notes inspections where you've found issues

1 with respect to the work of the specialist, and then
2 there are enforcement actions in addition.

3 In terms of the recommendations, I think the most
4 important one may be the need to strengthen the guidance
5 often require incremental disclosure of the auditor's use
6 of specialists in general, right, and specifically the
7 use of specialists that are employed by the company being
8 audited.

9 We also need more specific guidance on the use of
10 the work of specialists by the auditor and the auditor-
11 specialist communications and then improvements in 336.
12 And I think you add to this that it's critical to have
13 communications with the audit committee on many of these
14 issues.

15 And so there it is, the need to specify auditor
16 communication with and different disclosures to the audit
17 committee with respect of the use of specialists. And
18 particularly I think the focus should be on a
19 communication of those hand-off issues because that's
20 where there were disagreements.

21 So what were those disagreements, how critical
22 are they to the financial statements and how were they

1 resolved? That's something that I think the audit
2 committee needs to be aware of.

3 The auditor should also be required to disclose
4 information relating to potential impairment of the
5 specialist's objectivity, including any fees for services
6 unrelated to the audit, and there again, as I point out,
7 some details would be very helpful.

8 So now before I go there though I wanted to --
9 and I hope I've left some time for the other team members
10 to make comments. I'm working here at a disadvantage
11 because one of my team members is ill and can't be here,
12 but I've tried very hard to get Lynn's perspective across
13 in these slides.

14 But Gary, Larry and Bob Mercer, any thoughts?
15 Norman?

16 MEMBER SHOVER: I might as well start, thank you.
17 And this is coming completely through the lens of a
18 portfolio manager. As somebody who's acting as a CIO of
19 a mutual fund, I appreciate, deeply appreciate what
20 auditors and accounting people do, but it's just not my
21 skill set.

22 Anyway when it comes to fair valuation, I think

1 you need to be encouraged that the rules today have
2 effectively telegraphed the inherent subjectivity of a
3 valuation, something that perhaps wasn't so well
4 telegraphed before.

5 And with that in mind, with fair valuation, to
6 prove that, I guess, is that these valuations can be
7 grouped Level 1, Level 2, Level 3, again helping the
8 investor understand that these valuations are subject to
9 a lot of subjectivity. It's not written in stone.

10 At the end of the day, investors, what do they
11 want? They simply want to understand the approach and
12 have confidence that the inputs were accurate. And so
13 I think the better that that's telegraphed, the better
14 off we all will be.

15 And if you don't mind, I just want to make one
16 other point that's near and dear to my heart. I guess
17 a challenge would be investors would benefit from having
18 fair value measurement procedures included as a separate
19 standard.

20 I don't know if that's something that you would
21 laugh about or roll your eyes at, but I think that would
22 be important for the investor to have. The entity must

1 have clear guidance with regard to acceptable approaches
2 to valuation and also providing full disclosure of the
3 approach and the inputs utilized.

4 In my world I think that would solve the problem,
5 and it sounds like it's easily solved, but again from an
6 investor's standpoint, that's how I see it.

7 MEMBER SONDHI: Thanks, Larry.

8 Bob, do you want to go next?

9 MEMBER TAROLA: Thanks, Tony. Great job putting
10 that forward. I've a few things I want to comment upon.

11 First of all, we need to distinguish between
12 accounting and auditing. Much of this deals with
13 accounting. And I certainly don't want any of the folks
14 observing this proceeding to think that accountants can't
15 make good faith, reasoned, reasonable estimates, or
16 frankly that auditors can't audit in a good faith manner
17 and come to a conclusion that the estimates are
18 reasonable. And estimates vary in complexity from Level
19 3 investments where there might be little information
20 available to the risk of complex litigation to the risk
21 of collecting money and other risks in the financial
22 statements.

1 I'm in favor of our group's conclusion that
2 perhaps transparency and complete independence are two
3 important elements to help investors be comfortable with
4 the process of accountants making estimates, audit
5 committees reviewing the accountant's work, auditors
6 reviewing the accountant's work, regulators reviewing the
7 accountant's work, so there's a lot of review in this
8 process of estimation.

9 The use of inside or outside specialists, I think
10 that needs to be understood better, and whether it's
11 inside or outside, there are different risks to the audit
12 in my estimation. Are your insiders really proficient?
13 Are your outsiders really independent?

14 And so that would present some, I think, some
15 regulatory audit standard to help to make sure that the
16 auditing is as rigorous as it can and should be. But the
17 idea that estimates are somehow new risks in financial
18 reporting, they're not. They've always been there, and
19 accountants and auditors have been able to deal with them
20 for a long time.

21 MEMBER SONDHI: Thank you, Bob.

22 Norman.

1 MEMBER HARRISON: Thank you, Tony. I'll be very
2 brief because I think you did a terrific job of
3 summarizing our work and the recommendations.

4 I'd just highlight a couple of points. One is on
5 the issue of specialists and disclosures. I think it's
6 an important illustration of the weave of the fabric of
7 the issues we talk about in this group because there are
8 a lot of overlaps and interrelations. And this one in
9 particular does come to the issue, as Bob and others
10 indicated, of independence.

11 And I think failing robust disclosures, at least
12 around the use of engaged specialists and information
13 about their prior and other relationships with the
14 issuer, you have a significant risk of a back-door
15 independence issue that otherwise won't be apparent, and
16 I think it's important that the steps be taken to address
17 that.

18 On the issue of the audit quality indicators, I
19 spoke a bit about that earlier. We'll have, I know --
20 I expect a further group discussion about that. The only
21 observation I would make is that, you know, again, it's
22 not a new issue.

1 I know that the Board's publication is of
2 relatively recent origin but the issue's been around a
3 long time. As we pointed out in one of our slides, it
4 was one of the recommendations highlighted in the Paulson
5 Commission's work.

6 I think when we're dealing with a topic like this
7 one where it isn't an issue of this rule or that rule or
8 this standard or this threshold that there is an array
9 of outcomes here. There's a long list of possible
10 indicators.

11 I think we've tried to give some guidance as to
12 ones we think are particularly important. I don't think
13 any of us believes that there is only ideal or a perfect
14 list or a set that will ever be derived through whatever
15 level of consultation and discussion and debate. I would
16 urge the Board in this instance not to let the perfect
17 become the enemy of the good and to take some action.

18 Let's get started on this. Promulgate an initial
19 set that seems to have some consensus behind it with the
20 knowledge that experience will tell you how you've done
21 in the investing community through boards like this, and
22 other bodies will provide feedback. But I think we've

1 been talking about it for quite a while, and I'd urge we
2 get to at least a starting point and get something done.
3 Thanks.

4 MEMBER SONDHI: Steve, I just want to make one
5 quick comment. I just wanted to mention that, you know,
6 I agree, estimates have been around for a long time, but,
7 you know, I also think that the change in marketplace
8 needs a different focus. It calls for a different focus.
9 You know, I'll give you an example.

10 A couple of years back, or maybe it has been a
11 little less than that, one of the gaming companies
12 announced that they actually had a profitable quarter.
13 And the reason was that, you know, people playing this
14 particular game would purchase long-lived assets from the
15 company, and they would purchase perishables. And the
16 perishables were easy, because when players purchased
17 those you'd recognize revenue right away. But for the
18 perishables, you had to use an estimate of how long those
19 perishables -- I'm sorry, for the long-lived ones, you
20 had to develop an estimate.

21 And what this company was doing was basing their
22 estimate on how long an average player played the games

1 and taking the revenue for those long-lived assets over
2 that period. And this period they reported a profit
3 because the number of players had declined, and they were
4 playing for a much shorter period, so this was an
5 estimate. It's perfectly fine. You know, we can discuss
6 that.

7 But the point is that this was a place where
8 based on that estimation technique, because their market
9 was dwindling, because their business was declining, they
10 ended up reporting a profit.

11 And I think that's the distinction that I'm
12 trying to get at is that estimates, yes, they've been
13 around forever, and I know a lot of people do a great job
14 of it. The fundamental point though is that they've
15 changed a great deal.

16 CHAIRMAN DOTY: This is a fascinating discussion
17 because again as an auditor, I've just finished reading
18 an article by a very bright professor named Steven
19 Glover. He was at Brigham Young. And Steven's a very
20 clever guy, an articulate, clever guy, and he argues
21 well.

22 He has a paper now which is based on a laboratory

1 hypothetical experiment in which he interviews audit
2 partners and engagement partners. And it's about
3 something Bob Tarola said that just clicks with it, and
4 that is if you read Steven's paper, and you're a layman,
5 you come away with the sense that maybe it's just too
6 tough, that it can't be done.

7 Now he is arguing that our rules that the current
8 standards, unchanged, impose perverse incentives,
9 economic incentives on the auditor, and in fact
10 discourage independence, objectivity and skepticism in
11 the performance of the audit estimates.

12 I raise this because it seems to me the questions
13 that are coming out of the group raise some questions as
14 to whether his survey is well-based. I would be
15 interested in knowing if people read Steven Glover's
16 piece. He's very transparent about his methodology,
17 about how he selected and what the universe of persons
18 interviewed are.

19 But the conclusions that he draws or seems to me
20 to be drawing from the persons interviewed are really
21 quite different from the conclusions that the investment
22 advisory group were coming up with from experience. And

1 that is that more specific guidance that actually
2 requires more by way of auditing internal controls are
3 needed, that in fact auditors can do this, have been
4 doing it a long time, and there are many estimates they
5 could make.

6 He seems to be retreating into the argument that
7 it's just so tough that whatever the auditor decides with
8 the length of the chancellor's foot based on his
9 judgment, based on just what he thinks, ought to be
10 enough for an audit standard.

11 And that's not what I hear the investor advisory
12 group saying, but this is a request that people read it,
13 and let us know what you think. As I say, Glover's very,
14 he's a very capable guy, but what you're seeing seems to
15 suggest that maybe there's a different view, a different
16 slant entirely on the implications he has on the
17 standards and what auditors do in the estimate.

18 CHAIRMAN HARRIS: A couple of you have raised the
19 issue of independence risks associated with the
20 engagement specialists, and I'm wondering whether or not
21 you have any recommendations in terms of how those issues
22 ought to be addressed.

1 MEMBER HARRISON: Steve, I think what you're
2 concerned about in the first instance is the history, if
3 any, of the specialist with the issue or business
4 relationship either during or preceding the audit period,
5 have they done other work for them, and if so, what level
6 of fees have been paid.

7 And I think I'd really like to know if it was a
8 significant portion of their business, particularly if
9 it was an individual or a small consulting firm that's
10 been called in for a specialized task, was the issuer
11 some meaningful percentage of their revenue over a
12 prescribed period of time.

13 I think it's an issue of financial, other
14 financial ties and dependence on the issuer as a client
15 that would be high on my list of concerns.

16 CHAIRMAN HARRIS: Well, there are a number of
17 tent cards up. I don't know whether you want to
18 recognize them, Tony, or I will. But Chief Accountant
19 Schnurr has his card up and Steve Kroll and Chairman Doty
20 and Joe Carcello, so --

21 MEMBER SONDHI: Okay.

22 CHAIRMAN HARRIS: -- why don't you be the

1 conductor?

2 MEMBER SONDHI: And Jeanette, do you want to, did
3 you have -- is your card up there? Oh, it's Steve.
4 Okay, go ahead.

5 MR. SCHNURR: Just a couple of questions. The
6 first recommendation that you have is on the wanting
7 accounting estimates and fair value is that prescribing
8 auditor disclosures, and there are four bullets to that.

9 And I'm, first of all, questioning whether you
10 meant auditor disclosures, or did you mean company
11 disclosures? Because these are typically things that I
12 think to some extent have been dealt with as part of the
13 audit reporting project, and conclusions around or
14 comments around the fact that information about the
15 company's financial statement should be provided by
16 management and not by auditors. So that's my first
17 question.

