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## PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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## AUDITOR'S REPORTING MODEL

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## PUBLIC MEETING

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THURSDAY, APRIL 3, 2014

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The public meeting convened in the National Ballroom in the Westin Hotel, 1400 M Street, N.W., Washington, D.C. at 9:00 a.m., James R. Doty, PCAOB Chairman, presiding.

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

2 9:00 a.m.

3 MR. DOTY: Well, good morning. Good morning. We  
4 have a panel that is focused on the issues raised by the  
5 proposal of auditors responsibility for other  
6 information. And it's a highly qualified panel.

7 But before I introduce people, a bit of news from  
8 the front. We're advised by Natalie Berger of the EU  
9 that the European reform proposals, which were summarized  
10 so ably in Sven Gentner's materials yesterday in which  
11 he discussed in detail, were passed by the European  
12 Parliament this morning.

13 So they're now law in the EU with the overarching  
14 subject to the country and member state is for you to  
15 have a more restrictive, or a stronger policy.

16 The panel, as I said, has extraordinary  
17 qualifications. Jeremy Perler is the Director of  
18 Research at Schilit Forensics. And he's the co-author  
19 of Financial Shenanigans: How to Detect Accounting  
20 Gimmicks and Fraud in Financial Reports. It's gone  
21 through three editions in 2010.

22 Previously he served as the in-house forensic

1 accounting analyst for Coatue Management, a long/short  
2 equity hedge fund. Director of Research for CFRA.  
3 Auditor of PricewaterhouseCoopers. He served on the FASB  
4 Financial Accounting Standards Advisory Council as a  
5 representative of the investor community.

6 Michael Young. Litigation partner at Willkie  
7 Farr & Gallagher. His practice concentrates on  
8 securities and financial reporting with a particular  
9 emphasis in accounting issues.

10 He's also chairman of the Financial Reporting  
11 Committee of the New York City Bar Association. He is  
12 chair of the firm's securities litigation and enforcement  
13 practice.

14 His trial work has included financial reporting  
15 matters in federal, state and bankruptcy courts  
16 throughout the United States. His experience includes  
17 the landmark jury verdict for the Defense in the first  
18 securities class action tried before a jury pursuant to  
19 the Private Securities Litigation Reform Act of  
20 1996/1995.

21 He previously served as a member of the Financial  
22 Accounting Standards Advisory Counsel. He is the Chair

1 of the Financial Reporting Committee of the New York City  
2 Bar. And he is counsel to the AICPA and the Center for  
3 Audit Quality.

4 Michael has a record -- a distinguished record in  
5 this area that is second to none. And he's going to have  
6 a lot to say.

7 Peter Nachtwey is Chief Financial Officer at Legg  
8 Mason. A member of the firm's Executive Committee. He's  
9 responsible for the areas of finance, investor relations,  
10 corporate communications, human resources, operations and  
11 technology.

12 Previously he was Managing Director and Chief  
13 Financial Officer of the Carlyle Group. Prior to joining  
14 Carlyle, he was a partner at Deloitte & Touche. Served  
15 as the Northeast Regional Managing Partner for the  
16 Investment Management Industry. He is a current member  
17 of our, the PCAOB's Investor Advisory Group.

18 Mike Gallagher. Manager Partner for Assurance  
19 Quality at PWC. He supervises national office efforts  
20 in the areas of accounting services, US Securities and  
21 Exchange Commission services, risk management, strategic  
22 fault leadership, auditing services, auditing

1 methodology.

2 He's also responsible for PWC's audit  
3 transformation program, learning and development,  
4 regulatory relations and inspections groups. He  
5 currently serves as the Chair for the Center of Audit  
6 Qualities Professional Practice Executive Committee. He  
7 is a current member of the PCAOB standing advisory group.

8 Gentlemen, welcome. Jeremy, the floor is yours.  
9 Thank you.

10 MR. PERLER: Good morning. And thank you for  
11 having me on this distinguished panel. I am delighted  
12 to be here today.

13 It's a great honor to speak with you and share my  
14 perspectives on a topic as important as other information  
15 and the auditors role in financial reporting. Thank  
16 Chairman Doty for that nice introduction.

17 If I may, I'd like to add a little bit more  
18 context on my background as I believe it to be helpful  
19 in understanding how my perspectives as a financial  
20 statement user have been framed. I spent the last 17  
21 years studying and analyzing companies who employ  
22 aggressive accounting and manipulative reporting tactics



1 to embellish their financial performance.

2           My current role as an advisor to asset managers,  
3 is at a forensic accounting consultancy called Schilit  
4 Forensics. We advise well regarded investment firms that  
5 engage us to unravel complexities and uncover  
6 misrepresentations in the accounting and financial  
7 reporting of their portfolio companies.

8           Now over the years I've had the pleasure of  
9 working with and advising hundreds of asset managers on  
10 the accounting and reporting practices of their portfolio  
11 companies. So my perspectives today are based not just  
12 on being a power financial statement user myself, but on  
13 my daily conversations with these investors.

14           From these interactions, I gained a strong  
15 understanding of relevancy and how financial information  
16 is consumed and used in the investment decision making  
17 process. Now the topic of other information is an  
18 extremely important one. And I commend the Board of its  
19 efforts to increase auditor's scrutiny to areas beyond  
20 the financial statements.

21           It speaks to what is to me the biggest problem  
22 facing financial reporting today. The growing dissidence

1 between audited financial results and the key performance  
2 metric showcased by management.

3           This is a weak spot in our financial reporting  
4 system that allows issuers to bypass the traditional  
5 audited financial statements and engage in an  
6 un-scrutinized parallel conversation with investors. By  
7 not participating in this conversation, the audit  
8 function is weakened and the investors are worse off.

9           Indeed the traditional audited financial  
10 statements are becoming less relevant as an investor  
11 communication tool. It has been commonplace for  
12 management to present self-made, non-GAAP metrics as more  
13 relevant proxies for earnings and cash flow performance.

14           These metrics are delivered to investors in  
15 earnings releases, PowerPoint presentations, as well as  
16 the MD&A and other places outside the financial  
17 statements. And it is usually the case that these  
18 metrics are the most important data points and  
19 disclosures to the investment community.

20           Often these metrics make sense and provide very  
21 helpful insight into a company's operations. For example  
22 same store sales for a retailer, organic growth for an

1 acquirer or earnings excluding a large litigation  
2 settlement.

3           However in many cases they don't, like something  
4 called steady state free cash flow before special items.  
5 And the laughable adjusted cash EBITDA less one-time  
6 items.

7           However in all cases, regardless of their  
8 legitimacy, these metrics are unaudited and susceptible  
9 to the whims of management discretion and definition and  
10 disclosure. For example, when EBITDAs no longer  
11 flattering, it becomes adjusted EBITDA. And then  
12 adjusted cash EBITDA. And then finally adjusted cash  
13 EBITDA less one-time items.

14           And even in cases where the metrics seem  
15 commonplace and logical, they are easy to redefine as  
16 needed. For example determining which stores are  
17 included in same store sales is rife with discretion.

18           Relying on management to self-police these  
19 important metrics is insufficient just as it is  
20 insufficient for traditional GAAP measures. To be clear,  
21 the issue here is not whether a company is honest or  
22 disingenuous about these disclosures, rather it is that

1 the supremely important disclosures and data points are  
2 not being scrutinized by auditors. A point which is  
3 generally lost on investors.

4 This is where I believe the Board's proposals on  
5 other information and helpful. The current financial  
6 reporting paradigm promotes this environment in which  
7 many of the most important metrics to investors are  
8 widely unchecked.

9 Enhancing auditor responsibility over this  
10 information by as the Board proposes, requiring  
11 evaluation of these disclosures with a focus on material  
12 inconsistencies and material in the statements is common  
13 sense and will no doubt strengthen and add robustness to  
14 our financial reporting system. And ultimately lead to  
15 fewer cases of willful or negligent misrepresentation.

16 I recognize that evaluated scrutiny likely means  
17 added procedures. However the benefits to investor  
18 protection and public disclosure far outweigh the costs.

19 The flow of information from companies to  
20 investors has changed. And so too should the auditor's  
21 responsibilities. Naturally I would like to see more  
22 steps taken to reign in the mass promotion and

1 dissemination of un-scrutinized information. But I  
2 recognize that many of these efforts would be beyond this  
3 Board's jurisdiction.

4           However I believe this Board's proposal regarding  
5 other information shows leadership. And is a very  
6 positive step that will have a powerful impact with  
7 regard to protecting investors and promoting more  
8 reliable and representative financial disclosures.

9           Thank you for the opportunity to participate in  
10 this conversation. And I look forward to our discussion.

11           MR. DOTY: Thank you. Mr. Young.

12           MR. YOUNG: Well, I am exceedingly sympathetic to  
13 the desire of investors for better information. Like a  
14 lot of people in this room, I am reading 10Ks all the  
15 time and they have gotten to be as dry as dust.

16           And what is particularly frustrating as I think  
17 about it, is that it does not have to be like that. It  
18 is theoretically possible to write about things. To  
19 write about business things, even with all of the rules  
20 and the regulations and all of that, it is theoretically  
21 possible to write about things in a way that is  
22 understandable and informative and interesting.

1           And at the risk of sounding trite and saying the  
2 obvious, I would offer that perhaps the best illustration  
3 of that is the Annual Shareholder Letter of Warren  
4 Buffett. It is interesting, it is understandable. You  
5 get the sense of what's going on within his companies.  
6 The challenges, the triumphs, the failures.

7           And the question for me is how can we get people  
8 to write like Warren Buffett? Boiling it down.

9           My concern with the other information proposed  
10 standard is that it doesn't get us there. And in fact  
11 my concern is that it may take us in the opposite  
12 direction.

13           Now let me explain why. The Board has asked me  
14 to focus on how the standard will be interpreted and  
15 applied. And that is actually the root of my concern.

16           Under this standard, I would expect auditors to  
17 find themselves being held fully accountable for other  
18 information. They will be evaluating the information.  
19 They will be speaking to its truthfulness and if the  
20 information turns out to be false, they will have some  
21 explaining to do.

22           And even if they are able to point to the

1 standard and to say, well we missed the false statement,  
2 but look at the standard, we complied with the standard.  
3 That to my way of thinking, does not satisfactorily  
4 mitigate the concern. Because historically where  
5 auditors have missed a false statement, insistence on in  
6 compliance with the applicable standard, has not  
7 sufficiently mitigated the appearance of professional  
8 failure.

9           So as I think through how this standard will  
10 work, my own reaction is that probably two things will  
11 happen. One is that the amount of work needed to be  
12 undertaken by the auditor will need to increase  
13 commensurate with the risk. Or the information will need  
14 to get easier to evaluate. Or both. And I would expect  
15 both.

16           So one consequence of the standard, as well  
17 intentioned as it is, is that it may create an incentive  
18 for management to draft other information in a way that  
19 is easier for the auditor to evaluate. That runs less  
20 of a risk of auditor recalcitrance.

21           And the concern is that we will end up building  
22 into financial reporting, still another incentive to

1 favor objectively verifiable information of the sort that  
2 auditors are more comfortable with at the expense of the  
3 kind of subjective commentary that connects the dots and  
4 explains what the data means in very day words of the  
5 sort which may be harder for the auditor to evaluate.

6           And you know, to my way of thinking, that's the  
7 opposite of the direction in which we want to go. I mean  
8 when I think of it as an investor, I think about wanting  
9 management to connect the dots.

10           Don't just give me the data, but tell me what the  
11 data means. Tell me how you are looking at this data and  
12 what it's telling you management, as to what it means for  
13 your past performance, what it means for your future  
14 performance. What the data means for risk.

15           And I'm concerned that instead, under this  
16 standard, we would be headed more in the direction of  
17 disconnected, objectively verifiable data. And therefore  
18 the 10Ks, if this is possible, would even get less  
19 interesting.

20           And I would like the record to reflect that for  
21 the first time in the history of recorded civilization,  
22 an attorney has taken less than his allotted time.



1 MR. DOTY: We'll make up for it Mr. Young. We'll  
2 make up for it.

3 MR. GALLAGHER: Mr. Chairman I'd like to reserve  
4 that for my remarks.

5 MR. DOTY: But did you record the time? Mr.  
6 Nachtwey.

7 MR. NACHTWEY: Thank you Chairman Doty. And  
8 hopefully I won't you know, screw up the timing by using  
9 all the time he saved us. But first of all good morning  
10 to all of you. And thank you and the other members of  
11 the PCAOB for the opportunity to be here and speak with  
12 you today.

13 I think the proposed standard regarding auditors  
14 reporting on their involvement in other information is  
15 of great interest to me and to my organization. But this  
16 morning I'll speak from three very different  
17 perspectives.

18 So first as a former audit partner with Deloitte  
19 & Touche where I practiced for 25 years. Second as CFO  
20 of Legg Mason, an S&P 500 company and an issuer of public  
21 company financial statements. And then finally as a  
22 fiduciary for almost \$700 billion of third-party assets

1 under management by Legg Mason.

2 My remarks represent my own views and do not  
3 necessarily reflect those of Legg Mason or my colleagues.  
4 So with that bit of housekeeping out of the way, let me  
5 address the proposed reporting standard which I generally  
6 favor, but with some key caveats that I'll address in a  
7 moment.

8 I think it's important to recognize that with  
9 this proposal, we're talking about information auditors  
10 are already required to read and consider in auditing  
11 public company financials. So I believe it is a positive  
12 step to have auditors clarify what they are currently  
13 involved with, as users of financial information very  
14 often rely on numbers outside of the financial  
15 statements.

16 At a very high level, this proposal provides the  
17 audit profession with the opportunity to help investors  
18 and others understand what information outside of the  
19 financial statements the auditor has been involved with.  
20 And that is clearly a worthy objective.

21 But we should be careful to comprehend the real  
22 world implications of such changes and weigh the

1 potential costs against benefits. In that regard we must  
2 be very clear-eyed in understanding the value of these  
3 benefits to investors, which easily could be overstated.  
4 And we need to be thoughtful about added costs, which are  
5 ultimately borne by investors and can easily be  
6 understated.

7           In my view, the public generally believes that  
8 auditors already verify information outside the audited  
9 financials. As a consequence, many investors have an  
10 imperfect understanding of what auditors actually do with  
11 that information.

12           They may believe auditors are involved with any  
13 and all numbers in a company's annual report or 10K,  
14 including numbers not derived from the books and records.  
15 And of course as all the auditors in this room will know,  
16 that is not true. But without a bit of a roadmap, how  
17 can investors be sure where the auditors have been  
18 involved?

19           So I'll give you an example of this from the  
20 asset management industry. For firms like Legg Mason,  
21 a key performance indicator is assets under management  
22 or AUM. AUM is generally a big number both

1 quantitatively and qualitatively. And we often use it  
2 as shorthand to describe the size and scale of our firms  
3 as you may note that I just did in my intro about Legg  
4 Mason.

5           Consequently, AUM gets significant MD&A attention  
6 by asset managers. Yet the related numbers are not per  
7 se audited. However, our auditors do see our AUM numbers  
8 and perform significant work around them given their  
9 direct impact on our revenues. And I think investors  
10 would likely find value in knowing auditors have done  
11 work on these disclosures which would provide an  
12 important check on management.

13           The proposal also may provide the audit community  
14 at large with better leverage. Currently there is no  
15 recourse for audit firms if they disagree with management  
16 assertions outside the financials, other than the nuclear  
17 option of pulling their audit opinion and resigning from  
18 the client.

19           So I believe the proposal properly structured,  
20 could promote a more useful dialog between auditors and  
21 management. There could be other benefits as well.

22           In stock and debt offerings, underwrites require

1 the company's auditors to review and report on  
2 information outside the financial statements, and provide  
3 them with comfort letters. If the other information is  
4 already reviewed and reported on, this could expedite and  
5 possibly lower the expense of public offerings.

6 While I like those aspects of the current  
7 proposal, it's critically important to determine now, in  
8 advance, whether the potential benefits truly justify  
9 making a change. Because history has shown that  
10 regulations are seldom, if ever, rolled back, owing to  
11 silly things like greater than anticipated costs.

12 I also believe other aspects of the proposal  
13 require further review and consideration. First and  
14 foremost, we must develop a common understanding of what  
15 the word evaluate means. Or eliminate it from the  
16 proposal. And this I refer to both in terms of how much  
17 work the audit firm should do and how much information  
18 they should provide in their reports.

19 If left in I feel evaluate will cause significant  
20 additional work by auditors. The resulting expense to  
21 issuers and investors would not add commensurate value  
22 in my view.

1           The PCAOB should make clear whether the proposal  
2 calls for auditors to do more work, or simply report on  
3 the work they have already done. And I strongly advocate  
4 the later.

5           Further it is unclear what other information is  
6 in scope. For example, annual reports often include a  
7 company's headcount. A disclosure of the auditor is  
8 generally not involved in.

9           Clarity around how auditors evaluate qualitative  
10 statements or assess materiality of non-financial data,  
11 is also very important. Examples of these include  
12 descriptors firms frequently use to reference their  
13 industry standings such as, we are one of the largest,  
14 or we are one of the fastest growing.

15           How can auditors validate those types of  
16 statements. Frankly, in my view, they can not and should  
17 not. To the extent that information outside the audited  
18 financials is deemed part of the auditor's scope, it  
19 becomes very important to clearly identify information  
20 not within an auditor's expertise, and thus not within  
21 their scope.

22           And then practically speaking, boilerplate

1 language that would obviate the clarity of the PCAOB and  
2 the clarity that the PCAOB investors seek in this area.  
3 And I think it's important to recognize that we live in  
4 one of the most litigious societies on the planet. And  
5 like it or not, boilerplate will be part of the bargain  
6 in this proposal. We should acknowledge that up front  
7 and be careful to encourage as little of it as possible.

8       Finally, there's the cost of the reporting  
9 extension itself. Auditors will be doing more, even if  
10 it's just adding language and documentation based on  
11 existing requirements. Auditors will want to pass these  
12 costs onto their clients.

13       Clients will also have to deal with a higher  
14 level of questions and documentation auditors will need  
15 for their files, which will require them to add  
16 headcount. Both of these are costs that our investors  
17 would ultimately bear.

18       The proposal however, need not become onerously  
19 expensive or another giant process creator. Thus I do  
20 not see any concerns -- any of my concerns here as fatal  
21 to its adoption. But I do believe the Board needs to  
22 exercise proper due diligence as it has with other

1 initiatives to avoid the potential pitfalls I and others  
2 have noted.

3 I think this session is a great example of giving  
4 the regulatory community, the audit firms and their  
5 corporate clients, like Legg Mason, time and opportunity  
6 to work through these important issues together.

7 So I applaud the Board and the staff for making  
8 this event happen. And I think you for your kind  
9 attention.

10 MR. DOTY: Thank you. Mr. Gallagher.

11 MR. GALLAGHER: Thank you Chairman Doty and  
12 members of the Board and staff. I appreciate the  
13 opportunity to provide feedback today on the Board's  
14 proposed auditing standards related to the auditors  
15 reporting model and other information.

16 First let me recognize that these proposals  
17 represent the culmination of several years' work by the  
18 PCAOB what has taken place in a context of global  
19 reexamination of the auditor's reporting model with the  
20 objective of making the auditor's report more  
21 informative. I commend the PCAOB for this effort and  
22 applaud the continued outreach including this public



1 meeting to seek feedback from all stakeholders.

2           As the Board has noted, the auditor's pass/fail  
3 model is still highly valued. Therefore it's extremely  
4 important for the Board to consider the feedback from all  
5 stakeholders to look for ways the audit report and the  
6 role of the auditor can continue to evolve to better meet  
7 the needs of stakeholders today and minimize unintended  
8 consequences.

9           Speaking on behalf of PWC, we support the changes  
10 to the auditor's report. Including reporting with  
11 respect to other information that will be responsive to  
12 the feedback, while maintaining or improving audit  
13 quality.

14           Avoiding the auditor becoming the original source  
15 of information about the company, I'll talk more about  
16 that in a second, insuring the benefits exceed the cost,  
17 and I believe these proposals represent a really strong  
18 step in how we can enhance the current auditor's  
19 reporting model.

20           In addition, we're challenging ourselves to  
21 continuously explore ways to enhance the role of the  
22 auditor, beyond what the profession does today in order

1 to address the evolving needs and complexity of global  
2 capital markets. While we believe there is much in the  
3 Board's proposals that has merit, we also have concerns  
4 that some of the fundamental changes included in the  
5 proposals pose challenges.

6 Today I'll describe certain of these challenges  
7 and then offer suggestions that we believe will still  
8 achieve the intended outcomes of the proposals while  
9 mitigating unintended consequences. I'll briefly touch  
10 on critical audit matters and then focus my comments on  
11 other information.

12 With respect to critical audit matters, we  
13 understand that and support, including critical audit  
14 matters in the audit report, as a way of making it more  
15 valuable to investors. However we believe it should be  
16 limited to, or focuses on, matters that were material to  
17 the financial statements that resulted in the most  
18 significant interaction with the audit committee.

19 We believe these changes and others that we  
20 suggest in our common letter would add meaningful  
21 information to the audit report while not placing the  
22 auditor in the position of being the original source of

1 information about the company. It will also minimize the  
2 potential that including critical audit matters in the  
3 audit report will chill the dialog between auditors and  
4 management, something which could have an adverse effect  
5 on quality.

6 Now in listening to the discussion yesterday,  
7 which I thought was outstanding, a couple of comments  
8 that I at least with respect to PWCs position on CAM, I  
9 think is worth some clarification.

10 There was the notion that if the auditor is not  
11 the original source of information about the company,  
12 then isn't the auditor just repeating what's in the  
13 financial statements. And at least our view of things  
14 is no.

15 That an example of what we would be concerned  
16 about is potentially a litigation matter that the auditor  
17 discusses with the audit committee. The culmination of  
18 that discussion was that no disclosure was required  
19 because it was remote.

20 Well theoretically under the proposal, there may  
21 be some pressure to record that or report it as a  
22 critical matter, thereby you know, driving disclosure

1 that management is not required to make, through the  
2 audit report. And we would be against that.

3           However, that does not mean that the auditor  
4 can't and shouldn't say more about the matters that they  
5 are reporting on as CAM. And specifically, the issues  
6 that in the auditor's judgment, drove the CAM disclosure.

7           You know, whether it's the materiality of the  
8 matter, the judgment involved in coming up with the  
9 matter, the susceptibility to change. And talking about  
10 the audit response to why something was a CAM.

11           And you won't find that information in the  
12 financial statements. But that's information about the  
13 audit, and I think that that can be valuable to  
14 investors.

15           The other point I want to raise from the  
16 discussion yesterday was this notion of 91 percent. And  
17 that 91 percent of investors don't read the auditor's  
18 report as it exists today.

19           My own view is that's a very misleading  
20 statistic. We do substantial outreach to the investor  
21 community at PWC through our investor institute run by  
22 Kayla Gillan.

1           And the feedback we get from investors is, they  
2 may not read the reports word for word, it's a standard  
3 report, I wouldn't expect most to do that every time.  
4 But they look at every report. They look at every single  
5 one for who the auditor is, and was there something in  
6 the report that went beyond the standard.

7           So I go back to what Chairman Doty said when he  
8 opened up the meeting yesterday. The pass/fail report  
9 has value. I would say it has quite a bit of value.  
10 What we're talking about today is how do we enhance that  
11 value and make a good produce better?

12           So back to other information. We support the  
13 Board's intent to enhance the existing standard by  
14 requiring communication about the nature of the auditor's  
15 responsibility for other information to report. However,  
16 we believe the proposed standard as drafted, could  
17 potentially increase rather than decrease the expectation  
18 gap and risk increased execution -- or inconsistent  
19 execution by the use of language that's ambiguous and  
20 susceptible to varying interpretation.

21           In addition, we believe the proposed other  
22 information standard will result in a significant

1 increase in audit effort. Particularly with respect to  
2 information not directly related to the audited financial  
3 statements, with a corresponding significant increase in  
4 costs that in our view could exceed the value or the  
5 benefit.

6           To be clear, we are not opposed to enhancing the  
7 performance standard beyond what it is today if there's  
8 a market demand for such an enhancement. However  
9 enhancing the performance standard will by definition  
10 require additional work, which will increase costs.

11           It's our understanding that the intent of the  
12 Board with this standard was to have the auditor report  
13 on the information generally based on the level of work  
14 performed under existing practice. If that's the  
15 objective, we believe certain changes should be made to  
16 the proposed standard which I'll describe.

17           As an example of language that's ambiguous and  
18 susceptible to vary interpretations, is the use of the  
19 term evaluate as the performance standard. We believe  
20 this term is more commonly associated with the auditor's  
21 responsibility in an audit to determine whether the  
22 evidence obtained is sufficient and appropriate to

1 support the opinion to be expressed in the auditor's  
2 report.

3           We recommend replacing the proposed performance  
4 standard of read and evaluate with one that is more  
5 likely to result in consistent execution and more  
6 efficient in terms of the value provided for the effort  
7 involved. Specifically, we believe that proposed other  
8 information standard should include an overall  
9 requirement that the auditor read all other information  
10 regardless of whether that other information is directly  
11 related to the audited financial statements.

12           The auditor would then perform a prescriptive set  
13 of procedures similar to comfort letter procedures with  
14 respect to material other information directly related  
15 to the financial statements.

16           Finally, we recommend the language in the auditor  
17 report explicitly describe the limited procedures the  
18 auditor performed as opposed to a conclusion. Thereby  
19 decreasing the expectation gap and eliminating the  
20 practical challenges associated with a conclusion.

21           If the stakeholders would find value and demand  
22 exists for the auditor performed procedures on

1 non-financial information, then perhaps a separate  
2 attestation engagement with separate reporting on other  
3 information could be considered. Good discussion  
4 yesterday about potentially an attestation standard with  
5 respect to MD&A or elements of MD&A. We would support  
6 that.

7           So in closing, I'd like to again thank you for  
8 the opportunity to provide the feedback on the proposals.  
9 The recommendations I've outlined today, and the others  
10 provided in our comment letter are intended for the  
11 proposals to meet their intended objectives while  
12 minimizing unintended consequences.

13           These proposals represent a strong step in how we  
14 can enhance the current auditor's reporting model. And  
15 I look forward to continuing the dialog as we evaluate  
16 how we can further enhance the role of the auditor in the  
17 capital markets beyond what we do today.

18           Thank you Mr. Chairman.

19           MR. DOTY: The panel has given us a lot to chew  
20 on. Mr. Harris.

21           MR. HARRIS: Well I think I agree with both Pete  
22 and Mike with respect to the term evaluation. And the



1 need to develop a more common understanding of what the  
2 word evaluate means.

3 I'm not quite clear Mike in terms of what you're  
4 recommending other than described the procedures that  
5 were follows. So -- and Mike you're a lawyer, so between  
6 the three of you --

7 MR. YOUNG: I didn't come here to be insulted.

8 MR. HARRIS: It wasn't meant as an insult.  
9 Especially given your commentary, which is much  
10 appreciated.

11 But how would each of you -- what term would you  
12 use other than evaluate and other than describing the  
13 procedures that would presumably go to the word evaluate?  
14 Is there a term of art that you would prefer?

15 MR. GALLAGHER: Steve I guess my -- as I  
16 mentioned in my comments, I think the most plain way to  
17 communicate is just to share you know, in plain English,  
18 what we did.

19 And you know just to give you a flavor of what  
20 that would be, typically, as you're probably aware, in  
21 comfort letter situations, when companies are raising  
22 capital and the underwriters are doing due diligence,

1 typically what the auditor does with information, an MD&A  
2 for example, where there's comparisons around revenue or  
3 other financial metrics, is the auditor would recalculate  
4 the numbers that are shown in MD&A.

5           They would compare it to information that's  
6 included in the audited financial statements to the  
7 extent that exists. To the extent that doesn't exist,  
8 you could tie things back to original books and records  
9 which are subject to a company's system of internal  
10 accounting control.

11           And so our view is the best way not to have an  
12 expectation gap, because I'm not sure there is a perfect  
13 term that would capture in a word or two, what we do is  
14 just -- let's lay it out. Let's explain you know, that  
15 if information is directly related to the financial  
16 statement and it's in there and it's potentially  
17 material, we do these you know, prescriptive -- this is  
18 what we do.

19           And with respect to the other information, you  
20 know, we do what we do today. We read it for consistency  
21 and look for material inconsistencies in the financial  
22 statements.

1           MR. HARRIS:    And Mr. Young I think that you  
2 quoted Chair White in terms of the concern about  
3 information overload.  And you talked very eloquently  
4 about being concise and understandable.  So I think that  
5 I don't disagree with where Mike is coming from in terms  
6 of describing evaluation.

7           But you know, you could get into some pretty  
8 significant information overload just in the description.  
9 So how would you concisely deal with the term evaluate?

10          MR. YOUNG:  I wish I had a good answer to that.  
11 And appearances notwithstanding, I really would like to  
12 be helpful.  Let me tell you the challenge as I see it.

13          And that is I agree with the problem with the  
14 word evaluate.  The challenge is not so much the verb,  
15 the challenge is the broader concept of the auditor  
16 speaking to the truthfulness of the information because  
17 users of the information are going to be inclined to boil  
18 it down very quickly.

19          And if they see the auditor speaking to the  
20 subject of the truthfulness of the information, they're  
21 not going to think about whether the word is evaluate or  
22 examine or inquire into or review.  They are going to say

1 to themselves, the auditor spoke to the truthfulness of  
2 the information. The information as we now know turned  
3 out to be false. And therefore, it sounds like the  
4 auditor didn't do its job.

5           And to illustrate, let me just -- let me describe  
6 a newspaper story that we have all seen many, many times.  
7 And that is the newspaper story says there was a fraud  
8 at XYZ Company. The auditor failed to detect the fraud.  
9 Where was the auditor?

10           How many times have we seen the newspaper story  
11 go on to say, however, under the applicable auditing  
12 standards, this fraud was conducted in such a way that  
13 the auditor would not be expected to detect it. I'm  
14 still waiting for that story after more than 30 years.

15           The challenge as I see it. Evaluate is a  
16 troublesome concept and a troublesome word. And I agree  
17 with that. And I wish I could say that that problem can  
18 be mitigated by choosing a different word. But I think  
19 the problems more deep rooted than that.

20           MR. DOTY: Mr. Ferguson.

21           MR. FERGUSON: Yes, I want to focus for a minute  
22 to see if I understand what was said correctly. And I

1 want to focus particularly on the statements that Jeremy  
2 made and Mike Young, which seem to be in many ways polar  
3 opposites. And to present us with a binary choice here.