18 And in terms of trying to better understand the
19 bullet, you know, for example, the third bullet is
20 information material to financial statements but not
21 otherwise required by reporting and regulatory standards.
22 I'm not exactly sure how you would even make that

1 determination.

2 I mean, there are certainly securities and laws
3 around information that is material that has to be
4 disclosed, but I'm not sure how if you're trying to
5 burden the auditor with the idea of trying to search
6 everything to determine what's not in the financial
7 statements is now their responsibility to try to
8 determine what is material that's not in there. So
9 that's kind of my first question.

10 There is on the following slide in terms of
11 recommendation, the requirement that an expectation of
12 estimates should be mandatory. And what I'm really
13 struggling with that is, you know, if you look at a big
14 financial institution or some others who have loan-loss
15 models, are you suggesting that the audit firm would have
16 to create their own model to estimate those losses?
17 Because that would be a daunting task for them to have
18 to do with respect to each of their clients.

19 And so I think, you know, there are certainly
20 situations where it's easier for a company or for an
21 audit firm to do their own independent estimate of a
22 particular instrument, but if you're talking about other

1 estimates other than, you know, financial instruments,
2 I think it's -- you know, I'm just having a hard time
3 understanding how that would be something that could
4 actually be implemented and have the financial statements
5 being audited and reported on in a timely manner.

6 So those are, really, with respect to, you know,
7 the auditing and accounting estimates and fair value,
8 those are kind of my big questions.

9 MEMBER SONDHI: Anybody can jump in, but I'm just
10 going to make a couple of quick comments in response.
11 The first issue was with respect to who is required to
12 provide that disclosure. And, you know, I'd clarify that
13 by saying that much of this information, if it's not
14 already being provided by management, has to be available
15 in order to enable the auditor to conduct a comprehensive
16 test of these. Some of that information will have to be
17 provided outside that world and in the financial
18 statements in order to enable investors to better
19 understand what the basis of those estimates is.

20 So what I'm suggesting is that there are places
21 where the information available is not sufficient for me
22 as an outsider, as an analyst, to fully evaluate whether

1 those things are, whether those estimates, those fair
2 value measures are as good as that.

3 I'd go, for example, with derivatives. There are
4 times when I've seen derivative disclosures where it's
5 very hard to say, you know, what direction of risk the
6 company has taken. Those disclosures are almost
7 completely opaque. And I was looking, I actually went
8 to the dictionary to see if I could find a stronger word
9 than opaque. But they're absurd. There's no way to
10 understand what those things are saying, so there has to
11 be additional information available to allow us to get
12 a better sense of them.

13 So there are two possibilities. There's two
14 sides of this. Some of it the auditor needs more of, and
15 some of it we need outside need more of. You're
16 obviously right about information that's material but not
17 currently required. I'm not asking for the auditor to
18 go look for every single possibility.

19 I'm saying where management has used something
20 which they would not otherwise be required to disclose,
21 I think they need to tell the auditor that, what the
22 basis is. And then there'll have to be judgment in terms

1 of whether that's publicly disclosed within the
2 boundaries of these securities laws, et cetera, that you
3 mentioned.

4 With respect to the auditor's replication of the
5 models, and I, you know, I certainly agree with you that
6 with respect to the financial instruments world and the
7 banking, financial institutions world, that some of those
8 requirements are going to be very, very difficult. The
9 fundamental question for me as an investor is what is it
10 that I'm going to need to ensure that that's reliable
11 information?

12 I'm not asking for something, you know, for a
13 complete replication, but there has to be something other
14 and something more than simply taking what is given and
15 performing some tests. So that's there, there's a
16 question of what has to be done. Okay.

17 Steve, you want to go?

18 BOARD MEMBER KROLL: Thank you. First, I want to
19 thank the group. These are, although they're not a lot
20 of slides, I know how much thought went into this and
21 it's going to be very helpful to us going forward. I do,
22 I would ask, and I don't want to go into it here, but I

1 just thought I would like to raise a question that maybe
2 we can discuss offline at some point.

3 Several of these recommendations, ratio of audit
4 staff to partners, reports on internal controls and
5 enforcement actions, percentage of audit reports that
6 reported material weakness, are slight, slight variations
7 on AQIs we've already got. So the question is, is the
8 idea that we've got to tune them up a little bit or is
9 there something more fundamental missing?

10 But as I say, I just, the problem with this
11 subject is that it gets pretty granular pretty quickly.
12 And we don't need to do that here, but if maybe we could
13 talk offline about that question. But thank you very
14 much for your thoughtfulness.

15 BOARD MEMBER FRANZEL: Yes, I have a question on
16 one of the recommendations for the auditing accounting
17 estimates and fair value measurements. It's the
18 recommendation that auditors test and report on the
19 internal controls, relevance, reliability and
20 appropriateness of the models, data and assumptions
21 underlying the process of management's development of
22 estimates.

1 So under our current standards, you know, this
2 would be happening under the risk assessment model and
3 the current assumptions of materiality and so on. Are
4 you suggesting something beyond what's in the current
5 standards, and what would you envision?

6 MEMBER SONDHI: I think it's more of an issue of
7 -- I understand that this is supposed to be happening.
8 The question is, are the issues whether we're being
9 provided as investors, provided enough information about
10 these tests? And so the idea, the objective would be to
11 develop a way to provide this information more
12 specifically, more clearly.

13 BOARD MEMBER FRANZEL: So you're really talking
14 more about a disclosure matter rather than changing the
15 risk assessment and internal control auditing standards
16 at this point.

17 MEMBER SONDHI: It's mostly a change in
18 disclosure, I agree, because it's not clear to me what's
19 happening with respect to that.

20 Joe, you want to go next?

21 MEMBER CARCELLO: Thanks, Tony, and thank you to
22 you and your group for your work here. It's a number of

1 things, I think, are interesting, and we're talking about
2 it.

3 So Jim, in response to the Glover paper, as you
4 may know it will be presented at the end of October at
5 the Contemporary Accounting Research Conference in
6 Vancouver. So since you probably won't be there, there
7 will be a discussant. I will be there. There will be
8 a hundred well known academics there, so I can give you
9 or Samantha a report on kind of the criticisms of that
10 paper or the compliments of that paper, so you'll get
11 some feedback on that. It'll be vetted pretty thoroughly.

12 In terms of, Tony, your slides, I think the
13 comparing management estimates to actual results, which
14 I think Jeanette just asked about, is one of the more
15 important recommendations.

16 And I do think there is an issue of maybe better
17 disclosure, which I guess is more of an SEC issue than
18 a PCAOB issue. I can't think of the relevant part of,
19 I guess it's -- I always get S-X and S-K mixed up where
20 I am.

21 But there's already a requirement, I think,
22 around accounts receivable that, I forget the number or

1 the -- but you have beginning of the year, you know, bad
2 debt expense for the year, charge-offs, write-offs, and
3 then end of year. So you can basically then map the
4 expense from prior years at least to some extent into the
5 current year's write-offs. It's not perfect, but you can
6 get a rough sense of that.

7 And so that exists right now or at least around
8 accounts receivable. I don't think it's a GAPP
9 requirement; it's an SEC requirement. And so maybe more
10 of that type of disclosure would be helpful.

11 As you may remember, when we did the survey on
12 the audit report a few years ago, and we asked investors
13 what they wanted, the number one item was more
14 information around estimates and judgments. That was the
15 single most important item. So, you know, maybe that's
16 an SEC issue, maybe that's a PCAOB issues, but it's a
17 very important issue.

18 In terms of, Tony, your Slide A, in terms of
19 information on firm leadership and how it is selected,
20 I think that's really important particularly as we think
21 about culture of firms, particularly as we think about
22 growth in consulting, but I don't think this is granular

1 enough.

2 So if, you know, pick a firm. If KPMG puts in
3 place a new CEO or senior partner, whatever they call
4 that person, and you give the vote, that doesn't really
5 tell me what I want to know. What I want to know is what
6 was the vote by the audit partners. So if the overall
7 vote was 80 percent but the vote by the audit partners
8 was 35 percent, that's a very, very different message,
9 and I think a very important message.

10 I think someone asked you this already, maybe
11 Steve, about percentage of audit reports and internal
12 controls that reported a material weakness. As Steve
13 talked about, this is already kind of a derivation of
14 this; it's already in the AQIs.

15 I think, with all due respect, Tony, to you and
16 your group, I think what they already have in their AQI
17 is probably better than this. Because unless I'm
18 misreading this, percentage of audit reports and internal
19 controls that reported a material weakness, so to
20 optimize this I'd give every client a material weakness?
21 That doesn't make any sense, right.

22 So what you want is material weakness that you

1 want ICFR reports to be adverse in advance of problems.
2 That's useful. That's really useful. But you don't want
3 just blanket adverse reports on internal control. That
4 doesn't tell me a lot.

5 And then in terms of, I do think there's a major
6 issue here around treating engaged specialists different
7 from employed specialists. And in fact, as you point out
8 in Slide whatever it is, it's on Page 10 that an
9 auditor's employed specialist must be independent but an
10 engaged specialist is not, the only word I can think of
11 for that is ludicrous. I can't even think of another
12 word that would describe that.

13 So if I have an engaged specialist and I do a ton
14 of work for management that's okay, but if the specialist
15 is employed he or she has to be -- I can't even reconcile
16 that. So maybe someone smarter here can reconcile that.

17 The thing that makes me uncomfortable, and,
18 Marty, you probably saw this in my comment letter if
19 you've read it, is, and maybe I'm misreading your
20 document around engagement partner identification and
21 identification of other firm participants.

22 But at least the way I'm reading this, and if I'm

1 reading it wrong you'll correct me, is on Page 11 the
2 disclosure requirements and computation of total audit
3 hours presented in Appendix 1 have been modified to
4 exclude specialists engaged, not employed, by the
5 auditor. This change -- and then they explain why.

6 But it would seem to me, if I'm reading that
7 right, it would go in the direction, Tony, opposite what
8 your group is recommending because you'd have even less
9 visibility around the use of engaged specialists. At
10 least the way it was written originally you'd have some
11 visibility around the use of engaged specialists. No?
12 Reading it wrong?

13 MR. BAUMANN: Well, you wouldn't have visibility
14 around the use of engaged specialists, they would be in
15 the denominator of the calculation of the total hours.
16 And so if you're trying to say the total hours on the job
17 were a hundred thousand, if you added in the engaged
18 specialist they're a hundred and one thousand. But then
19 you're trying to figure out, well, what percentage of the
20 work was done in XYZ firm in London, XYZ firm in Hong
21 Kong, et cetera, so it's really on a denominator issue.
22 It's not a disclosure issue.

1 MEMBER CARCELLO: Okay, so they were never going
2 to have been disclosed.

3 MR. BAUMANN: They were never going to be
4 disclosed under that.

5 MEMBER CARCELLO: Okay, okay. Well, maybe they,
6 well, I still think that's an issue, maybe not around
7 this particular stand.

8 MR. BAUMANN: What the recommendation's being
9 made here is that you think there should be some sort of
10 disclosure when auditors rely on engaged specialists.

11 MEMBER CARCELLO: Yes.

12 MR. BAUMANN: But that was not part of the
13 transparency disclosures ever, but that's a
14 recommendation coming out of your group.

15 MEMBER CARCELLO: Okay. So those are some
16 thoughts in response to what you have.

17 MEMBER SONDHI: Thank you, Joe. Let me just
18 briefly comment on some of these things. Some of the AQI
19 recommendations are certainly on similar issues, but one
20 of the reasons we've drawn them out here and are
21 emphasizing them is because we feel that additional work
22 is needed to change the way we look at those.

1 So it's not that the proposals and the concepts
2 release are not there or they're not correct or anything,
3 it's just the point is from an investor's perspective we
4 were looking at it a little bit differently and we'd like
5 to see something more than that.