4           As I heard you Jeremy, you said that indications  
5 -- or that statements by management, things like key  
6 performance indicators, non-GAAP measures, are not  
7 subject to audit and are area because they're not looked,  
8 are potential areas for fraud or for manipulation or for  
9 management to tell a story that is not necessarily  
10 reflected in the audited financial statements.

11           You Mike on the other hand, seem to say that if  
12 we have the auditor start looking at these things, we  
13 will inevitably inhibit their use in such a way that they  
14 are effectively the only really clear communication  
15 management makes. That the audited financial statements  
16 are increasingly not relied on by investors. And that  
17 we will actually make disclosures by management less  
18 useful.

19           Those seem to me to pose a binary choice. You  
20 know, we're dammed if we do and we're dammed if we don't,  
21 under your two arguments together. Are they  
22 reconcilable? Am I mishearing?

1 MR. YOUNG: Lew, I actually think that they are.  
2 And let me try to reconcile them. Because first of all  
3 I'm a big fan of Jeremy and his firm. And I've got  
4 Howard Schilit's book on my selves. And he and I are in  
5 the same business, which are investigating problems.

6 I think they are reconcilable. And let me  
7 explain how. One is one of the things that Jeremy told  
8 was that these different ways of looking at things can  
9 be helpful. And that's true. They can be helpful.

10 Another thing is we did not hear from Jeremy that  
11 the information is not truthful. We just heard that it's  
12 not the best way of looking at it. And I give a lot of  
13 credit to the sophistication of investors.

14 I mean I think Jeremy's main point was that the  
15 information is being sliced and diced in a way that while  
16 it's truthful, creates an impression that you shouldn't  
17 have if you look at different ways.

18 Also, the information that Jeremy's talking  
19 about, I don't think would get included in other  
20 information. I mean the 10K isn't going to have that  
21 kind of non-GAAP information.

22 So the other information proposal wouldn't really

1 reach it. You would have to even go further than other  
2 information. If in fact, well let me stop there.

3           So I don't think, I'm not hearing from Jeremy  
4 that this is misstated stuff. It's just looking at it  
5 in different ways, some of which is helpful, some of  
6 which may be less helpful.

7           That's not what I'm really speaking to. I'm  
8 really speaking to the concern that management will strip  
9 out sort of the dot connecting subjective information  
10 because of concern about auditor recalcitrance.

11           Is that helpful? I --

12           MR. FERGUSON: Yes, I mean that is sort of. I  
13 want to hear from Jeremy too though.

14           MR. PERLER: And what's most interesting to me,  
15 and I understand right now the scope of the proposal is  
16 very broad, all other information. But my comments are  
17 more focused on all detail and disclosures related to  
18 communicating the financial performance, or financial  
19 status of the company.

20           So anything like market share, or subjective  
21 comments like that I'm less concerned about. It's more  
22 here is our adjusted earnings. Or here is our non-GAAP

1 revenue.

2 MR. FERGUSON: Statements that are based on the  
3 financials.

4 MR. PERLER: Based on the financials, arrived  
5 from or proxy for.

6 MR. FERGUSON: Just different from the connecting  
7 the dots information. Or can be different.

8 MR. YOUNG: Yes, but how would the auditor police  
9 that. I mean if it's true and if it's consistent with  
10 the financial statements, is the auditor going to say we  
11 don't think that's the best way of looking at it?

12 MR. PERLER: Well I do also want to say most of  
13 the time it is true, it's a way to communicate it. But  
14 many of the frauds and many of the you know, fraud with  
15 a lower case F if you will, were rooted in these  
16 misstatements that are subjectively altered.

17 So I don't want to say there are not  
18 misstatements in there, but this is the area rife for  
19 discretion that I think is -- right now it's beyond the  
20 auditor's reach and stepping into that area will not just  
21 -- it's not just a matter of policing the metric, it's  
22 a matter of changing the overall behaviors.



1           Maybe auditors -- or maybe companies would not  
2 use some less relevant or manipulative metrics.

3           MR. DOTY: Mr. Hanson.

4           MR. HANSON: I've got a question and direct  
5 towards Pete, but I want everybody to weigh in.

6           In overall the feedback we've collective heard  
7 from you and others that the use of the word evaluate is  
8 problematic. The scope of what gets included is  
9 problematic, and that's what I want dig a little bit  
10 deeper on.

11           And also the fact that it's a game changer that  
12 the auditors actually report on the conclusions from  
13 that. And I'm kind of surprised that none of you touched  
14 on that one.

15           So I'll want overall reaction to the actual  
16 reporting of we did this stuff, evaluate or whatever the  
17 procedures are an didn't find anything. But on the  
18 scope.

19           And Pete you teed up that this is somewhat  
20 similar to what's accomplished in a comfort letter. And  
21 my experience with comfort letters, that underwriter's  
22 counsel starts with, they want every single number,

1 including the page numbers, some sort of comfort given  
2 on it in this 200 page prospectus.

3           By the time you're all said and done, there's a  
4 lot on the cutting room floor that there's no comfort  
5 given on so that whatever's disclosed falls on the floor.  
6 And the hierarchy of what underwriter's counsel usually  
7 wants is, gee if you can trace it directly to the  
8 financial statements, that's the best.

9           The second best is to the general ledger. A  
10 third best is to a schedule which reconciles to the  
11 general ledger. And then fourth is to a management  
12 prepared schedule that doesn't tie to anything, which  
13 those sometimes fall on the cutting room floor.

14           But the exercise of doing the comfort letter is  
15 very precise in that the exact number that you're given  
16 comfort on is circled with the exact procedure identified  
17 as to what was done. And one of my concerns is an  
18 investor will never know what comfort was given on any  
19 given number within the other information because it's  
20 not distinguished.

21           In some numbers there will be some comfort given,  
22 so reconciled the financial statements are tied to the

1 general ledger. In others, there's not a darn thing you  
2 can do about that number because the auditor doesn't have  
3 that information. And what we're doing in this proposal  
4 would not impose an obligation to go find the support for  
5 every number.

6           So Pete any ideas about how we could better  
7 identify to investors to make it more useful for them.  
8 And maybe your reaction how your team of analysts and  
9 investors would think about this with an unknown, we  
10 don't know what the auditor actually did. And whether  
11 they did anything to the numbers we find most important.

12           Is that even helpful if it's a well, I don't know  
13 what the auditors did, so I can't really take any comfort  
14 at all in it.

15           MR. DOTY: That's compelling testimony. Does  
16 Michael Gallagher agree that you're tending toward a  
17 comfort letter approach to this?

18           MR. GALLAGHER: Yes, I believe, yes. I think  
19 that we have to be careful not to have the perfect be the  
20 enemy of the improvement.

21           And I think regardless of what standard you put  
22 out there, whether it's evaluate or some other standard,

1 because of the different nature of the information that's  
2 included in other information, you're going to have  
3 varying degrees of comfort if you will, for lack of a  
4 better word, in terms of what the auditor did and what  
5 the auditor was able to do.

6           Now I would hope that whether it's through  
7 technology or some way, that the numbers that can be  
8 traced back you know, to a system, something that ties  
9 to the general ledger or something that is covered by the  
10 system of internal control, perhaps that can be  
11 identified in some way. Okay, to give that reader better  
12 procession in terms of you know, at least some sense of  
13 what was done relative to that.

14           But in the meantime I think some if it will be  
15 intuitive. I would say maybe pick your percentage  
16 depending on the investor. You know clearly if it's a  
17 revenue number or something that's you know, directly  
18 related to the financial statements, it will be quite  
19 clear based on the articulation of the report, well that  
20 was something that was tied to the financial statements  
21 or ultimately something that came from the internal  
22 control system.

1           But in the spirit of making improvements and not  
2 having it be perfect before we make the improvement, is  
3 in the spirit of where we were going with our suggestion.

4           MR. NACHTWEY: And it's a great question. And I  
5 think first of all by referencing the comfort letter  
6 process, I think that's a somewhat imperfect process for  
7 the reasons you've mentioned. It's all about the  
8 investment banks throwing the risk football back and  
9 forth between the accounting firms.

10           And so the more they can get the accounting firms  
11 associated with every number including ridiculous things,  
12 you know the page number thing isn't too far off.  
13 Anything a monkey could do, and they could have their own  
14 staff, but they want to have the auditor on the hook.

15           So I don't think slavishly following the comfort  
16 letter approach is probably going to be workable here.  
17 I think something that's closer to read and consider,  
18 although I'm sure the lawyers in the room and at the  
19 table will say, well that's no less specific than  
20 evaluate. And I agree it's not.

21           But it is something that's exactly what the  
22 auditors do today. And I think we have to put some of

1 the burden on this into how the standard is drafted  
2 itself. What does it mean when they say if we stuck with  
3 evaluate, which I hope we don't, but if we did, you know  
4 it's got to be very clear what that means.

5           If we say read and consider, what does that mean.  
6 Right now I think everyone in the accounting profession  
7 understands very clearly that means A, read it. B,  
8 consider whether it's inconsistent with anything that's  
9 in the financial statements you've audited. And C, make  
10 sure that if it comes out of the books and records,  
11 you've got even more certainty about it.

12           So I think there's a great understanding in the  
13 profession -- I don't think, you know fairly stated, and  
14 you know in current standard audit opinion, if we were  
15 subjecting that to the same level of scrutiny we're  
16 subjecting these words to, we'd have the same issues with  
17 fairly stated. But people have gotten used to that over  
18 many, many decades of reporting and again, what the  
19 standard says.

20           I also think we're in completely unbroken ground.  
21 When we're over many, many decades we're talking about  
22 a two paragraph opinion that we've sometimes some of the

1 firms reverse the paragraphs, or the combine the  
2 paragraphs, but they pretty much all say the same thing.

3           And that's given investors and users a lot of  
4 comfort. Because they don't have to read a report and  
5 guess well, what's the auditor telling me? If it's  
6 pass/fail, I know if they've passed it, they've got a  
7 good understanding of what was done.

8           So I think a bunch of what's in scope comes from  
9 what are you going to ask the auditors to say. And then  
10 again, what should be in scope. I think non-GAAP  
11 financial measures, you know by in large virtually every  
12 number, I know certainly the ones that Legg Mason  
13 reports, of which we've got primarily three.

14           And frankly, I talk to investors that probably 40  
15 percent of my life is spent either on earnings calls or  
16 in investors sessions with both sell side analysts, or  
17 buy side investors. And Legg Mason is a buy side, so our  
18 mutual funds are out investing in things every day. But  
19 they're relying on sell side analysts who mostly work for  
20 the Wall Street firms in terms of their diagnosis of our  
21 financials.

22           They're not only relying on that, but they

1 heavily rely on it. And frankly 80 percent of the  
2 questions that I get, and I get all the numbers  
3 questions, my CEO gets all the fun ones to talk about  
4 strategy, et cetera, 80 percent of those questions are  
5 about the non-GAAP measures. Because GAAP unfortunately  
6 forces us to do some things in our financials that the  
7 analysts look and say that's not relevant.

8 I'll give you one example and then I'll pass the  
9 microphone on. But net revenues in our business. You  
10 know there's a lot of tension around wanting to make sure  
11 in accounting parlance we're reporting everything that's  
12 coming in. And then everything that's flowing out is an  
13 expense and what's left for the shareholders.

14 But in our business we have a huge amount of  
15 marketing costs that are referred to as 12b-1 fees that  
16 are highly regulated part of the mutual fund business.  
17 And 100 percent of those fees are passthroughs to the  
18 distribution partners that we have.

19 So no one looks at that as revenue that comes to  
20 Legg Mason, because why in the world would you be in a  
21 business where you have 100 percent of your revenues  
22 going out as expense?



1           So the analysts want to understand in terms of  
2 are we running the business efficiently. What is the net  
3 revenue that's actually coming to you that you're  
4 managing. And what's the margin you have off of that.

5           So again, very few of the questions that I get go  
6 to the GAAP numbers. They go more to the non-GAAP.

7           MR. DOTY: Ms. Franzel.

8           MS. FRANZEL: Thanks for being here today.  
9 Assuming we get the verb right here, you know evaluate,  
10 consider, read. Or maybe we need more than one, you know  
11 sort of verb to apply to different categories of  
12 information. I'd be curious to hear your thoughts on  
13 that.

14           But what are the categories of information that  
15 you think would be most important to have some kind of  
16 explicit auditor involvement and conclusion on. Right  
17 now we've got a very broad you know, other information.

18           Are there certain categories where you would  
19 envision that we'd get most value from auditor  
20 involvement? And what level of auditor involvement would  
21 that be? And the question is for all the panelists who  
22 would like to respond. Start with Jeremy.

1 MR. PERLER: Yes, I think in my mind it's a  
2 no-brainer for there to be auditor involvement on  
3 anything used to communicate financial performance. Be  
4 it a number, be it a qualitative disclosure about why  
5 revenue grew ten percent this year.

6 I would say that area is the most important area.  
7 Everything else would be below it.

8 MR. YOUNG: I'm a listener on that one. So I'm  
9 going to defer.

10 MR. NACHTWEY: Ditto.

11 MR. GALLAGHER: Yes, I like the discussion that  
12 was held yesterday where we discussed and we supported  
13 the CAQ proposal of reporting the auditor involvement with  
14 critical accounting estimates. Because those are the  
15 things that if they're done right, are really the most  
16 important things that drive financial performance, or  
17 where financial performance could be effected most  
18 significantly.

19 And I think there is a real opportunity to up the  
20 game in terms of how well they are written. Right now  
21 there is not auditor involvement beyond the read and  
22 consider. I think if the auditor were to attest to that,

1 I think the quality of compliance with SEC rules and the  
2 clarity with which it was written, I think would only  
3 improve.

4           So supportive there. And as I said, I do agree  
5 with Jeremy, I think things that are most significant and  
6 directly associated with the financial statements that  
7 really drive how a company's evaluated, is where the  
8 auditor involvement should be greatest.

9           MR. NACHTWEY: Again, it's a difficult issue. I  
10 think investors probably today assume anything has a  
11 dollar sign on it, or even if it's a number, that the  
12 auditors have done something with it.

13           You know frankly I think it's difficult for the  
14 audit profession to do much with things that don't come  
15 from -- directly from the books and records. And things  
16 that are subject to the internal control system, you know  
17 a lot of thought and theory that's been put into internal  
18 controls by a number of bodies including COSO.

19           But I think confining it to things that are you  
20 know, within the expertise of the auditor, mostly  
21 financial information, financial numbers. The things  
22 that are so often have been in these tense meetings with

1 underwriters, that they want auditors to comfort.

2           And the same kind of things that I think Jeremy  
3 is talking about here. I agree they are important  
4 numbers. So things like square footage. So a firm that  
5 owns office buildings or regional malls, et cetera, is  
6 -- has square footage is a key, not so much performance  
7 indicator, but certainly a key statistic in their  
8 financial reporting.

9           Yet there's incredible amount of subjectivity as  
10 how you measure square footage. So I used to do some  
11 real estate work in a prior life. And in New York City,  
12 we always talked about the gross leasable area was how  
13 far you could throw your boss out the window. And then  
14 you've got to measure that distance onto the sidewalk.

15           And this was all a game of the real estate  
16 brokers and the owners and the tenants deciding how much  
17 they're going to pay in rent. And then what's leasable  
18 area? Do we count the restrooms? Do we count the  
19 elevator shafts, et cetera? Things that accountants  
20 clearly aren't capable of accessing.

21           The second one, proven reserves. Some of the  
22 resource, oil and gas, minerals business, et cetera.

1 Incredibly complex. Not something -- I can tell you,  
2 again I'm a CPA, I spent many, many years both in school  
3 studying for the exam. In practice and in no way shape  
4 -- I know what a proven reserve should be. But am I  
5 engineeringly capable of going out and verifying it?  
6 Absolutely not.

7           And then last but not least, in the valuation  
8 space. And there was a time in my prior life at Deloitte  
9 where I ran the valuation practice for the firm. Not  
10 because I was an NAI and knew really the first thing  
11 about the science of valuation, but the firm needed  
12 somebody back when FAS 141 and 142 came out, to connect  
13 the valuation folks to the auditing folks.

14           And it's a very different again, amount of rocket  
15 science that goes into valuing things. Whether it's hard  
16 assets or financial instruments.

17           So I know I haven't given you a clear answer to  
18 that. It's -- this is why I'm suggesting that we have  
19 to be very careful at constructing this thing. And  
20 making sure that we don't cause more confusion by people  
21 assuming once the auditors started reporting on  
22 information, if it's not clear exactly what they've done,

1 on what numbers, we create some difficulty.

2           So the last point. In going back to this, we're  
3 breaking new ground on the reporting. Everybody's taking  
4 comfort in having this one page, two paragraph opinion.  
5 And then we may be in a land where you need an appendix  
6 to the opinion that describes exactly what's done.

7           You don't want to torture everybody to have to  
8 read that to get to the substance, but it might help with  
9 the litigation protection. And for the ones who really  
10 want to go deep on this, they'll have the information as  
11 an appendix to the report.

12           MR. DOTY: Brian Croteau.

13           MR. CROTEAU: I think Pete you started to  
14 actually answer the question I was going to ask. But I  
15 wanted to come back to the evidence point again.

16           I'm obviously again for the fairest amount.  
17 There will be a range of evidence that the auditor  
18 gathers and has in his files. And you know, some  
19 information will be covered -- would be covered under  
20 Jay's model and under the proposed standard.

21           And other -- for other information, there would  
22 be a range of relevance relative to the information in

1 the auditor's file. And to the extent that we're talking  
2 about a report that is a paragraph or two versus  
3 describing for each specific element of the other  
4 information what was done.

5 My question was really is it more risky or more  
6 helpful to have that kind of report? And I'd be  
7 interested in other's thoughts on that. I think you just  
8 started to answer that question. I'd be interested to  
9 know what others think about that.

10 MR. YOUNG: Forgive me, I don't understand the  
11 question.

12 MR. CROTEAU: So in some cases, the auditor may  
13 not have any information from the financial statement  
14 audit in the file. And in other cases the information  
15 the auditor has may be relevant to some degree, or may  
16 be completely relevant to the other information that's  
17 being looked at. But yet the report we're talking about  
18 wouldn't necessarily identify what was done for each  
19 element.

20 And I guess my question is, is that kind of  
21 report that generally describes what the auditor has  
22 done, relative to the other information, the procedures

1 performed, helpful? Or is that likely to be more  
2 confusing without what Peter was just sort of describing,  
3 sort of a tick mark legend if you will, of what was done  
4 for every element?

5 MR. YOUNG: Right. Here's the challenge. And  
6 that is let's say we want to take, I'll call it a comfort  
7 letter approach, because that really crystalizes it. You  
8 got a number, you circle it, the auditor looks at the  
9 number, very little ambiguity there.

10 The challenge is coming to that level of clarity,  
11 that level of crispness, that sort of line of demarcation  
12 when you're talking about other information more  
13 generally. Now sure if we could have the auditor circle  
14 numbers, well yes, okay, that would take care of it.

15 But in a sense, almost anything you say about the  
16 business, at some level ties to something in the  
17 financial statements. And let me give you an example  
18 which makes it perhaps a little bit more concrete.

19 And that is risk management, it's a big thing  
20 right now. Disclosure about risk management. And let's  
21 say that the company says, and speaking, you know  
22 speaking operational, we believe that we have effective



1 risk management.

2 Well the auditor knows that the company has FAS  
3 157 Level 3 assets. And let's say sure enough the value  
4 of those assets goes down. And then the contention is,  
5 auditor, how could you have allowed management to say  
6 they have effective risk management when you knew they  
7 had FAS 157 Level 3 assets, and look what's happened.  
8 The value has gone down. That's not effective risk  
9 management. How did you let them say that?

10 Now that's an example. You don't think of an  
11 operational statement about effective risk management as  
12 really tying to the financial information. But those  
13 dots are not difficult to connect.

14 How realistic is that hypothetical? Not only is  
15 it pretty realistic, it's not even very creative.

16 MR. DOTY: Mr. Baumann.

17 MR. HARRIS: What do you do in that situation  
18 where there's effective Level 3 assets?

19 MR. DOTY: Steve, let's hold it. Let's let Marty  
20 pursue the question and then we'll get back. You'll get  
21 another round.

22 MR. BAUMANN: Thanks. You've all made a great

1 contribution to this important topic. And I really  
2 appreciate Mike's comment about don't let the perfect be  
3 the enemy of the good here.

4 I -- Jay asked a really good question. He talked  
5 about investors really don't know which level of  
6 assurance was given on different numbers because the  
7 auditor knows more or less about different number in the  
8 other information. And that's a good point, but still  
9 can't we still improve auditor reporting without getting  
10 perfect in this regard?

11 I'd be interested in Mike and Jeremy's reaction  
12 to a comment that was made by Pete in his remarks that,  
13 we are the fastest growing company in this industry, is  
14 something that he said cannot -- auditors cannot report  
15 on that type of information.

16 Now as part of the risk assessment standards,  
17 auditors are required to gain an understanding of the  
18 company and it's environment, which encompasses industry  
19 factors including a competitive environment. So auditors  
20 have to understand a company and it's environment as part  
21 of the risk assessment standards.

22 So if the auditor is doing that and is reading

1 the company reports about its growth, its strategy, also  
2 minutes of the Board of Directors, and is aware of the  
3 fact that they believe that they have some problems in  
4 growth. And that they have competitors that are growing  
5 faster than them, and have better products than they do.

6           And the auditor reads that statement that says we  
7 are the fastest growing company in the industry, but the  
8 auditor knows that that's not what is reflected in  
9 management's own records in the board meetings that he  
10 attended, or audit committee meetings, is that not the  
11 type of information where the auditor could and should  
12 say to management, we think you have a material  
13 misstatement of fact here that we think has to be  
14 corrected.

15           So and isn't that the kind of information that  
16 otherwise could be very market moving in other  
17 information that might be at the heart of what we're  
18 trying to get at here?

19           MR. PERLER: Yes, I think that would be a  
20 material, and if the auditor saw that as a material  
21 misstatement of fact, that would be a great area for  
22 discussion and something that the auditor could speak

1 about and communicate with management, absolutely.

2 I recognize the subjectivity of that particular  
3 statement, and what are you using to make that judgment?  
4 Growth in what measure? And you can pick any measure and  
5 say we're the fastest growing company. However I do  
6 think that would be a helpful area. Less important to  
7 me than actual financial reporting numbers, but helpful.

8 MR. GALLAGHER: So Marty, the way I think the  
9 auditor would approach it today, is ask management, hey  
10 you're making this statement, what is it based on. You  
11 know recognizing that it's a very ambiguous statement.  
12 There are so many ways you could measure you know,  
13 fastest growing.

14 So very ambiguous, and you'd want to get behind  
15 it in terms of what is your basis for making that claim.  
16 And if there wasn't a basis for making that claim, I  
17 think the auditor would likely raise it and say hey, this  
18 is problematic.

19 But it would be very difficult for the auditor to  
20 report on that because of the subjectivity of it. And  
21 there's probably some metric that they can find given the  
22 ambiguity of the measure that they might be able to

1 support the claim. Whether you think that that measure  
2 was a reasonable measure would be another matter.

3           So those are -- that's the caution we would have  
4 as auditors in terms of reporting on information that's  
5 fundamentally not objective, it's subjective and  
6 potentially ambiguous.

7           MR. NACHTWEY: I was thinking Marty, I recognize  
8 as well that that's you know, an important area for  
9 investors to have a feel for. But it's a question of  
10 whether the auditor is the right place to get the  
11 information, or a standard that we can craft that  
12 everyone would agree objectively. First of all, how do  
13 you define industry.

14           And so there's many subsets and levels of SIC  
15 codes we could go through as to is it you know, a very  
16 finite example, Legg Mason, are we a financial services  
17 company? In which case you're going to compare us to  
18 insurance companies, banks, broker dealers, et cetera.  
19 Or are we an asset management company, and within that  
20 are we an active asset manager versus passive like a bank  
21 or et cetera.

22           And then getting into the unit of measure, is it,

1 or what is fastest growing. Is it units of production?  
2 Right now most tech companies that are being sold for  
3 billions of dollars have you know, fast growing stuff,  
4 and they're not making any money.

5           So is it you know, growth and profitability,  
6 growth in units of sales, growth in revenues. I think  
7 is where the challenge is. But like Mike, my prior life,  
8 if I had a management that was consistently, you know it  
9 when you see it. And if they're consistently misstating  
10 things like that, those are the kind of clients you say,  
11 should we be associated with.

12           MR. BAUMANN: Or at a minimum, if they're making  
13 that kind of statement and you know it's factually wrong  
14 because in their minutes of the board meeting, they've  
15 asserted you know, we're the third fastest growing in our  
16 industry in every single category. You'd want them to,  
17 when you read and whatever the verb is, evaluate or  
18 consider, whatever, say maybe that's something I've just  
19 read, but I think either management has to correct, or  
20 my report would say we did read this and we found  
21 something to be materially inconsistent with our  
22 knowledge of the company, or a material misstatement of

1 fact.

2 MR. DOTY: Steve Harris.

3 MR. HARRIS: Getting back to me.

4 MR. DOTY: Yes, go ahead Steve.

5 MR. HARRIS: The question on Level 3, what's the  
6 responsibility and role of the auditor to report on, in  
7 essence impossible to value assets?

8 MR. YOUNG: Well I mean I would think it is to  
9 come to a judgment as to whether management's judgment  
10 in trying to value the assets is fairly presented as of  
11 the date of the valuation. You know, it's -- I would not  
12 view the auditor as having a -- no, no, now I'm talking  
13 about auditing standards. Please correct me where I go  
14 astray.

15 But I would not view the auditor as having a  
16 responsibility for you know, thinking what the value's  
17 going to be next month. It's what is the value under  
18 Level 3 as of the date of the information.

19 MR. HARRIS: But there is no value. I mean Level  
20 3 is from my understanding --

21 MR. YOUNG: Oh no, you -- no, there's a value,  
22 it's just hard to set the value.

1           MR. HARRIS: There's such a range. I mean from  
2 everything I gather, it's such a range that it's  
3 virtually impossible to value. So in essence what you  
4 do is to what is extent is the auditor responsible for  
5 reporting the difficulty in valuing the Level 3 asset.  
6 If at all.

7           MR. YOUNG: Well -- that actually is a very good  
8 point. Because it take us to what Mike Gallagher was  
9 talking about earlier about critical audit matters.

10           And that's one, if I may leave other information  
11 just for a moment. I mean that's actually something that  
12 would be useful for investors to see, that this is  
13 challenging number. You know, you've got a FAS 157 Level  
14 3.

15           But you have to come to a value. I mean the FASB  
16 doesn't say, gee it's tough to value, so just leave it  
17 blank.

18           MR. DOTY: Lewis.

19           MR. FERGUSON: Yes. Alan Beller talked about  
20 this yesterday. And as I heard him, what he said was he  
21 had two concerns about it. One was the question that  
22 there did not appear to be any materiality standard in



1 terms of what the auditor did. And number two, you  
2 didn't really know what the auditor had done beyond  
3 evaluate this large body of other information.

4           Would it help for example if assuming we cure the  
5 problem with evaluate and come up with a definition of  
6 what the auditor, that is clear and understandable and  
7 people know what it means. Beyond that, that auditor has  
8 to say and in addition, we preformed procedures with  
9 respect to the following areas, so the reader knows more  
10 specifically in this body of other information, what  
11 areas the auditor thought were worthy of attention enough  
12 to do work on.

13           Does that help?

14           MR. GALLAGHER: So Lew I would break it down  
15 between other information and CAM. And I don't recall  
16 yesterday whether Alan's comments were focused on  
17 articulate -- potentially articulating procedures with  
18 respect to critical audit matters.

19           That I would be less enthusiastic about a litany  
20 of procedures that was performed, that may call into  
21 question whether you have a problem with that number or  
22 not. As opposed other information where again, if the

1 purpose of the Board was to capture what practice does  
2 today with respect to other information. And we do  
3 things that go beyond what we're required to do in order  
4 to manager our risk.

5           So we're required to read and consider. Do we do  
6 more than that? Sure. We tie numbers out all the time.  
7 Whether it's in connection with a comfort letter, or just  
8 you know, just to get the 10K done. Every number in MD&A  
9 that's the key numbers for sure, are tied out.

10           So I think articulating procedures and what we do  
11 just being transparent about what we do today,  
12 recognizing the imperfections that from Jay's comment,  
13 which we recognize. And I think Brian's question is  
14 exactly the right one in terms of the consumer, would  
15 they find it to be more confusing, or would they find it  
16 to be helpful?

17           I think that would be a great thing to test in a  
18 field test.

19           MR. FERGUSON: Are you saying that you do think  
20 that would be helpful to do?

21           MR. GALLAGHER: I think in the context of other  
22 information, not CAM.

1 MR. FERGUSON: Yes, that's what I'm asking. I'm  
2 not asking about CAM. I meant other information.

3 MR. GALLAGHER: I do, but I would keep it limited  
4 to you know, a few categories. Not an endless  
5 articulation of individual procedures.

6 MR. DOTY: Jay.

7 MR. HANSON: A question mostly directly at Jeremy  
8 around the non-GAAP financial information. It seems to  
9 me that one of the problems is that there are no  
10 standards around how you present any particular non-GAAP  
11 measure. And I know that we can't solve that problem,  
12 the PCAOB.

13 And I'm looking at Mr. Kroeker, and I'm guessing  
14 that he would say gee, we're having enough problems with  
15 disclosures on GAAP matters, much less taking on non-GAAP  
16 measures. And Brian's colleagues in Corp Fin are the  
17 ones that tend to do some policing in the non-GAAP  
18 measures.

19 But it seems like there is a fundamental problem  
20 of there are no definitions behind it, nothing uniform.  
21 Even if something as on a simpler end of the scale as  
22 same store sales, that there are many ways to compute

1 that.

2           But without solving that problem, which I don't  
3 know is even solvable, I think we're always going to have  
4 the problem of people saying whatever they want to say  
5 with whatever caveats being on it. And there will always  
6 be a schedule that describes how the number was computed.

7           But you made a -- I'm trying to figure out what  
8 my question is here. Because I -- do you have  
9 suggestions about getting at the core of that problem of  
10 it's a wild, wild west relative to non-GAAP measures.  
11 Or is it your message really that auditors paying more  
12 attention to that may curb just the use of some non-GAAP  
13 measures at all?