6 Similarly, as you pointed out with respect to the
7 percentage of audit reports and so on, absolutely. I
8 think your, I appreciate very much your adding that.
9 because in and of itself the number's irrelevant. It's
10 not going to tell me anything, you're right. If you
11 combine it with something as you said, you know, then
12 yes.

13 But that's what I think the challenge is. I
14 think we need to move in that direction. We need to
15 think about the audit quality indicators as not being
16 percentages of this or that, just as you said with the
17 firm, you know, the new CEO's vote is 80 percent but only
18 35 percent of the audit partners voted for him, then
19 that's information. That data point has some value.

20 So that's the objective here is to try to point
21 out some of these so that we can go back and take another
22 look at them and say what is that that would make that

1 particular indicator actually useful, even more useful,
2 let's say. I'm not saying that they aren't. Okay, and
3 I appreciate the comment on the engaged versus the
4 employed, and I think that is certainly an important
5 recommendation there. Marty?

6 MR. BAUMANN: Thanks. I just wanted to go back
7 to something that Jim Schnurr said earlier. And Jim,
8 it's really a comment that is, it was the question about
9 accounting versus auditing issues on these
10 recommendations. And your recommendations, really, are
11 quite similar to many of the comment letters we received
12 on the estimates paper in that regard, in that many of
13 them PCAOB can only do so much in terms of improving
14 audits of estimates. There really needs to be greater
15 disclosure about the sensitivity, assumptions, models,
16 measurement uncertainty needs greater disclosure.

17 And so the recommendation was that, from a lot of
18 commenters, that really was an issue for PCAOB, FASB and
19 SEC to address that, yes, we had a piece of it to improve
20 auditing standards, but that many of the commenters
21 thought there was the need for improved disclosures at
22 the same time so there would be a greater understanding

1 around how important the assumptions, how sensitive the
2 estimate was to assumptions, how much measurement
3 uncertainty there might be in a particular estimate.

4 So a lot of these things seem to sound a lot like
5 that and they sort of, I don't want to say mix up, but
6 the comment letters we got were both recommendations on
7 accounting and recommendations on auditing in saying,
8 well, I guess you all have to work together to solve
9 them, and I think that's coming through here as well.

10 MEMBER SONDHI: Thanks, Marty. I think that as
11 you said we did try to point that out that we need that.
12 The need for disclosure is something that I, you know,
13 I find it absolutely critical being an analyst.

14 But I have found that it often does get short
15 shrift. The new revenue standard is a great example.
16 The core principle of the new revenue standard says
17 revenues should be recognized when goods and services are
18 transferred in the amount, and so now you've got
19 recognition and measurement in the amount that the seller
20 expects to be entitled to, and then it stops. Not a word
21 on disclosure in the core principle and I find that very
22 odd.

1 Now it so happens that the new revenue standard
2 has a lot of disclosure proposals and so on and it
3 actually does a very good job, but I think it's
4 indicative when the core principle is silent on one of
5 the three basic components of financial reporting. So
6 I find that, you know, that happens a great deal.

7 And I don't, you know, I agree with you with
8 respect to the accounting versus the auditing issue. I
9 think there are places where it's very difficult to draw
10 the line. It is very important that the three entities
11 work together to ensure that they're talking about the
12 same thing.

13 As you said, you've got one piece of it, the
14 SEC's got another piece of it and the FASB has a third
15 piece of it. And it's critical that they all work
16 together. This is a lot of our investments at risk in
17 the way this whole thing works out. You're too close,
18 that's why.

19 MEMBER SILVERS: That's all right. Really, in
20 the spirit of the last two comments, and going back, Jim,
21 to a couple of the questions that you posed. You know,
22 this body and the SAG have been talking about problems

1 around both estimates, fair value estimates and, fair
2 value measurements and estimates for some time for some
3 years, and as has been noted, there is a kind of
4 interweaving here of different people's jurisdictions.

5 And I was sort of curious, you know, what your
6 view is. I understand you don't speak for anybody but
7 yourself, but I'm curious as to what your view is sitting
8 over at the Commission as to what ought to be done in
9 this area to strengthen the audit in light of the growing
10 prominence of these two features.

11 MR. SCHNURR: You know, in looking at --
12 particularly, let's talk about fair value measurement,
13 certainly there have been hundreds of comments that the
14 PCAOB has issued in Part 1. But if I step back from that
15 and I look at how many restatements have come out of that
16 there's virtually none and very little. There haven't
17 been a lot of enforcement actions. There are no, you
18 know, restatements.

19 So certainly we need to focus on the
20 implementation of the, or the execution, performance of
21 the auditing standards, and I do think there is confusion
22 around the various sections in the audit or in literature

1 that deal with accounting, auditing of these estimates.

2 So I think there is certainly room for
3 improvement in the auditing standards, but when I step
4 back and say, is there a really big problem here with the
5 actual estimates that are being made and are in the
6 financial statements, I don't see any manifestation that
7 those estimates have been materially misstated, because
8 we haven't seen restatements coming out of this. And
9 eventually though those would have to manifest themselves
10 over an extended period of time. They just don't, you
11 can't just, the auditors couldn't get lucky that many
12 times with respect to not performing the audit
13 procedures.

14 So I think this is, it's a complicated area. I
15 do think there's certainly an area that needs to be
16 improved and I have been very supportive of the PCAOB
17 moving forward with this project. But I'm questioning
18 whether or not there's a big financial reporting problem
19 here as opposed to an auditing problem.

20 MEMBER SILVERS: If you don't mind, I can't
21 resist asking where do you think that type of problem
22 currently exists in the financial reporting system?

1 Meaning, if this issue isn't driving restatements, what
2 do you see as driving restatements and what steps are you
3 taking in those areas?

4 MR. SCHNURR: Well, as I said, I haven't observed
5 a lot of restatements as it relates to measurements of
6 fair value. So I'm not seeing those, so that's why I'm
7 saying I don't see it as a financial reporting problem.
8 That companies are doing a reasonably good job of making
9 the estimates and, you know, they're doing it based on
10 the standards.

11 There might be deficiencies with respect to
12 valuation methodology, and that's a whole separate
13 discussion that, you know, that probably could be
14 addressed at some time, but that doesn't relate to the
15 auditing of the estimates.

16 MEMBER SILVERS: That's not the question I'm
17 asking you. I'm asking you what are you doing in the
18 areas that you do see as driving restatements? I want
19 to be reassured that you're doing something about
20 something.

21 MR. SCHNURR: Well, obviously when a restatement
22 occurs there are several things that the, you know, our

1 Commission staff would do. One of the things that we --

2 MEMBER SILVERS: But I'm not asking what you
3 would do, I'm asking what you are doing.

4 MR. SCHNURR: No, as I'm saying what that we do.

5 MEMBER SILVERS: Because what I have the
6 impression of is the answer is always no. That the
7 Commission's accounting staff is standing in the way of
8 meaningful action on issues that have been before the
9 PCAOB and where investors have been advising the
10 Commission this is serious stuff for a decade. That's
11 what I see. So tell me, what is it you all are actually
12 doing?

13 MR. SCHNURR: Well, what we do when there is a
14 restatement is, first of all, we will question around the
15 question so whether the controls were in place. There's
16 also the enforcement obviously, we would then take a look
17 at that and --

18 MEMBER SILVERS: Again, I'm not asking you what
19 you would do.

20 CHAIRMAN HARRIS: Damon, actually, I don't want
21 to get into too much of the contentious back and forth
22 here.

1 MEMBER SILVERS: Okay, I've made my point.

2 CHAIRMAN HARRIS: I think your point is well
3 taken, and Jim, unless you want to, you know, respond --

4 MR. SCHNURR: No, I'm happy to take this offline
5 with Damon at some point, but I don't think it's
6 constructive in this.

7 CHAIRMAN HARRIS: Yes, why don't we do that. And
8 then Curt --

9 MEMBER BUSER: If I could though just add to what
10 Jim has said, just in terms of the work that we've been
11 doing from an internal controls perspective, focused on
12 with Corp Fin and enforcement, the areas where we are
13 seeing the highest degree of restatements, areas of cash
14 flows, certain areas relative to revenue.

15 We have in fact been very active relative to
16 Jim's points, making sure that companies are identifying
17 on a timely basis material weaknesses and disclosing
18 those. I think you'd find that there are more
19 enforcement actions and more investigations in this space
20 than we've had ever before.

21 You know, I think it's unfair to suggest and
22 inappropriate to suggest that where there are areas of

1 problems in financial reporting we're not taking action.

2 I think the record is very clear on that.

3 CHAIRMAN HARRIS: Tony, why don't we move to you
4 and then, well, no, Curt had his tent card up for ten
5 minutes. And then Tony, and then I'll ask a question,
6 and then Mike, and then we'll break.

7 MEMBER SONDHI: I just wanted to make a comment
8 in response to this issue that's been going around here
9 as to whether there are restatements of fair value. And
10 I think that may be in part due to the nature of that
11 particular estimate of fair value. It's not because you
12 don't have remeasurements and you don't have
13 restatements, I think the question, if you're looking for
14 restatements I think you're looking at the wrong thing.
15 I think you have to ask a very different question. And,
16 but I will take your point and we can do this differently
17 later and offline.

18 But let me first go to Curt, and then Mike. Did
19 you have, do you still have your -- okay. You can leave
20 it down. I'll come back to you. But Curt, would you go
21 ahead please?

22 MEMBER BUSER: Sure. So, first, thanks to the

1 team for putting these together, because these are
2 important topics. We need to address them. We can't
3 wait. But a couple thoughts, and I will try not to
4 repeat what others have already said.

5 First, we've got to be very clear what the
6 specific problems that we're solving. And in this area
7 of fair value and in estimates there's a broad number of
8 types of instruments or types of fair value estimates and
9 a broad number of just estimates in general that
10 management makes.

11 And so I would contend that be careful with
12 blanket standard setting over all of those types of
13 items. We need to be very specific as it relates to the
14 specific problems and how then do we solve that through
15 standard setting, be it, you know, financial reporting,
16 disclosure, or through improved audit procedures.

17 Second thought, there's a lot of comments around
18 added disclosure and some of which is around kind of
19 specific audit procedures. We ought to ask ourselves,
20 are we still asking for the audit to be done of the
21 financial statements taken as a whole, or are we asking
22 for audits of individual elements? And if we're asking

1 for audits of individual elements of those financial
2 statements, well, then I'd like a report on those
3 individual elements.

4 If we're asking for kind of to keep where we
5 currently are on audits of the financial statements as
6 a whole, then guidance around materiality, and
7 sensitivity, and the like becomes all that more
8 important.

9 I also think that, you know, the comment that
10 Larry made before on inputs is incredibly important,
11 incredibly important. Because if you have a complex
12 instrument or asset to value and the inputs are wrong,
13 guess what, it's wrong. And I don't care what kind of
14 market, corroborative data or other sort of stuff, but
15 the underlying input's wrong.

16 The thing you then have to get to is, okay, well,
17 what is fully in control of all of the parties and how
18 might then, you know, might there also be sensitivities
19 around that or other things, because some of that may not
20 be accessible.

21 So, you know, let's say you make an investment in
22 a company and you only own 19 percent. Maybe you have

1 board rights, maybe you don't. Maybe you have influence,
2 maybe you don't. I'm talking kind of real influence,
3 not, you know, accounting speak. And so then the
4 question is can you get that data, and then the question
5 gets into, you know, how much of that data might be
6 uncertain. Because it's coming from, maybe, parts of the
7 world where the standards are very different, or prone
8 to corruption, or prone to other issues, and what's the
9 criteria there?

10 Now let's take it to the other place. Let's say
11 that you do control it, and you do have that data. Well,
12 does that then mean that the auditor has to audit that
13 data or is it suffice to say that it's audited? Now all
14 of that would then be historical information.

15 Now let's assume your valuation is based on
16 prospective information, i.e., future cash flows, next
17 12 months' expected earnings. Now, how then does the,
18 now obviously it's the base, obviously, but then those
19 kinds of guidance for that go into the process, I think,
20 are key to kind of think through. But it's not simple.

21 Then, you know, in terms of the valuation
22 guidance, how do you kind of encourage kind of multiple

1 approaches and multiple approaches that corroborate, I
2 think, is another way to kind of get at this in terms of
3 often, you know, providing guidance to solve issues.

4 The disclosure issues I agree with. The question
5 you then have to ask yourself is, okay, the disclosure
6 issue is just to give a parameter of what's the range of
7 outcome, or is the disclosure sufficient for the user to
8 recompute, redo whatever, or come to a different answer?
9 So those are two different criteria.

10 Then you have to ask yourself questions around
11 aggregation. So a lot of financial institutions are
12 going to have lots of financial measures and lots of
13 Level 3, and so how then to package all of that so that
14 it is consumable can be often very trying. Or is it just
15 the significant items, okay, now which ones are the
16 significant ones and which ones aren't the significant
17 ones?

18 Well, then how do we think about conservative
19 anymore? Because fair value to me has always been fair
20 value, not conservative value. Is that still what we
21 want? So do we want, you know, a conservative bias and
22 stuff, I'm not saying that we should because there's

1 different problems with that. But when you then go to
2 kind of its true fair value, be careful, you know, then
3 we have to be able to expect errors on both sides of that
4 equation.

5 And if we're not willing to tolerate errors on
6 both sides of that equation, then ask yourself whether
7 or not you still want true fair value, or you want
8 something different.

9 And then you've got to think about, you know,
10 often the financial statements that are being used, are
11 they private versus public, and usually I'm pretty clear
12 that I don't think there should be any distinction. But
13 I could make an argument for a closed end fund where
14 you've got to, you know, an audit of that where the
15 discrete set of investors that are sophisticated, if you
16 had retail investors in the mix you'd get a different
17 situation.

18 But there's a lot of, all my comments are really
19 getting to there's a lot of complexities here, be it as
20 we've talked about financial reporting or auditing, and
21 we've got to make sure we know what problem we're solving
22 before we write a standard, because otherwise you're

1 never going to get the cost-benefit right on it.

2 MEMBER SONDHI: I certainly agree with that.
3 Let's see. Mike.

4 MR. BAUMANN: I just wanted to remind the
5 advisory group that, and Chairman Doty mentioned this,
6 this morning, that we intend to re-propose the standard
7 on, the proposed standard on the auditor's reporting
8 model in early 2016.

9 And while that doesn't deal with all of your
10 disclosure issues that you hear, and a lot of the
11 disclosure matters as I said I think you're talking about
12 some are potential disclosures the accounting frameworks
13 could pick up. Some investors, I think, did want the
14 audit reporting model to have the auditor to have more
15 disclosures about the financial statements, but at least,
16 as proposed, that was really more about the audit.

17 The enhanced auditor reporting that's taking
18 place already in the U.K., and the IAASB standard, I
19 think those are somewhat, and hopefully what I think I'll
20 be asking the Board to re-propose, goes partially towards
21 some of your concerns here, which would be what were the
22 critical auditing matters, what were the most subjective

1 complex matters the auditor dealt with, disclose those
2 as critical audit matters and then disclose, or comment
3 on how the auditor addressed those critical matters.

4 So I think that information will go somewhat
5 towards helping investors, I believe, understand what
6 were the most subjective, challenging issues in the audit
7 in the financial statements, and then how the auditor
8 addressed those. So again it won't provide new
9 information about the financial statements, but it will
10 at least provide information about the audit and how the
11 auditor dealt with those. And I think you're seeing some
12 of these reports already in the U.K. and elsewhere.

13 And generally what I'm finding in looking at
14 academic papers to date is that they're finding that
15 information to be useful and valuable in terms of this
16 content in terms of providing investors with new
17 information, useful information to pursue further with
18 management, as they wanted to make inquiries about those
19 complex estimates.

20 CHAIRMAN HARRIS: And then, Tony, a final
21 question, you know, following up on what Curt mentioned
22 with respect to this specific problem and the need, and

1 it's following up on a question I asked this morning.

2 Why are you recommending greater transparency,
3 and this is on Page 80, within the audit practice and
4 firm-wide of total revenue and revenue disaggregated by
5 business line, profit sharing and such that is provided
6 by specific business segments to other segments, and
7 percentage of firm's revenues invested in, A, technology,
8 and B, training? What do see as the problem there that
9 needs to be addressed, and the need?

10 MEMBER SONDHI: I wanted to just start by saying
11 thanks, Marty, for that clarification. I appreciate
12 that. Steve, you know, we've talked about this aspect
13 before and that is, the essential question was how is the
14 inherent conflict in the audit versus the advisory role
15 affecting things?

16 So part of what we're looking at in terms of the
17 revenues, in terms of, you know, what the cross subsidies
18 might be and so on in the discussion that Mercer and I
19 had earlier, comments we exchanged, the whole objective
20 is to see if whether we can better understand this
21 conflict and do something about this issue.

22 Because we've talked, you know, other people have

1 mentioned, Joe mentioned earlier about consulting work
2 being better, this that and whether the profitability is
3 changing or not, changing, et cetera. And these types
4 of disclosures will help answer those or help with some
5 of those questions.

6 Now, overall, I did want to say that one of the
7 things I will -- you know, certainly appreciate in this
8 discussion that has followed the presentation is that,
9 and we've done this in the morning as well in the
10 previous two sessions, that it really is critical that
11 we understand and ask the right question and then just
12 as critical that we employ the right methodologies to
13 address them. We ask the right questions with respect
14 to that. So I appreciate all of that. Thank you.

15 CHAIRMAN HARRIS: Norman, we'll give you the last
16 word.

17 MEMBER HARRISON: I'll be brief. I know we're
18 trying to get to break. I apologize. I think we all
19 recognize, just to follow up on Tony's response, and I
20 know, you know, the staff has taken the same view in the
21 paper, in the concept at least on indicators, that part
22 of what we're trying to do here, an important part of

1 what quality indicators are designed to do is not to
2 address problems as such but to arm consumers with
3 information to make a better educated choice about whom
4 they engage as their auditor.

5 So this really goes to the process of auditor
6 selection and-or renewal on an engagement to have
7 additional data points in hand including the ones Tony
8 just, or that your question pertained to, so that
9 consumers of audit services can make better informed
10 judgments about which of the firms has the resources, has
11 invested in the resources, has the expertise and the
12 capacity to develop a high, and to deliver a high quality
13 audit with, you know, on a timely basis with independence
14 and all the other requirements that are associated with
15 that.

16 So I think that's how in looking at these I think
17 many of us view them as the, and this is like a
18 Consumer's Digest for audit committees. It's information
19 data in hand to ask questions and facilitate a more, a
20 better informed decision making process.

21 CHAIRMAN HARRIS: Well, Tony, thank you and your
22 group. I know the tremendous amount of effort that went

1 into this and the email traffic that went amongst
2 members. And so I want to thank you and Mercer and
3 Norman, you and Larry and Bob, Lynn in absentia and Gary,
4 because I know these have been difficult issues. But
5 you've certainly given us an awful lot to think about and
6 we appreciate it very much. And with that why don't we
7 just take about a seven-minute break, come back at 3:15
8 so we can catch up and get everybody out of here on time.

9 (Whereupon, the above-entitled matter went off
10 the record at 3:06 p.m. and resumed at 3:19 p.m.)

11 CHAIRMAN HARRIS: All right, we've got our
12 essential participants in the room, so let's turn to the
13 next subject which is a discussion of the letter from the
14 Chamber of Commerce dated May 29th relating to the
15 effectiveness of internal controls over financial
16 reporting under Section 404 of the Sarbanes-Oxley Act.

17 This topic was mentioned by a number of you for
18 discussion, and I will turn first to Chairman Doty and
19 SEC Chief Accountant Jim Schnurr and then to Helen Munter
20 who will discuss our inspection process and give an
21 overview. So Jim, thank you.

22 CHAIRMAN DOTY: Thank you, Steven. Well, first

1 of all, we are fortunate in that we are joined by Helen
2 Munter, who has absolute authoritative and crisp
3 information to impart to any questions you all may have.
4 And it's in our view a very good sign that there was an
5 interest by Curt Buser and others in the room to hear
6 what we have to say about this.

7 As Steve mentions, Jim Schnurr and I were
8 recipients of a letter dated May 29 from the Council for
9 Economic Competitiveness of the United States Chamber of
10 Commerce, the Center for Capital Markets Competitiveness
11 of the U.S. Chamber.

12 The letter is, as Steven says, long. It's 19
13 pages long and it's been distributed to you. What might
14 not be apparent from the letter is that we had met with
15 the Chamber, with Tom Quaadman and financial preparers
16 who were brought in to discuss some of these issues with
17 us as early as February of this year. It would not be
18 correct to infer from the letter that we have been
19 turning a deaf ear, or a blind eye, or merely rejecting
20 out of hand any attempt by the Chamber to call to our
21 attention important aspects and effects of our inspection
22 program.

1 Second, I will employ a rhetorical advice that
2 Paul Gunson used to use as the general counsel of the
3 SEC, and that is without commenting on this letter from
4 the Chamber in any specific way, I would merely note that
5 to have the PCAOB and the SEC take seriously a public
6 concern and to address that concern does not require that
7 the spokesman or the spokesperson of the concern be
8 either well-informed or necessarily well-motivated with
9 respect to the issues being raised.

10 We assume both good information and good
11 motivation in this case from the Chamber. We also have
12 ongoing good relationships with the Chamber. We see them
13 often. We are around the corner from them. And our
14 relationship I would characterize as being cordial, if
15 as the letter demonstrates sometimes challenging.

16 Now, the interesting aspect of this also is that
17 we have a meeting tomorrow with the Chamber and with
18 eight other preparers of financial, you know, financial
19 reports are being brought in. The ground rules that we
20 wanted to set for these meetings were that we should have
21 people who had actually experienced the issues that were
22 being discussed.

1 It was our view, Jim and I, I think Jim Schnurr
2 and I share the view that in this case hearsay is not
3 helpful. It's a little bit like the 30 Years War in
4 Europe, in which the atrocities were always well reported
5 in the province that was across the border. And, you
6 know, the people telling you about it really hadn't been
7 there, when they were there.

8 So what we want to know is where preparers of
9 financial statements and reporting companies really have
10 been engaged with their auditors in issues of the type
11 that are raised in the letter and have an incident to
12 report or details to report that should cause either us,
13 the regulators, or the audit firms to consider the
14 process of internal control auditing. And with that I
15 think I will defer to my colleague Jim Schnurr for
16 additional comments.

17 MR. SCHNURR: Thanks, Jim. Just to, you know,
18 follow up on Jim's comments, we did meet with the Chamber
19 and the preparers back in February, and it was at
20 actually before we finished that meeting that I suggested
21 that in order to address their concerns we would need to
22 get very granular about the fact patterns.

1 Because if you step back and look at the issue
2 there could be a number of different potential problems.
3 For example, there could be a problem with the actual
4 auditing standards. There could be a problem with how
5 they're being interpreted by the inspection group. There
6 could be a problem with the firm's execution of those
7 standards. There could be a problem with their guidance
8 and how it's being implemented by the engagement team.

9 And there also could be a problem where there
10 might be a disconnect between the auditing standards and
11 the management guidance that the SEC issued for
12 preparers, and there might be a couple of others. But,
13 so in order to understand where there might be a problem
14 and whether it was let's call it systemic, the only way
15 to do that would be actually get very specific fact
16 patterns from the preparers, and understand what their
17 control structure was, and where they were having issues
18 with their auditors.