14           MR. PERLER: It's a great topic. And I think  
15 Pete illustrated it really well when he said that 80  
16 percent of his investment community asks him about the  
17 non-GAAP metrics then the GAAP metrics.

18           And I'm not an advocate of banning non-GAAP  
19 metrics. Or turning them all to GAAP, or telling  
20 companies that you can't report this information, because  
21 I agree it would curb information flow.

22           And I recognize that this is a fundamental

1 problem that the system has, that it could foster a wild  
2 west situation. But I think there are absolutely steps  
3 that could be taken. Particularly from the auditors  
4 perspective.

5           You know some easy ones include -- we all know  
6 for every company, what are their most important investor  
7 communication metrics? Pete just said at his company  
8 there were three non-GAAP metrics that they use. Every  
9 -- you go to open-ending earnings release, and you look  
10 in bold on page one, and you can see right there what  
11 they're communicating to investors.

12           For those metrics, at minimum, to not have any  
13 robust quality check or auditor scrutiny on them, I think  
14 is a problem that could be fixed with some procedures.  
15 I don't want to suggest everything and anything needs to  
16 come under the umbrella, but there is a way to pick off  
17 the most important investor communication metrics.

18           MR. HANSON: And just a commentary on that, which  
19 is -- which we've heard some feedback in different  
20 settings that auditor involvement in press releases. And  
21 actually Mike Cook, one of our standing advisor group  
22 members, talks a lot about the need for auditors to get

1 on the train earlier than at the tail end when the audit  
2 report is issued.

3 But that in most companies, the auditors do have  
4 some involvement with the press release. But  
5 definitionally, since most major companies issue press  
6 releases long before the audit report is ready to be  
7 signed, it's an imperfect exercise. And the auditor is  
8 never going to be able to sign off because they're not  
9 done with their audit yet. So that is a real change.

10 MR. PERLER: I recognize that. I think many of  
11 these metrics do find their way through the MD&A. And  
12 just this overall scrutiny over what the most important  
13 metrics are will influence what metrics are used. And  
14 just to acknowledge, the audited financial reports are  
15 not the primary communication tool with investors.  
16 They're not secondary, they're not tertiary, they're what  
17 -- above that are the earnings releases, the conference  
18 calls, the PowerPoint presentations, the one on ones.  
19 This is how companies communicate with their investors.

20 And the audited financial statements are well  
21 below that. So I think it -- and I know it speaks to a  
22 grander change in the system, but I think some kind of

1 involvement with the key measures reported in those other  
2 communication tools only makes sense from an auditor's  
3 perspective. That's where investor protection would be  
4 best served.

5 MR. GALLAGHER: If I could just add to that. I  
6 think that I agree with Jeremy. And I would certainly  
7 be supportive if the demand exists on the part of the  
8 stakeholders, investors and others, to have auditor  
9 involvement in press releases and others.

10 But I would also say that this notion that the  
11 audit is all the way at the back end, which from a time  
12 perspective it is, but I think when a press release comes  
13 out, there's the knowledge that an audit's being done.  
14 And God help the company that has numbers that are  
15 different in the audited financial statements from their  
16 press release.

17 Now you do have that. Sometimes you have a  
18 subsequent event which was beyond their control. And I  
19 think the market generally understands that. But if a  
20 company consistently, like more than once, has an issue  
21 that -- where there's a disconnect between those audited  
22 financial statements which come later, and those numbers

1 are different than that press release, they're going to  
2 pay a pretty heavy price.

3 MR. DOTY: Jeanette.

4 MS. FRANZEL: I want to talk a little bit about  
5 the potential impact of whatever we do. Let's assume we  
6 can get it exactly right. The impact on perhaps  
7 increasing the expectations gap. Because to me that  
8 seems to be another factor that we need to worry about.

9 So if we define auditor's involvement and we  
10 define the scope of auditor's involvement, yet you do  
11 have some qualitative connecting of the dots and  
12 presentation matters that could potentially be  
13 misleading, even though the auditor has managed to get  
14 comfortable with the various numbers. What do you all  
15 see as potential risk here in terms of increasing  
16 expectation gap and what advice would you give for us to  
17 consider that?

18 Let's start with Jeremy. And I think Michael you  
19 touched on a lot of that.

20 MR. PERLER: I think the expectation gap is very  
21 large right now. I'm not too worried about increasing  
22 it. The question I get very frequently from investors



1 when I point out some sort of misrepresentation, is why  
2 aren't the auditor's looking at this?

3           Whether it's in the press release, whether it's  
4 in the MD&A. I would say if you surveyed investors, the  
5 vast majority would think that the MD&A is audited.  
6 Maybe not the press release. But I think the expectation  
7 gap is so wide, I wouldn't fear implementing something  
8 just because it might increase.

9           MR. YOUNG: I think that in everyday language,  
10 this will be -- start to be referred to as auditing MD&A.  
11 Or auditing the 10K. And the distance between that  
12 articulation and the reality will be the expectation gap.

13           MR. NACHTWEY: And I actually agree with both  
14 what Jeremy and Mike have said here. And I think there  
15 is a huge expectation gap today. I do think that  
16 investors by and large believe that if auditors have  
17 signed off on an audited financial statement including  
18 in some other public filing, or in a public filing, that  
19 virtually all of the other information, particularly if  
20 it's a number, and if it's got a dollar sign even more.  
21 That the auditors have been involved with that.

22           And even the ones who have a better or more

1 sophisticated knowledge, I think assume okay, I realize  
2 the auditor may not have subjected it to the same level  
3 of audit procedures, but it's a higher level than what  
4 auditors are capable of doing.

5           So I think this is a great opportunity to tighten  
6 that expectation gap. But depending on how we ultimately  
7 you know, articulate the proposal, it could cause -- it  
8 does have the risk of creating more confusion.

9           MR. GALLAGHER: I agree with Pete's comments.  
10 And I go back to Brian's question. I mean the true test  
11 here is if we can experiment. You know whether it's  
12 finding the perfect word or articulating the procedures,  
13 and get a reaction from those that use the financial  
14 statements. And look at the other information and get  
15 a reaction. Is this helpful, is this widening the  
16 expectation gap, or is it closing it.

17           MR. DOTY: I am concerned listening to Michael  
18 and to some extent the rest of the panel. With the  
19 notion that we have now auditors as a matter of practice,  
20 looking at other information. The concern that if the  
21 issuer knows they're going to have to say something where  
22 they find inconsistency, this will result in management

1 leaning toward cooking the books. They will lean toward  
2 withholding information. They will lean toward trying  
3 to make it -- to neutralize the comment.

4           It seems to me that they do that at their peril.  
5 And the suggestion is what comes out of the suggestion  
6 is that the involvement -- some involvement as Jeremy is  
7 suggesting of the auditor and the audit process and other  
8 information and addressing inconsistencies, should  
9 correct, should produce management conduct that is  
10 better.

11           I understand the liability issue. But is the  
12 panel comfortable with the notion that we do not -- that  
13 we will not empower the auditor. We will not by virtue  
14 of directing the auditor to form judgments of some kind.  
15 That we've decided that what comes out of this panel  
16 discussion is there's a lack of uncertainty about  
17 evaluate.

18           But some -- requiring the auditor to form some  
19 judgment and communicate some judgment, is that  
20 consistent with best corporate practice and best  
21 disclosure? Do you really -- do you believe that that  
22 in fact leads us away from boilerplate?

1           So are you willing to say we're going to abandon  
2 the attempt to have the auditor perform some judgmental  
3 review. And then having done it, communicate that. Is  
4 that where you are? No involvement?

5           MR. YOUNG: Look, I know you guys have put a lot  
6 of work into this. But I'm afraid that's where I am.  
7 And let me -- and let me respond to.

8           Warren Buffet in his most recent shareholder  
9 letter says something about a write down. But the number  
10 is economically meaningless. If an auditor were  
11 reporting on that statement, that statement would not be  
12 in there.

13          And I remember an earlier shareholder letter --  
14 but I do other things in life besides read his  
15 shareholder letters, just but -- an earlier shareholder  
16 letter I think we talked about a reserve. And he said  
17 the one thing we know about that number is it's wrong.

18          If an auditor had responsibility for reporting  
19 that sentence, it wouldn't be in there. And my concern  
20 -- I mean let me say it this way. The lawyers will take  
21 over. The lawyers will go over the disclosure and they  
22 will look at the risk, and they will say, fastest

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1 growing, maybe it's right, but there's evidence to the  
2 contrary, get that statement out of there. Economically  
3 meaningless, get that statement out of there.

4           And the thing -- I mean they have -- 10Ks have so  
5 little life now. I mean you know, maybe an argument is  
6 they're so unbearable now you can't make it any worse.  
7 But, you know, hope spring eternal.

8           And my concern is bluntly, the lawyers will take  
9 over.

10           MR. NACHTWEY: Chairman Doty, as I said in my  
11 comments, I generally favor the standard. And I think  
12 because going back to Jeanette's question, I think  
13 there's more risk and harm today in terms of the lack of  
14 understanding of what auditors are involved with and the  
15 other information, that we can close that expectation  
16 gap.

17           And I think to obviate the issue that Mike so  
18 wisely raises, you don't want to limit you know, what  
19 Warren Buffet could write. But those kind of subjective  
20 things, are not really the part, the purview of the audit  
21 firms. And we shouldn't be forcing the audit firms to  
22 get involved in that stuff.

1           Again I think it's much more about reporting and  
2 what they already do, to make it clear to investors where  
3 the auditor's been involved in other information. Or as  
4 Mike said, Mike Gallagher said before, and again from my  
5 experience of you know, 25 years at Deloitte, we were  
6 involved with a lot of the information. And we just have  
7 to come up with an appropriate way for them to report on  
8 what involvement they have. What the information is  
9 they're involved in and the level and scope of what  
10 they've done.

11           MR. DOTY: Well there's a real dichotomy that  
12 emerges. Because Jeremy began with a very profound  
13 statement that he says that he has an understanding in  
14 his career of how information is read and used, consumed.  
15 The whole panel I think fits that description.

16           You all have through your careers, a heightened  
17 understanding of how information is read and consumed.  
18 And I take it that along with Mike Gallagher's written  
19 materials, I thought there was not the same reluctance  
20 or the same concern about the critical audit matters, the  
21 CAMs.

22           That in fact in your view of some of the

1 arguments made that the evidence concerned with  
2 involvement in other information, would in fact suggest  
3 that you think there is not a risk in having CAMs in the  
4 audit report. That's a different breed of cat. I know  
5 it's not your panel's subject.

6 And there are issues of naming the engagement  
7 partner and the tenure of the firms that were discussed  
8 yesterday and that are coming out of the European model,  
9 and that we are considering. I would like to know the  
10 panel's views as sua sponte as they are, on whether in  
11 fact we should proceed with CAMs, engagement partners,  
12 tenure.

13 Are these matters that are a different issue than  
14 the ambiguities and the dangers of other information?  
15 Jeremy?

16 MR. YOUNG: May I speak first to that?

17 MR. DOTY: Please, please.

18 MR. YOUNG: Let me speak to the CAM question. I  
19 actually think that at a -- I think there's a lot of  
20 benefit to the CAM disclosure if it's done right. I mean  
21 don't get me wrong. I think there's some issues.

22 But at a conceptual level, there are tough

1 numbers. I mean Steve it goes to your point about FAS  
2 157 Level 3 assets. You know the mere fact that FASB  
3 says you've got to come up with a number doesn't make it  
4 easy. And doesn't mean that there's not a range that  
5 takes you from A to Z.

6 And it's useful for investors to understand that.  
7 And that's good for investors. It's good for preparers.  
8 It's good for auditors. And by the way, in at a  
9 conceptual level, that helps you with regard to  
10 litigation risk. I mean you're talking about challenges,  
11 you're talking about risks. You're talking about  
12 problems.

13 The disclosure of problems doesn't get you into  
14 litigation trouble. It's the non-disclosure of problems  
15 that gets you into litigation trouble.

16 Now permit me to just insert here, I was in the  
17 room yesterday when Alan Beller was speaking, and I  
18 accept that when you get into the weeds, there are some  
19 real issues. But that's really on the implementation.

20 At a conceptual level, I would not suggest that  
21 you abandon the CAM project. Quite the contrary. I'm  
22 sort of cheering you on as a matter of concept.



1 MR. PERLER: I agree. There are benefits to the  
2 CAM, the auditor's name. I agree with all of that. I  
3 think all of those -- or I should say, the most important  
4 thing that can be done on the entire proposal is around  
5 these most important financial metrics I talk about. All  
6 of those are very helpful context as well.

7 But in my mind, strengthening the robustness of  
8 the system for communicating financial performance, is  
9 the most important thing that can be done.

10 MR. NACHTWEY: I appreciate having the  
11 opportunity to weigh in on those. Although again, having  
12 spent as much time studying them as we did this topic.  
13 But I have concerns about all three. Don't have to be  
14 fatal.

15 But in terms of the first, in terms of CAM, so  
16 management already does MD&A with massive disclosures and  
17 footnotes. If you go to some of the big banks, just  
18 critical accounting policy runs on for 20 pages.

19 So ours is a little less complex, but still runs  
20 to probably 10 pages just in the main footnotes. Get  
21 into MD&A, there's going to be even more.

22 So how do we make sure that we're not confusing

1 investors by auditors saying one thing. Now presumably  
2 auditors would agree with our disclosures, or they  
3 wouldn't have signed off on the audit opinion. But now  
4 you get into words as opposed to numbers.

5           And so the time that it would take to make sure  
6 that we're consistent. And if we're not, the idea that  
7 either the company did something wrong, and therefore  
8 should have had a qualified opinion. Or the auditor's  
9 disclosing information that management should have been  
10 disclosing to begin with.

11           And I do have some tissue rejection about the  
12 idea that auditors should be the source of original  
13 disclosures from -- about the company. But again I think  
14 there could be workable things.

15           I do agree as Mike says, you know FASB, the Level  
16 3 asset issue, and I've had clients -- audited clients  
17 and was the CFO for a firm that literally had 100 percent  
18 of their assets that were Level 3. And you know did --  
19 the users of those financial statements really understand  
20 the challenges in valuing those.

21           And the risk, valuing them on any given day is  
22 tough enough. Trying to say what's going to happen

1 between now and next quarter, virtually impossible.

2           On the engagement partner, that's a, it's a tough  
3 one. You know, from my view, I had audit clients, I had  
4 one of the largest audit clients in my former firm. I  
5 had 200 partners, audit partners around the world that  
6 worked on that client.

7           So, I mean, I can sign it, but, gee, I'm relying  
8 in large part on those other 200. Do we want a laundry  
9 list, but I accept the fact there were other professions  
10 that do, you know put the individual's name on it.

11           I just question whether -- does that have as much  
12 value as people might think? Or is it misleading that  
13 there's simply one, you know, one individual that's  
14 responsible for the audit.

15           And then on the tenure front, could be a good  
16 disclosure. We do it. We do it in response to a  
17 shareholder proposal. But quite frankly, my concern  
18 there is it's a data point that without some context to  
19 it, can be used by, you know, folks that want to make a  
20 point. Well we just should not have long tenured  
21 relationships.

22           Well I guarantee you, that audit whose name will

1 remain nameless for the moment, but where I had 200 audit  
2 partners on it. Imagine trying to get 200 audit partners  
3 in the new firm up to speed, overnight, on an incredibly  
4 complex business.

5           So rotation is -- tenure in my mind is simply the  
6 camel's nose under the tent of forcing the rotation  
7 discussion, another step down the fairway. And I'm not  
8 sure it's the appropriate way to do that.

9           MR. GALLAGHER: So CAM, as the written comments  
10 suggest, and my oral comments, very supportive of CAM.  
11 As to tenure, very similar to what Pete just articulated.  
12 It's a data point. Certainly no issue about having it  
13 be somewhere, probably the proxy is the best place to put  
14 it to be able to provide that context.

15           The partner identification as we've communicated  
16 in our response letters to that proposal, we're  
17 supportive of transparency and letting everyone know who  
18 the partner is. Just logistical issues about whether it  
19 belongs in the report or if there's a way to do it and  
20 have that transparency without creating other issues.

21           MR. DOTY: Any last questions? Go.

22           MR. HARRIS: I had just one final question. And

1 Pete I wasn't exactly sure in your statement where you  
2 say a key performance indicator is assets under  
3 management. What's the auditor's role? What do you view  
4 as the auditor's role in that area?

5 MR. NACHTWEY: Again, it's not a number that  
6 actually comes out of the general ledger. But it's a  
7 number that general ledger numbers are derived from.

8 So assets under management, bottom line is, daily  
9 we calculate our revenues off the assets that we manage.  
10 So there's I don't know how many thousands of different  
11 fund products and separate accounts that all have  
12 different fee structures.

13 So every day we obviously have this in the  
14 system, but there's also some subjectivity to it, where  
15 my finance team has to effectively book revenues on a  
16 daily basis. So again the auditors can't ignore AUM,  
17 it's the first part of the equation. So asset times fee,  
18 equals revenue.

19 On the other hand, AUM isn't subject to the same  
20 kind of you know, double entry accounting system tension,  
21 or the same -- it's subject certainly to our internal  
22 control system, but in a different way.

1 But again, that's why I used it though as I think  
2 a good example, a little bit of what Jeremy's getting at  
3 is, you know that's a really important number. And it  
4 goes beyond the financials.

5 Every month the market waits with bated breath  
6 for all of -- for my firm and all of our peers, to  
7 announce what our AUM is. And it moves the stock  
8 immediately once it goes -- once that goes out.

9 So again, it's something that I think having the  
10 market understand clearly, what level of involvement the  
11 auditor has and doesn't have with that number is  
12 important.

13 MR. HARRIS: But what do you think the level of  
14 involvement of the auditor should be in that instance?

15 MR. NACHTWEY: Well I think it already is heavy.  
16 So I think you know, articulating what that involvement  
17 is, I think would be important.

18 MR. DOTY: We're at break. We're having a break.  
19 We have a great panel coming up.

20 Let's take 15 minutes. Let's be back here  
21 promptly at 10:45 if we can. Thank you all. And thanks  
22 to the panel. Extraordinary panel.

1           (Whereupon, the foregoing matter went off the  
2 record at 10:30 a.m. and resumed at 10:49 a.m.)

3           MR. DOTY: Good morning. The panel, whom we  
4 welcome, includes William Touche, the senior audit  
5 partner of Deloitte, in the London audit practice. He  
6 also leads Deloitte's UK Center for Corporate Governance.

7           And as a center leader, follows developments in  
8 the UK regulatory environment, the listing rules of the  
9 SSA, the FSA and the developments of the UK Financial  
10 Reporting Counsel.

11           William Touche is Deloitte's representative on  
12 the Audit and Assurance Faculty of the ICAEW and also  
13 serves on its corporate governance committee.

14           Philip Johnson, the Non-Executive Director of  
15 Yorkshire Building Society. Prior to joining that  
16 society, he was the head of Audit Quality and Risk  
17 Management at Deloitte, UK. During his 30 year tenure  
18 as a partner at Deloitte, he was a Board member, also  
19 served on the Structure and Risk Committee and  
20 Compensation Committee, and sat as the first Chairman of  
21 the Audit Committee.

22           Previously he was the President of the Federation

1 of European Accountants, a member of the International  
2 Auditing and Assurance Standards Boards, and the  
3 International Ethics Standards Board Consultative  
4 Advisory Groups.

5 He serves on the scientific committee of the  
6 World Congress of Accountants of 2014. And he's a  
7 current member of the PCAOB Standing Advisory Group.

8 Tony Cates is head of audit for KPMG UK, and also  
9 for Europe, Middle East and Africa. He joined KPMG in  
10 1987, qualified as a chartered accountant in 1990, was  
11 promoted to partner in 1998.

12 He spent a year on secondment to KPMG in Kuwait  
13 in the 1990s and has subsequently held a number of senior  
14 leadership roles in the firm, as well as serving a wide  
15 range of clients from owner managed businesses through  
16 to the FTSE listing across a number of sectors -- FTSE  
17 100 clients across a number of sectors.

18 Liz Murrall. Director of Corporate Governance  
19 and Reporting at Investment Management Association, the  
20 trade body representing the UK asset management industry.  
21 She monitors the developments in corporate governance,  
22 companies' reporting requirements, assesses the



1 implications for the industry, and where necessary,  
2 lobbies for change.

3 She represents the IMA on a number of committees  
4 including the Institutional Shareholders Committee, the  
5 CBI's Companies and Financial Reporting Committees, the  
6 Corporate Reporting Users Forum. She is the secretary to  
7 a cross industry group that liaises with the  
8 International Accounting Standards Board and the Main  
9 Accounting Practices on Reporting and Auditing.

10 Before IMA, Liz Murrall worked at a number of the  
11 main accounting practices providing consulting services  
12 to a variety of financial services consultants.

13 The experience and the expertise represented on  
14 this panel regarding changes in the auditor's report in  
15 the United Kingdom, have direct relevance for us and what  
16 we're trying to learn. And we appreciate your doing it.

17 Please begin Mr. Touche.

18 MR. TOUCHE: Well, thank you very much Chairman  
19 and members of the Board for inviting us here today.

20 And so I'm going to give you perspectives from  
21 the point of view of a practicing audit partner who  
22 issued one of the first audit reports under the new

1 regime. And that was for British Sky Broadcasting and  
2 their satellite broadcaster.

3 I thought I'd touch on three areas. And first  
4 why I believe extended auditor reporting is so important  
5 for the future of the profession. Second I'll share some  
6 observations gained from signing last year in July, one  
7 of these first reports.

8 And third, based on that experience, just a few  
9 observations on what works in the UK and some  
10 perspectives on what I perceive the challenges will be  
11 for the second year of reporting. Because I think we're  
12 all very excited about the first. But actually the  
13 second is also - you need to have a view on.

14 So to start, I thought I'd mention that I  
15 wouldn't be here today unless I was a big fan of the new  
16 regime. However a lot of the success of the regime in  
17 the UK is because at the same time as introducing the new  
18 auditor reporting, the FRC also introduced new  
19 requirements for Boards and for audit committees.

20 For Boards, to make two statements, first of all  
21 that the annual report is fair, balanced and  
22 understandable. And second, that it contains sufficient

1 information to explain the strategy, business model, and  
2 performance of the company.

3           So in addition to these, new requirements for the  
4 audit committee and its own reporting to shareholders,  
5 that they should examine the scope of the audit, and  
6 explain in their report to shareholders, the key issues  
7 that they considered and how they were resolved in  
8 respect to the financial statements.

9           So, and I know this is a hot topic here. In my  
10 view, this quite properly puts the communication  
11 responsibility for financial statement judgments on the  
12 company rather than the auditor.

13           And it also highlights and reinforces the role of  
14 the audit committee in supervising on behalf of  
15 shareholders, the production of the financial statements,  
16 the supervision of the scope of the external audit, and  
17 the resolution of key issues raised by the auditors, and  
18 doing that on behalf of shareholders.

19           So second, just a few introductory contextual  
20 remarks about B Sky B. It has a reputation as one of the  
21 most successful and innovative companies in the UK, well  
22 led by a management with a focus on its core mission.

1 And in common with many consumer-oriented companies, its  
2 focus and clarity is reflected already in its annual  
3 report.

4           So I was very pleased when the CFO and the CEO,  
5 Andrew Griffith and Martin Gilbert -- and Martin is a  
6 significant investor, he's the Chief Executive of  
7 Aberdeen Asset Management, a major institution investor  
8 -- agreed to take the lead in early adoption.

9           So first the importance of the new external audit  
10 report. So I've been a partner for about 18 years at  
11 Deloitte. We employ 15,000 people in the UK. And we  
12 recruit about 700 graduates into the audit practice. And  
13 all hugely talented people. And most of whom will use  
14 their training as a springboard for successful and  
15 fulfilling careers in finance and business.

16           Now for these people, the facts that the key  
17 matters we address in our audit work are now directly  
18 described in our public reporting, is actually rather  
19 inspiring for our new auditors. They're proud to see  
20 their work so directly described in an audit report. It  
21 underscores the public interest nature of our work at a  
22 time when the profession has had a pretty rough ride.

1           It invigorates their personal sense of  
2 responsibility and pride. And it underscores to them why  
3 quality is so important in everything that we do.

4           So from the perspective of Deloitte UK, we see  
5 the audit report as an opportunity to inform shareholders  
6 about the important work we do on their behalf. We're  
7 appointed by shareholders to form our view on the overall  
8 financial statements. The commenting now on the major  
9 areas of focus of our work actually seems quite natural  
10 in the public domain. Even just a few months of the new  
11 reporting regime.

12           So speaking as a member of the profession as a  
13 whole, thanks to the leadership of the FRC, and the good  
14 work of many others, I think we've been given an  
15 opportunity to reestablish the value of audit. And of  
16 course without being too sentimental, London's pretty  
17 proud that we've taken the lead out there.

18           And just as also we've taken a bit of the lead on  
19 our comply or explain governance model, which has helped  
20 the governance regimes' shape around the world, led by  
21 the FRC, the ICAEW and the EBRD as well. And that's an  
22 important part of the reporting structure.

1           So what were the experiences of the new extended  
2 auditor reporting? As I said Sky embraces it from the  
3 very first suggestion. The attitude of the company is  
4 very much if we can lead, then we will.

5           Now the new audit report drives auditors to  
6 describe the areas of focus that consume audit effort.  
7 And the matters that we chose to report on, record  
8 recognition, the recognition of programing costs when  
9 they're expensed, and the validity of capitalization of  
10 capital projects are those that do consume our audit  
11 effort. And are areas that are routinely discussed with  
12 the audit committee.

13           So the topics were already well aired. And there  
14 should really be no surprises for management or for the  
15 audit committee on any of the topics commented in audit  
16 reports. So from a communication perspective, there's  
17 a bit of a breakdown would have occurred if there are  
18 surprises at the 11th hour.

19           And the next question I thought would be of  
20 interest, if the topics are understood and well aired,  
21 were the words difficult to find to describe them. And  
22 that, in fact this proved to be uncontroversial as Sky's

1 hugely respectful of the work of the external auditor and  
2 of the reporting that we have to make under the standards  
3 that we follow.

4           So we had very little discussion about the choice  
5 of words. But in some companies that perhaps may be less  
6 respectful of the audit, maybe the auditor's latitude  
7 that provides a much more potent voice now with the new  
8 form audit report, actually should engender greater  
9 respect for the role of the auditor and for the  
10 profession. And probably greater engagement with the  
11 auditor by management and the audit committee. And I  
12 expect this will be one of the positive outcomes from our  
13 new regime.

14           I thought one of the challenges would be to  
15 figure out how many issues to report and the level of  
16 detail. But again, this proved to be quite  
17 uncontroversial. We actually -- I have a keen focus on  
18 trying to keep comments succinct, and again with the  
19 focus on year two, I think succinctness will be a  
20 benefit.

21           I've had shareholder representatives comment to  
22 me that it would be very helpful to flag in year two what

1 has changed. So following the less is more principle  
2 when describing the audit risks and responses would be  
3 a very good principle to adopt.

4 So to summarize, a few ingredients for success.  
5 Early discussion and communication. The company's robust  
6 governance that respects the role and work of the  
7 auditor. And remember that the audit report is about  
8 succinct communication with investors.

9 I think one challenge to be faced in the coming  
10 year is the proposed reporting on the internal controls.  
11 And you've obviously had internal control reporting here  
12 established for longer than we have. Under the proposed  
13 changes, it will be very interesting to see how our free  
14 form audit reporting develops.

15 So a few final lessons. One boilerplate  
16 disclosures are public enemy number one. Innovation and  
17 company specific tailoring could be stifled by requiring  
18 specific ordering or prescribing standardized language.  
19 And you can achieve comparability by achieving a limited  
20 number of defined headings, allowing freer form reporting  
21 under each.

22 And we're seeing in the UK a wide variety of



1 practice emerging based between firms and between  
2 individual partners. I personally like our opinion,  
3 which is focused on the audit effort rather than -- and  
4 leaving the audit committee to explain the judgments.  
5 And our opinions on the statement as a whole whether they  
6 show a true and fair view, it's up to the audit committee  
7 to explain their scrutiny of management's judgments.

8           And I think there needs to be real care and  
9 attention in explaining audit procedures. I don't think  
10 we should be going into a long laundry list of audit  
11 procedures.

12           And finally, and perhaps the most important  
13 point, is we're very lucky to have the governance regime  
14 that we have. Where the audit committee itself and the  
15 Board has to make these statements, which if you like are  
16 auditor reporting regime compliments.

17           So I hope that's been a helpful commentary. And  
18 a scene-setter for the panel discussion.

19           MR. DOTY: Thank you. Mr. Johnson.

20           MR. JOHNSON: Thank you Chairman and thank you  
21 for -- sorry, technology. Thank you Chairman and thank  
22 you for your kind remarks. And also for inviting me to

1 speak here today.

2 I am here in my capacity as an audit committee  
3 chair, thus representing a part of the non-executive  
4 director community. But I've also had great interest in  
5 seeing the audit profession move forward.

6 Having spent 30 years as an audit partner in a  
7 Big Four accounting firm, during which time I helped  
8 develop communication to audit committees. I had six  
9 years in Europe representing the accounting profession  
10 discussing changes to our profession and the auditor  
11 reporting model.

12 And now as a chair of one audit committee, and a  
13 member of another, at last I can say that we finally  
14 started to tackle the long standing information gap  
15 concerns, which so long has been described by  
16 stakeholders as an expectation gap.

17 You heard comments yesterday about how long it  
18 has been since there was a change in the auditor's  
19 report. 80 years was mentioned for the US and Nick Land  
20 commented about 150 years in the UK.

21 This 150 years goes back to the middle of the  
22 industrial revolution when trade expanded, companies got

1 bigger and external capital was sought in ever increasing  
2 amounts. The owners were not the managers anymore. So  
3 the audit as we know it, was formulated to give assurance  
4 to the owners that the financial statements properly  
5 reflected the company's financial position.

6           So having said that, it is quite clear to me that  
7 the purpose of the audit is for the auditor to inform the  
8 investor. Thus the need to provide more than just a pass  
9 or fail. Recognize that the pass or fail model is  
10 fundamentally important to the investor.

11           I appreciate that the UK has a different legal  
12 system and a different litigation environment. We also  
13 have a set of principles based standards rather than the  
14 rules based approach. The new audit reporting standard  
15 is only 16 pages long including the application material.

16           And therefore the auditor can use his judgment as  
17 to how to report on the requirements in the standard.  
18 Quite different to what is normal here in the US.