19 So in the context of that Jim and I got together
20 and agreed that it made sense for the PCAOB to take the
21 lead on this and invite the firms in, or with the firms
22 as well as the companies, we're going to do this kind of

1 sequentially, and then decide what we needed to do
2 additionally beyond that. But certainly I think we're
3 going in with an open mind in terms of whether there is
4 a problem here or not, or if there is some problem
5 somewhere else in the system that needs to be addressed.

6 So we've essentially been waiting, quite frankly,
7 on the Chamber to come and meet with us for eight months.
8 The letter that was issued in May was a surprise. We
9 weren't aware of it, wasn't aware of it was coming. We
10 actually read about it in a newspaper before I received
11 my copy. But that doesn't really change anything. I
12 mean we're, you know, we're trying to approach this in
13 a very professional manner.

14 And we're, you know, in terms of our nexus we
15 obviously have, you know, oversight over preparers, we
16 have oversight over the audit firms and we have oversight
17 over the PCAOB, so that's one of the reasons we're kind
18 of at the table here. So we're looking forward to
19 starting the dialogue tomorrow and, you know, we're going
20 to see where it goes.

21 CHAIRMAN DOTY: And tomorrow the PCAOB will be
22 ably represented by Jeanette Franzel who's devoted

1 substantial attention to this issue. Helen?

2 MS. MUNTER: Thank you. And thank you all for
3 letting me be here this afternoon to talk a little about
4 internal control over financial reporting. It's in
5 particular from an inspection's perspective. And I think
6 ICFR is a really hot topic now. Almost every day that
7 I read the newspaper there's an article about ICFR, AS5
8 or even inspections, and shockingly to me not all of
9 those articles are flattering.

10 But I think that it's great to be talking about
11 ICFR and I wish that more people would talk about it from
12 a positive perspective, because when ICFR is effective
13 it absolutely provides an underlying foundation for the
14 financial statements for the quality of financial
15 reporting and provides investors with a very good basis
16 to make their decisions as they evaluate the financial
17 statements of any company.

18 And when ICFR is not effective that integrity in
19 the system is damaged, is impaired. So I think the
20 ability to rely on the internal audit, on the internal
21 control reporting is really critical and is very
22 important.

1 When we do our inspections we are doing an
2 integrated inspection of an integrated audit, so when we
3 pick an area to look at we drew that based on a risk
4 assessment that we have. We're looking at what we
5 believe are the most risky audits at any firm, and we're
6 looking at the portions of those audits that we believe
7 have the greatest level of risk.

8 When we identify a deficiency in the internal
9 control opinion there's frequently a knock-on impact to
10 the opinion on the financial statements themselves. When
11 the auditor scoped their audit they assumed they'd have
12 a certain amount of reliance from the internal control
13 testing that they did, and if they failed to get that
14 reliance it likely has an impact on the financial
15 statement audit itself, and could result in an
16 unsupported opinion on the financial statements as well.

17 From an inspection's perspective, our focus with
18 respect to ICFR, I think, is just to be able to clearly
19 evaluate whether the firm was able to comply with the
20 standard. Were there any deficiencies in the work that
21 the firm did in that regard?

22 We come to this with a team of very experienced

1 inspectors. On average, our inspectors have more than
2 17 years of professional experience. And one of the
3 things that I think is interesting to understand is we
4 have grown over the last ten-plus years in doing
5 inspections.

6 We've continued to recruit people with extensive
7 experience working at the largest audit firms. We've
8 also been very fortunate to be able to add some
9 individuals who come directly from industry and who bring
10 that experience as a preparer to their job at the PCAOB
11 as an inspector.

12 We've been able to have some employees who have
13 experience at other regulators or working in foreign
14 countries. So we have a diverse group of employees with
15 varied experience that they bring to the evaluation of
16 the work that they're looking at in all areas, but I
17 think in particular in considering the work done around
18 ICFR that can be very, very informative.

19 When we do our inspections, we focus on
20 individual issuer audits all with a goal to forming an
21 opinion and a view on the firm's system of quality
22 control. And you all are familiar with the Part 1s of

1 our reports that really call out the deficiencies that
2 we identify on the individual issue or audits that we
3 look at.

4 I think the more interesting, and to me the much
5 more important part of our report is Part 2 which remains
6 non-public as long as the firm's able to take successful
7 remedial action, and that is where we discuss potential
8 systemic defects and actual defects and potential defects
9 in the firm's system of quality controls and that's a
10 very important part of our report.

11 And the deficiencies that we've identified around
12 ICFR have driven commentary in that way in Part 2 of a
13 report and those are the areas where the firms have taken
14 some really significant action. In looking back over the
15 last several years, ICFR has been at the top of the list
16 of findings that we have had. In 2013, approximately 36
17 percent of the integrated audits that we looked at we
18 determined that they had failed to support their opinion
19 on internal controls.

20 All of the 2014 reports are not yet issued, but
21 many, many of those reports are issued and if you've had
22 the chance to review those you've noticed that some firms

1 have recognized a significant improvement in their
2 results. That does not extend across all firms, across
3 all audits or across all engagement teams, but that
4 improvement is very encouraging.

5 Much has been accomplished by the firms through
6 the remedial actions that they have taken, but there's
7 still more to be done. I'm most pleased by the fact that
8 when we go out and we do inspections we encounter a
9 number of engagement teams who are very clearly doing it
10 right who have done a very good job at performing a risk
11 assessment, scoping the work to be done and performing
12 that work. And we've come away from those inspections,
13 you know, with no comments and with a view into how an
14 auditor can do a good, high quality job in this very
15 difficult area.

16 I think, overall, as firms continue to work on
17 ICFR, and there's still quite a bit of work to be done,
18 we're looking to gain a deeper and more holistic
19 understanding of the sorts of changes that a firm can
20 make, can implement in order to be more successful.

21 As we've looked at the work, I would bucket today
22 the three big areas where engagement teams and firms tend

1 to struggle in doing their ICFR testing. The first area
2 is in understanding a company's flow of transactions.
3 And, you know, this is just a critical first step in
4 planning an effective audit, and without this
5 understanding the team might well fail to identify
6 appropriate controls to test and might fail to test
7 controls that are responsive to actual fraud risks that
8 have been identified.

9 One of the things that we've found in teams who
10 have failed to link controls to identified fraud risks,
11 where that has happened it has tended to happen more
12 often in the area of revenue than in any other area. So
13 clearly a critical area to the testing.

14 The second big area of deficiencies that we still
15 find are in the testing of management review controls.
16 Management review controls serves as a detective control,
17 meaning intended to ensure that management is able to
18 identify errors, inaccuracies or fraud in the financial
19 statements before they are finalized.

20 In order to rely on management review controls,
21 the auditor needs to understand the control and to test
22 to see that it is operating and operating at an

1 appropriate level of precision in order to detect
2 material misstatements.

3 So, for example, if the auditor is looking to
4 test a management review control related to a budget to
5 actual review of financial statements that occurs on a
6 monthly basis, merely ensuring that that control took
7 place is not sufficient for the auditor to do. The
8 auditor needs to understand and what matters, what the
9 management actually did, what they looked at, what was
10 the result, what additional inquiries were made and what
11 changes if anything resulted from that.

12 Where we found this deficiency we've talked to
13 engagement teams, and we're spending a lot of time on
14 root-cause analysis and talking to engagement teams about
15 what happened in this particular circumstance. And one
16 explanation in this area that we've heard quite a bit is
17 a concern raised about a lack of documentation that
18 exists at management.

19 Sometimes management will say that they have
20 appropriate documentation of the control for their use,
21 yet it's not enough for the auditor in its current form,
22 and it might not be enough for the auditor to use if they

1 want to rely on this control to a significant degree in
2 performing their testing.

3 I think that this represents an area where
4 increased discussion between the auditor and their issuer
5 client is very important. You know, the auditor needs
6 to explain what it is that they are looking for and what
7 that additional documentation will help them with what
8 audit objectives it will help them to achieve, and the
9 management can consider whether it in fact has that
10 documentation in a different form, in a different place,
11 or whether it would be worth it to increase the available
12 documentation.

13 But I think that dialogue is a very important
14 part of solving this problem. And, you know, if the
15 answer's flat out no that the issuer is never going to
16 provide that documentation, the auditor needs to
17 understand that and then think about what controls they
18 should be testing. Maybe they should be different
19 controls.

20 The third area where we've had a number of
21 deficiencies is related to the testing of system-
22 generated data or reports. And in this area the problem

1 that we have found is the auditor is relying on a control
2 and doing testing of the control, but a significant part
3 of that control is in input that comes from a system-
4 generated report.

5 So, for example, if the control relies on sales
6 prices coming from a price list, the auditor needs to
7 understand that that price list that is looked to is the
8 correct price list and needs to do some testing of that,
9 or understand what controls exist to ensure that
10 management is testing that.

11 This is an area that I think is a very discrete
12 area, and it is an area where we've seen discussion with
13 engagement teams about the specifics of it, I think, have
14 resulted in some very focused changed work in the
15 following year. So this is an area that I see as very
16 remediable in terms of the auditor being able to do some
17 specific procedures in order to address this.

18 I also think that this is an area that's a good
19 example for us of where discussion at the individual
20 engagement team complements well discussion at national
21 office about tools and templates and guidance. Because
22 I think sometimes with these deficiencies, until they are

1 real, such as the goal of, you know, hearing from issuers
2 about what are the real and specific problems, it's more
3 difficult perhaps for an engagement, audit engagement
4 team to adjust the nature of their testing if they don't
5 necessarily see themselves in the mirror when they hear
6 the problem that is out there.

7 What could be the cause of these deficiencies
8 that we find? I think many times in taking remedial
9 action firms have updated their methodology and guidance,
10 and where they have done this they have tended to see
11 good results come from that.

12 Some of the other problems that we suspect is
13 root causes relate to staffing and turnover. And going
14 back a few years, there were periods where hiring was at
15 a lower level and resulting in, you know, smaller
16 classes, if you will, of auditors able to do the work
17 going up the ranks, and that we think has had an impact
18 on the quality of audits in certain situations.

19 And we've also noted other situations where we
20 have identified concerns about the appropriateness of the
21 supervision and review in a particular engagement
22 situation. We've also heard from auditors about concerns

1 as to the issuer's processes and the issuer's controls
2 and documentations.

3 And I appreciate that that is a very, very real
4 concern. In a situation where an issuer client has
5 particularly good systems, good controls and well
6 documented process it's a whole lot easier to do a very
7 good audit. And where that is not true it's very
8 difficult to do the audit.

9 One of the important parts of the dialogue we
10 have with firms and with the engagement teams is, well,
11 in those situations what was your consideration as to
12 whether there were significant deficiencies or even
13 material weaknesses at the issuer client, and if those
14 existed those should be reported. So I think that that's
15 an important part of this.

16 Firms have clearly taken various actions coming
17 to address the remediation. Enhanced documentation has
18 been one result. Additional layers of review have been
19 another result, including monitoring activities from
20 firms with respect to some of the templates and other
21 tools that they have implemented. And I think it is very
22 important for a firm to take appropriate monitoring

1 action when they implement changes to their quality
2 control system in order to ensure that those changes are
3 effective and really taking hold.

4 Going forward, I think better ICFR auditing can
5 be achieved not necessarily with more work or with
6 exponentially more work. I would hope it is with smart
7 work. I think that in situations where testing was not
8 being done, the wrong testing was being done and being
9 done in barely being done, more work will be required.

10 But there are certainly situations where auditors
11 have devoted substantial time to work that could be
12 reengineered in a different format and performed in a
13 more effective and performed in a more effective and more
14 efficient fashion. I think that applying a mechanical
15 approach to the audit, and, for example, just checking
16 that a management review control was performed without
17 proper planning can lead to ineffective testing of
18 controls and procedures and that with appropriate
19 planning and an appropriate understanding of the risks
20 and of the company's processes the audit can be done very
21 well, and we certainly see a number of engagement teams
22 doing that.

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1 It's important to appropriately scope the testing
2 that is done. Our root-cause program that we have is
3 very focused on ICFR testing, and most of the large firms
4 have their own root-cause initiatives and then they are
5 also very focused in this area. And I think we'll be
6 seeing some real improvements coming into the future.

7 I find it reasonable that making improvements in
8 this area has taken time, has taken years and that these
9 findings have continued to recur. We have seen
10 improvement in the kinds of findings that we have. So
11 they're getting a lot closer to the bar, even if not all
12 teams are meeting the required level of effort that is
13 required.

14 I think continued dialogue is very important
15 between audit teams and their issuer clients, between us
16 and the audit firms. We have been very active with firms
17 in the remediation cycle, and for us the remediation
18 cycle is that 12-month period following the issuance of
19 an inspection report, where firms are working to address
20 the criticisms we've included in Part 2.

21 We have dedicated teams of people who work with
22 each of the firms in that effort. We're available to

1 review draft submissions that they might make. We can
2 provide feedback as to the suggested course of action
3 that they are choosing, what has worked for others, what
4 has been difficult for others in going down certain paths
5 in terms of remedial action. But we've been very, very
6 focused on being available and being willing to review
7 drafts prior to a firm's final submission, for both the
8 largest firms but for any firm.

9 So for the smaller firms as well, I have a
10 dedicated team of people who do nothing but review the
11 remediation and engage with those firms as often as they
12 would like. Not all firms want to talk to us during that
13 period at all, and there's a bunch of them that submit
14 their final response on the 364th day of the year, and
15 that's fine. They certainly can do that. They'll get
16 reviewed after the period, but we are available to engage
17 with the firms during that period.

18 So I think with that, I'd like to open it up to
19 any, you know, questions or comments that you all might
20 have. I think the planning of the audit, and the
21 planning in particular of the approach to ICFR, is what
22 is very important here.

1 CHAIRMAN DOTY: Just one point before I recognize
2 questions. Helen, I take it our position is, yes, we
3 know auditors are doing more work. We know that more
4 work is being done on internal controls. We know that
5 in many cases the firms are doing it differently. But
6 we have not raised the bar. We have not changed the
7 standard, and we have not amended what we think is a good
8 audit or what is a defective audit.

9 MS. MUNTER: Yes; thanks. AS5 came out in 2007,
10 and it hasn't changed. And we haven't changed in terms
11 of how we evaluate the work that is done. Our evaluation
12 really is on the compliance.

13 I think that in the, you know, last eight years
14 that we've been looking at AS5 -- and in the ten-plus
15 years we've been doing inspections -- we've gotten
16 better, right? We've gotten better at being inspectors
17 and better at doing our jobs and understanding the work
18 that it is that we are evaluating, but that doesn't mean
19 that we're moving the bar.

20 MEMBER TAROLA: Thank you, Jim. And thanks,
21 Helen. I have a question and then a comment. I'll take
22 them one at a time. The question is: to what extent are

1 your concerns and exceptions coming from the auditor not
2 properly assessing the design of internal controls over
3 financial reporting versus finding that their compliance
4 testing was inadequate?

5 MS. MUNTER: I wish I knew the answer to that off
6 the top of my head. But it is absolutely a mix, and we
7 look at both as we're doing our procedures.

8 MEMBER TAROLA: Yes, because if they're assessing
9 the design as being adequate and then coming up with
10 problems during the test for effectiveness, probably the
11 client and the auditor have misconceptions about how the
12 thing is working. So I think that is important. I also
13 would say that if the design isn't sound, why bother
14 testing the compliance?

15 The second, this is more of a comment than a
16 question. I have to say that when Steve shared the
17 letter with the investor advisory group, I said that I'm
18 experiencing similar issues, as expressed in the letter,
19 as a CFO and an audit committee member.

20 And almost every year I have to say to auditors,
21 'Do not dismiss my involvement in the reporting process.
22 Do not assume that things must be wrong because something

1 didn't happen down here. Please check with the person
2 who is responsible for signing off before you make that
3 conclusion.' You cannot dismiss the value of experience
4 in the reporting process. And even there may be
5 situations where either design or effectiveness is
6 somewhat either compromised or not as effective as it can
7 be, that can mitigated with a knowledgeable person
8 looking over the numbers.

9 MS. MUNTER: I agree; right. I think that
10 management review controls are critical, are fundamental,
11 and I think they can be a great way to approach the
12 audit. It's just important that the auditor communicate
13 well with the client about what exactly is the control,
14 how it operates, and then set forth to test that.

15 MEMBER BUSER: Helen, thank you. I thought your
16 report was very good. I thought, you know, putting this
17 letter in front of this group was important, and I, you
18 know, applaud the actions that the SEC and the PCAOB are
19 taking.

20 I also think it's good to kind of reflect back,
21 you know, ten-plus years ago as Pete Nachtwey said, I
22 think the audit standards, or really the audits that are

1 being done today are far better than they were 2002 and
2 prior.

3 And whether that's, you know, Sarbanes-Oxley or
4 ICFR or the inspection process, I don't know. But all
5 of it together is making a difference, so I think that's
6 really good. And I think anyone -- from a management
7 perspective -- who doesn't believe in internal controls
8 or the importance thereof, probably shouldn't be in
9 management.

10 And, you know, the internal control process and
11 having that subject audit, I think, is good, and that's
12 part of being a public registrant and you sign up for it,
13 that's part of the duty to do it. Does it achieve all
14 of our goals and objectives in terms of pre-warning
15 signs? I don't know. Probably not. But having it there
16 is important.

17 However, we continue to get a lot of noise. Some
18 of it valid, some of it not valid. And I encourage the
19 approaches you're taking, kind of like where are the
20 errors occurring in that communication process and then
21 dealing with specifics.

22 And as a question/thought to consider, while AS5

1 hasn't changed in a number of years, my sense is that,
2 you know, the inspection process or interpretations or,
3 you know, just as the inspections have gotten better,
4 that auditors are now clearly approaching things
5 differently, and as preparers or issuers they're
6 frequently left to kind of being educated by the auditors
7 who are being educated by their firms in the inspection
8 process.

9 And so as a question I kind of say, well, should
10 we think about doing, you know, a review of the
11 standards/guidance and the SEC's issued guidance for
12 management? And there's a COSO framework. But does it
13 make sense to take that and align that with, I'll say,
14 AS5 as interpreted?

15 So, you know, AS5, plus however it's being
16 inspected, align it with the standards that management
17 have, or should we have a new standard written for
18 management, and then therefore, you know, because look,
19 management's got to assert to it first, right? You know,
20 before the auditors, you know, as a CFO I'm signing off
21 on it first.

22 So, you know, it's one thing for me to kind of go

1 higher, you know, people informing on your staff, and
2 that's a good thing for me to have, which I've done. But
3 you then also, you know, you kind of really what's the
4 standard that I'm looking to.

5 So when, you know, an auditor raised something
6 that object to that we can have an honest, good
7 discussion around the standard and the approach to it.
8 I think that might take -- because, you know, I think
9 about it even in terms of Generally Accepted Accounting
10 Principles.

11 We often, you know, we'll have disagreements, but
12 then, you know, two reasonable people can talk it through
13 and come to the right kind of position. I think the same
14 thing might be helpful in this area to get rid of some
15 of the noise. Just a thought, but thank you.

16 MS. MUNTER: I appreciate that, and I do think it
17 is important, you know, to have the dialogue between the
18 auditor and the issuer client about, you know, what is
19 the auditor trying to achieve, and what is the best way
20 to do that? Management knows a whole lot more about what
21 controls exist, documentation exists, et cetera. Thank
22 you.

1 MEMBER SILVERS: I feel like deja vu here. I was
2 involved at the SAG in advising the PCAOB -- first on AS2
3 and then on AS5 -- and I was part of investor group
4 together with Ann Yerger, who it's unfortunate is no
5 longer -- who's changed jobs and is not with us -- in
6 talking with Chris Cox and John White, who at that time
7 chair in Corp Fin at the SEC on AS5, and trying to find
8 a good mean, a good balance -- which I think is language
9 referred to in this letter -- around the burdens around
10 getting internal controls right, but also not doing so
11 at a prohibitive cost or distraction to management.

12 And, you know, it's always been clear, I think --
13 from an investor perspective looking at this -- that
14 there are a bunch of different competing kinds of
15 incentives here, and virtue doesn't lie a hundred percent
16 in anybody's corner.

17 At that same time, it was clear coming out of the
18 passage of Sarbanes-Oxley and the events of the early
19 2000s that the concept of strong internal controls and
20 strong enforcement behind them, which really kind of had
21 a lot of its roots in the Foreign Corrupt Practices Act,
22 was absolutely essential in order to have the process of

1 financial reporting and auditing be meaningful.

2 And unfortunately, after this process around the
3 drafting of AS5 in 2007, we then had a set of events that
4 said to me that really this area was not being properly
5 enforced and not by the -- and I think whose fault that
6 was I have no line of sight to, but it was absolutely
7 clear that the country's major financial institutions had
8 grossly inadequate internal controls, and nobody said or
9 did anything about it -- both before and after the fact.

10 And that, I'll give you two anecdotes about this.
11 I had a meeting with the board of Citigroup -- with the
12 audit committee chair of Citigroup -- in the spring of
13 2008, after it was clear that Citigroup was in a very bad
14 state because of its exposure through special purpose
15 vehicles, to subprime mortgages.

16 And I was told by the audit committee chair that
17 he had been told by the head of the mortgage department
18 that they had no exposure to subprime mortgages. Now
19 somebody didn't explain to the audit committee chair that
20 there's such a thing as a secondary market. And there
21 were no internal controls processes to ensure that that
22 information was in front of the audit committee chair.

1 Similarly, two years later it turned out that
2 there was wholesale fraud in the execution of the
3 fundamental documents involved in the mortgages during
4 the subprime bubble. Meaning that the representations
5 were made throughout the financial accounting process
6 that people had actually executed deeds, you know,
7 mortgages, literal mortgages, and they hadn't.

8 Now this was pursued eventually by attorneys
9 general in various states, Justice Department and so
10 forth. But the internal controls issues, in my mind,
11 were never satisfactorily excavated.

12 What I see happening here is that the PCAOB is
13 doing its job and asking hard questions about internal
14 controls. Everything that you guys said -- excellent
15 presentation -- reiterates that to me. People who are
16 used to these standards not being enforced are unhappy.
17 It's hard work to meet them, and it may be that here and
18 there, there have been, you know, things that are not
19 really useful that have happened; incentives have been
20 created and so forth.

21 The investor community was always of the view
22 that it was worthwhile to engage in a conversation about

1 those dynamics. This was true at the time of the
2 enactment of AS2 and at the time of the enactment of AS5.
3 But having been through all this, I have a certain
4 suspicion about exactly what is going on when PCAOB
5 receives a letter like this in terms of motivations.

6 And I think it's very important that the PCAOB
7 and the SEC do exactly what it sounds like you're doing,
8 which is sit down with the folks from the Chamber. And
9 I should note, by the way, the AFL-CIO -- like you --
10 deals with the Chamber all the time in many respects and
11 constructive ways.

12 Sit down with these folks and, you know, do the
13 Missouri thing. Show me. Bring people who are not paid
14 lobbyists, right, and have them tell you that exactly
15 what they have experienced. And then go through this
16 letter with a big black Magic Marker, and anything that
17 anybody can't actually point to a company-specific
18 instance of, draw a big line through it, right. And then
19 the ones where people can bring company-specific
20 instances to the table, engage.

21 MEMBER HEAD: Again, it's Mike Head. And this
22 one probably is as dear to my heart because of my role

1 prior to, you know, leaving, or retiring from TD
2 Ameritrade as being the chief audit executive.

3 And one, I share that you guys are doing
4 wonderful work, and there's a time lag between the
5 inspection results and the firm's remediating those, and
6 a lot of it, I think, can come about from Part 2 is not
7 public. The audit committees don't see it. We hear what
8 the firms want to share, but we don't see the document.