19           We heard from Nick Land yesterday that the new  
20 auditor reporting model in the UK caused some tensions  
21 between auditors and management. When I was working in  
22 Brussels, it was stated at one point by the European

1 commission, that they wanted to create some tension  
2 between the audit committee and management in order to  
3 create better corporate governance.

4           The question must be, is it tension or is it  
5 challenge? If it's the latter, then it can only be  
6 healthy. And for the audit, it can only result in a  
7 better quality audit.

8           So with this backdrop, let me focus a little bit  
9 on what happened in the UK. As we already mentioned, the  
10 FRC encouraged by Parliament and investor groups, first  
11 it looked at the corporate governance code for company  
12 reporting, focusing on the role of the audit committee  
13 and what it should cover in the audit committee report.  
14 And then as an audit standard center, look for changes  
15 to the audit report.

16           To give credit where credit is due, by looking at  
17 both audit committee reporting and auditor reporting, the  
18 FRC has addressed or moved a long way to addressing the  
19 shortcomings of two of the three legs of the corporate  
20 reporting stool. The third leg is the financial  
21 reporting framework, which also needs some changing. But  
22 two out of three is a good start.

1           This is why I think the SEC and FASB also have a  
2 role to play here in the US and not just leave change in  
3 this area in the hands of the PCAOB.

4           Turning to my personal experience of the changing  
5 environment in the UK, let me focus on the company where  
6 I chair the audit committee and what if any were the  
7 differences in reporting I've seen as a consequence of  
8 the changes.

9           By way of scene setting, we are a financial  
10 institution. The second largest building society in the  
11 UK with 55 billion dollars of assets. We are involved  
12 in savings and loans but also have a regulated financial  
13 advice business, have some complex financial instruments,  
14 undertook two significant mergers during the financial  
15 crisis and accounts under IFRS. As a consequence, we  
16 have a number of significant judgments to make each year,  
17 and also carry some significant risks.

18           So at December 31, what did our auditors report  
19 on? Well let me start by saying that their comments were  
20 merely on the risks, which could result in material  
21 misstatements in the financial statements relating to  
22 critical accounting policies and estimates and the

1 judgments made by management.

2           Firstly, let it be said that the audit opinion,  
3 i.e. the pass or fail opinion, came right up front in the  
4 first paragraph. So no confusion there. Which was a  
5 concern expressed yesterday by some presenters.

6           They made specific comments about going concern  
7 and the work that they had undertaken. But also had to  
8 comment whether they had identified any material  
9 uncertainties that cast significant doubt on the group's  
10 ability to continue as a going concern.

11           They helped to define materiality and the level  
12 of audit differences that would be reported to the audit  
13 committee. That was covered yesterday, so no need to say  
14 more now.

15           The most significant change however, was the  
16 requirement to identify the areas of risk that our  
17 auditors consider could give rise to material  
18 misstatement in our financial statements. And how the  
19 audit scope responded to those risks.

20           Our audit, the risks identified were loan loss  
21 provisions, particularly important due to the change in  
22 economic levers; fair value adjustments, an important

1 judgment as we set those provisions a few years ago when  
2 economic conditions were quite different; revenue  
3 recognition; provisions to customer remediation as a  
4 result of some legacy and current issues identified by  
5 the regulator where we had to make provision for future  
6 payments to our customers; and potential fines to the  
7 regulator.

8 Capitalization of costs. We're undertaking a  
9 very significant upgrade of all our business systems over  
10 the next years. With both internal and external experts,  
11 and totaling hundreds of millions of pounds.

12 Hedge accounting, treasury instruments where  
13 there is no active market and deferred taxation. Again,  
14 reasons articulated yesterday.

15 You can see from this list, the risks require the  
16 company and the auditor to exercise a high level of  
17 judgment. And all or a combination of any two or more  
18 could have a very significant impact on the report of  
19 profit and the financial position of the group. As a  
20 financial institution, those matters were seen to be  
21 useful to the understanding of our financial position.

22 In the Rolls Royce audit report mentioned so

1 often in the submissions yesterday, the risks identified  
2 centered on revenue recognition, recoverability  
3 intangibles, accounting for subsidiaries and associates  
4 due to the many collaboration agreements, liabilities  
5 arising from sales financing arrangements, bribery and  
6 corruption, and presentation of underlying profit.

7           Very important to understanding the Rolls Royce  
8 position so tailored to that company's circumstances.  
9 But quite different from those disclosed in my  
10 financials.

11           So what about the audit committee and the auditor  
12 engagement? Was there any difference? Compared to  
13 previous years, there was certainly more engagement  
14 between the members of my audit committee and the  
15 auditor. This was partly due to the enhanced audit  
16 committee reporting. But also due to the changes in the  
17 audit report.

18           Both were new requirements in 2013. We had  
19 common interests to say what we had done and why we had  
20 done it. There was early engagement and improved dialog  
21 during the audit process. The audit committee were more  
22 engaged during the audit planning phase, focused heavily



1 on key matters within the financial statements, and were  
2 far more engaged with management and the auditors to  
3 ensure appropriate judgments were being made and that the  
4 reporting of these judgments was appropriate.

5           There was more detail provided by the auditor to  
6 the audit committee as to how they had satisfied  
7 themselves on the key judgments. And there was more  
8 challenge to management.

9           As far as the audit team were concerned, the  
10 members were far more aware of what was important in the  
11 business. And they seemed to share a higher level of  
12 skepticism and overall challenge while doing their work.

13           So let me say some concluding remarks. From my  
14 experience across two audit committees with two different  
15 audit firms, I am certain that the quality of the audit  
16 was improved as a consequence of the changes brought in  
17 by the FRC. It also helped to move away from boilerplate  
18 reporting. Every company is different.

19           So the risks and significant matters identified  
20 need different disclosure. I don't subscribe to the  
21 notion that the auditor will revert to boilerplate.  
22 There will be refinements made in the future. But I

1 think the auditors recognize the need to inform, not just  
2 comply.

3 Another added value as a result of better auditor  
4 reporting will be that across a number of years,  
5 stakeholders will be able to identify any changes in the  
6 risk profile within a company. Another helpful piece of  
7 information to all stakeholders.

8 Nick Land mentioned that he did not expect a  
9 change next year in the Vodafone audit report. But if  
10 there was a change and new risks were emerging, then that  
11 really is information worth having.

12 Another positive is in relation to identifying or  
13 helping identify sector issues. Analyzing audit reports  
14 across particular sectors can inform on emerging issues.  
15 We tend to focus on the concern of a company analysis of  
16 competitor-disclosed information. It could be that when  
17 you do the analysis, one company stands out as a outlier,  
18 thus prompting questions to be asked.

19 So let's focus on the positives coming out of  
20 enhanced reporting rather than have a fixation on the  
21 negatives. We need consistency however in auditor  
22 reporting irrespective of the jurisdiction where a

1 company resides.

2           It would be better if we could have just one  
3 reporting model across all jurisdictions. But the  
4 current PCAOB proposals helped us move closer together.  
5 I think looking at the risks rather than looking at the  
6 effort should be considered by the PCAOB. But no one  
7 party will get everything right the first time. We will  
8 improve matters and regulation will evolve just like  
9 everything else. Darwin said evolution is a given. We  
10 should all take heed of this and evolve.

11           If the US does not embrace change, I'm sorry to  
12 say this, but in my view it would be nonsense if the  
13 largest capital market on earth, provided the least  
14 amount of information to the investor community on the  
15 key matters influencing the financial information on  
16 which those investors are making their decisions.

17           In the UK, in the rest of Europe and  
18 internationally through IAASB, the wind has changed. Let  
19 us sail in the same direction. And I would encourage the  
20 PCAB to move forward just as the rest of the world is  
21 moving forward.

22           MR. DOTY: Thank you. Tony Cates.

1 MR. CATES: Thank you Chairman. Chairman it's my  
2 guess that when Nick Land and now UK regulators chose an  
3 accelerated timetable for our review of audit reporting,  
4 that was because they wanted the UK experience to be  
5 something that others could benefit from.

6 So I'm very happy to be here today and to talk  
7 about what we've been doing in the UK. Let me start by  
8 saying, you know, why I think that reform was needed.  
9 The catalyst was obviously the financial crisis. But  
10 perhaps this just brought to the surface an issue that  
11 had been around for some time - a decline in  
12 shareholders' trust in companies and in audit.

13 Audit should have been playing a key role in  
14 creating trust between shareholders and their companies.  
15 But it became apparent that it wasn't delivering all that  
16 it could.

17 Now to me as an auditor, the value of an audit is  
18 very clear. But to the shareholder, the binary audit  
19 opinion, just wasn't delivering it.

20 So I think it was absolutely right that we needed  
21 to make a bold move on a long form audit report. To say  
22 what we thought the issues were and what we did about

1 them. After all, auditors are for shareholders. So  
2 shouldn't we deliver more of the value that comes from  
3 our work directly to those shareholders, not just by the  
4 audit committee.

5 Now in terms of putting that into practice, it  
6 may be easier for the UK to do that. In UK law, our  
7 audit reports are for and addressed to shareholders as  
8 owners only, rather than as traders of shares. Using the  
9 audited accounts to hold directors to account. And  
10 that's not necessarily the case elsewhere.

11 Now in practice, my biggest worry was the short  
12 timetable and a very short auditing standard. Just five  
13 paragraphs. However, there was wide recognition that the  
14 regulator had laid down a challenge to use those few  
15 words to show the value of audit.

16 And with the UK's less fiercely litigious  
17 environment, it was easier for us than perhaps it may be  
18 here, to respond to that challenge on the basis of just  
19 five paragraphs. Essentially we did that by learning on  
20 the job on our September year-end reports. And  
21 converting that experience into firm-wide policy and  
22 guidance and rolling it out across the firm, with a

1 central team to provide support and a measure of  
2 consistency in our approach.

3           So what was the critical deliverable for us? We  
4 saw that as the description of our work on the key risk  
5 areas. And it's this, not say the materiality figures  
6 which were also required, that really demonstrates the  
7 value of audit. By showing how we brought our experience  
8 and independent mindset and skepticism to bear.

9           That demands that we flag the key things that we  
10 have to test. So not just that we had to test the  
11 subjective assumptions in the risk area, but specifically  
12 which assumptions. And not just that you tested them,  
13 but how you applied your outsider's perspective with a  
14 bench marking against data, or against your own views of  
15 say growth potential in the sector or for the specific  
16 client.

17           When we did our KPMG survey of first movers, and  
18 at that point only 19 companies had reported in  
19 mid-January, this was the area where we found most  
20 variety. Not surprising for the most difficult aspect  
21 of the new UK reporting.

22           The UK's new reporting by describing some of our

1 audit procedures, inevitably begs a question. What more  
2 can the report say about for example, what the auditor  
3 found in his testing? At KPMG in the UK we thought this  
4 question should not be left hanging, but should be  
5 tackled face on.

6           So in order to promote debate about that, about  
7 the value and about the challenges, we've tested out the  
8 idea in a very small number of reports and we've heard  
9 about that just earlier, by also giving the findings of  
10 our work in each risk area.

11           That debate has only just started and I'm not  
12 here today to promote any kind of position on that. But  
13 I do think that you and your stakeholders debate as you  
14 debate the way forward for the US, you might want to have  
15 one eye on the question of where it could lead in the  
16 future.

17           So back to the existing reporting model in the  
18 UK. Is it a challenge to do this kind of reporting?  
19 Yes, it is a challenge. Is it worth doing? Absolutely  
20 yes.

21           But at the same time, we shouldn't fool ourselves  
22 that better auditor reporting is the answer to preventing

1 future financial crisis. It can only ever be part of the  
2 solution, and focusing on the adequacy of corporate  
3 reporting, of corporate governance and stewardship, are  
4 all fundamental prerequisites, without which improved  
5 auditor reporting will mean nothing.

6 Thank you.

7 MR. DOTY: Thank you. Liz Murrall.

8 MS. MURRALL: Thank you Chairman. And good  
9 morning. And thank you very much for inviting me here.

10 I very much welcome this opportunity to give an  
11 investor's perspective of the changes that the FRC  
12 introduced to audit reports in the UK, and the improved  
13 transparency around the audit process that we now have.

14 I'm here on behalf of the Investment Management  
15 Association, the trade body for the UK asset management  
16 industry. Our members include the asset management arms  
17 of the investment banks, the retail banks, the insurers,  
18 the managers of occupational pension schemes and  
19 independents.

20 We have around 220 members in total, and  
21 collectively, they have about 4.5 trillion of assets  
22 under management globally. 67 percent of those holdings



1 however are held in companies listed outside the UK.  
2 They're held internationally.

3           This means that our members are major investors  
4 in companies.    And they have an interest in the  
5 requirements governing the preparation and audit of these  
6 companies' accounts and the information disclosed to them  
7 as users.

8           So what do investors want from the annual  
9 reported accounts, and the assurance and audit of that  
10 information? Essentially the accounts are a confirmatory  
11 document published some time after the events to which  
12 they relate. They're about management's accountability  
13 to its investors. The shareholders who put up the risk  
14 capital and bear the residual risk.

15           Management is entrusted with shareholders' funds  
16 and corporate reports should show how those funds are put  
17 into use and performance derived from them. Accounts  
18 show the accountability with stewardship of management.

19           The fact that these accounts are subject to an  
20 audit is vital to investors' confidence in those  
21 companies, and the markets value the information and  
22 investors believe what they're told about their investee

1 companies. If that presumption was exposed as faulty  
2 then the system could seize up.

3           Nevertheless, investors have had concerns about  
4 the quality of the audit, the auditor's accountability  
5 and transparency to investors for some time. Certainly  
6 well before the financial crisis. Many of these concerns  
7 were a product of the fact that investors felt excluded  
8 from the audit process and the real findings. They were  
9 largely invisible.

10           And whilst as we've heard, the binary opinion,  
11 pass or fail, is very important, the audit reports  
12 otherwise tended to focus very much on details of what  
13 the auditor did not do, rather than what they did.

14           It's been said that 91 percent of investors do  
15 not read audit reports. I don't think that's surprising  
16 given what's in them. But I would actually refute that.  
17 I think investors do look at the audit reports, but it's  
18 very quick. Just to see whether or not it's qualified  
19 or not and who did the audit.

20           All this did the profession a disservice and some  
21 investors were questioning the value of the audit. This  
22 needed to be changed and trust reestablished. Tony has

1 mentioned trust in his opening statement.

2           The FRC's framework was a welcome part of that  
3 change in introducing a more enlightened audit report.  
4 This was a big leap forward. It is the most significant  
5 advance in auditor reporting in decades. And a challenge  
6 has been thrown down to auditors and a competitive edge,  
7 if you like almost, introduced into audit reporting.

8           And whilst the 30 or 40 examples of the new style  
9 reports are quite mixed, this is an evolving process,  
10 investors are very positive about the changes.

11           So what has changed? First the FRC requires  
12 auditors to disclose audit materiality. This should mean  
13 that investors are better able to assess the quality of  
14 those reports. Currently we have few indicators or no  
15 indicators of that.

16           Most importantly, the new audit report tells  
17 investors what the auditor assessed, as we've heard, the  
18 main risks of material misstatement. Effectively what  
19 the critical accounting policies and estimates were.

20           What is important here is that it's not a kitchen  
21 sink approach, but a risk-based approach. Investors  
22 don't want a laundry list of procedures. What they need

1 to know is why something was a risk of material  
2 misstatement, what the auditor's response to that risk  
3 was, and also what the outcome was.

4           This information will help investors identify and  
5 understand the significant judgments in the accounts.  
6 It gives them a hook to further challenge executive  
7 management and hold the audit committee and external  
8 auditor to account.

9           This greater understanding should contribute to  
10 the relationship between management and investors,  
11 enhanced trust, and ultimately, in the long term, reduce  
12 the cost of capital and increase the value generated for  
13 investors and the end beneficiaries, their clients.

14           So what have we found? Well the requirements  
15 were effective for accounting periods starting on or  
16 after October, 2012. And I think it was commendable that  
17 certain companies adopted early. As William said, B Sky  
18 B did and also Ashmore and Vodafone. And I think  
19 Vodafone was producing annual reports in accordance with  
20 this while the ink was still drying on the revised  
21 standard.

22           Concerns were raised yesterday whether the

1 information could be market sensitive. As I've said, the  
2 main role of accounts is as a confirmatory document to  
3 the market. They're historic and produced some time  
4 after the period to which they relate.

5           The information that is price sensitive has to be  
6 disclosed under the market abuse regime. And as for  
7 investor's decisions themselves, they're more likely to  
8 be made around the preliminary announcement or investor  
9 road shows than through the accounts.

10           But the key thing and the important thing is that  
11 all this information that is out there can be tied back  
12 to the accounts and that these accounts have been  
13 independently assured.

14           There were also concerns yesterday whether this  
15 reporting could result in mixed messaging. We don't  
16 believe that is the case and we haven't seen that to  
17 date. I think it's important to remember that the  
18 preparation of the accounts is the responsibility of the  
19 company and its Board and they should made the necessary  
20 disclosures about the company's position and performance.

21           As regards to the transparency we're discussing  
22 here, only the auditors can report on what they actually

1 did and what they found. However one of the concerns  
2 that we did have is whilst the FRC's requirements tells  
3 investors of the key risks and how they were addressed  
4 in the scope, I think it's -- many of us are asking  
5 questions why it didn't go further. And ask what did you  
6 find. How aggressive or cautious did the auditor find  
7 the company's estimates or judgments.

8           This is something that's already subject to a  
9 dialog between the audit committee and the auditor. And  
10 investors would value this insight too. And I think  
11 we've heard that there are certain reports. And there  
12 are two that I can name, Rolls Royce and UL Resources  
13 that have actually gone that step further and reported  
14 what the auditor found.

15           Lastly, several standard setters are looking a  
16 proposals to change the audit report. As I said at the  
17 outset, 67 percent of all equities managed by our members  
18 are held internationally. Investors want harmonized  
19 international standards for audit reports.

20           And whilst we recognize there is some consistency  
21 in a number of the proposals, unintentional and  
22 unnecessary differences should be avoided. And as Philip

1 has said, we would encourage the PCAOB to follow the  
2 steps that have been taken internationally.

3           To conclude, investors have had concerns about  
4 audit quality and the transparency of the audit process  
5 for some time. Steps are being taken to address this and  
6 the FRC's package of reforms enjoys the support of the  
7 investment community - the real end client of the audit  
8 process.

9           Thank you.

10           MR. DOTY: Before I recognize Jeanette Franzel,  
11 let me say that while delivered in a very understated  
12 British way, these four statements contain bombshells.  
13 They are in fact terrific statements. Jeanette.

14           MS. FRANZEL: Thanks for coming today and sharing  
15 your insights and experience. This is very valuable to  
16 us. A couple of you made comments about the need for  
17 international -- or for standards to sort of come  
18 together internationally. And we've got KAMs, we've got  
19 CAMs, and we've got the UK approach.

20           And so I'd be interested on your views as to  
21 maybe the risks that we're currently facing and how can  
22 we bring all of these proposals closer together. But

1 also I'd like to hear about advantages and disadvantages  
2 that you've experienced from the UK approach that maybe  
3 we should think about as we move forward with our  
4 proposals. So start with Mr. Touche.

5 MR. TOUCHE: Looking forward to year two. I mean  
6 if you look back at year two and you've got a huge amount  
7 of variation across border, and we've got significant  
8 variation in the UK with companies or firms or partners  
9 doing different things, I think it could lead to some  
10 frustration.

11 So I would encourage standardization with the  
12 user in mind. And so anything you can do to harmonize  
13 and lead with all these various definitions and drive an  
14 international consensus would be very, very helpful, with  
15 the user in mind.

16 MS. FRANZEL: Any advantages or disadvantages  
17 from your experience that we should keep in mind?

18 MR. TOUCHE: I mean from the perspective of the  
19 dialog with companies which is you know, not the source  
20 of my invitation today, I think the primary  
21 responsibility for commenting on judgments, as I said  
22 earlier, should be with management.



1           Now as I said, we're blessed with a regime where  
2 the audit committee is required in the UK to report on  
3 judgments. And I think that regime does not exist in  
4 many parts of the world. Including perhaps as much as  
5 you would like here.

6           And so I would encourage some evolution of the  
7 responsibilities for audit committees to report on key  
8 judgments in relation to the financial statements as part  
9 of a package of measures.

10           MR. CATES: Just from my perspective, I think  
11 some commonality is a good thing. But actually we are  
12 operating in different environments. And having you  
13 know, learning from each other as we evolve, could also  
14 be seen to be a good thing.

15           So there would be some positive things about  
16 having slightly different approaches. I think in the UK,  
17 the short brief kind of overview standard, the five  
18 paragraphs I referred to, actually enabled us to be quite  
19 innovative in the way we were doing things. And so  
20 different partners and different firms have taken  
21 slightly different approaches. And I think that's  
22 benefitted all of us actually because it will help us

1 evolve a much better product in the long run.

2 MS. MURRALL: I think in terms of trying to align  
3 the requirements internationally, I think what we've seen  
4 from the European Commission and we've seen from the  
5 IAASB and the FRC, is they're actually focusing on things  
6 like material misstatements, significant risks.

7 So it's getting away from ensuring that we have  
8 a sort of laundry list of issues. And I think that would  
9 be very helpful. And just the terminology itself is  
10 going to confuse -- could potentially confuse the  
11 international markets if that could be aligned.

12 As to the advantages and disadvantages as to what  
13 we've seen in the UK, and I think there have been a lot  
14 of advantages in terms of opening this Pandora opening  
15 this black box so that we can see what happens in the  
16 audit process. And I think that is going to help the  
17 dialog between auditors, management and investors going  
18 forward.

19 But the potential disadvantages is potentially as  
20 we heard yesterday, as to whether or not this could  
21 become boilerplate over time. And if it's not read, then  
22 it's not going to be any use to anybody if that does

1 happen. I think there are various safeguards to prevent,  
2 to help that.

3           The fact that the standard itself is very high  
4 level and principles-based, and gives the firms a lot of  
5 flexibility in terms of what they're reporting. And also  
6 was saying a lot of sort of change in the audit process.  
7 There's been a lot of pressure and there's been sort of  
8 a regulatory proposals for mandatory rotation and  
9 tendering. So we're going to have more change of  
10 auditors. And I think that will bring a fresh pair of  
11 eyes to this reporting and change this.

12           And of course it is different in the UK in that  
13 we have a different sort of corporate governance regime.  
14 We operate very much with -- under company law with  
15 shareholders having certain rights to monitor and respond  
16 to what happens in companies. And a very strong role for  
17 our audit committees, which is not necessarily shared  
18 internationally.

19           MR. DOTY: Jay Hanson.

20           MR. JOHNSON: I was only just going to add a  
21 point. That when I, and Martin was also in the IAASB CAG  
22 and when they were talking about this project for ISA

1 700, they were coming up with all manner of things. And  
2 I think that there -- they took on board I think that the  
3 auditor can't second guess what all the stakeholders will  
4 want to see from the audit report.

5           And I think that is absolutely critical that what  
6 is reported is useful information. But doesn't lead  
7 people down the road through the financial statements and  
8 pinpoint certain things that you ought to look up. You  
9 have emphasis -- if something's so important, you have  
10 an emphasis matter paragraph.

11           But I think that you do have to be careful that  
12 you don't take away from the user, the ability to read  
13 and inquire. And that was a good move. And I think that  
14 evolved through the process.

15           So I would -- all I would say as far as the PCAOB  
16 is concerned, it is good not to be too prescriptive and  
17 good not to as the chairman was talking about yesterday,  
18 leading the witness.

19           MR. DOTY: Jay.

20           MR. HANSON: Question for the gentlemen that have  
21 actually had to do this one time now. It's a two part  
22 question.

1           One is my observation about the ability to  
2 describe the risks, the materiality and then the scope  
3 of the audit, how it addressed the risks. That for the  
4 well-organized, proactive engagement team, that could  
5 pretty much be done at the time you've completed your  
6 planning for the engagement. And look back at the end  
7 to say well gee, did anything new come up for new risk  
8 or anything unintended that we need to do to change how  
9 we describe the scope.

10           And so I just want your thoughts to do it -- did  
11 I get that right? That's effectively what, and setting  
12 aside maybe the first year of implementation challenges,  
13 but that's directionally what your new standard is  
14 suggesting.

15           But then also to connect to something that Ms.  
16 Murrall said. That that's one level of helpfulness for  
17 investors, but the more helpful thing is going to be so  
18 what? What did you find? And maybe your thoughts about  
19 the practical implications of how difficult that may be  
20 at the end of engagement, to then describe, what did you  
21 find?

22           MR. CATES: I think in terms of the actual risks,

1 what we're really doing to some extent is describing the  
2 risks that we described to the audit committee at the  
3 outset of the audit. And we monitor them through the  
4 audit and we focus our attention on them. And we comment  
5 to the audit committee on them at the end of the audit.

6 And in some sense, it's a frustration, or has  
7 been a frustration that actually we have that focus and  
8 that debate. And really, you know focus on those risk  
9 areas through the audit. And then historically just come  
10 up with this binary audit opinion and no one really knows  
11 what we focused on.

12 So actually, it's been a release in a way to be  
13 able to say you know, actually these are the things that  
14 we did focus on. And ordinarily and for well-run  
15 businesses, you will find that you know what those risks  
16 you expect to be at the outset and you follow them  
17 through. But you're also ready to be flexible at the end  
18 and to be skeptical about what new risks might come up  
19 towards the end of the audit.

20 So I think that ties in very well with the audit  
21 committee reporting you know, for sure. Now the second  
22 part of your question related to the so what question.

1 And we've released -- KPMG has assigned two reports now,  
2 the Rolls Royce report and the New World Resources, which  
3 Liz mentioned, where we have put some additional  
4 commentary on.

5           It was with some trepidation that I authorized  
6 those approaches and it is one audit partner that has  
7 done that. And we spent a lot of time thinking about  
8 that. And I'm not really -- we didn't do that with the  
9 intention of doing that in a more widespread way. We did  
10 that with the intention to really be bold and to start  
11 a debate.

12           So we haven't really decided where to go with  
13 that in the future. But clearly it has kicked off a  
14 debate. I think again, what we're doing in that  
15 situation is being even more open about the type of  
16 discussion that we have with the audit committee.  
17 Because we would always have that sort of discussion as  
18 to how you know, the level of judgment involved in  
19 provisioning and where the company sits on that.

20           I do feel that you know, it might be -- it will  
21 be difficult in the long -- it will be difficult in the  
22 short term should I say, to actually you know, do that

1 with a wider number of companies. But I'm glad we've  
2 kicked off that debate at least.

3 MR. TOUCHE: So yes for sure in the transition  
4 year in particular. Most of our clients wanted to see  
5 what the audit report would look like before we had done  
6 the pass.

7 So yes, when you present your planning paper, the  
8 chances are most of our partners have also presented an  
9 outline of what it might look like. And that's just good  
10 communication. It allows the annual report to be  
11 constructed in a cohesive way.

12 It allows the audit committee to start thinking  
13 about how they're going to describe the key risks and  
14 judgments that they're responsible for making. So that  
15 they can start thinking about their language and so on.

16 So that up front communication is essential. And  
17 if there's fear in transition, that de-risks and removes  
18 quite a lot of that fear in that transition period.

19 Just coming back to the so what. And the  
20 commentary on individual judgments. And as Tony said,  
21 I think there is a debate to be had that's only just  
22 beginning. My -- and of course the fear is that by



1 commenting on individual items in the financial  
2 statements, you take away from the true and fair view as  
3 a whole. It clearly provides color to that. Because  
4 there is a range of judgments that all add up.

5           And we were just talking with Liz earlier and you  
6 know, the problem is if you need to go down this path and  
7 you say oh, you could have done this, or you could have  
8 done that. Or it's a bit cautious, or a bit aggressive  
9 here. Investors of course will want to know well,  
10 supposing you added all that up, what would the impact  
11 be. And then you get an alternative set of numbers.

12           So this debate will run its course. And I hope  
13 that we'll end up with an opinion on the -- a view that  
14 reinforces the opinion on the financial statements as a  
15 whole rather than a whole list of individual opinions on  
16 individual judgment areas.

17           MR. JOHNSON: Can I just make one point from the  
18 audit committee experience. Certainly when we had the  
19 report from our auditors to the audit committee, they  
20 did, because of all the areas that they were covering,  
21 they did put us onto a spectrum.

22           So each individual item that I commented about

1 before, whether it was loan loss provisioning, whether  
2 it was fair value, et cetera, et cetera. And certainly  
3 valuation methods and results. There was, all those were  
4 on a spectrum.

5           We found out as a board -- well as an audit  
6 committee and then subsequently that was taken to the  
7 board. We found that very useful to assess where we were  
8 compared to our peers. Because the auditors did have  
9 insight of what was happening in the market, what was  
10 happening in that class.

11           So we were much more comforted by the fact that  
12 we had that information available to us as a board. Now  
13 the question then is should that be rolled out. I am  
14 very much aligned with William, with having some caution  
15 about having a whole series of mini-opinions. The audit  
16 opinion is the financial statements as a whole.

17           So if we're actually -- if you, it depends how  
18 far it goes to what is described. Because I wouldn't  
19 like to be in the position where every major judgment  
20 area on my balance sheet had a mini-opinion on it.

21           But I think it is -- you know I think it is a  
22 debate that needs to take place. And I know that it is

1 already started. And the interesting thing for me is  
2 that we're now only, we're six months in. That's all we  
3 are. Sixth months in. There's only been 40, 50,  
4 whatever number of reports that have taken place.

5 And already, the auditors are starting to talk  
6 about what more they can do. What more information that  
7 they can get, rather than go the other way around and  
8 saying well, after the first round perhaps we went a bit  
9 too far with this or a bit too far with that.

10 So I think that's an interesting dynamic as far  
11 as the audit firms are concerned. Is that they're  
12 looking to moving it forward even more. Whereas in the  
13 past there had been reticence to do anything.

14 And so I think that's encouraging. And certainly  
15 from an audit committee perspective, we like to know  
16 where we sit on that spectrum, and we don't want to be,  
17 you know we are a conservative financial institution.  
18 So we don't want to be having racy policies and racy  
19 judgments. And it does help us to ensure that we're not  
20 in that space.

21 MS. MURRALL: Thank you. I mean I think  
22 investors do want to know where management's judgments

1 lie. And what the audit work was done on that and the  
2 assurance gained by it.