9 So, you know, we've talked several times that we
10 think, for the investors and the audit committee, that
11 Part 2 shouldn't be non-public, and that would address
12 early on with management why they're getting these
13 requests from the audit firms. Because a lot of what's
14 in here, I think, is noise that's occurring.

15 In fact, I know, prior to my retiring, our firm
16 was coming and saying, well, now our firm has set a new
17 standard because we want to fully embrace compliance with
18 the audit of ICFR. And our firm has said now for us to
19 have adequate documentation -- even though we didn't
20 require it last year, we require it this year -- and we
21 know that.

22 And so these, there's examples in here. They

1 will be able to bring examples to the table, but it's
2 that transition of we're remediating and what they feel
3 comfortable sharing and transparency they're willing to
4 have with their audit clients, and then the requests and
5 what they're bringing to the table as now what are firm
6 standards.

7 And where the rub really hits the road is they
8 get in a situation where they say for firm standards they
9 have to have this documentation. They use an example in
10 here of flow charts versus narratives or other things.

11 And what that feels like to the client, the
12 registrant, is we now have to provide documentation to
13 the firm to meet their required documentation standards
14 when nothing has changed in how they test or how
15 management documents. And they're not saying anything
16 is wrong; they're just saying for their files to
17 adequately document their audit, they now need that, and
18 that's requiring their clients to do more work.

19 And I think it's this transparency and transition
20 and timing difference. The wrong thing to do is to say
21 there's anything wrong with AS5 or the inspection process
22 or what you're asking the firms to do. I think it's a

1 communication between the firms and their clients and
2 more transparency and ensuring everybody understands.

3 And then who shares the burden? Is it something
4 that has to be absorbed by the audit firm, or is it
5 something that's shared by the audit client because maybe
6 their documentation needs to be enhanced a little bit
7 also.

8 So I maybe sound like I'm defending you, because
9 I think that this is purely communication transparency,
10 and there's nothing wrong with the standards, and they're
11 doing what they're supposed to be doing is my humble
12 opinion.

13 CHAIRMAN DOTY: Thank you, Mike. The Chamber has
14 not been entirely comfortable with the communications --
15 with the publications of the Board encouraging audit
16 committees to get behind Part 2, as you know. But that
17 seems to be catching on, and I think more and more audit
18 firms are saying well, we do it. We do it regularly.

19 Brian, you've had your card up for a while.

20 MR. CROTEAU: Oh thanks, and I almost hate to say
21 anything after hearing what Damon and Mike have had to
22 say, and this seems to be going so well. But let me just

1 chime in here.

2 In context of on the 2007 reforms and AS5 and
3 management guidance being put in place, I was -- you
4 know, in a prior role at the SEC -- but in the middle of
5 all of that in some ways. And I think it's important to
6 distinguish that from what we're talking about here a
7 bit, which maybe is not so surprising that this many
8 years later, an area that is probably one of the most
9 judgmental, difficult areas -- thinking about management
10 review controls, the precision of those controls and how
11 they operate -- is an area of focus and an area that
12 people struggle with.

13 And so different from what we saw, I think, back
14 in 2007 which were a fairly broad list of concerns that
15 we, I think, mostly addressed. I think we're now down
16 to something that's much more narrow here, although
17 highly important relative to an effective reporting on
18 internal controls -- having effective controls, reporting
19 on controls in the audit.

20 You know, I don't want to prejudge the
21 discussions we'll have over the coming days, but I
22 certainly do think that there's probably something for

1 everyone here relative to thinking about what management
2 can be doing, what the auditor can be doing, and what we
3 as regulators can be doing differently to improve things
4 in this space and make sure that we're doing it in a way
5 that focuses on risk at a reasonable cost.

6 So I'm optimistic in that regard, and I do think
7 another aspect of the timing and where we are now is that
8 from time-to-time it's good for management to step back
9 and reassess their own controls and reassess how they
10 know that they've got adequately precise controls and
11 that they're operating effectively.

12 And some of the questions that we ask -- working
13 with Corp Fin or enforcement -- through our work we find
14 at times some of the answers surprising in that regard
15 from a controls perspective, and it tells me that there
16 may be some amount of deferred maintenance or at least
17 deferred thinking relative to maintaining controls.

18 And so I'm optimistic about these discussions,
19 and I just thought I would add a little perspective from
20 where I sit.

21 CHAIRMAN DOTY: Brandon Becker.

22 MEMBER BECKER: I suspect this will be a long

1 conversation that will at least continue until the
2 arrival of the next administration. But I do think that
3 one problem area that is hard to distinguish is the
4 communication issue that's already been alluded to.

5 It's very easy as an intermediary to invoke the
6 SEC made me do it, or the Board made me do it, whether
7 or not they did or they didn't. And it's easy to protect
8 yourself by layering out additional processes and
9 procedures in the name of somebody else required you to
10 do it, and it's hard to sort that out. It's very hard
11 to sort that out.

12 However, what I have seen creep in is increasing
13 documentation where it feels like the documentation is
14 for the sake of the documentation, or for the sake of
15 somebody being able to look at the documentation, as
16 opposed to it can't be done that way.

17 Now some of that is inevitable. We have
18 increasingly moved from a world where goodwill and good
19 intent is insufficient. You've got to be able to show
20 that you actually follow the proper procedures and that's
21 acceptable, but I think to the extent that in the
22 dialogue you do have, you can try and sort some of that

1 and ask yourself, 'Are these levels of documentation
2 really furthering our substantive goals collectively in
3 terms of investor information and the adequacy of our
4 testing of the controls?'

5 That's probably a worthwhile question to pinch
6 yourself about, and also to ask yourself whether or not
7 the intermediaries -- you know, the fault is in our
8 stars.

9 CHAIRMAN HARRIS: Well, Chairman Doty, Chief
10 Accountant Schnurr, and Helen Munter, thank you very
11 much. I think this has obviously been a very
12 constructive and positive and helpful discussion.

13 Now to conclude in terms of the final discussion,
14 I asked each of you to give us what you would consider
15 to be the top priority you think the Board should be
16 focusing on and why.

17 So Larry, if we could start with you and go right
18 the way around the table, we can conclude in a timely
19 fashion.

20 MEMBER SHOVER: You're starting with the wrong
21 guy.

22 CHAIRMAN HARRIS: Well, we can come back. Mercer,

1 you know.

2 MEMBER BULLARD: Well, this is Mercer. Coming
3 from a securities background I always put a lot of
4 emphasis on enforcement. So I would revisit something
5 Chairman Doty has pushed for, which is a greater
6 transparency in the enforcement process and the
7 adjudication and making that public.

8 CHAIRMAN HARRIS: And you can also indicate the
9 why, if you choose to, as we go around the table.

10 MEMBER BULLARD: Because, yes, I think that kind
11 of transparency like with respect to Part 2 -- although
12 I'm not exactly sure what Part 2 is -- the effect that
13 it has on behavior is undeniable. I mean I'm a big
14 believer in, you know, you tack a few hides to the door,
15 you change behavior.

16 And there's nothing like exposing the basis on
17 which agencies act in order to get people to think hard
18 about, you know, whether they want to have to deal with
19 those consequences or going to change their behavior.

20 CHAIRMAN HARRIS: Grant.

21 MEMBER CALLERY: I hadn't put that on my list,
22 but actually when Mercer mentioned it, that is, I think,

1 something -- and I know it's got a statutory basis and
2 you have difficulty in becoming more transparent in the
3 enforcement process.

4 But having lived through 30 years at NASD/FINRA,
5 where we started with the "businessman's forum," that was
6 all behind closed doors and moved very slowly until bad
7 things happened to the organization toward more
8 transparency. I think that any organization that is
9 quasi-governmental but is using governmental type powers
10 or authorities over the lives of people and the
11 businesses of people -- even including the National
12 Football League -- need to have a greater degree of
13 transparency to get the credibility that they really need
14 for the process, because there's always a feeling when
15 it's not the government that there is an inherent
16 conflict that is there, and the less transparency there
17 is the more that is going to prevail.

18 And along a similar line, I think the issue that
19 we talked about this morning and that we talked about
20 last year and this whole thing about firm business models
21 and the consulting practices -- again, without prejudging
22 where on the spectrum, whether they're in the right place

1 or the wrong place -- I think, again, looking into that,
2 getting some transparency to it between the PCAOB and the
3 Commission, so that you can -- and as Jeanette said this
4 morning -- you don't have the information to do a lot of
5 that. You should get the information, analyze it, and
6 then come out and say here is where we are and this is
7 why we're here. Because again, as long as these articles
8 just keep showing up, people are going to always have
9 that nagging feeling about it. So that would be my
10 second one.

11 CHAIRMAN HARRIS: Curt.

12 MEMBER BUSER: So the issue that I think really
13 as a whole kind of framework we need to be always mindful
14 of is relevance. I find it amazing the amount of
15 materials that we publish, put out, and what exactly gets
16 consumed, read or used by the investing public.

17 Now I get it that the SEC and the regulators and
18 the auditors read it all, but in terms of the questions,
19 comments that I get back, it's always kind of
20 interesting. And where it generally goes to is what they
21 really want is something simple.

22 They want to be able to assess is the current

1 price of whatever we're talking about. Is that the price
2 they should buy at, or is that the price they should sell
3 at? And so what they want is really information to speak
4 and help them do that in a simple way.

5 And so increasingly what's happening -- my
6 observation, and I may not have a full appreciation --
7 is that folks are looking at earnings releases and non-
8 GAAP financials increasingly more than, really, the rest
9 of the materials that are put out. And only after the
10 fact they go looking back through the rest of the
11 materials to kind of see whether or not it had been
12 explained or disclosed or what not if there was an issue.

13 And so that just leads me to the conclusion
14 around: do we have the right models, both from a
15 reporting standpoint, an auditing perspective and the
16 like? And so it may lead one to the conclusion of more
17 assurance on some of these other reports -- whether it's
18 more assurance on MD&A, assurance on the earnings
19 release, assurance on what have you. It may lead you to,
20 you know, really -- as Tony has talked about before --
21 you know, more of a cash flow focused.

22 You know, because one of the things that I often

1 do as I'm looking at our portfolio companies I'm
2 thinking, well, is this business producing cash, and how
3 much cash is it producing, and what's the cash that I can
4 see coming off of it?

5 And so I want evidence of that. Is the cash on
6 hand going higher? Are the distributions and cash
7 available to take out greater? Is that being paid down,
8 or is it being reinvested in the business? And if it's
9 being reinvested and stuck on the balance sheet
10 someplace, I've got a whole bunch of other questions.

11 But ultimately I want to kind of how do I free
12 that cash up to get it back out? And that is, I think,
13 fundamentally what all investors kind of want to know.
14 And so, you know, the comments that we had before on fair
15 value, was it reporting or was it auditing, and I think
16 that part of the consensus was it was some of both.

17 I think that comes back to the model that we have
18 here, too, in what is it that will enable investors, and
19 especially I think what's important is institutional
20 investors versus retail investors. And the more that
21 we're also seeking to protect the retail investor, how
22 do we make it simple and transparent and easier for them

1 to get at?

2 And quite frankly, you know, you wrestle with the
3 same issues with your management teams, your board
4 members and what not, how to get the material to them so
5 that they can consume it quickly and understand it and
6 focus on the key items.

7 So that's really what I leave with is, you know,
8 how do we collectively kind of get at relevance of what
9 we're doing? Otherwise, you know, I'm concerned that,
10 you know, the question, the survey that we had before on
11 importance of audit, we'll get different answers at a
12 different point in time.

13 CHAIRMAN HARRIS: Brandon.

14 MEMBER BECKER: With all due respect to Jim, if
15 we are going to be facing a period of heightened macro-
16 volatility -- whether due to interest rates or
17 commodities or China -- I really think that Tony's Slide
18 Number 4 -- the fair value of the estimates, the quality
19 of earnings -- is what the game is about as amended by
20 Curt's very useful comments about context and the
21 specificity of how you apply that materiality, whether
22 it's an accounting issue.

1 But as -- and this may reflect my background over
2 my career dealing with financial institutions or public
3 companies that are de facto hedge funds -- we need to be
4 able to rely upon these numbers on a going-forward basis.
5 And I just think that there is more to be done in that
6 area, and I thought that Tony's slide captured it very
7 well as an agenda.

8 And if anything, without trying to reprise my
9 conversation with Damon about going concern, I think this
10 gets to many of those issues because this is where you
11 see a lot of the volatility in your ability to know
12 what's going on with subprime, to know what the netted
13 positions are, to know what the derivatives book is, even
14 if it's written in stone.

15 CHAIRMAN HARRIS: Norman Harrison.

16 MEMBER HARRISON: Thank you, Steve. At first,
17 very briefly, I would never presume to speak on behalf
18 of this entire group about anything except to thank Nina
19 and Tope and everybody on your staff for all their great
20 work. This is a large group of cats to herd and get all
21 in one place on the same day and ready to go, and so
22 we're grateful to have them.

1 CHAIRMAN HARRIS: You totally preempted me.

2 MEMBER HARRISON: It matters more from you because
3 you're the boss, but on our behalf I wanted to say
4 thanks. And to you, Steve, for your stewardship. I mean
5 you've been a faithful and energetic leader of this group
6 for six years now, and those of us who are charter
7 members in particular, I think, have really been
8 privileged to work with you. Appreciate what you have
9 done.

10 Two things on my list, and I'll be brief because
11 I'll be largely repeating myself. I was very delighted
12 to hear Marty say that there will be a re-proposal early
13 next year on the auditor reporting model.

14 I think, you know, we saw in the -- I guess Joe's
15 gone. But in the survey, this year's survey and
16 certainly in the survey two years ago, you still get a
17 feel and a flavor for some cynicism or skepticism in the
18 investor ranks about cozy relationships between audit
19 committee members and management teams, and the whole
20 process by which nominees are stood up, and how the
21 relationships actually function.

22 And I think the more guidance and the more light

1 you can shine on, you know, the workings of the audit
2 process and relationships between the auditor and audit
3 committees and improved reporting around the audit, I
4 think, will be welcomed by investors.

5 The other one -- just to repeat myself -- again
6 full speed ahead, pedal to the metal on the audit quality
7 indicators, both as a worthwhile tool in their own right
8 to educate consumers of audit services, but also because
9 they overlap and will provide data for other issues that
10 we've discussed today and in other settings around
11 transparency, around independence, and a lot of the other
12 issues.

13 I was looking in preparation for today at the
14 list of topics we have discussed at our meetings going
15 all the way back to 2010, and in five of the six years
16 there's been a specific working group that had something
17 to do with firm transparency and governance, global
18 networks, audit firm practice, the audit firm business
19 model and incentives. We've talked about this year in,
20 year out.

21 And I think that collecting data and requiring
22 reporting in the form of those indicators will bring a

1 lot of transparency to bear on all of that and, I think,
2 to the good of the capital markets.

3 CHAIRMAN HARRIS: Thank you. Bob.

4 MEMBER TAROLA: I'll endorse the moving forward
5 with the auditors reporting model as quickly as you can;
6 I think that would close some of the gaps that you heard,
7 particularly from Tony as an analyst.

8 And I would extend it one step further, and that
9 is between those bedrock audit reports that seem to be
10 the basis on which analysts and investors rely or get
11 comfort with the integrity of the system, there's
12 numerous other reporting that goes out that is not
13 subject to any auditor association in the way it's
14 digested.

15 So whether it's earnings releases or other bits
16 or elements of financial information, I think it would
17 be important for investors to know that the auditors did
18 something with it, some sort of imprimatur, and that the
19 audit be intertwined with the release of issuer
20 information on a regular basis, not just once a year.

21 CHAIRMAN HARRIS: Mike Head.

22 MEMBER HEAD: The good thing about going this

1 late is you can say, "Yeah, me too" on a lot of things.
2 But the three things I had down, which has been mentioned
3 already, is I really think the more public disclosure of
4 the inspection and enforcement process, and trying to
5 figure out a way to get past that legal hurdle in a
6 productive way, I think, will go a long way to resolving
7 a lot of the communication issues that were raised
8 symptomatically in the Chamber's letter.

9 I definitely think we're way overdue on the audit
10 reporting model, and I was glad to hear it was going to
11 be re-proposed too. I think it's going to tie a lot of
12 what we were talking about disclosure accounting if we
13 know what the auditors considered material and how they
14 approached them, and most of those are going to be those
15 judgment and estimate areas that are material to that
16 company, I think, is a very, reconciliation, and Marty
17 said it better than I could say when he summarized it.

18 And I'm not a big fan of just performance
19 indicators for the sake of performance indicators, but
20 to the degree it will increase transparency and provide
21 information that will help the investors, I'm all for the
22 AQIs. I just think it should be less and not more; those

1 things get really unruly if you just add one after
2 another.

3 So I would encourage it to be very focused to
4 encourage transparency and not you spend a day just
5 trying to figure out what they're all telling you.

6 CHAIRMAN HARRIS: Damon Silvers.

7 MEMBER SILVERS: You know, like Mike said, you
8 can just say "me too" now, and so I will. Me too on the
9 importance of audit quality indicators and of putting
10 some thought into getting them right, having the right
11 ones. You know, similarly, the inquiry -- and just, at
12 the end of the day, my grasp on the terms of art is
13 fading -- but the inquiry into audit reporting model, I
14 think, is a similar exercise.

15 These are areas where if you get them right you
16 give investors -- particularly investors with a more
17 sort of buy and hold model -- the tools necessary to
18 monitor their investments. The folks I represent,
19 that's where we're coming from.

20 And in the audit space we just to date don't have
21 enough of the right information to be able to do that
22 work in that space as compared, for example, to how much

1 we have in some other critical sort of governance
2 junctures like executive comp, right.

3 We have tons of data, and we're getting pretty
4 good at figuring out what works and what doesn't. So
5 the PCAOB investing in those areas and Commission
6 support of work in those areas is, you know, what we're
7 looking for.

8 CHAIRMAN HARRIS: Tony Sondhi.

9 MEMBER SONDHI: Thank you. Steve, I also wanted
10 to extend what Norman had said earlier, and that is I
11 appreciate your encouragement of the team undertaking
12 this particular project that we did today. It was very
13 helpful.

14 In terms of what I'd like to focus on is
15 something that I did say in our group's recommendations,
16 and the essence of it is, you know, more transparency
17 around those disclosures about those critical areas,
18 such as the estimates, the fair value measurements, the
19 use of the specialists, and so on.

20 And I just wanted to add a couple of comments to
21 something that was said earlier. I too have noticed in
22 earnings conference calls -- as Curt pointed out --

1 there's very little emphasis or discussion of actual
2 financial reporting issues. People are, most of the
3 time, talking about non-GAAP measures and so on,
4 although the power of the financial statements and the
5 information in them was, just again an anecdote last
6 year.

7 One of the largest companies in Europe, in the
8 middle of a lot of congratulations on non-GAAP measures,
9 an analyst happened to ask about a disclosure on
10 securitizations, and the CFO got it wrong in explaining
11 it and it turned out it cost them about 40 percent of
12 their share price. And this is now -- I think it's
13 about 16 months since that happened, and it hasn't
14 recovered.

15 So getting the information right, getting those
16 disclosures right, still, I think, makes a big
17 difference. So, again, I encourage you on these things
18 that you're working on to focus on greater transparency,
19 better disclosures.

20 CHAIRMAN HARRIS: Gary. Gary Walsh.

21 MEMBER WALSH: Yes, thanks a lot for including me
22 in the activities. I was going to say transportation

1 and disclosure, and since I was -- since Tony beat me to
2 the punch, I think I should share that I've been trying
3 to pay attention to all that's gone on and the
4 conference calls with Tony, and I've really been
5 absorbing as much as I can.

6 I'm a CPA, a CFA. The only thing I can really
7 think of is: Heaven help the retail investor. I don't
8 think we can make it that simple. Ours is an
9 interesting business in that you have to be licensed to
10 sell securities or mutual funds, but anyone can buy
11 them. And, you know, I think that's part of the
12 problem. A requirement to make it so that, you know,
13 everyone has to use an investment advisor, I think would
14 be perfect.

15 So, at the very least, I think what we need to do
16 is make sure that we have an awareness of the skills
17 that are needed, and we portray an awareness of the
18 skills that are needed, and we make the game as fair as
19 possible, and that a knowledge that failure still
20 occurs.

21 And I like Judge Sporkin's comment about having
22 more investigation about what's going on. I think the

1 PCAOB should take the model of the National
2 Transportation Safety Board and come up with, you know,
3 a root-cause analysis very soon after any failure, and
4 I think that would solve a couple of things.

5 I think we'd get to the heart of what really went
6 wrong, but I think we would help the awareness of the
7 fact that this isn't a risk-free endeavor, and I think
8 that awareness would be healthy for everyone and not
9 leave people with the unrealistic expectation that
10 there's always a safety net.

11 CHAIRMAN HARRIS: And then Larry Shover.

12 MEMBER SHOVER: Thank you. This is a time to
13 dream big and not to manage expectations, for me anyway.
14 So after being on this committee for three years, I
15 really have noticed how much more visible the PCAOB has
16 become in three years' time. It's great. I think
17 investors have greatly benefited, especially from the
18 123 evaluation approach. And I'm just really happy
19 about that, and I can't say enough.

20 When it comes to dreaming big, as an investor I'd
21 like to see some working towards like a standardized
22 rating system, or template of sorts, that would capture

1 the various and sundry questions, allowing investors to
2 obtain, you know, just a better understanding of what's
3 going on in the plumbing of the financial statements,
4 like how the valuations were computed, also to help
5 investors assess the risks or the perceived risks.

6 The bottom line is let investors understand that
7 there is subjectivity, which the PCAOB has done a great
8 job at, and have information -- allow them to have
9 information to decide on their own how much value to
10 place on the numbers that are in front of them. Thank
11 you.

12 CHAIRMAN HARRIS: Well, with that I want to
13 extend a heartfelt thanks to all of you. It's been a
14 real pleasure working with you. I think you all know
15 that your three-year terms end this year, but you can
16 all re-up for another three years. I very much hope
17 that you will do that. I've found this participation
18 and your involvement to be extraordinarily helpful.

19 Even though a number of these issues keep on
20 recurring year in and year out, they have caught the
21 attention of the PCAOB and the SEC. I think we are
22 making progress on a number of them.

1 I would once again extend particular thanks at
2 this point with respect to today's session to Grant
3 Callery and Tony Sondhi and Joe Carcello for leading
4 their sessions. I think they were all productive, and
5 I know they involved a terrific amount of work.

6 So I want to thank them especially, but all of
7 you for participating in those working groups. A large
8 number of you have been stalwarts over the years, and I
9 hope you'll continue to be so over the next three years.

10 And finally, and maybe most importantly, these
11 sessions are -- as Norman pointed out -- somewhat
12 challenging to put together in a productive fashion, and
13 I want to commend the terrific work of Nina Mojiri-Azad
14 and Tope Folarin, who have done yeoman's service in
15 terms of helping you with the materials and facilitating
16 the working and the productive sessions.

17 And so with that I want to thank everybody very
18 much and the SEC for their observation and
19 participation. Thank you.

20 (Whereupon, the above-entitled matter was
21 concluded at 4:30 p.m.)

22

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C E R T I F I C A T E

This is to certify that the foregoing transcript

In the matter of: Investor Advisory Group

Before: Public Company Accounting Oversight Board

Date: 09-09-15

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.



Court Reporter

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