3 And if we look at the requirements as they stand,  
4 the audit committee is required to report on the  
5 significant issues on what they did. The auditor is  
6 required to report on the risks of material misstatement  
7 on what they did. But no one is required to report on  
8 what they found. Investors want that information.

9 MR. DOTY: Thank you. Lewis.

10 MR. FERGUSON: Yes, as I understand it at the  
11 present time, these requirements are limited to a subset  
12 of public companies, whether it's the FTSE 350 or  
13 whatever it is I don't know, but it's a subset.

14 So I have two questions. One, what do these new  
15 requirements do to audit costs and/or fees? And two,  
16 will it be and should the requirements be expanded beyond  
17 the original subset of companies? Should they be applied  
18 to all public companies for example? Or all audits?

19 MR. CATES: In terms of -- you're right, it's  
20 limited to companies actually that comply with the  
21 combined code which is largely the FTSE 350 and some  
22 others that comply voluntarily.

1           In terms of costs, I heard Nick Land say  
2 yesterday that they didn't think there was any cost. I  
3 mean I can ensure you there is some cost. The -- it's  
4 not so much getting the issues together. We've already  
5 got those issues together for the audit committee. But  
6 it's actually you know, drafting the statement and having  
7 some form of quality control over the audit opinion.

8           You know so at KPMG in the UK, we issued around  
9 80 opinions in total. And some in the future. And  
10 actually we have a centralized process and we set aside  
11 not just our technical people, but some of our best  
12 client-facing partners to also review those opinions, so  
13 we could get some best practice.

14           So all of that costs. But it's not a huge cost.

15           MR. FERGUSON: Were those passed on in higher  
16 fees?

17           MR. CATES: And in most and many cases yes. They  
18 were passed on in higher fees. But not -- I wouldn't say  
19 that significant fees.

20           Should it be expanded to other companies? I  
21 think it covers the main companies that investors are  
22 invested in. It's probably more a question for Liz than

1 me.

2 MS. MURRALL: Yes, I mean it covers all companies  
3 that are required to adhere to the UK corporate  
4 governance code. That is a premium listed segment in the  
5 UK. And that is the main UK listed companies.

6 I suppose one of the concerns that I do have is  
7 increasingly we're seeing overseas companies come to the  
8 UK to list. And they may have significant operations in  
9 countries that may not have the same auditing standards  
10 and it's how they're going to actually adhere to this  
11 going forward. I think that could be a difficulty for  
12 them. Because you need uniformity in the list.

13 As regards the costs themselves, as regards to  
14 investors. Auditors are scrutineers on behalf of the  
15 investor community. We don't have any issue with what  
16 it costs, although obviously we wouldn't want to see the  
17 costs should be any cost increases should be reasonable.

18 But I think in terms of that, particularly the  
19 increased tendering we're seeing, I think there is a  
20 concern to whether or not the audit tenders could compete  
21 on cost. And I think it's very important that that  
22 process is owned by the audit committee such that cost

1 doesn't drive the decision and its quality. Thank you.

2 MR. TOUCHE: I echo what Tony has said. And I  
3 think it's worth just bearing in mind that the auditor  
4 reporting regime was introduced with a package of other  
5 measures for boards and audit committees. So that helped  
6 if you like in the whole company redesign of annual  
7 reports in the last six months, which also has been a  
8 modest additional fee. But as Tony said, not enormous.

9 MR. JOHNSON: Our fee went up really marginally.  
10 There was no significant increase in those costs  
11 certainly as far as the company was concerned. I don't  
12 know whether the auditors will be looking at their  
13 margins next year, having gone through the experience and  
14 how much time they did have to put into it.

15 But certainly from the first year that we  
16 experienced it, it didn't increase the costs. Whether  
17 it should go any broader, in the UK of course we --  
18 there's a large number of companies other than the FTSE  
19 350 that are subject to audit.

20 From a personal perspective, if you have stock  
21 listed on a stock exchange, then why shouldn't you have  
22 -- why shouldn't you give this -- why shouldn't the

1 auditor give this information. You can easily lose  
2 money. The investor can easily lose money on small  
3 companies as they can with large companies.

4 So I think it's not necessarily a size - from my  
5 perspective, it's not necessarily a size issue. It's the  
6 fact that you have external shareholders investing in  
7 your company. And I think that you have to have that  
8 mindset. And a lot of the companies, if it goes down to  
9 private companies, which in the UK a number of private  
10 companies do have a foundation to have audits.

11 Then, when you've got management and owners, it's  
12 a small group. I don't think there is a need to do it  
13 across the whole spectrum.

14 MR. DOTY: Steve Harris.

15 MR. HARRIS: Well Mr. Touche, first of all, I  
16 commend you on your testimony. And when you say without  
17 becoming too sentimental, I don't think you were at all  
18 sentimental.

19 But I do think your testimony was extraordinarily  
20 powerful. Especially in light of the testimony that  
21 we've had the previous day. And the way that you grasped  
22 at the opportunity and the pride that you took in your



1 profession. And the way that you relished the challenge  
2 to reestablish the value of the audit.

3 And the public interest nature of our work and  
4 how it invigorates their personal responsibility, the  
5 auditor. And how important it is what you're doing on  
6 behalf of shareholders, and if we can take the lead, we  
7 will. I think that view was shared by all of you.

8 But I just want to say that that is in  
9 juxtaposition to some of the comments that we've heard  
10 the previous day. And I for one very much appreciate the  
11 understated way that each of you communicated that  
12 message.

13 I guess I have two questions. One, you all speak  
14 about investor groups and the outreach to investor  
15 groups. And Liz let me take you out of this conversation  
16 for a moment because you are generally viewed among the  
17 investor constituency as an investor advocate. And I say  
18 that from my perspective in a very positive sense of the  
19 word.

20 In the United States, investors are often  
21 criticized as not having any idea really what they want.  
22 Not speaking with one voice, not having a bottom line.

1 And the profession being unable to glean what investors  
2 want.

3           Two parts of the question. One, could you  
4 describe a little bit of your investor outreach in the  
5 UK. Who are these investors and how much money do they  
6 have under management?

7           And second of all, do they speak with anything  
8 even remotely approaching a unified voice in terms of what  
9 they want and in terms of a bottom line.

10           MR. TOUCHE: First of all, thank you for your  
11 very kind comments. And I think we're all very pleased  
12 to be here to make a contribution to your debate.

13           Yes, we're very lucky. I mean London is you  
14 know, a very large capital market. All of us who are  
15 practicing there in London, head offices of the big four  
16 firms all located within you know probably half an hour's  
17 walk of most of the investor groups' offices. And there  
18 are probably only you know ten or a dozen people that we  
19 need to know. And we are in very regular contact with  
20 the representatives of the investor groups, of which you  
21 know, Liz is one.

22           So it's been very strong and open dialog both

1 between the firms and the investors and the regulators  
2 and the investor groups. And that dialog has been not  
3 necessarily in plenary forum. It's been one-to-one.  
4 We've been exchanging messages and emails, and all the  
5 rest of it with people as this thing has evolved.

6           So it has encouraged an open dialog. And as far  
7 as our firm is concerned, two years ago we have -- we  
8 instituted an annual general meeting where we invite  
9 stakeholders, the public interest to come and hear what  
10 we're doing on audit quality and innovation and all those  
11 other things. We started that a couple of years ago.

12           That's gone down very well with the investor  
13 groups. And it's their opportunity to quiz us in the  
14 form of an annual general meeting, about what we're  
15 doing. So that's part of our public interest agenda.

16           As far as engagement with the companies is  
17 concerned, which I think is the other part of this  
18 question. I think this is all quite new. Liz mentioned  
19 earlier that we've had the remuneration and regulations  
20 all changed and investor groups have been very distracted  
21 by that's taking up an awful lot of time to form policy  
22 with companies.

1           And we are now waiting and companies are now  
2 waiting to see how investors will engage with this huge  
3 amount of additional information that they have now  
4 received. But we know in advance that for example, the  
5 corporate governance teams have been relocated in many  
6 instances to sit alongside the fund managers.

7           So then more integration in some of the investor  
8 houses so their joined up dialog, you know, is brought  
9 to bear with the companies.

10           And then the other feature about the UK regime is  
11 that we have, the FRC is also responsible for the  
12 investor code, which is the stewardship code. To  
13 encourage investor groups to reach out to their investee  
14 companies.

15           So we're fortunate that we have the one regulator  
16 responsible if you like for all angles in our little  
17 dynamic within our -- the city of London where we can  
18 walk to each other's offices.

19           MR. CATES: Just a couple of things to add for  
20 me. I mean I think things are changing. I hosted a  
21 round table of FTSE 100 audit committee chairs a couple  
22 of years ago with some investors. And actually to a

1 person, they'd had -- no investor had ever talked to them  
2 about the audit. Where they said their remuneration  
3 committee chairs were always being asked to go and report  
4 on remuneration. They haven't had the discussions around  
5 audit.

6 Now that was a couple of years back. And I'm  
7 hearing now that that's changing. Part of that due to  
8 -- part about interest in audit reporting I think is  
9 changing that. And part of that is EU audit reform and  
10 rotation and tendering.

11 And so we're seeing investors, from my  
12 perspective at least getting much more interested in  
13 audit and what's happening in audit, which I think is a  
14 good thing. After all, it's the investors who we report  
15 to.

16 MR. JOHNSON: Can I just, I'd just like to pick  
17 up on, not to repeat what's been said, I'd like to pick  
18 up something that William said, and that was kind of  
19 dialog.

20 I think in the UK, what we have found is that  
21 over the last four or five years, perhaps even longer,  
22 that firms, investors, regulators, preparers, academics,

1 have got together and started to talk -- and talk about  
2 the issues. And talk about resolution of issues.

3 And so -- and it may be because we're all in one  
4 place, i.e. in London, and we're all within half an  
5 hour's walking distance of each other. But there has to  
6 be a will for people to actually engage with each other.

7 And I think that in the UK we've been very  
8 fortunate that there's been that engagement. From my  
9 experience in Europe, that has not been the case in many  
10 parts of Europe. There hasn't been that dialog. There  
11 hasn't been that engagement.

12 And the things that have been happening as you  
13 mentioned Chairman this morning, the vote has taken place  
14 now. And so we've now got law in the European Union.  
15 On many matters relating to the audit firms and auditor  
16 reporting and even wider, that a lot of the comments that  
17 were being made during the early parts of that couldn't  
18 be made by the jurisdictions because they couldn't see  
19 the future. Because they hadn't had the dialog.

20 And I think it is so important that the groups do  
21 that, have that dialog. And so I would encourage as much  
22 dialog as possible in order to get all these groups

1 facing in the same direction.

2           And I was also on -- and it goes wider than that,  
3 and it's looking to see what more you can deliver. What  
4 you can look at. And I was asked to be on a group, on  
5 Sir David Tweedie's institute, the ICAS. And there we  
6 were looking at assurance on management commentary.

7           And this was before any standards, it started  
8 two, two and a half, three years ago. And the Scottish  
9 Institute got the groups that I mentioned, but even  
10 further in the group, journalists, financial journalists.  
11 And a whole spectrum of -- and there was about 10 or 12.  
12 All from a different background. Whether you were an  
13 auditor, whether you were an investor, whether you're  
14 a journalist. Because they've got an interest and  
15 they've got an influence as well through financial  
16 journalism.

17           And it was really looking at where the future was  
18 and what things might change. And I think just getting  
19 people talking and having that dialog is so important if  
20 you want to get the right answer. Because there's all  
21 different groups, have different interests. And it's  
22 actually making sure that we try to take away some of the

1 concerns, but also get to what, as much as possible,  
2 people do want from all the various different groups.

3 MR. HARRIS: And then Liz, I didn't want to keep  
4 you out. In the United States the fourth hitter in a  
5 baseball batting order is the power hitter. That's known  
6 as the cleanup. I want to get the three gentlemen on the  
7 record.

8 But if there's anything you'd like to add in  
9 terms of the, I guess the bottom line, one of the bottom  
10 line issues is do investors from your perspective know  
11 what they want in terms of the audit report and some of  
12 these issues we're dealing with?

13 MS. MURRALL: Investors covers quite a wide  
14 population. I mean it sometimes can be taken to include  
15 this little analyst population. Whereas the investors  
16 that I'm representing are the institutional long term  
17 investors, the people that put up the risk capital. And  
18 I think you will probably get a different perspective  
19 from long term investors to analysts preparing sort of  
20 research reports. I think it's a different focus as I  
21 think I outlined in my talk.

22 But also what I would highlight in terms of



1 investors' interest and their engagement on these issues,  
2 William mentioned the stewardship code in the UK. This  
3 became -- this was introduced into what is now the FSA's  
4 rules in December, 2010. And we do, as an industry body,  
5 the monitoring on behalf of the FRC as to what adherence  
6 to the code actually means in practice.

7           And what I would highlight, is that in 2010,  
8 there were 80 signatures that had committed to  
9 stewardship and the code. And in 2013, there are just  
10 under about 300.

11           So investors are engaging on these issues and  
12 they are reaching out to companies and auditors to  
13 develop that dialog. Thank you.

14           MR. DOTY: The Chief Auditor has his flag up.

15           MR. BAUMANN: Thank you. I want to first of all  
16 share in the comments that the Board members have made  
17 about the quality and depth of your presentations and  
18 comments. So thank you very much for all of that.

19           Mr. Touche, in your commentary, you say a lot of  
20 the success of the regime in the UK is because at the  
21 same time, it's introducing a new regime for audit  
22 reporting. The FRC introduced new requirements for the

1 board to report about judgments and estimates and other  
2 matters like that. No similar initiative is underway in  
3 the United States with respect to audit committee or  
4 board reporting.

5           So if I could ask you to speculate a little, all  
6 of you, the auditors certainly speculate. Since there's  
7 no similar initiative underway here, what, well if you  
8 didn't have a similar initiative in the UK, how would  
9 that have impacted your reports and your progress in  
10 terms of reporting, this extended auditing reporting.

11           And then maybe Ms. Murrall, from your  
12 perspective, what would be the perspective of the quality  
13 of the information you received if it was only the  
14 auditor report on the risk of material misstatement, but  
15 not commentary, at least from the audit committee on  
16 significant judgments and estimates in financial  
17 reporting.

18           So given that we don't have the two legs of this  
19 stool, how would you think it would be different?

20           MR. TOUCHE: I think it's quite tough and I'm  
21 sure that's why you're asking the question. I think it  
22 is quite tough. And I tried to draw that out in my

1 commentary. I think the auditor can still comment on the  
2 areas of focus. And the real question is if the areas  
3 of focus are then commented on by the auditor in their  
4 report without findings, how are you going to get the  
5 findings presented.

6           And I suspect that you would find that  
7 behaviorally, if auditors do that, audit committees may  
8 well wish to comment on judgments in the MD&A, or other  
9 areas of the front half. So I suspect these things will  
10 happen naturally without the structure that we've been  
11 blessed with in the UK.

12           Because I -- and the questions around original  
13 information about the company and the company's  
14 conclusions. And I suspect most companies would say  
15 actually we want to earn the communications of those.  
16 And I think from my perspective, that's right and proper.

17           MR. CATES: Not much to add to what William said.  
18 I mean I absolutely agree with what he said.

19           I mean what we found in our initial survey was  
20 that by and large, the issues that the auditor raised in  
21 the audit report were the same issues that the audit  
22 committee had raised. There were one or two differences,

1 but generally speaking, you know there was a commonality  
2 between what the audit committee said was really  
3 important and what they focused on and what the auditor  
4 said was important as well.

5 MR. JOHNSON: Martin, I did say in my submission  
6 that I thought it was very important that the audit  
7 committee report does move along. It's interesting, the  
8 audit committee, the report that we have, one, two,  
9 three, four, five, six pages long, and it covered the  
10 work that we'd done as an audit committee.

11 Interestingly, I signed it in my personal name as  
12 chairman of the audit committee. Just as William and  
13 Tony signed the audit opinion in their own name as  
14 auditors. And I think that it's all about you know, it's  
15 accountability and all the things that we talked about  
16 as I was saying.

17 And it would be interesting. I don't know what  
18 we would have done as an audit committee if the FRC  
19 hadn't said to us, you need to enhance the reporting.  
20 You need to do this, you need to do that. I get the  
21 sense actually, because given the amount of engagement  
22 that we have with the auditors, we actually might have

1 wanted to write the story ourselves and put our  
2 perspective on it.

3           You know I can't say that that would be the case.  
4 But I just feel that you know certainly with -- I'm very  
5 fortunate, I have some very good audit committee members.  
6 But I think that the companies haven't come screaming to  
7 this table. They've actually embraced it.

8           And Tony mentioned that this was a collaborative  
9 approach as far as the reports that they issued. And you  
10 know, Deloitte was the first with Nick Land as chairman  
11 of the audit committee at Vodafone. And that went before  
12 it was mandated.

13           So I think that in the UK, there is a realization  
14 that more needs to be done in reporting. And it gave us  
15 a framework to work to from the FRC. But I actually  
16 think that we would have probably said more than we would  
17 have had to, even if it wasn't there. And I think that  
18 is useful.

19           MR. BAUMANN: And then from your perspective Ms.  
20 Murrall, what would be the value of the risks of material  
21 misstatements without the audit committee reporting on  
22 the judgments and estimates?

1 MS. MURRALL: Well I think if the auditors start  
2 to report on things that management has not reported on,  
3 I think ultimately it would drive management to report.  
4 Otherwise they'd be seen as being you know, dereliction  
5 of their own duties to set out their financial position  
6 and statement of performance.

7 So I think there's a strong likelihood it would  
8 actually start to drive management to disclose that  
9 whether or not the audit committee was disclosed  
10 elsewhere in the accounts.

11 MR. DOTY: I'm aware that I'm standing between  
12 this group and lunch. I want to observe that I was  
13 pleased to see in the ICGN letter to the IAASB, a ringing  
14 endorsement of the point that naming the engagement  
15 partner in the audit report improves transparency and  
16 provides additional accountability that you believe will  
17 foster audit quality.

18 One of the issues that we face and must wrestle  
19 with is how you know that investors will find information  
20 useful and why we think it's useful. Mr. Touche has I  
21 think written and spoken eloquently to the fact that the  
22 more information that is in the new FRC standard, one of

1 the great benefits of that information being that it has  
2 improved a sense of professionalism and a sense of  
3 meaningful role for the auditor.

4           There are other statements shot through your --  
5 that appear in various of your papers on this. We heard  
6 in one of the panels earlier, that there is a lot of  
7 information that investors may want. Investors always  
8 want more information. Information increases volatility.

9           And is it really information that protects  
10 investors, or is it merely information that gives them  
11 a desired or an imagined benefit? What I find striking  
12 about all four of your views of this subject is that  
13 first you do not seem to me to insist that investment --  
14 that investors show that their protection requires a  
15 certain level of transparency and information.

16           On the other hand, you seem sure in your  
17 confidence that the information that is sought by the FRC  
18 proposal and the now European standards, will benefit  
19 investors. And it would be very helpful to our thinking  
20 if you could instruct the Board on how you know this is  
21 beneficial. And whether investors -- how will investors  
22 make good use of the information?

1           MR. TOUCHE: So let mention just the, go back to  
2 the one piece that the FRC and package that we haven't  
3 focused on. And that is that the company has to explain  
4 its business model and the risk inherent in the business  
5 model.

6           So from the very beginning of the annual report,  
7 you get a flow focused on what the core business is.  
8 What are the risks and challenges. And by the way, we've  
9 also had a very clear mandate from the FRC that the  
10 annual report is not a marketing document. It is a  
11 report about stewardship.

12           So it's supposed to have balance and be fair and  
13 understandable and all those other things. But you start  
14 with a business model. And then the accounting risks  
15 that we end up describing are those that flow from the  
16 company's business quite naturally.

17           And if you start with that framework in mind,  
18 that is the essence of what the investors would like to  
19 understand further.

20           MR. CATES: A couple of comments to add to that.  
21 I think the information through the audit report really  
22 has given the investor some kind of hook to discuss those



1 risk areas with management, with the board, which it just  
2 never had before. So there is a wish, for the investor  
3 to have that type of discussion with management.

4           And secondly, just an observation is that in 20  
5 odd years of auditing, I've never had so much kind of  
6 interest from investors in what I'm doing and sort of  
7 emails out of the blue from people saying this is a  
8 really positive thing.

9           And much more engagement with investors as a  
10 whole. Not on specific companies, but as a whole. And  
11 I can only see that as a real positive.

12           MS. MURRALL: I think it's disappointing if  
13 investors keep on asking for more. Because what we do  
14 want is accounts that tell a story of management  
15 stewardship of the business. And we need cohesion  
16 between the front half and the narrative reporting and  
17 the back half and the numbers.

18           And I think one of the requirements that the FRC  
19 introduced, which I think we very much welcomed, is the  
20 directors have to state that the accounts are fair,  
21 balanced and understandable.

22           And I think that that is a very good move.

1 Because I think in the past you could have taken a set  
2 of accounts. You could have ripped the front half away  
3 from the back half, you may have had trouble matching the  
4 two.

5           So I think you know, we want accounts that tell  
6 a story as to what management has done to resources  
7 entrusted to it and exercised its stewardship, and that  
8 story needs to be cohesive, not full of clutter.

9           So whereas there may be requirement, people may  
10 ask for other information, I think there is other  
11 information that could be disposed of in the accounts.  
12 Like do we really need to have the director's  
13 remuneration regulations in the accounts? Do we need to  
14 have all the accounting policies, where they're generally  
15 just a restatement of IFRS.

16           I think these things could be looked at and we  
17 could cut some of the clutter. Thank you.

18           MR. DOTY: Again with the profuse thanks of this  
19 Board, this institution for the distance you have  
20 traveled, and the thought you have given to helping us  
21 with what is perhaps the most challenging and the most  
22 important standard setting project that we have.

1 Thank you. Each of you, thank you again. And  
2 it's been wonderful to have you here.

3 We will adjourn for lunch and we will reconvene  
4 promptly at 1:00. Thank you.

5 (Whereupon, the above-entitled matter went off  
6 the record at 12:15 p.m. and resumed at 1:00 p.m.)

7 A-F-T-E-R-N-O-O-N S-E-S-S-I-O-N

8 (1:00 p.m.) Audit Tenure/Elements of Auditor's  
9 Report

10 MR. DOTY: Well, good afternoon.

11 Peter Clapman is formerly the senior vice  
12 president and chief investment officer for TIAA-CREF,  
13 chairman of the governance committee and a member of the  
14 audit committee of iPass today. He serves on the board  
15 of the National Association of Corporate Directors. He  
16 is also vice chairman of the Conference of Mutual Fund  
17 Leaders, and also a current member of the PCAOB's  
18 Standing Advisory Group.

19 Monty Garrett is vice president of finance at  
20 Verizon Communications. Previously, he was chief  
21 financial officer and chief accounting officer of Doosan  
22 Infracore International, the manufacturer of Bobcat

1 construction equipment. He is currently a member of the  
2 Dooson board of directors and audit committee, and he  
3 began his career with Ernst & Young as a member of the  
4 audit practice.

5           Joan Amble is the president of JCA Consulting, a  
6 public company board member, NACD Council of Audit  
7 Committee Chairs at NACD, and retired executive vice  
8 president and principal accounting officer at American  
9 Express. Previously, she was with General Electric, as  
10 chief operating officer and chief financial officer for  
11 GE Capital Markets. She's a director of Booz Allen  
12 Hamilton Holding Corporation, Brown Foreman Corporation  
13 and Sirius XM Radio, Inc. She is also the co-founder and  
14 chairman of Women in America, an organization that  
15 focuses on the development of women professionals -- not  
16 chairman but chair of Women in America.

17           Jim Liddy is the US vice chair of audit at KPMG,  
18 where he is responsible for creating and executing the  
19 strategic vision for the US audit practice. In addition,  
20 he serves as the Regional Head of Audit, Americas, and  
21 chair of the Americas Audit Steering Committee for the  
22 firm. Prior to his current role, he served as national

1 manager of audit for KPMG, and the national business  
2 leader of KPMG's financial services practice.

3 A panel that brings to bear omnicompetent  
4 experience and insight on the issues of auditor tenure  
5 and other basic elements of the audit report. Thank you  
6 all. Peter, if you will begin.

7 MR. CLAPMAN: Thank you very much, Mr. Chairman.  
8 And I hope I'm selected to be the keynoter of this  
9 esteemed panel on the premise that I can get things  
10 livened up after lunch, and I hope my remarks are taken  
11 in that spirit.

12 I'm very pleased that the PCAOB has convened this  
13 roundtable to examine very important issues that address  
14 the disclosures given to investors about the audit  
15 process. In my opinion, the disclosure system presently  
16 is flawed in material respects and improvements are  
17 necessary.

18 The PCAOB has advanced certain proposals that,  
19 while modest in tone and scope, would be beneficial and  
20 should be implemented. Just to complete the record, in  
21 addition to my written remarks, I note that I was -- I  
22 participated in a roundtable probably about a year and

1 a half ago on the issue of a proposal at that time on  
2 whether mandatory auditor firm rotation was in the public  
3 interest.

4 My position at that time was that auditor  
5 rotation is a sound premise, should be implemented, at  
6 least to the point where companies and audit committees,  
7 after a period of years, should put out the audit  
8 assignment for rebidding, for further discussion, even  
9 allowing for the possibility that the company, the audit  
10 committee, would decide if the present auditor is the  
11 right choice, but at least make that consideration.

12 And my concern at that time, which is still a  
13 concern today, is that too many audit committees simply  
14 make this a routine matter, and do not, as they should,  
15 seriously consider the selection and tenure of their  
16 outside auditor. And, to me, this goes to the issue of  
17 independence.

18 I also applaud the PCAOB for inviting to this  
19 roundtable as many participants from other countries, in  
20 particular the UK. In terms of my own experience, as you  
21 noted, I was the chief investment lawyer for TIAA-CREF  
22 and head of its corporate governance program.

1 I also chaired the International Corporate  
2 Governance Network for four years between 2000 and 2004.  
3 And at that time, it was clear, and I think would  
4 generally be acknowledged by people in this field, that  
5 the governance structures and investor protections in the  
6 United States was superior to basic protections and  
7 governance practices abroad.

8 And I fear that this is no longer the case. And  
9 I think your participants from the UK hopefully made this  
10 clear, that they have advanced certain issues, in fact  
11 those including the audit process, which provide for  
12 greater investment protection in my view than currently  
13 exists in the United States. And, in particular,  
14 advancing the notion of whether auditor rotation is  
15 appropriate, auditor rebidding is appropriate. I'm  
16 talking about after a fair number of years, not to just  
17 be done sporadically but done consistently and with a  
18 view towards enhancing independence.

19 And I think including in this last panel this  
20 morning it was noted that, for example, if you do  
21 implement one of your proposals, which I strongly am in  
22 favor of, which is to have the audit report include the

1 tenure, the number of years that the particular audit  
2 firm has audited a particular company, that that has  
3 generated in the UK, and I think it would in the United  
4 States as well, generate more interest on the part of  
5 audit committee members, and also create the impetus for  
6 investors to care more about this than they currently do.

7           And part of the problem, I think, for investors  
8 is that it is extremely hard or almost impractical for  
9 an investor to know for how long a particular audit firm  
10 has audited a particular company. And I think the record  
11 is clear, and it was clear a couple of years ago as well,  
12 that some audit firms have been the outside auditor for  
13 particular companies as long as decades. I heard in one  
14 case that it almost got to be close to 100 years.

15           So, that sort of disclosure, which I think would  
16 help generate greater interest on the part of both  
17 investors and audit committee members, I think, would be  
18 strongly beneficial and in the public interest and  
19 something that investors want.

20           I also particularly note that your two new  
21 proposals, first to include the tenure of the current  
22 audit firm, and then secondly to include the named lead



1 engagement partner, involve no costs.

2           One of the issues always at stake on potential  
3 reforms or initiatives on the regulatory side is whether  
4 particular benefits to some parties will be overwhelmed  
5 or in some cases offset too significantly by cost to  
6 other investors. And, obviously, regulators have got to  
7 take that concern into consideration.

8           Again, my point about these two proposals is that  
9 they involve no costs. So, therefore, no investor is  
10 unduly burdened with costs affecting disclosures which  
11 would be extremely helpful and important to other  
12 investors that truly believe independence is a key issue,  
13 and that the current system ought to be enhanced in the  
14 favor of broader disclosures to protect investors on  
15 these audit concerns. Because currently it is very  
16 difficult with the disclosure system in place for  
17 investors to even find out how audit firms have been  
18 selected, how they are regarded in terms of continued  
19 tenure and the like, and I think these reforms would be  
20 extremely beneficial.

21           One final note, because I see the red light, is  
22 that in my former position at TIAA-CREF, we voluntarily

1 did both. We both did rebidding at certain intervals,  
2 and at a certain point we did rotate audit firms. Our  
3 experience was that the costs were nominal, if any  
4 additional cost, and our audit process and the audit  
5 quality was enhanced.

6 And we believe that if the PCAOB adopted, first,  
7 these particular proposals and considered the broader  
8 questions, it would be both cost-worthy and protective  
9 of investors, in a way that's very much needed. And I  
10 support these proposals.

11 MR. DOTY: Thank you, Peter. Monty Garrett.

12 MR. GARRETT: Good afternoon. I appreciate the  
13 opportunity to come here today to represent Verizon on  
14 this panel. We obviously have a keen interest in matters  
15 related to auditor reporting. We also spend a great deal  
16 of time and effort communicating with existing and  
17 potential investors and finding ways to get them the  
18 information they need to make informed investment  
19 decisions.

20 To that end, we appreciate the efforts of the  
21 PCAOB to address investor needs, and we want to continue  
22 to work with the Board and the staff to accomplish this

1 joint goal.

2 I was invited here today to provide Verizon's  
3 input on the proposal to add auditor tenure to the  
4 standard auditor's report. Our view on that specific  
5 concept is best understood in conjunction with our views  
6 on Docket No. 34 as a whole. As such, I'll discuss our  
7 view on tenure, and then expand a bit on the overall  
8 proposal.

9 Like many other public companies, Verizon  
10 discloses information about its audit firm, including  
11 tenure, in our annual proxy filing, where we ask  
12 shareholders to ratify the appointment of the auditors.

13 For the benefit of our shareholders, we also  
14 provide background on how the audit committee considers  
15 auditor tenure in connection with its evaluation of the  
16 auditor's independence, and, more broadly, auditor  
17 appointment.

18 In other words, we see audit firm tenure of one  
19 component of a robust governance process discussion in  
20 our proxy related to the evaluation of the auditor.  
21 Accordingly, we think that reporting of auditor tenure  
22 is most meaningful when presented within the governance

1 context.

2           It's not completely clear to me what conclusion  
3 can be drawn from auditor tenure information, but if an  
4 investor finds it useful, there does not seem to be harm  
5 in providing the information in an appropriate context.

6           As mentioned in Appendix 5 of the proposal, the  
7 available research findings on correlation between  
8 auditor tenure and audit quality vary widely. Some  
9 researchers suggest that an auditor with a long tenure  
10 may have a higher likelihood of independence being  
11 impaired, while other researchers suggest an auditor with  
12 a short tenure may not have sufficient depth of  
13 understanding of a company to render a reliable opinion.

14           I believe the Board concluded that there was no  
15 analytical information to provide any really meaningful  
16 correlation. In all sincerity, I do hope to get insight  
17 today on how the tenure information is valuable, as we  
18 are always interested in transparency and a better  
19 understanding of how to anticipate our investors' needs.

20           To emphasize this point, we come to work every  
21 day knowing there are two groups of people that we cannot  
22 live without: our customers and our investors. We're

1 fully committed to listening to our investors and caring  
2 for their needs, and that includes addressing concerns  
3 that have led to this proposal.

4           To that end, we have chosen to disclose our  
5 auditor's tenure information in our proxy statement, and  
6 we believe that's the proper home for such disclosure,  
7 rather than the auditor's report. Our view on this is  
8 a subset of our overall view that an auditor's critical  
9 role is to provide assurance that the GAAP financial  
10 statements provided by the issuer are materially  
11 accurate.

12           Some aspects of the proposal include discussion  
13 of critical audit matters and commentary on other  
14 information, may require the auditor to go beyond its  
15 very critical core responsibility of providing assurance.  
16 As stated in our comment letter, we're concerned with  
17 having auditors provide this commentary, as we feel that  
18 the first line of disclosure about the company should be  
19 provided by the issuer.

20           If the auditor deems the material misleading or  
21 inadequate, and the issuer does not rectify it, then the  
22 auditor has the means to opine accordingly. The current

1 pass/fail opinion is clear and concise, and leaves no  
2 doubt as to the auditor's view. Free form language may  
3 not be as clear and may leave readers unsure of the audit  
4 result.

5 Alternatives were discussed yesterday that we  
6 think give investors the additional information on risk  
7 they're seeking while preserving the roles of issuer and  
8 auditor.

9 Specifically, the alternative of having the  
10 issuer expand the disclosure in Footnote 1 to cover CAM  
11 items in a more thorough fashion, along with an  
12 auditor-specific review of that disclosure, would seem  
13 to address many of our concerns.

14 Views on that matter were discussed at length in  
15 earlier panels. My only point is to extend our view on  
16 the issuer's and auditor's roles to the tenure  
17 information. Let the issuer provide the information to  
18 investors in the appropriate form and context. Investors  
19 will receive the information they desire, and the risk  
20 of misinterpreting auditor tenure without proper context  
21 will be avoided.

22 We have no issues with the other basic elements

1 of the auditor's report included in the proposal. We're  
2 not sure if the additional wording on independence adds  
3 value, as the existing reporting format already includes  
4 reference to the auditor being independent, but we  
5 certainly see no harm in including it.

6       Again, thank you for the opportunity to  
7 participate in this very important process.

8       MR. DOTY: Thank you. Joan Amble.

9       MS. AMBLE: Okay, thank you. I appreciate the  
10 opportunity to participate today and for all of you  
11 taking the time to seek constituent views on these very  
12 important topics. The comments I offer are my own and  
13 do not necessarily represent the views of the  
14 organizations of which I am affiliated.

15       My background includes positions as an accounting  
16 instructor, an auditor, a standards-setter, and for most  
17 of my career, a senior financial officer of a major  
18 corporation. I presently serve on the boards of three  
19 public companies, and I believe you have invited me to  
20 participate because of that role.

21       Therefore, while my comments are informed by all  
22 of my experiences, they apply most specifically to those

1 as audit committee chair and member. However, my  
2 perspective, similar to most, I assume, is to seek sound  
3 financial reporting with an unequivocal commitment to  
4 integrity, strong governance and transparency, as it  
5 relates to all parties involved. Company management,  
6 directors and auditors each have a role to play.

7           Although asked to comment on auditor tenure and  
8 other basic elements of the auditor's report, given the  
9 significance of the important topic of disclosure of  
10 critical audit matters, I feel compelled to note that I  
11 disagree with the direction the Board has taken on this  
12 proposal and do not support it as currently written.

13           Along with the vast majority of audit committee  
14 members with whom I've had the opportunity to discuss  
15 this matter, I believe including critical audit matters  
16 in auditor's reports would lead only to much longer but  
17 not necessarily more useful reports by including  
18 information already adequately provided by management in  
19 footnotes or MD&A.

20           I was pleased to see that many audit committee  
21 members, as well as the NACD, provided input to the Board  
22 to elaborate on the reasoning for this opposition.



1           The other subject not subject to this panel's  
2 discussion relates to the auditor's responsibility  
3 regarding other information, on which, time permitting,  
4 I will provide comment, as that too is an element of the  
5 proposed changes I do not support as currently written.

6           The specific areas to be addressed in my comments  
7 today are audit tenure, independence, and auditor's  
8 responsibility for financial statements and related notes  
9 and schedules and for fraud. While auditor tenure may  
10 be an interesting data point for some users of financial  
11 statements, I do not support its disclosure in the  
12 auditor's report.

13           Auditor tenure, when taken out of context, has  
14 the potential to unnecessarily obscure the question of  
15 audit quality and perhaps cause some to erroneously  
16 conclude a direct correlation between tenure and audit  
17 quality, which, to my knowledge, no verifiable  
18 correlation exists.

19           Further, I do not think auditor tenure negatively  
20 impacts audit quality or independence. People and  
21 actions do. My experience has been that the engagement  
22 team on the ground, and its ability to access specialized

1 expertise within the firm, provides the basis for sound  
2 audit quality, not the number of years a firm has audited  
3 a company.

4           In addition, mandatory rotation limits the years  
5 senior members of the engagement team can audit, which  
6 provides a regular introduction of differing and fresh  
7 perspective to the audit engagement. If tenure were to  
8 be introduced as an element of governance, the placement  
9 seems better situated in the proxy statement as part of  
10 the audit committee report, or with the ratification of  
11 auditors.

12           I have no objection with the recommendation to  
13 expand the auditor's report regarding independence.  
14 However, having said this, I think it is important to  
15 underscore the significance of the ongoing review of  
16 audit quality by the audit committee, and the use of  
17 audit committee executive sessions and other interactions  
18 with auditors to understand the nature and the quality  
19 of the engagement, and to engage in dialogue about the  
20 independence, the integrity, the objectivity and  
21 competence of the engagement team and the firm in  
22 fulfilling its professional responsibility as the

1 auditor.

2           This ongoing review of audit quality is a core  
3 responsibility of the audit committee, and provides a  
4 thoughtful basis of judgment regarding the audit quality  
5 we seek, and provides a firm foundation for continuous  
6 improvement in audit quality from the auditor.

7           I support the Board's proposal to enhance the  
8 auditor's report by identifying financial statements,  
9 including related notes and schedules as part of the  
10 financial statements that were audited. I also support  
11 the proposal to revise the auditor's report to recognize  
12 the auditor's responsibility to plan and perform the  
13 audit to obtain reasonable assurance about whether the  
14 financial statements are free of material misstatements,  
15 whether caused by error or fraud.

16           As noted at the onset, I would like to close with  
17 my brief perspective on auditor's responsibility  
18 regarding other information. As many have noted,  
19 clarification of work done by the auditors should be  
20 provided in the auditor's report.

21           If the Board determines it will move forward with  
22 this proposal in some form, I encourage the Board to

1 accept Deloitte's offer of assistance in the development  
2 of a workable model for expanded auditor involvement with  
3 other information.

4 I further recommend that consideration be given,  
5 first, in a phased approach, to the auditor's  
6 responsibility regarding quantitative non-GAAP measures.  
7 There are many instances when a company feels  
8 quantitative non-GAAP measures are more meaningful to  
9 users of their financial statements than GAAP measures.

10 However, I would venture to say that auditor  
11 involvement, in terms of evaluating the rigor around the  
12 process, the controls and testing of those non-GAAP  
13 quantitative disclosures is varied and therein lays an  
14 opportunity to clarify what the auditor's responsibility  
15 for that information should be, and how this  
16 responsibility should manifest in terms of auditor  
17 reporting. Thank you for the opportunity to speak.

18 MR. DOTY: Thank you. Jim Liddy.

19 MR. LIDDY: Thank you. Chairman Doty, Members of  
20 the Board, Chief Auditor Baumann, and other  
21 representatives of the PCAOB, SEC and FASB, I appreciate  
22 the opportunity to meet with you and share some

1 perspectives on the PCAOB's auditor reporting model  
2 project, and more specifically to address the topic of  
3 auditor tenure and other potential changes to the  
4 auditor's report.

5           Speaking on behalf of KPMG, we certainly support  
6 the Board's objective to improve the auditor's reporting  
7 model and increase its relevance to financial statement  
8 users, and we are in favor of constructive and practical  
9 changes to the auditor's reporting model.

10           However, as we have heard in certain of the  
11 panels, including the one just before us at lunch,  
12 stakeholders are not necessarily aligned regarding the  
13 nature and extent of such changes. Investors, audit  
14 committees, auditors and preparers have differing views  
15 on what information auditors should provide.

16           This is an important project of great interest to  
17 many different stakeholders, and one that requires  
18 careful deliberation to develop a solution that can be  
19 practically applied. We need to take our time to figure  
20 out what the markets need relative to what auditors are  
21 able to provide. We also need to be mindful of what's  
22 happening globally, and certainly over the last day and

1 a half we've gotten some great commentary in that  
2 particular regard.

3           Moreover, we need to recognize and accept that no  
4 solution in this area will meet the desires of all  
5 stakeholders. In developing possible enhancements to the  
6 auditor's report, we have been guided by a set of  
7 principles including: one, auditors should not be the  
8 original source of information about the entity.  
9 Management's responsibilities should be preserved in this  
10 regard. A fundamental shift from the auditor attesting  
11 to information prepared by management to the auditor  
12 providing original information about the company could  
13 result in unintended consequences that are not in the  
14 best interest of investors.

15           Secondly, any changes to the auditor's reporting  
16 model should enhance or at least maintain audit quality.  
17 On behalf of the 7,000 folks in our audit practice in the  
18 United States, I can tell you that we're focused on audit  
19 quality each and every day, and our efforts of continuous  
20 improvement, together with that of the Board, have very  
21 positively contributed to an increase in audit quality  
22 over the last dozen years or so.

1           Third, any changes to the auditor's reporting  
2 model should narrow, or at least not expand, the  
3 expectation gap.

4           Fourth, any changes to the auditor's reporting  
5 model should add value, and not create investor  
6 misunderstanding. Specifically, any revision should not  
7 require investors to sort through what we refer to as  
8 "dueling information" provided by management, the audit  
9 committee and/or the independent auditors.

10           And lastly, auditor reporting should focus on the  
11 objective rather than the subjective. Financial  
12 reporting matters assessed by the auditor can be highly  
13 subjective. However, it's important that auditor  
14 communications provide objective information about these  
15 matters.

16           As it relates specifically the topics of  
17 independence and tenure, we agree with the addition of  
18 language on auditor independence explicitly stating that  
19 the auditor is required to be independent. This is  
20 consistent with the requirement that the auditor's report  
21 be titled "Report of Independent Registered Public  
22 Accounting Firm," and provides clarification of this

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1 within the auditor's report.

2           We do not believe, however, that the inclusion of  
3 a sentence about the auditor's tenure within the  
4 auditor's report is appropriate. As noted in the PCAOB  
5 release, no nexus has been established between an  
6 auditor's tenure and audit quality, and requiring such  
7 information in the auditor's report might give the false  
8 impression that a correlation between the two does in  
9 fact exist.

10           We do, however, acknowledge that the  
11 communication of an auditor's tenure may be an item of  
12 interest to some stakeholders, and we support the  
13 communication and transparency that disclosing this  
14 information may provide. Therefore, we recommend that  
15 this information be required to be disclosed through  
16 different means, such as in Form 2, or as our other  
17 panelists today have indicated, in the audit committee's  
18 report.

19           Finally, with respect to the topic of addressees  
20 of an auditor's report, we do not support addressing the  
21 auditor's report to parties other than shareholders and  
22 the board of directors, or an equivalent body.



1           We believe this would create additional  
2 litigation risk and would not improve the communicative  
3 value of the auditor's report. Adding addressees to the  
4 auditor's report will not affect those with access to it.  
5 The auditor's report is a general use report available  
6 to all capital market participants: shareholders,  
7 bondholders, rating agencies, analysts and others, that  
8 the issuer can distribute without restriction, and to  
9 which third parties have ready access via the issuer's  
10 SEC filings.

11           This concludes my prepared remarks. Thank you  
12 again for the opportunity to participate in today's  
13 discussion, and I look forward to addressing any  
14 questions the Board might have on this important topic.

15           MR. DOTY: Thank you. Mr. Harris?

16           MR. HARRIS: Well, I would just agree with Jim.  
17 I think it's important to focus on the objective, narrow  
18 the expectation gap, and be mindful of what is happening  
19 globally on the audit quality. I don't have any  
20 questions. I think that I heard from the previous panel  
21 what's happening in terms of globally on the audit  
22 quality. I think it's different from what's happening

1 here. I think the trend outside the United States is  
2 considerably different from what's been going on in the  
3 United States. So I think we do have to keep that in  
4 mind.

5 I think the expectation gap is huge, and I think  
6 everything ought to be done to attempt to narrow it,  
7 because I think the focus of investors versus the  
8 profession is not narrowing, it's broadening.

9 So I was happy to hear from the last panel that  
10 there is increased dialogue, and I agree that there ought  
11 to be a focus on the objective. So I don't have any  
12 questions, Mr. Chairman.

13 MR. DOTY: Lewis.

14 MR. FERGUSON: Yeah. I have a question,  
15 essentially, for all of you, but may be directed mostly  
16 to Ms. Amble. Because it appears as I listened to you  
17 is that your view is that the auditor, at most, should  
18 be commenting on disclosures by management, and what the  
19 management talks about risks and audit policies in its  
20 footnotes or whatever should be the source of the  
21 disclosure rather than the auditor.

22 We just listened to a panel from the United

1 Kingdom, where their model has gone in a very different  
2 direction, and as far as I could tell, the investor  
3 response to that appears to have been overwhelmingly  
4 positive. That's point one.

5           Point two, it looks like the IAASB is about to  
6 adopt a standard that's very similar to ours and -- so  
7 there are two questions here, really. One, what should  
8 we make of the UK experience? Is it is anomalous because  
9 it's the UK?

10           Number two, do we run a risk as a nation if the  
11 international standard diverges significantly in terms  
12 of what auditors should do, that we have a standard that  
13 does not really comport with that at all?

14           So it's two questions, but if each of you could  
15 address it, I'd appreciate it.

16           MS. AMBLE:    In terms of --    because you're  
17 speaking to the critical audit matters at this point, and  
18 as I think about that, there's a question about what is  
19 disclosed as having been done by the auditors. But, to  
20 me, the bigger question is is the concern that there is  
21 a view that the auditors are not doing enough? And I  
22 don't know how disclosure addresses that.

1           It would seem to me if the issue is, number one,  
2 we think that auditors are not performing the appropriate  
3 procedures, if we think that they are somehow the source  
4 of the issues that companies have had, whether it's  
5 financial failure or accounting misstatements, then I  
6 would address that issue. And I would address that in  
7 terms of the training, the audit requirements that out  
8 there, the protocols and how they are monitored.

9           But disclosing it only -- as I read, you know, I  
10 read through the -- one of the reports, I think it was  
11 the Rolls Royce report on critical audit matters, and I  
12 found it to be very interesting in terms of what they  
13 did. But, honestly, I didn't see anything that was  
14 astounding in terms of audit procedures that were done.  
15 It made sense for the areas that they were auditing.

16           So while I found it interesting, it wasn't  
17 necessarily that enlightening to me. I did see something  
18 that was interesting, because on one of their comments,  
19 they mentioned that -- they talked about a design of  
20 control having a weakness, which, to me, is now getting  
21 at their assertions and their comments with regards to  
22 internal controls over financial reporting.

1           But other than that, that was the only real  
2 substantive comment on that. And, honestly, I think  
3 that's an area, if they were going to be any discussion,  
4 is worthy of more discussion, in terms of what is done  
5 to ensure that the SOX processes are designed  
6 appropriately, the internal controls over financial  
7 reporting are designed appropriately, and that there's  
8 the right corporate culture to ensure that issues are  
9 appropriately raised, and when raised are appropriately  
10 addressed.

11           I don't know that critical audit matters get to  
12 that in itself. I would just get to the direct part of  
13 the issue.

14           The second point that I would say is if there's  
15 a concern with the core responsibility of the audit  
16 committee, which is to look at the audit quality on a  
17 continual basis, not just an annual basis, then I would  
18 look to the performance of the audit committees, and  
19 whether or not there needs to be more enlightening there.

20           So I hear your point. Whether there's a  
21 divergence of practice, that in and of itself does not  
22 create any substantial issues for me. There's divergence

1 in how we account for matters. So, in terms of how  
2 auditors discuss their audits, that is not disturbing to  
3 me in any way.

4 I just don't know whether disclosure in and of  
5 itself will improve audit quality. And if that's the  
6 desired objective, I don't know how disclosing and  
7 discussing it achieves that objective.

8 MR. CLAPMAN: I would try to answer your question  
9 in rather broad terms, and drawing back to my earlier  
10 point that at one point -- at one stage back in the early  
11 part of the prior decade, the US was considered the  
12 leading country in the world in terms of investor  
13 protections, which I no longer think is the case.

14 And I think the UK, for example, experience,  
15 shows how investor interest on particular questions gets  
16 enhanced as regulation or, in some ways, soft regulation  
17 through the manner in which Great Britain encourages  
18 these developments, really does generate a better  
19 relationship between investors and companies, audit  
20 committees and audit firms.

21 I don't think, in response to the last comment,  
22 that it's an issue of concern in the UK about the audit

1 committee. I think the point, and it was raised in  
2 basically the presentation of this roundtable, that  
3 there's currently an asymmetry in terms of regulation,  
4 in terms of what the company knows its audit committee  
5 deals with and what investors know. And, in the interest  
6 of investor protection, I think this asymmetry ought to  
7 be narrowed, and I think the proposals of the PCAOB go  
8 in that direction, and that's why I support them.

9 MR. LIDDY: I'm going to refer back to our  
10 comment letter, because if you think about the core  
11 objective of the project at hand, you know, we do have  
12 a responsibility at present, you know, relative to the  
13 information that's in MD&A, specifically as it relates  
14 to critical accounting estimates and such.

15 But the practical reporting in that regard is on  
16 an exception basis, meaning if there's information  
17 therein that's materially inconsistent with the  
18 information that we've gained in the performance of the  
19 audit. We believe, actually, one of the best ways to  
20 help achieve the objective that the Board has laid out  
21 is to require auditor association with that particular  
22 information in MD&A.

1           Now, that would require some changes, and what I  
2 mean by that is we have to -- the SEC would have to  
3 require that the critical accounting estimates section  
4 be clearly within MD&A; they'd have to review existing  
5 interpretive guidance to determine how it fits in within  
6 the context of Regulation S-K.

7           But then we'd also have to, from a PCAOB  
8 perspective, look at the existing attestation standard,  
9 and see what we could do therein to more formally  
10 associate the external auditor with the critical  
11 accounting estimates section within MD&A.

12           MR. GARRETT: Thank you. I guess the way I look  
13 at this as an issuer is -- and maybe I shouldn't, but if  
14 the auditor is being relied on to tell the investor so  
15 much, I almost feel like I've failed in my disclosure  
16 attempts as a preparer.

17           It seems, in a perfect world, I should be giving  
18 all the information that's needed to the investor on the  
19 estimates and the other more difficult things to account  
20 for an audit, which would leave the auditor almost  
21 rehashing what generally-accepted auditing standards are,  
22 which is, I know, not the point of all this.



1           So I feel like we've got to look, as issuers,  
2 internally at where are we failing, where we need an  
3 auditor to pick up for us. Maybe that's not the way we  
4 should look at it, but that's kind of the way I hear it.

5           As far as the UK comment, the only thing I can  
6 say is there are differences in the environment. The  
7 accounting is fundamentally different, as we all know,  
8 between with IFRS and US GAAP. As Peter pointed out,  
9 there's differences in the role of the audit committee  
10 and the audit committee chairman.

11           So I think it's almost unavoidable to have some  
12 differences, not to mention, as has been pointed out, we  
13 are in a litigious society in the United States. It  
14 seems inevitable there will be some differences. But I  
15 don't think we can just accept that there will be  
16 differences and go on. We should narrow the gap.

17           I think the last thing I'd say to Mr. Harris is  
18 I really take what you had to say to heart. I feel like  
19 you seem almost disappointed in us. So we, as issuers  
20 of financial statements, don't want to have the PCAOB  
21 kind of throwing their hands up and not being happy with  
22 what we're doing. So I really listen to what you have

1 to say.

2 MR. HARRIS: Well, I appreciate that, and we  
3 obviously want to work very closely with you.

4 MR. DOTY: Jay?

5 MR. HANSON: One primary question that is based  
6 on something that, Joan, you had in your statement, but  
7 I'm going to direct it first to Jim, and then let the  
8 rest of you comment. And then separately I've got a  
9 different question for Peter.

10 So, on the point you made, Joan, about the  
11 independence assertion in the audit report, and the  
12 importance of the audit committee's role in the dialogue  
13 with the auditor about their independence, their  
14 objectivity, their skepticism, their competence, it just  
15 sparked kind of a tangential question that I'll start  
16 with Jim, about what -- at KPMG, what do you do to help  
17 educate audit committees and management about their role  
18 in making sure that the auditor is independent within the  
19 specific independence rules around scope of services and  
20 things like that? Which, as some of us know, is an  
21 incredibly complex book of rules that sometimes, at least  
22 in my view, are not always easy to figure out what the

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1 right answer is.

2           And I'm just curious about what you do to help  
3 educate effectively the possible buyer of the services,  
4 like you educate all of your professionals as the sellers  
5 of the services.   And then, Joan and Monty, your  
6 experience with -- as preparers and audit committee  
7 members.

8           So I'll pause for a second to let you answer.  
9 But, Peter, my question for you is just slightly  
10 different from that in that on the auditor tenure  
11 question, your three co-panelists have each suggested  
12 that, while they don't object to tenure, but it's better  
13 placed in the audit committee report.   And I'm just kind  
14 of curious as to your reaction to their positions on  
15 this.

16           So, I'll start with Jim.

17           MR. LIDDY:   Well, that particular question, I  
18 think we've got to recognize that when you look across  
19 the spate of public companies that we are associated  
20 with, there's different levels of maturities within those  
21 companies themselves.   And you tend to find, in the  
22 larger companies in particular, that there's a level of

1 maturity there, not only with respect to the auditor  
2 independence rules, but there is a better and more  
3 comprehensive understanding of the roles and  
4 responsibilities of management, as well as the roles and  
5 responsibilities of the auditors per se.

6           Now, certainly, whether it be a mature company or  
7 one that is, I want to say, less mature, there's a fair  
8 amount of dialogue obviously at different points of year,  
9 presentation of the audit plan, a very specific  
10 discussion of our responsibilities, a compare and  
11 contrast to management's responsibilities.

12           So, I mean, the most fundamental way it gets  
13 achieved, quite frankly, is through regular and ongoing  
14 dialogue about the auditor's responsibilities, and making  
15 sure that there's absolute transparency from an audit  
16 committee perspective.

17           MS. AMBLE: In terms of -- I'll speak to what  
18 approach we've taken on audit committees. It's really  
19 no different than when you're working in a company as  
20 well, but there's a number of different things, and there  
21 are a lot of good opportunities.

22           One thing which I think is very helpful is

1 continuing education, whatever form that is; being part  
2 of different professional organizations and currently  
3 having highlighted what the responsibilities are and best  
4 practices and what people are doing.

5           That is very, very helpful to keep that in front  
6 of you in terms of important things to think about,  
7 particularly looking how companies are growing and are  
8 so much more complex today, which means the audit of  
9 those companies is obviously going to be more complex.

10           So in terms, certainly what I do on my audit  
11 committees, is I really look very seriously at whether  
12 or not the auditors being assigned have grown with the  
13 company, and their skills match the skills that are  
14 requisite for the risks inherent within the company, just  
15 as you would look at the finance organization within the  
16 organization as well.

17           The other thing is to look very seriously, and  
18 not to allow it be reduced to five minutes, is how you  
19 engage in the executive sessions with the auditors.  
20 That's the time when people can just really talk very  
21 clearly and you can get into issues potentially in a more  
22 in-depth way, and taking advantage of that, and how the

1 auditors respond gives you a very good indication of  
2 independence.

3 I know there are a lot of independence rules in  
4 terms of the investments and so on, and I assume the firm  
5 does that very, very well. What we will look to is the  
6 character of the individual, and do they understand the  
7 culture of the company well enough so that issues are  
8 being appropriately raised, and when they are being  
9 raised, they know how to deal with the difficult  
10 conversations, if you ever have any.

11 I mean, that is so important to be able to do  
12 that, just as it's important for management as well.

13 The other thing is really the offline discussions  
14 you have as well. Anybody knows, if they're not a  
15 committee chair, that your job goes well beyond the audit  
16 meetings. There's a lot that happens in the preparatory  
17 meetings, where you meet with management in advance of  
18 the meeting to go through the agenda and the particular  
19 topics that will be addressed. But then you also meet  
20 with the auditors as well.

21 And, again, those discussions give you what I  
22 call the ability to have the Ouija board test, to

1 understand the talent of the team and how seriously  
2 they're looking at things, and if they're looking at the  
3 right things.

4           So those are some -- certainly not all, but some  
5 of the things that I think are pretty common with audit  
6 committees and audit committee chairs.

7           MR. GARRETT: I am fortunate to work at a company  
8 that does have a very strong focus on governance. We  
9 have a very strong audit committee, a very strong  
10 chairman of our audit committee, and a lot of the culture  
11 flows from that.

12           I think, similar to Joan, we have a very robust,  
13 more offline process of discussing issues with the audit  
14 committee and getting their reaction. I think there's  
15 a healthy amount of respect between the audit firm and  
16 the company and the audit committee that also helps.

17           There's, I would say -- I wouldn't use the word  
18 "tension," but there is healthy challenge that goes back  
19 and forth, and it never causes a problem. Part of that  
20 is the strong governance culture.

21           I think, in terms of the auditor getting involved  
22 in helping the company with governance, I kind of have

1 a different perspective on that with the company for  
2 which I'm on the audit committee, which in some ways the  
3 opposite of Verizon. It's a small private company, and  
4 there it's almost indispensable, the work that the  
5 auditor performs in helping the company understand how  
6 to govern better.

7 MR. CLAPMAN: If I could go immediately the  
8 questions that you posed to me. First, I thought I was  
9 actually in agreement with Monty Garrett, that disclosure  
10 is appropriate. He puts it in the proxy statement, as  
11 opposed to the auditor report, which is the focus of this  
12 discussion.

13 I would note that that's voluntary, that there is  
14 no requirement that Verizon or any other company do that.  
15 And the reality for the investment world is very few  
16 companies do what Verizon does do. There are some that  
17 do.

18 So I'll then try to address the other comments  
19 from the two panelists that oppose, for example, the  
20 inclusion of the tenure of the particular auditor in the  
21 audit report.

22 Here I'll start, at the risk of what you can



1 generalize from an anecdotal experience, when I was at  
2 TIAA-CREF, we shifted from one audit firm to another, and  
3 one of the benefits to us as an organization was that the  
4 second audit firm -- which the first audit firm was high  
5 quality; they did a terrific job.

6           The second audit firm took a second look at some  
7 of the questions that had been seemingly resolved with  
8 the first audit firm. And in retrospect now, as I view  
9 that experience, there were a couple of instances of  
10 that. It was a healthy development to go through as an  
11 organization, somebody that has a second look at issues  
12 that were resolved one way, and see how they might be  
13 resolved in another way.

14           Apart from that, I do take issue with the notion  
15 that inclusion of auditor tenure could be misleading.  
16 And basically I think that is -- to make that right,  
17 you'd have to believe that investors just don't know how  
18 to use the information that's disclosed to them, and I  
19 would challenge that notion.

20           I think if you surveyed some of the key  
21 institutional investors, they believe that auditor tenure  
22 going to the issue ultimately of auditor independence --

1 and it's not just technical independence. I think there  
2 are a few instances where auditor tenure might affect a  
3 situation where auditor independence was lacking in the  
4 past.

5           But there's auditor independence and there's  
6 auditor independence, and getting back to the second look  
7 aspect of it, I think that's extremely valuable. So I  
8 would say that there should be more trust that investors  
9 that think it's valuable will use it appropriately;  
10 investors that think it has no value could ignore it.

11           It's a disclosure that you could require that  
12 imposes no costs on the investors that don't care about  
13 auditor tenure. But I believe, just like in the British  
14 experience, that once these issues get onto the table,  
15 you will find more dialogue, more interest on the part  
16 of institutional investors and other investors, and  
17 you'll have examples of where a particular audit firm has  
18 been the auditor for a particular company for decades,  
19 and that will give investors the opportunity to at least  
20 ask questions about it. And right now they don't have  
21 the information. And that's why I would strongly support  
22 the PCAOB making that disclosure a requirement.

1           MR. HANSON: A couple of reactions. And when I  
2 posed my question, it was really in a context I didn't  
3 describe, which is in the imaginary world that the SEC  
4 would take up the issue of making it required in a proxy  
5 statement. So it wasn't just voluntary, which as Brian  
6 has observed, we have observed lots of things on the  
7 SEC's agenda, and we have no ability to impose that on  
8 the SEC, and there might be several things that might be  
9 worthy for them to take up.

10           Another just reflection and a little bit of a  
11 surprise at what you've said, is that for the analyst  
12 that wants to know how long a company's been -- an audit  
13 firm has been a company's auditor, at least I'm not an  
14 expert in using the SEC's online filing search system,  
15 but in any company I've tried to figure it out, I could  
16 figure it out in about two or three minutes, the auditor  
17 changes within the last 20 years on the EDGAR system.

18           So it's not hard to find. So it just kind of  
19 surprised me that those that want it can't find it.

20           MR. DOTY: Do you want to respond to that, Peter?

21           MR. CLAPMAN: Yeah. There's lots of things that  
22 could be required conveniently in the way of disclosure

1 to make the information convenient without going into an  
2 elaborate process, even if it's doable.

3           Again, I come back to the question that this is  
4 a costless requirement to put in information of this  
5 sort, that some investors, and I would suggest that most  
6 of the institutional investors will find this information  
7 potentially important and interesting, to make that  
8 disclosure better for them is a positive thing the PCAOB  
9 could do.

10           MR. DOTY: Jeanette Franzel.

11           MS. FRANZEL: This has been a very interesting  
12 discussion. Many of the panelists here have touched on  
13 issues which we've been hearing throughout these two  
14 days, and it's really an issue of, gee, does some of this  
15 really belong in the auditor's report? Should the  
16 auditor be reporting on original disclosures or should  
17 management be doing it? Should the audit committee be  
18 putting some of this into the audit committee report or  
19 in the proxy statement, you know?

20           And, unfortunately, the reality is our system of  
21 regulation over financial reporting and governance and  
22 disclosure is fragmented. So here we are at the PCAOB

1 identifying potential disclosures that might be helpful  
2 to investors, and the only thing we can do is require  
3 that it be thrown into the auditor's report.

4           So I think that, in some cases, we're hearing  
5 discussion or we're hearing disagreement on certain  
6 issues that would be of great value to some investors,  
7 but the real disagreement is putting it into the  
8 auditor's report.

9           You know, so I guess we can always just keep  
10 requiring more and more in the audit report. But at some  
11 point, you know, some of these issues of critical  
12 accounting policies and MD&A and tweaks that maybe need  
13 to be made on management's side, so that then the auditor  
14 can take a different role, would strengthen the system,  
15 you know, in its entirety.

16           So I have that concern, and I would like just to  
17 hear your comments in terms of how concerned are you  
18 about that. Maybe it's not a big concern. Maybe we can  
19 compensate, you know, for all of the problems in the  
20 disclosure system by putting it all into the auditor's  
21 report.

22           But I think at some point the fragmentation here

1 will cause risk, and it will cause proposals that might  
2 not be the best solutions. I guess what really caused  
3 me to go down this line of thinking was Peter's comments  
4 that, in his opinion, the disclosure system presently is  
5 flawed in material respects.

6 Well, if that's the case, I'm not sure we can  
7 solve it all through the auditor's report. But I'd  
8 appreciate any comments or thoughts that you all have on  
9 that, how it relates to some of the things we've been  
10 talking about, and I see I just caused Brian to raise his  
11 name card as well.

12 MR. GARRETT: I think it is interesting the way  
13 you described that, that it's a bit fragmented. And, you  
14 know, you have your purview over the auditor's report,  
15 and is that really the best way to address some of these  
16 things? I think our opinion is maybe not, especially  
17 with the items like the CAMs.

18 Again, it just feels strange to have the auditor  
19 giving information other than just their basic audit  
20 steps, which, as I think about it, aren't those really  
21 available? I mean, you have steps -- everyone uses the  
22 same steps to audit certain things. It's prescribed.

1           So if there's a shortfall, it seems it's up to  
2 the company to beef up the disclosures on what things.  
3 Again, if it was hard to audit, it was also hard to  
4 account for. So if that's the problem we're trying to  
5 solve, then we do need to solve it if investors are  
6 concerned about it.

7           To me, it doesn't seem like the audit report is  
8 the way to do that.

9           MR. DOTY: Jim Kroeker had his flag up first.

10          MS. FRANZEL: Do any of the other panelists want  
11 to comment on that?

12          MR. LIDDY: I guess, if I may, I'll just make one  
13 anecdotal comment, and I think back to my many years in  
14 practice, when I'd go and I'd talk to the financial  
15 management people at a particular audit client, and we  
16 would -- I would discuss as it relates to a particular  
17 transaction or estimate or policy statement or whatever,  
18 and talk about disclosure in the underlying financial  
19 statements.

20          And someone would invariably say, well, that's in  
21 the 10-K. Well, it's in MD&A per se, but it's not in the  
22 financial statements and we think it's particularly

1 important that it be included in there. And I think  
2 that's an important point, because at the end of the day,  
3 when we put an audit opinion on a set of financial  
4 statements, we've got to be satisfied that there is  
5 reasonable and appropriate disclosure of all those  
6 matters that are important from an investor perspective,  
7 in terms of understanding those financial statements  
8 taken as a whole.

9 I'm not commenting about the disclosure  
10 framework, you know, overall. But I am talking to that  
11 I think it's a pretty important part of our job to  
12 evaluate those financial statements, and to make sure  
13 that the discussions are appropriate in the context of  
14 the financials as a whole.

15 MS. AMBLE: Since you brought it up, which goes  
16 outside of the topics of the discussion today, I think  
17 it would be fabulous if the SEC and the FASB and the  
18 PCAOB could be in concert on a number of things.

19 And I think one area -- I mean, some of the  
20 discussions and push-back that you've heard is the volume  
21 of the financial statements just becomes very  
22 substantial, and they're already very substantial.



1           Part of the culprit for the volume of the  
2 financial statements is there is duplication, because you  
3 do have two different bodies, the SEC and the FASB,  
4 requiring information, and you cannot cross-reference in  
5 all cases for them to be complete.

6           So I think anything to take away the duplication  
7 and things that add no value, in the way in which they're  
8 presented today, would be a wonderful thing.

9           I also think having clear line of sight of  
10 responsibilities for each of the organizations being  
11 adhered to, so that you don't bring in things that are  
12 interesting and nice to know, but really not directly  
13 under that organization's purview. I think that would  
14 be, you know, something very positive.

15           I also think if you were to get the MD&A and the  
16 financials more consolidated, you may also have the  
17 opportunity to have SOX oversee more than just financial  
18 controls. One of the biggest concerns I have with  
19 non-GAAP measurements is they're not under SOX. And  
20 arguably if that is more important to investors, and that  
21 moves the needle on your stock price, it would seem to  
22 me that the standards required for GAAP measurement

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1 should be at a minimum what should be required for those.

2           Today, they're not under SOX. And I know that  
3 because it was something that was not determined to be  
4 part of the basic financial statements. And I would  
5 disagree with that. I would think that you should have  
6 it expand to that as well.

7           So that's kind of going beyond your question, but  
8 getting to would it be nice for all of us standard  
9 setters to kind of coalesce? I think that would be great  
10 if they were sitting here potentially, and not us.

11           MR. DOTY: Peter, I'm going to get back to you,  
12 but I want to give FASB and the SEC a chance.

13           MR. KROEKER: Actually, your remarks are a good  
14 segue to the question I had. One, I think we do have a  
15 fabric that works well together. You know, obviously our  
16 responsibility is much narrower than the SEC's  
17 comprehensive authority with respect to accounting  
18 standards that we have. I think we do work complimentary  
19 together, but just a personal view.

20           But, Jim, you mentioned earlier the issue of  
21 auditing assurance, or some type of attestation around  
22 critical accounting policies, critical accounting

1 estimates. And it occurs to me, in the vein of  
2 duplication at least potentially, and there's a lot of  
3 complaint about Footnote 1 often and how does that  
4 correspond to critical accounting policies.

5 One way to address that, again, speaking for one  
6 person from the FASB, would be for us to consider  
7 bringing more directly the obligations that are existing  
8 in MD&A, and we'd have to deal with staff interpretations  
9 and other things, but to bring that into the financial  
10 statements.

11 That could accomplish two things. One,  
12 reduction, at least, of confusion about whether there's  
13 duplication, but also then bring in directly an auditor  
14 attestation requirement specifically to things that are  
15 already often covered in the context of an audit. But  
16 I wonder if you or others had reaction on that.

17 MR. LIDDY: My only reaction, quite frankly, is  
18 I think, you know, we're raising it in the context that  
19 a dialogue in this vein, you know, we think is both  
20 reasonable and appropriate when you think about the core  
21 objective of the reporting model standard here.

22 We'd welcome a dialogue about it to figure out

1 the best way to provide the information that's of most  
2 value to investors, and potentially the least cost to the  
3 companies themselves.

4 MR. CLAPMAN: If I could just have one final  
5 crack at your question, it would be that we've going to  
6 deal with the situation that we've got to deal with.  
7 That's my perspective on it. I've urged the SEC to  
8 include disclosure about auditor tenure, as Verizon  
9 voluntarily does. We might be having a different  
10 conversation if the SEC had done it or will do it.

11 But from an investor perspective, I think it  
12 comes back -- and you made the point earlier -- that I  
13 think there's a material flaw in the disclosure system  
14 now, and there's something that PCAOB can do about it.  
15 There's something the SEC can do about it, and I'd  
16 encourage each to move on it. That's, I guess, where I  
17 come down on your broad question.

18 MR. DOTY: I'm not through with you yet, Peter.  
19 Brian.

20 MR. CROTEAU: Thank you. I just wanted to follow  
21 on from Jeanette's remarks, and actually, Peter, your  
22 remarks, and actually some of what Jim has now just said.

1 Now is probably a good time just to remind you that these  
2 are my own views.

3           But with respect to what the SEC can or can't do,  
4 I just want to comment that, you know, in the seven or  
5 eight years that I've been now involved in this, I've  
6 been involved in making recommendations to the Commission  
7 on nearly all of the PCAOB standards that they've  
8 developed thus far. And not once have we made a  
9 recommendation, so far, that says we recommend that the  
10 Commission adopt this because you're too busy to do  
11 something that would be better or more appropriate.

12           I certainly don't think we should start that now,  
13 is my own view. So to the extent that -- that was the  
14 basis for my comment yesterday.

15           To the extent that commenters still believe that  
16 there's something the SEC should be doing, or that a  
17 disclosure would be better placed in the audit committee  
18 report, I'm glad that we're still hearing those kinds of  
19 comments and I encourage those kinds of comments, because  
20 I don't think we should start with the presumption that  
21 the Commission wouldn't do something or couldn't do  
22 something.

1           So I really appreciate the feedback that we're  
2 getting in that regard, and we'll continue to listen to  
3 that.

4           MR. DOTY: I'm mystified a bit. There's been a  
5 lot of discussion in the panels to a matter that Lewis  
6 alluded to, and that's the fact that Europe is moving  
7 ahead, and the UK is moving ahead, and the concern that  
8 we might not be right there in the vanguard of  
9 disclosure.

10           Whether that will translate into different costs  
11 of capital for us in the long run, we don't know. But  
12 one of the things the Board, I think, must worry about  
13 is the potential that, after some years, it will  
14 translate into some differential in the premium which our  
15 equity markets enjoy, and the charges for which capital  
16 exacts -- sources of capital exact their funds.

17           And the confidence that they have in the  
18 completeness of the regimen or the regime of disclosure,  
19 and the enforcement of the regime of disclosure, seems  
20 to be, if we're reading the sources correctly, if we're  
21 reading the academic research correctly, that seems to  
22 be something that does translate into cost of capital.

1           Verizon discloses this tenure matter for some  
2 reason.    If you put aside just the fact that other  
3 advanced capital centers are making the disclosures that  
4 we have asked you comment on, and if you look at just  
5 what we are doing or not doing, it would seem to me that  
6 preparers, directors, audit committee people, auditors,  
7 are all to be concerned that if there's something we can  
8 do here that gives investors information which they have  
9 been asking for for over a decade, in some cases decades,  
10 and if we can do that without increasing a great deal of  
11 the cost of obtaining and delivering that information,  
12 we ought to seriously consider doing it.

13           And I would be surprised if in Jim Liddy's long  
14 and distinguished career as an auditor, Jim, if you had  
15 never seen a case in which the desire of a young auditor  
16 not to lose or vex a promising or a valued client had  
17 never prejudiced that accountant's views.

18           The point being, I don't think it's possible to  
19 prove the negative here and to say that there is no  
20 relationship between tenure and independence, there's no  
21 relationship between tenure and skepticism.

22           Therefore, I am puzzled with how you deal with

1 Peter Clapman's position as an investor, and as a former  
2 CREF official, that this is something that investors  
3 want. How do you face your investors and say, we think  
4 you can't handle the information, we don't believe you  
5 can use it, we don't know that it's useful, we think it  
6 may confuse you, we think you may make precipitous  
7 judgments based on tenure?

8           You have the entire proxy statement. You've got  
9 a lot of things available, many megaphones available to  
10 management, megaphones available to audit firms that KPMG  
11 uses regularly in the reports that they issue, on why it  
12 is that, in fact, the retention and the choice of an  
13 auditor is a complicated matter.

14           Many things have to be valued. Many things have  
15 to be weighed. But why would it be that we would want  
16 to deny this information to investors now, when it is in  
17 many ways the easiest, the best-known and the cheapest  
18 kind of information to include in an audit report?

19           And it has the risk that if we don't do this,  
20 we're actually withholding something that looks to the  
21 investor, that is perceived by the capital markets as  
22 being something that diminishes the completeness of our



1 disclosure regime and the enforceability of our  
2 disclosure regime.

3 We're putting ourselves at risk, possibly, on  
4 cost of capital. Why do you want to do that? Anybody.

5 MR. LIDDY: If I may, I'll start. I mean, just  
6 to make it clear, I mean, this information may very well  
7 be important to investors, and we're actually supportive  
8 of the idea of communication and transparency regarding  
9 the concept of auditor tenure.

10 I guess our objection relates to specifically  
11 including it in the auditor's report, and it relates to  
12 a specific correlation being made between the tenure  
13 number and whether that is reflective on audit quality  
14 or not.

15 MR. DOTY: But, Jim, that's your most immediate  
16 communication with your stakeholders, with your investing  
17 public, is your report.

18 MR. LIDDY: I don't disagree with that, but,  
19 again, I think, you know, from our vantage point, we're  
20 supportive of, you know, greater transparency about it.  
21 We see a growing, growing number of companies that are,  
22 as a normal practice, disclosing it in their audit

1 committee reports. We also think that as a matter of  
2 convenience that could be done in the Form 2 as well.

3 MS. AMBLE: I've actually been on both sides of  
4 the fence on this one. My initial reaction when I read  
5 the proposal was what's the problem? Putting it in  
6 doesn't cost anything.

7 It was really after thinking about it further  
8 that I thought, you know, it really isn't, though, an  
9 audit matter per se. It's a governance issue. I mean,  
10 if I had my druthers, I'd rather have the auditor sign  
11 the report personally.

12 I mean, I know that's not a very popular position  
13 to take, but to me that's more important. The individual  
14 who was responsible for that audit engagement and  
15 ensuring that everything, all of the professional  
16 responsibilities have been discharged appropriately.  
17 That is much more important to me.

18 I think, from an audit committee perspective,  
19 it's important to look at the duration of the audit firm.  
20 But quite frankly, whether it's one year or 30 years, it  
21 still boils down to the people with the feet on the  
22 ground, the people that are there in the engagement and

1 how they're responding to the needs and risks of the  
2 company.

3           So, like I said, I think if it's deemed important  
4 for everyone to disclose it from a governance  
5 perspective, put it in the proxy. Two of my three firms  
6 where I'm on the audit committee, we do disclose it. But  
7 it's not for the gallant reasons that you just described.

8           I mean, one disclosed it, but they're challenging  
9 whether they want to anymore, because they thought it was  
10 a good thing to say that we've had the same auditor for  
11 a number of years, and we've developed a very positive  
12 and thoughtful relationship in ensuring quality audits.  
13 Now that they're seeing that people are seeing that  
14 tenure might connote something negative, they're  
15 wondering, gee, I wonder if that wasn't a good  
16 disclosure.

17           The other one had it in because we had changed  
18 auditors, because we had merged firms, and one firm had  
19 one auditor and the other had another. So you had to  
20 pick one, and so it was required to be put in, and it was  
21 just kept over for the last couple of years. So my guess  
22 is there are probably other people in that same camp as

1 well.

2           So, while, you know, I think it's an interesting  
3 disclosure, I think when you speak of it in the context  
4 of how the audit committee may evaluate that, I think  
5 that's very relevant. So putting it in the proxy, I'm  
6 not objecting to at all. But there are a lot of other  
7 interesting things that you could put in the audit report  
8 that we're not talking about, that I don't think are as  
9 high a priority, personally.

10           MR. CLAPMAN: If I could make, Jim, one further  
11 comment. The nature of prediction, that if there is  
12 disclosure of the tenure of audit firms, I think what you  
13 will do in this country is have a healthy debate, some  
14 of which has been aired at this panel, as to whether it's  
15 important, whether it serves the interest of investors  
16 and the public interest.

17           But I think it's a debate that is needed, and I  
18 think if you did have that disclosure, it would encourage  
19 more dialogue and I think this would be a healthy thing  
20 for the system.

21           MR. DOTY: I'm afraid that, at times, Ferguson  
22 and I both evidence frustration that we're not law

1 professors. So I hope you will forgive me for trying to  
2 push the Socratic method a little on you on the law  
3 professorial note. I think Jay did a good job of arguing  
4 with the witness, Peter, and arguing with you on this  
5 issue.

6 So this is a panel in which there's been a lot of  
7 give and take. Steve, do you want one more give and  
8 take?

9 MR. HARRIS: Yeah. Mr. Garrett, just so you  
10 understand where I'm coming from, I didn't want to leave  
11 any misimpression. The mission of the PCAOB very  
12 specifically is defined in Section 101. It's unequivocal  
13 and it's in quotes, and that's the preparation of  
14 informative, accurate and independent reports, audit  
15 reports.

16 So my perspective is how can we make the audit  
17 report more informative? So I want to elicit from as  
18 many people as I can, you know, a marketplace of ideas  
19 for how we improve the audit report. That's my  
20 perspective. Thank you.

21 MR. DOTY: We have a panel waiting, but this one  
22 has been terrific. Thank you all, and we'll see you

1 soon.

2 I'll introduce the next panel as they're coming  
3 in.

4 Charles Pagano is a partner at WeiserMazars, and  
5 his industry experience includes broker-dealers and  
6 financial services. He's currently a member of the AICPA  
7 and the Securities Industry and Financial Markets  
8 Association, in their compliance and legal division, as  
9 well as the financial management division. He's a  
10 current member of the NYSSCPA and the Stock Brokerage  
11 Committee. He chairs the Foundation of Accounting  
12 Education's annual technical conferences on audit issues  
13 for broker-dealers, and their annual conference on the  
14 securities industry.

15 Michael Fehrman is a managing director and head  
16 of the Accounting Policy and Advisory Group of the  
17 Americas at Deutsche Bank. In addition to providing  
18 transaction advisory services and financial statement  
19 review, he undertakes special projects throughout the  
20 bank and participates in various valuation and control  
21 oversight committees. Previously, Michael Fehrman was  
22 a member of the accounting policy team at Goldman Sachs,

1 and held various positions at UBS.

2           John Corcoran is a former vice president of MFS  
3 Investment Management. He also serves as the fund  
4 president of the MFS Funds, and fund treasurer for the  
5 MFS Meridian Funds. In his role, he manages the  
6 financial reporting, tax fund administration, custody and  
7 accounting oversight and valuation functions of MFS.  
8 Previously, he was a senior vice president of State  
9 Street, where his roles included managing the integration  
10 of Investors Bank & Trust, holding senior positions in  
11 fund administration and serving as the managing director  
12 of State Street's office in Edinburgh.

13           Jeff Burgess is Grant Thornton's national  
14 managing partner of professional standards. Earlier, he  
15 was the partner in charge of the firm's National  
16 Professional Practice Director Group, and the National  
17 Professional Practice Director for the Southeast Region.  
18 At Grant Thornton, he's also served as the partner in  
19 charge of the Greensboro, North Carolina office, and as  
20 the professional standards partner for the Carolinas  
21 practice.

22           This panel is here to discuss considerations

1 specific to investment companies and broker-dealers, and  
2 we appreciate it. Thank you. Charles?

3 MR. PAGANO: Thank you, Chairman Doty, and thank  
4 you for inviting me to participate in this PCAOB public  
5 meeting. As the leader of my firm's broker-dealer  
6 practice and former two-time chair of the New York State  
7 Society of CPA Stock Brokerage Committee, and current  
8 member of that committee, I welcome the opportunity to  
9 express views on the proposal.

10 The Mazars Group includes 14,000 professionals in  
11 70 countries, and WeiserMazars LLP here in the US  
12 includes 100 partners and 650 professionals in six US  
13 offices. We are the auditor for small issuers with less  
14 than .5 billion in market cap, and broker-dealers which  
15 range from small to medium-sized firms, non-clearing  
16 firms, including retail, trading, investment banking and  
17 firms with net capital ranging from \$20,000 to \$3  
18 billion; employees from three to several hundred.

19 For purposes of this discussion, I will define  
20 small broker-dealers as those which are noted in the  
21 proposal by the PCAOB's Office of Research and Analysis,  
22 specifically those BDs which comprise approximately 2,200



1 of the approximately 4,200 BDs in the US, and which have  
2 a minimum net capital of only \$5,000.

3           Also noted by ORA, 1,700 have revenues of less  
4 than a million, and only nine percent of the BDs are  
5 subsidiaries of issuers, who presumably are audited under  
6 PCAOB standards as part of the parent-subsubsidiary  
7 consolidations.

8           Only 311 of the 4,200 broker-dealers are subject  
9 to the customer protection rule, SEC Rule 15c3-3. The  
10 vast majority hold no customer funds or securities. The  
11 purpose of the proposed rule is to allow investors to  
12 enhance their ability to make investment decisions and  
13 for other financial users, which, in the case of  
14 broker-dealers, would be the regulators.

15           As noted in the proposal, approximately 90  
16 percent of the BDs are directly owned by an individual  
17 or an entity that owns more than 50 percent of the  
18 broker-dealer, and approximately 75 percent have five or  
19 fewer direct owners, who, the ORA suggests, and is my  
20 experience, are often active in the business.

21           Investors do not invest in the broker-dealer  
22 proper.       When a broker-dealer attempts to attract

1 capital, it will look to bring in other active  
2 shareholders or subordinated lenders who are generally  
3 existing shareholders. Therefore, we believe that  
4 investor would not benefit from the proposed change, as  
5 they are not investing in the broker-dealer.

6         The other financial users are the regulators.  
7 The BD industry is heavily regulated, with a robust  
8 surveillance system in place that includes FINRA, the  
9 SEC, the CFTC and state regulators. There will also be  
10 additional auditing oversight under PCAOB standards for  
11 years ending after June 1st, 2014, which will allow  
12 potential referral by the PCAOB to regulators.

13         If enacted, many BDs will have common critical  
14 audit matters that are already addressed in other  
15 reporting areas. Disclosure and information available  
16 to users, namely the regulators, is more than adequate  
17 in areas that are common to many BDs.

18         For example, valuation of securities and revenue  
19 recognition, which are both addressed in comprehensive  
20 footnote disclosures; the net capital computation, which  
21 is addressed in a required supplementary schedule and is  
22 extensively audited and disclosed; and compliance with

1 the exemptive provisions of Rule 15c3-3, the customer  
2 protection rule.

3           The additional costs of applying PCAOB Auditing  
4 Standard No. 7, effective June 2014, along with the  
5 implementation of other PCAOB auditing standards, have  
6 already added incremental audit costs to the small  
7 broker-dealer. A small broker-dealer will be asked to  
8 absorb additional costs if the proposed auditing  
9 standards are enacted.

10           A mid-size auditing firm's additional manpower  
11 costs to comply with the proposed reporting requirements  
12 for critical audit matters would include incremental time  
13 incurred by a senior manager, a partner, an EQR, an  
14 engagement quality control reviewer, in-house and  
15 possibly outside counsel and other firm experts or  
16 specialists to issue a report.

17           The BD is asked to issue a report within 60 days  
18 of year-end. This existing time constraint, with the  
19 possibility of additional reporting requirements, if  
20 enacted and applied to broker-dealers, is a more  
21 stringent time frame for a more significant public  
22 company, which may have a 75 or a 90-day filing

1 requirement.

2           There's a concern that additional reporting with  
3 these time constraints may affect audit quality in the  
4 race to get reports issued to meet existing deadlines.

5           Documentation of critical audit areas and  
6 compliance with the Auditing Standard No. 3 may be more  
7 burdensome and costly. Depending on the capabilities of  
8 the auditor, given a similar fact pattern, different  
9 auditors may produce different results.

10           Thus, the playing field may not be level for  
11 different sized accounting firms and their clients. The  
12 August 2013 SEC report on the progress of the interim  
13 inspection program noted that of 783 accounting firms  
14 that audited BDs for the 2012 audit year, 756 or 83  
15 percent of those firms audited only one to five  
16 broker-dealers each, while 14 firms or two percent  
17 audited 51 or more BDs.

18           I suspect that this might be somewhat  
19 price-driven. Some BDs may, in the interest of saving  
20 dollars, look for those auditors who can perform less  
21 costly audits, and in some cases, quality may suffer.

22           Given the statistics already acknowledged by the

1 PCAOB, including the size of the majority of the BDs, the  
2 size of the accounting firms that audit them and the  
3 likelihood that no useful additional information may be  
4 gained by additional requirements, we believe  
5 broker-dealers should be excluded from the proposed  
6 standards.

7 Our lack of support for certain aspects of the  
8 proposed audit standards, including their effect on  
9 issuers, as noted in our December 9th, 2013 letter to the  
10 PCAOB, primarily relate to the conviction that we should  
11 not supplant the responsibilities of management or audit  
12 committees.

13 We remain committed to participating in future  
14 discussions with the Board and staff to further enhance  
15 audit quality. We thank you for today's opportunity to  
16 participate.

17 MR. DOTY: Thank you. Mr. Fehrman.

18 MR. FEHRMAN: Thank you very much for the  
19 opportunity to appear today and to present Deutsche  
20 Bank's views on this topic. Deutsche Bank is a global  
21 universal bank, and one of the largest financial  
22 institutions in the world. To facilitate the products

1 and services we offer, we have a wholly-owned  
2 broker-dealer subsidiary in the United States, Deutsche  
3 Bank Securities, Incorporated, or DBSI.

4           Because Deutsche Bank is an SEC registrant, our  
5 auditors are subject to inspection by the PCAOB. As DBSI  
6 is a broker-dealer, the audits of its separate financial  
7 statements are also subject to inspection.

8           We support the goal of enhancing the information  
9 provided to users of financial statements, but believe  
10 the information should be presented by management.

11           In our view, any critical audit matter would most  
12 likely be a critical accounting matter as well, and  
13 therefore already discussed by the issuer. At best,  
14 therefore, a discussion of critical audit matters would  
15 seem to be redundant. Accordingly, we do not support this  
16 proposal in its current form.

17           I've been asked to comment on issues that this  
18 proposal would present to broker-dealers for their  
19 financial statements. While there are certain issues  
20 related specifically to broker-dealers, I believe many  
21 of the concerns we have with the proposal would be shared  
22 by other preparers of financial statements. But I will

1 begin with the matters that are specific to  
2 broker-dealers.

3       As you know, many broker-dealers do not provide  
4 a complete set of financial statements to their  
5 customers, and instead provide only a balance sheet with  
6 limited disclosures. It is highly likely that an auditor  
7 would find that there are critical audit matters  
8 resulting from income statement or disclosure information  
9 that is not included in the information provided to  
10 customers by a preparer.

11       Similarly, auditor comments on responsibilities  
12 regarding other information would have little meaning to  
13 the user if the information itself is not included in the  
14 report. If those comments are to be included in the  
15 customer report, it will raise confusion for the user of  
16 the report.

17       Clearly, the intent of this proposal is to add  
18 clarity and not confusion for the reader, and we believe  
19 this matter should be addressed during this exposure  
20 stage. We see this matter as an indication that perhaps  
21 application of a proposal to broker-dealers may not have  
22 received the same attention as for other entities.

1           While I very much appreciate the opportunity to  
2 comment on matters relevant to a broker-dealer, I do not  
3 believe my appearance today can adequately address the  
4 concerns of the whole industry. Accordingly, I would  
5 respectfully suggest that an additional outreach effort  
6 be made, particularly to smaller broker-dealers who may  
7 not have had the regular practice of responding to  
8 matters such as this.

9           Since PCAOB standards have only recently been  
10 applied to audits of broker-dealers, and given the small  
11 size and closely-held nature of many broker-dealers, I'm  
12 concerned that there could be significant matters that  
13 may be brought to light only with a more targeted effort  
14 to solicit input from the industry across all its  
15 segments.

16           One other aspect directly affecting  
17 broker-dealers is that the industry is already subject  
18 to significant regulation and oversight in both business  
19 practices, maintenance of capital levels and financial  
20 statement presentation.

21           Coupling that with the fact that broker-dealer  
22 financial statements are more often used by customers of



1 broker-dealers rather than investors, we question whether  
2 applying this proposal to broker-dealers will yield  
3 significant benefits that are not already addressed by  
4 existing regulations and oversight.

5           At a minimum, we would like to suggest that the  
6 PCAOB give further consideration to excluding  
7 broker-dealers from this proposal.

8           There are other concerns that apply to companies  
9 in general, but may be more acute for broker-dealers.  
10 For example, complex business activities, and the related  
11 management judgments applied, are more likely to result  
12 in critical audit matters than are simple business  
13 activities.

14           We are concerned that certain complex matters  
15 would almost always be cited by auditors as a critical  
16 audit matter. For example, hard to value securities,  
17 such as Level 3 securities, would likely be named as a  
18 critical audit matter for many broker-dealers.

19           As a result, rather than adding clarity for the  
20 user, there's a risk that such matters would come to be  
21 viewed as boilerplate disclosure and be ignored by the  
22 user.

1           On the other hand, a user of financial statements  
2 could react very negatively to all critical audit  
3 matters, and reach an incorrect conclusion that critical  
4 audit matters are indicators of problems in the  
5 broker-dealer's business.

6           Given the extent of discussion of Level 3 assets  
7 in both notes to financial statements and MD&A, there  
8 seems to be little information content to be gained from  
9 having them as a critical audit matter as well.

10          Further, a decision that something is a critical  
11 audit matter could be the result of the individual  
12 auditor's knowledge and comfort level, rather than an  
13 assessment of the matter itself. Of course, this concern  
14 is also applicable to financial institutions in general,  
15 and is not limited to broker-dealers. There may be other  
16 examples of critical audit matters that would become  
17 either false red flags or boilerplate language that would  
18 be ignored for both financial institutions and other  
19 industries as well.

20          We all know that the number of pages included in  
21 both quarterly and annual reports has steadily increased  
22 in recent years. Nowhere is this more true than for

1 financial firms of all types. Adding to the sheer volume  
2 of the material is the fact that much of the information  
3 is very complex as well.

4 Both the complexity of the business itself and  
5 the increasing requirements of accounting standards  
6 contribute to this increase in length and complexity of  
7 financial reports. Companies spend very substantial  
8 resources in preparing and explaining information and  
9 trying to do so in the most understandable way possible.

10 The result, however, is a perennial call for  
11 simplification and elimination of disclosure overload.  
12 Adding an additional view or set of commentary will  
13 certainly not help this situation.

14 As noted at the beginning of these remarks, we  
15 support efforts for increased transparency in providing  
16 additional useful information to users of financial  
17 statements. We do not think it should be the role of  
18 auditors to do so, and we cannot support the proposal as  
19 it currently exists. Thank you for your time.

20 MR. DOTY: John Corcoran.

21 MR. CORCORAN: Well, I'd like to thank the PCAOB  
22 for having us here today and to hear our comments. I'd

1 also like to thank you for saving what we think is the  
2 best panel for last.

3           Today I'm going to focus my comments on how the  
4 proposal impacts investment companies. And to put my  
5 role into perspective, at MFS, we have over 140 US mutual  
6 funds that we're issuing financial statements on,  
7 representing \$170 billion in assets under management.

8           US investment companies as a whole are  
9 responsible for the investment of nearly \$14 trillion in  
10 assets, and most of that being in mutual funds that have  
11 92 million shareholders. And there's approximately  
12 10,000 investment companies that are subject to annual  
13 audit requirement, and oversight by the PCAOB and the  
14 SEC.

15           As we stated in our letter, in our comment letter  
16 to the PCAOB, we do understand the PCAOB's overall  
17 objective to improve the value and relevance of the audit  
18 report, and support many of the proposed changes. But  
19 there are certain aspects of the changes proposed that  
20 we do have concerns with, especially as they relate to  
21 investment companies.

22           So, first, let's talk about where we support the

1 changes. Under the proposal, the auditor's report will  
2 be modified to include a statement that the auditor is  
3 registered with the PCAOB and is required to be  
4 independent. It also recommends the auditor's report  
5 more specifically articulate the auditor's responsibility  
6 with regard to fraud in notes to the financial  
7 statements.

8           We think these enhancements provide better  
9 clarity to investors of what the auditor's role is. It  
10 can be done without expanding the scope of an audit, and  
11 we support that.

12           The area that we probably have the most concerns  
13 about and do not support is the proposed introduction of  
14 critical audit matters, or CAMs. Let me take a few  
15 minutes to explain why.

16           We feel that in the context of an investment  
17 company, the CAMs are going to be associated to be a red  
18 flag or a sign there could be something is wrong with a  
19 fund, when in fact judgments and estimates and  
20 assumptions are an inherent part of the financial  
21 statement process.

22           As an investment company, we make extensive

1 financial disclosures and make certain judgments  
2 regarding disclosures on investment valuation. We'd  
3 expect the auditor to have to cull that out as a critical  
4 audit matter. But I think it's important to note that,  
5 even though those judgments are made, the auditor is  
6 certainly able to obtain enough information to give an  
7 unqualified opinion.

8           In these circumstances, calling this out as a red  
9 flag, we think, could raise a red flag to investors when  
10 no problem exists. Significant disclosure is already  
11 made and the financial statement opinion is unqualified.

12           Given the view that we would not expect to see an  
13 audit that doesn't have CAM, we think that's going to  
14 incent an auditor to identify more CAM to show the  
15 comprehensiveness of the work that they've done and their  
16 compliance with the PCAOB's directive.

17           Given our concern that these CAMs could be  
18 perceived as a red flag, it could have the unintended  
19 negative consequences that investors are going to use  
20 that as an objective yardstick in determining one fund's  
21 value versus another.

22           Let me explain how that could play out for us.

1 In a large complex like MFS, we employ more than one  
2 auditor. We have a two auditor model. So when this two  
3 auditor model, and it happens, we've got substantially  
4 similar funds audited by different audit firms, each of  
5 whom is going to have their own unique thoughts on what  
6 constitutes a CAM and how to document that within the  
7 auditor's report.

8           So we could have a fund with the same strategy,  
9 holdings, investment performance and disclosures, and  
10 still end up with having a different description of  
11 critical audit matters. And that would have the  
12 unintended consequence of putting one fund at a  
13 disadvantage over the other one because of subjective  
14 language in an auditor's report.

15           When you then take that and take it outside of  
16 just one complex and put it across the universe of  
17 investment companies, you can see that that expands our  
18 concern.

19           We also share the concerns raised over the last  
20 couple of days about CAM creating a piecemeal opinion and  
21 putting an auditor in a position to disclose information  
22 that management may not be required to disclose. I'm not

1 going to add anything to that today. I did in my written  
2 comments. I won't in the verbal comments today, other  
3 than to suggest that, in our context, if our financial  
4 statements and presentation over something like  
5 investments and investment valuation is not sufficient,  
6 I don't understand how an auditor is going to be able to  
7 reach an unqualified opinion on our financial statements.

8           The last concern I'll raise about CAM, and it's  
9 probably the one that's going to have the most impact on  
10 myself and my staff, is additional cost and time it's  
11 going to take with auditor's reports.

12           One could argue the level of audit evidence and  
13 audit work required to reach a qualified or unqualified  
14 opinion wouldn't change. But there will be additional  
15 effort to document conclusions of why something is or  
16 isn't a CAM, and to put documentation and non-standard  
17 language into the audit report. When non-standard  
18 language is put into the audit report, it's going to  
19 require additional review within the audit firm and  
20 within the management company, and depending on what it  
21 is, it could involve others.

22           The people who are doing that review are not the



1 low level, least expensive folks. So it's definitely  
2 going to add cost to review that language. That is also  
3 going to occur when a substantial amount of the audit  
4 work is complete. So it's going to be towards the end  
5 of a very compressed schedule for us. So we do have  
6 concerns with that.

7 Another aspect of the proposed standard that  
8 concerned us a bit is the inclusion of audit tenure in  
9 the auditor's report. I won't repeat what was said in  
10 the last panel, but our concern is just that the  
11 auditor's report is not impacted by audit tenure.

12 There's also a logistical problem with investment  
13 companies. For a company like ours, we have new funds  
14 starting and merging and changing every year. And there  
15 are some times that there's going to be reports with  
16 multiple funds being reported in one book and one set of  
17 audit opinions. Each has a different start date and  
18 therefore a different logistical audit tenure. So we  
19 think that would need to be addressed. We don't have a  
20 problem with disclosing audit tenure, but we think  
21 there's probably a more appropriate place to do it than  
22 the auditor's report.

1           The last area of the proposed standard I would  
2 like to comment on is the clarification of the auditor's  
3 responsibility for other information. We absolutely  
4 agree it could be helpful to clarify what components of  
5 other information we want the auditor to look at and what  
6 the expected level of auditor effort is here.

7           We do think some more work needs to be done to  
8 actually specify exactly which areas you would like the  
9 auditors to look at and what is the expected level of  
10 effort there.

11           This is particularly important with an investment  
12 company. If you put it in our context, whereas a  
13 financial company may have one set of financial  
14 statements that the annual auditor's doing every year,  
15 I have a set of funds being audited every month. We have  
16 over 35 different filings annually by trusts that have  
17 multiple financial statements within them, okay? So  
18 there's definitely going to be some costs associated with  
19 that, and there's definitely going to be some logistical  
20 issues associated with that.

21           So we want to make sure enough study is done on  
22 that what we have the auditors look at is something that

1 they have the expertise to look at. And that it has the  
2 appropriate cost-benefit.

3           So, given that, we would encourage additional  
4 outreach to be done to determine what are the areas of  
5 additional information that are of most value to  
6 investors? Of those, which of those does the auditor  
7 have the expertise to take a look at? And then have the  
8 auditor do some field testing so we can just test that  
9 the level of benefit does exceed the level of cost to do  
10 that.

11           So, in concluding, we do support a number of the  
12 initiatives. We certainly support the intent of what the  
13 PCAOB is doing. We thank you for having us here today,  
14 but as it relates to investment companies, there's a few  
15 things we would ask you to consider.

16           First, we'd ask you to reconsider the inclusions  
17 of critical audit matters in our reports, given that we  
18 think it would increase the cost of the audit and also  
19 could introduce some other notable negative unintended  
20 consequences to our funds.

21           We'd also ask you to consider using other public  
22 documents in the auditor's report, if you want to

1 disclose auditor tenure, and would ask for that  
2 additional outreach to be done on other information to  
3 clarify what other information might the auditor take a  
4 look at. Thank you.

5 MR. DOTY: Thank you. Jeff Burgess.

6 MR. BURGESS: Good afternoon, and thank you for  
7 the opportunity to provide my comments related to this  
8 important topic of auditor reporting. I commend the  
9 PCAOB for organizing this roundtable, and for its  
10 continued outreach. Grant Thornton supports the Board's  
11 effort to enhance the relevance and usefulness of the  
12 auditor's report.

13 My comments today are focused on the  
14 applicability of the proposed new rules to investment  
15 companies. And in doing so, I'll also provide some  
16 general comments about certain of the key aspects of the  
17 proposals, primarily CAMs and other information.

18 The application of the PCAOB's standards should,  
19 in most circumstances, be applied uniformly to all  
20 issuers. Although we understand the view that investment  
21 companies and broker-dealers could be scoped out of the  
22 proposal, we struggle with trying to define which issuers

1 should be included, versus those that would be exempt.

2 Where do you draw the line?

3           It's difficult to distinguish the circumstances  
4 in which an issuer or group of issuers might merit a  
5 discussion of CAMs from those that would not merit such  
6 disclosure.

7           Second, certain aspects of the proposals would  
8 likely need further evaluation, outreach and deliberation  
9 to be applicable to many investment companies, including  
10 consideration of the various fund structures and  
11 regulatory reporting constructs such as multi-fund  
12 filings.

13           With respect to CAMs, we believe that providing  
14 more insight into critical audit matters can give  
15 investors and other users of the financial statements  
16 information that could be useful in evaluating the  
17 underlying financial statements.

18           Grant Thornton's comment letter identifies  
19 suggestions for improvement with respect to the proposal  
20 scope, filtering mechanisms and form of communication.  
21 Our suggestions are intended to address concerns we have  
22 as to how the proposal aligns with current audit

1 processes and documentation protocols.

2           Concentrating on issuer investment companies, we  
3 share what seems to be the general view of many other  
4 commenters that the primary focus of CAMs will be in the  
5 valuation of investment securities. Valuation has been  
6 a significant focus of the SEC and investors in recent  
7 years, so a CAM related to this complex audit area could  
8 be relevant.

9           It's been our experience that audit teams are  
10 spending considerable time evaluating the sufficiency of  
11 audit evidence relating to valuing the more complex Level  
12 2 investments, as well as the Level 3 investments.

13           While we acknowledge that required financial  
14 disclosures in set forth in ASC 820, combined with  
15 additional management disclosures of portfolio risks and  
16 other details around investment portfolios, provide  
17 investors with a significant amount of information, it's  
18 possible that audit commentary for certain matters around  
19 a specific investment valuation that might be included  
20 in the CAM could be useful.

21           Most of the challenges relating to reporting CAMs  
22 for investment companies are ones that we believe also

1 apply to the broader population of commercial entities.  
2 We've highlighted three concerns that we've noted, and  
3 on which we've seen others comment.

4           The first two have been discussed at length for  
5 the last couple of days: the comparability and the issuer  
6 boilerplate language, the disclosure of original  
7 information by the auditors. The third comment relates  
8 to the ability of the information to be operational to  
9 the investor, and not just in a negative way.

10           And along the lines of what John said, it's  
11 essential for investors to better understand the context  
12 for how the auditor determines CAMs, and how those  
13 matters relate to the underlying financial information.

14           We share concerns expressed by others that  
15 investors may inappropriately look at the auditor's  
16 reporting of a CAM or multiple CAMs as a negative  
17 indicator as it relates to a fund, resulting in  
18 misinformed investment decisions.

19           These aren't easy issues to solve, and we suggest  
20 that further discussion and outreach, including perhaps  
21 consideration of a phase-in approach, might be a prudent  
22 way forward.

1           One final point on CAMs related to investment  
2 companies is the expectation included in the proposal  
3 that the auditor will rarely not identify a matter as  
4 critical. We believe that this expectation may create  
5 pressure to identify a matter, or multiple matters, when  
6 they really aren't any.

7           For example, a mutual fund that has a very  
8 straightforward and non-complex investment portfolio may  
9 not have matters that really meet the definition of a  
10 CAM, but the auditor might feel compelled to call certain  
11 matters CAMs just in order to report something under the  
12 proposed standard. So, in that regard, we suggest the  
13 PCAOB reconsider its view that the auditor will rarely  
14 not identify a CAM.

15           In response to the proposal related to auditor's  
16 responsibility regarding other information, we agree with  
17 the Board's view that investors and other users of the  
18 financial statements would benefit from understanding the  
19 auditor's responsibility for information that accompanies  
20 the auditor's report and financial statements.

21           Consistent with our views on CAMs, we also  
22 believe that this proposal should apply to investment



1 companies and broker-dealers that are issuers. However,  
2 we do not agree with the change in scope of the auditor's  
3 responsibility, or in the breadth of information subject  
4 to the proposed standard.

5           Current standards and practice provides for a  
6 read-and-consider model. The current PCAOB proposal  
7 increases the requirement to an evaluate-and-conclude  
8 model, which we believe would lengthen the time the  
9 auditor would need to spend on such efforts, thereby  
10 increasing the costs.

11           We do not perceive that these increased efforts  
12 will provide sufficient benefits to investors to justify  
13 the changes proposed in the release. Additionally, the  
14 annual filing requirements for investment companies  
15 differ from those of commercial entities.

16           Further analysis and outreach is important and  
17 could result in meaningful application guidance for  
18 investment companies to strike the right balance between  
19 enhancing the transparency of the auditor's involvement  
20 in information outside the financials and the additional  
21 cost in providing such information.

22           As the Board moves forward with its proposals, we

1 support a post-implementation review separate from the  
2 Board's inspection process that includes an evaluation  
3 of the direct and indirect efforts, effects on financial  
4 markets, regulatory scrutiny and litigation matters.

5           We believe it's inevitable that auditor judgments  
6 across and within firms will differ with respect to  
7 determining and describing CAMs, and as a result, there  
8 will be diversity in practice. We also believe that  
9 users of financial statements would utilize and apply the  
10 additional information to be included in the auditor's  
11 report in diverse ways to suit their specific needs.

12           Accordingly, monitoring the effects of the new  
13 auditor's reporting model, and whether it is not only  
14 being applied appropriately by auditors, but also has met  
15 user expectations, will be essential to achieving the  
16 objective of the proposed standards.

17           We're committed to providing meaningful and  
18 transparent information that's useful to investors, and  
19 doing so in a manner that will provide the most benefit  
20 while not creating a significant burden to issuers and  
21 investors in the market in general. Thanks again for the  
22 opportunity to share our views.

1 MR. DOTY: Thank you. Jeanette Franzel?

2 MS. FRANZEL: My question deals specifically with  
3 brokers and dealers, and who's using those financial  
4 statements, those audited financial statements, customers  
5 versus investors in the broker-dealer itself, and how  
6 might this be different from the discussions we've been  
7 having about investors and issuers, and how should we  
8 consider that?

9 MR. PAGANO: Okay. Well, as I noted,  
10 approximately 300 firms, 300 broker-dealers, are clearing  
11 or carrying-type firms, which hold customer securities  
12 and funds. In those instances, you know, there is a  
13 reporting requirement to the customer.

14 But on all other BDs, the majority, there is no  
15 customer statement nor ordered report that's sent to  
16 those individuals. It's not required. The securities  
17 and the funds are held by the clearing broker.

18 Now, there is a SEC website where even the small,  
19 introducing-type firm has to put an audited financial  
20 statement on that through the SEC website, and somebody  
21 could see the -- usually, the confidential report is not  
22 on that. Well, in some cases it is. But usually it's

1 just a balance sheet with footnotes.

2 MR. FEHRMAN: I think that's correct and  
3 consistent with my understanding as well, although I  
4 would just note that for a firm such as ours, our  
5 broker-dealer is wholly owned by the parent. So we have  
6 no outside investors at all, and it would really only be  
7 customers and regulators that would use the broker-dealer  
8 financial statements.

9 MR. HANSON: A question related to the funds.  
10 And we have suggested in our proposal that the  
11 application, especially around CAMs, is intended to be  
12 scalable. So not over-killing it, not under-killing it,  
13 but making it be the right size for the entity.

14 And I've heard the comments that you're making  
15 about, gee, are there really any CAMs for most  
16 straightforward funds that invest in traded securities  
17 where there aren't the Level 3 valuation issues? And I  
18 know we've put words in the proposal that suggest that  
19 most companies will have CAMs.

20 And I wonder if we have an opportunity here,  
21 because I don't like the idea of carve-outs. So if we  
22 could write something that would be applicable for all

1 types of audits, but scalable so that it's hitting the  
2 right things for the right companies.

3           Do you think it's possible for us to craft  
4 language that would accomplish the objectives without  
5 making a specific carve-out for a fund that would get at  
6 the scalability aspects, that it might very well that in  
7 a given fund there might not be a CAM and that's okay?  
8 Thoughts?

9           MR. CORCORAN: I'll defer to the auditor on how  
10 they'll interpret it. My fear would be that the auditor  
11 is going to want to demonstrate, hey, we've done a good  
12 job and there are critical audit matters. It's hard to  
13 suggest that the valuation of investments in an  
14 investment company is not a critical audit step, if  
15 nothing else.

16           I'd also point out that on our funds, for which  
17 we have minimal Level 3 disclosures -- I think our  
18 highest concentration of Level 3 securities in our funds  
19 are less than half of one percent. I still have,  
20 generally, three pages of disclosure on how I valued the  
21 investments. And the auditor is, as part of their audit  
22 guide, they are looking at 100 percent of the valuation

1 of my investments, okay?

2           So I'd be still fearful that they're going to  
3 want to cull that out as a critical audit matter. But  
4 it's not an issue. If it were an issue, they wouldn't  
5 be able to give me an unqualified opinion. That's my  
6 concern.

7           MR. BURGESS: I think John's concern is fair, but  
8 at the same time I do think that you could write the  
9 standard in such a way that this could be addressed. I  
10 think it's important that the standard be clear, that it  
11 is contemplated that it wouldn't be rare that a company  
12 might have no CAMs.

13           You know, in the terms of an investment company,  
14 like John described, where there are no Level 3  
15 investments -- we even have some that have mostly Level  
16 1 investments -- I have a hard time seeing that there  
17 would be a critical audit matter relative to investments  
18 in a fund that has primarily Level 1 investments.

19           But I do think there is some risk that auditors  
20 will feel the need to have at least one CAM. Or if I  
21 don't, you know, I run the risk of having not met the  
22 standard in the eyes of an inspector or somebody else.

1 So I think you just have to be mindful of each side of  
2 that coin.

3 MR. CORCORAN: I'm also not sure what a CAM could  
4 draw out about an example like investment valuation that  
5 I'm not already required to disclose.

6 MR. HANSON: In other words, how many times do  
7 you have to say "it's hard."

8 MR. FERGUSON: Yeah. I have a question. And I'm  
9 struck listening to you by, obviously, the enormous  
10 diversity among broker-dealers in this country. You talk  
11 about, Mr. Pagano, clients with capital ranging from  
12 \$20,000 to \$3 billion, and I assume Deutsche Bank is  
13 much, much larger than that.

14 So these are almost too different kinds of  
15 businesses. And the question I have is if we were to  
16 consider exemptions here, where we simply exempted  
17 certain businesses from these rules, what would be the  
18 line we should draw? I mean, they're clearing and  
19 introducing brokers. I mean, should it be introducing  
20 brokers that are excluded? Should there be a capital  
21 level below which you don't need to comply with these  
22 things? What would your advice be on that?

1 MR. PAGANO: Well, I would say, you know, if  
2 you're involved with customer funds, I think that's  
3 something that I could see having an interest in getting  
4 some confidence that those customer funds are in a good  
5 place.

6 So I would say that would be my biggest driver.  
7 You know, there are some broker-dealers that are part of  
8 a public filing as the holding company is a public  
9 entity, and presumably those are audited under PCAOB  
10 standards also.

11 So that would be important to us. I think those  
12 two things would be crucial. And I just -- I wanted to  
13 add -- Jeanette, you had a question before. Primarily  
14 with the smaller broker-dealers, it's the SEC and FINRA  
15 that are waiting for these audited statements to be filed  
16 within 60 days, and now SIPC this year. There was a  
17 recent change this past year where SIPC gets the full  
18 report clipping, the internal control report.

19 MR. FEHRMAN: I'm just sort of guessing here, but  
20 I would think that in a world where this proposal has  
21 come to fruition, a reader of Deutsche Bank's  
22 consolidated financials and related audit report would



1 probably not get much different information than a reader  
2 of the broker-dealer financial statement separately.

3           So I see the appeal of Mr. Pagano's comment, that  
4 perhaps broker-dealers that are a subsidiary of a company  
5 that's otherwise audited and otherwise reporting under  
6 PCAOB standards might possibly be exempted.

7           I think you might think about an exemption also  
8 for audits of smaller broker-dealers that are very  
9 closely held. I don't think that people look to the  
10 financial statements for safety and soundness. I think  
11 they look to the regulators for that. So I'm not sure  
12 there's much to be gained by that. They're not investing  
13 in the broker-dealer per se.

14           MR. FERGUSON: Do you have any experience, for  
15 example, from your customers who are customers of your  
16 broker-dealer, whether when they look at Deutsche Bank's  
17 financial statements, do they only focus on the  
18 consolidated financial statements of the Bank itself?  
19 Or are they interested about the entity actually with  
20 which they're dealing? Or do you know?

21           MR. FEHRMAN: I don't know the answer to that.  
22 I do know that we are required to send customers of the

1 broker-dealer broker-dealer financial statements, and  
2 we're not required to send them consolidated financial  
3 statements. But they are certainly available. But we  
4 have not made a study of that nature.

5 MR. HARRIS: Mr. Fehrman, you heard Mr. Corcoran  
6 tick off a number of items in the proposed standard that  
7 he supported. Is there anything in the proposed standard  
8 that you support?

9 MR. FEHRMAN: I think a great deal of what's in  
10 the standard, frankly, is already being done. It's just  
11 reported to the audit committee, rather than to the  
12 public at large. In as much as the audit committee is  
13 meant to be an independent body, and is in fact an  
14 independent body, I think that they are there also to  
15 protect the users of the financial statements.

16 So you have the company making an honest effort  
17 to provide good disclosure, in accordance with the  
18 requirements, in a way that's understandable. You have  
19 the auditors checking that. You have the audit committee  
20 checking the auditors.

21 So to answer your question, no. The thing I fear  
22 is this. The financial statements in and of themselves

1 are already a summary. You know, we have millions and  
2 millions of transactions, and we could give anybody more  
3 information -- and I jokingly said to people in the green  
4 room, we could print a copy of our trial balance and mail  
5 that out, and I would say that would detract rather than  
6 add to the information content of our annual report.

7           So, you know, just because the information is  
8 available and low cost, as was discussed on the previous  
9 panel, that does not make it useful information. So I  
10 have to say quite honestly, sir, that, no, I do not  
11 support this proposal.

12           MR. PAGANO: I'd like to add just to the  
13 auditor's responsibilities on other information. The  
14 oath or affirmation that's attached to the report, was  
15 noted in the proposal, would be subject to this. And  
16 actually I do see benefit in that the order gives some  
17 comfort on that.

18           MR. DOTY: Well, here's the problem. We had a  
19 financial crisis. And I take it some of the entities  
20 that fell flat were substantial banks and broker-dealers.  
21 And we had an investment company that broke the buck as  
22 a result of a concentration in the securities of the

1 broker-dealer. Holding itself out as a money market  
2 fund, it broke the buck.

3           And this attracted a lot of attention, and it  
4 resulted in us being charged with creating standards,  
5 audit standards for broker-dealers. The SEC reminded  
6 broker-dealers that they had to have audited financial  
7 statements, and that included some schedules and some  
8 fairly specific information. And I share here with Jay  
9 Hanson's concern over the carve-outs.

10           I think there's a well-trod, well-understood path  
11 for regulators creating guidance. And perhaps if you  
12 have funds for which the auditor has satisfied themselves  
13 there really is nothing in that fund portfolio but cash,  
14 money, high-quality government securities, maybe there  
15 are times in which the guidance could indicate that  
16 critical audit matters may in fact not be so rare in a  
17 particular area or segment, if we looked at it.

18           But right now, we're sitting here having looked  
19 at some broker-dealers, and having reluctantly determined  
20 that many of them, some of whom are carrying, don't have  
21 audits that are independent. We have a lot of errors  
22 that we see in the preparation of books and records by

1 the auditors. The material is in our public report.

2           So how do we simply say, well, notwithstanding  
3 the financial collapse, notwithstanding the instructions  
4 of Dodd-Frank, notwithstanding the statute under which  
5 we operate, which says we have to foster the interests  
6 of the public in good financial reporting. And  
7 notwithstanding the fact that we know that the SEC also  
8 wants to know, for the audits that it has a primary  
9 interest in, or that FINRA has a primary interest in,  
10 they want to know that the audit has been well-performed.

11           How do we do our duty by a wholesale exemption of  
12 an entire industry, which, as John points out, now has  
13 trillions of American savings in it? I guess Mr.  
14 Fehrman's position has the beauty of saying you don't  
15 think we should do any of it for anybody.

16           But don't we have a problem with the general  
17 carve-out? And isn't it clear that we've got to get to  
18 some kind of a mechanism for scaling the wind to the  
19 shorn lamb and treating how these different companies'  
20 business model suggest themselves to an auditor? Don't  
21 we have to do something here to fine-tune?

22           MR. FEHRMAN: I fully agree that things need to

1 be done. And things have been done, I think. We have  
2 Sarbanes-Oxley, of course, which I think actually  
3 predated the crisis. But we have the Volcker rule, we  
4 have Dodd-Frank, we have increasing levels of capital  
5 requirements.

6 We have substantial increase in regulatory  
7 oversight, all good and necessary things that I think are  
8 past due, and we're working hard every day to comply with  
9 all those things as well. I just question whether it's  
10 specific to broker-dealers, or much more broadly, whether  
11 this helps that situation.

12 If the auditor's doing a good job, he's doing a  
13 good job. I question whether the reader of the critical  
14 audit matters, the reader of the report on other  
15 information, will find that useful.

16 I think that they would rather know that there's  
17 a team of regulators, a team of auditors from the  
18 regulator that live in our building, that are there every  
19 single day, and are working very hard to make sure, as  
20 we are, that the institution is safe and sound and will  
21 be here, I hope, for another hundred years or more. I  
22 don't think this is the right way.

1           MR. DOTY: The comment from the United Kingdom  
2 yesterday and today was that they have managed it there.  
3 They've managed an expanded audit report, and they've  
4 done that without having undue delay in the delivery of  
5 the report and the reporting schedule, and without some  
6 kind of a hockey stick increase in costs.

7           So does your British -- you all have resources  
8 there. Does your UK experience suggest that perhaps this  
9 can be done?

10          MR. FEHRMAN: I'm not familiar with what's going  
11 on in the UK, quite honestly. I have read the IAASB  
12 proposal, which I think is very similar to this. I think  
13 we would have a similar reaction there.

14          You know, again, I just have to say that I think  
15 that the regulators are doing a very diligent job, and  
16 I think that that's the appropriate place to address many  
17 of the concerns you're listing.

18          MR. CORCORAN: I'm by no means an expert on what  
19 changes have happened in the UK. But my understanding  
20 is they are not -- the subset that they're applying to  
21 now does not include an OEIC, an open-end investment  
22 company, which would equate to our investment company.

1 I do think you need to consider, for lack of a  
2 better term, the simple nature of the operations of an  
3 investment company. Every investment company really has  
4 -- they may have different objectives in terms of what  
5 type of investments they're going to go into and what  
6 not, but all the more just in turn investing money in a  
7 portfolio that is 100 percent disclosed, 100 percent  
8 validated by the auditor, and pages of the disclosure on  
9 how those valuations take place.

10 MR. DOTY: John, it's a fair point, up to a  
11 point. To the extent you're talking about two-auditor  
12 funds, I think this is something that is of great  
13 interest. But when you're saying that you're concerned  
14 with critical audit matters, that there's going to be an  
15 assumption of something being wrong and a tendency to --  
16 many of your objections to the proposal would go to the  
17 kind of issuers who have been subject to it in the UK.

18 So I think you have in some ways narrowed the  
19 concern, when you say investment companies are a unique  
20 animal. It's a narrower subset of concerns you have when  
21 you're focusing on the peculiarities of the investment  
22 fund, of the investment company industry, it would seem



1 to me.

2 MR. CORCORAN: What I'm trying to suggest is the  
3 subjective nature of an auditor being able to cull out  
4 -- two different auditors may decide something different  
5 is a critical audit matter.

6 In a simplified structure like an investment  
7 company, that's going to have a much different impact  
8 than if I'm talking about a multinational corporation,  
9 where you would expect that sorts of things to be  
10 different.

11 MR. DOTY: And I do see that as a concern, lodged  
12 just as to how the proposal might affect investment  
13 companies. But I'm saying that on the broader attack  
14 which you make on the proposal, or the broader expression  
15 of disagreement with it, you are going to many of the  
16 issues which the UK seems to have successfully confronted  
17 and dealt with.

18 MR. CORCORAN: I think we can probably agree to  
19 disagree as it relates to an investment company context,  
20 which is all I'm speaking about.

21 MR. DOTY: Well, this has been helpful and  
22 informative and we thank you.

1           This concludes the first roundtable on the audit  
2 reporting model, and in some ways we did save the best  
3 to last. You all did a great job. Thank you.

4           (Whereupon, at 2:59 p.m., the meeting in the  
5 above-entitled matter was concluded.)

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<b>\$14</b> 227:9	<b>accomplish</b> 161:22 202:11 244:4	182:20	231:10,14,19	91:8
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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: Auditor's Reporting Model

Before: Public Company Accounting Oversight Board

Date: 04-03-14

Place: Washington, DC

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

  
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Court Reporter

**NEAL R. GROSS**

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